NORTON ROSE

Barristers & Solicitors / Patent & Trade-mark Agents

Norton Rose Canada LLP
Royal Bank Plaza, South Tower, Suite 3800
200 Bay Street, P.O. Box 84
Toronto, Ontario M5J 2Z4 CANADA

F: +1 416.216.3930
nortonrose.com

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Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, Suite 2700
Toronto, ON M4P 1E4

Your reference EB-2010-0018	Direct line +1 (416) 216-2311
Our reference 01012724-0011	Email richard.king@nortonrose.com

Dear Ms. Walli:

Natural Resource Gas Limited ("NRG") (EB-2010-0018)
Reply Argument (Phase 2)

Please find enclosed NRG's Reply Argument in the above-referenced matter. The Reply Argument is also being filed on the Board's RESS system, and served on all parties to the proceeding.

Please do not hesitate to contact me should you have any questions or concerns.

Yours very truly,

"Signed"

Richard King

/mnm
Enclosure

cc. Laurie O'Meara (Ayerswood)
Khalil Viraney (Ontario Energy Board)
Michael Millar (Ontario Energy Board)
All Parties to EB-2010-0018

DOCSTOR: 2341028\1

EB-2010-0018

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B); and,

AND IN THE MATTER OF Phase 2 of an Application by Natural Resource Gas Limited to the Ontario Energy Board for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, transmission and distribution of gas as of October 1, 2010.

NATURAL RESOURCE GAS LIMITED
REPLY ARGUMENT (Phase 2)

January 20, 2012

Norton Rose Canada LLP
200 Bay Street, Suite 3800
Royal Bank Plaza, South Tower
Toronto, Ontario M5J 2Z4

Richard J. King
(416) 216-2311
(416) 216-3930
richard.king@nortonrose.com

A. INTRODUCTION

1. This document sets out the Reply Argument of Natural Resource Gas Limited ("NRG") in respect of the last outstanding matter in NRG's application for fiscal 2011 gas distribution rates – namely the appropriate pricing of gas purchased by NRG from its related company, NRG Corp.

2. Board Staff and the Vulnerable Energy Consumers Coalition ("VECC") filed argument on this issue. The arguments of Board Staff and VECC are three-fold:

   - First, that the Board should order NRG to have an additional engineering study completed to consider other technical/physical options to solve the system integrity "problem".

   - Second, that the Board should order NRG to put out a Request for Proposals ("RFP") to solicit additional sources of gas supply as a way to solve the system integrity "problem".

   - Third, that the Board should continue the existing pricing arrangement between NRG and NRG Corp. until the results of the two items above are finalized.

3. It is NRG's submission that the first two items are unnecessary, and that the only issue that needs to be resolved by the Board is the pricing methodology governing gas commodity transactions between NRG and NRG Corp. Further, NRG's view is that the pricing methodology should be resolved in this proceeding and remain in place until NRG's next cost-of-service rate application (i.e., for the remainder of the IR term).

4. NRG provided its pricing methodology proposal and arguments supporting its proposal in NRG's Argument-in-Chief, and will not repeat them here.

B. CONTEXT FOR REPLY ARGUMENT

5. It is NRG's view that the differences between Board Staff and VECC on the one hand, and NRG on the other hand, stem from a difference of opinion as to how to approach the system integrity issue.

6. Board Staff and VECC argue from the premise that the "problem" here is that NRG <u>must</u> purchase some natural gas from a non-arm's length company. This sets up (according to Board Staff and VECC) a situation where the interests of NRG (and its ratepayers) are in conflict with NRG Corp. Consequently, the arguments of Board Staff and VECC are focused on finding any way to avoid that conflict from arising (i.e., finding ways to ensure that NRG does <u>not</u> have to buy gas from NRG Corp.).

7. NRG's view is that this is the wrong starting point.

8. NRG has always bought gas from NRG Corp., and plans to continue to buy gas from NRG Corp., because it makes good sense for NRG and its ratepayers. The fact that NRG Corp. has been exploring and developing wells in NRG's franchise areas as the distribution company has grown has only operated to the benefit of NRG's ratepayers. This was explained at length in NRG's Argument-in-Chief (see paras. 47 to 71) and neither Board Staff nor VECC sought to deny this in their arguments.

9. It does not make sense, in NRG's submission, to spend significant time and money trying to come up with ways to ensure that NRG does not have to purchase gas from NRG Corp. There is no "problem" with NRG having to buy gas from NRG Corp.

10. The only "problem" that needs resolution is the much narrower issue of appropriate pricing methodology. This is an issue (pricing of utility non-arm's length transactions) that the Board is well-suited to deal with, and is something that the Board has always done as part of NRG's rate cases.

11. The only difference from previous NRG rate cases is that gas prices are at historic lows (and levels that are not capable of sustaining NRG Corp.). The Board still needs to come up with an appropriate price for all gas to be purchased from NRG Corp. That has not changed.

12. Finally on this point, Board Staff and VECC seem to proceed from the premise that because there is a commercial relationship between NRG and NRG Corp. there must be a "winner-loser" outcome in any transaction. But as explained at length in NRG's Argument-in-Chief, that is not the case. It is possible for NRG's rate payers to benefit from NRG purchasing gas at a sale price that is acceptable to NRG Corp.

13. Indeed, the benefits of having NRG Corp. supply natural gas to NRG on the terms being proposed by NRG (i.e., at the floor price of $8.486 per mcf) were not challenged by Board Staff or VECC. These benefits are:

- local, dispersed natural gas supply points which contribute to system reliability;
- reduced charges from Union Gas Limited (as a consequence of less gas being required by NRG at its interconnection points with Union Gas Limited);
- lower gas distribution rates resulting from the avoidance of costly capital additions to supply NRG's southern service area; and,
- lower gas commodity pricing (as compared to gas from third parties) as a result of not having to pay transportation charges on NRG Corp. gas.

14. Again, neither Board Staff nor VECC take issue with the fact that these benefits accrue to NRG ratepayers as a result of gas purchases from NRG Corp.

C. THE NEED FOR ANOTHER ENGINEERING STUDY

(a) Introduction

15. Both Board Staff and VECC submit that the study completed by Aecon Utility Engineering ("Aecon") was too narrow in scope. In particular, Board Staff and VECC argue that the Aecon study did not look at "all possible solutions", and want another study to:

- examine whether there are "solutions" that Union Gas Limited could offer (e.g., a new connection point);
- determine the specific volumes required to maintain system integrity;
- consider the possibility of alternative wells (other than the five turned on for the purpose of the study); and
- include a robust sensitivity analysis.

16. Each of these will be discussed below but three points are worth mentioning at the outset. First, the terms of reference for the Aecon study were approved by the Board on February 4, 2011. Second, NRG made Mr. Chan available for cross-examination by Board Staff and VECC. Indeed, a number of hypothetical scenarios and circumstances were put to Mr. Chan during the oral hearing on November 30th and any questions he could not answer were dealt with by way of undertaking (which involved examining other simulation scenarios). Finally, there will always be other alternatives and scenarios to study, as well as changes in circumstances (e.g., customer make-up, physical system changes) that could prompt further examination and re-examination of the system integrity issue, but at some point the costs of studying the issue outweigh the benefits. As noted above, it is NRG's view that there are virtually no benefits to NRG or its ratepayers in seeking to find alternatives to avoid NRG having to buy gas from NRG Corp.

17. Whether or not there is a system integrity issue: (a) it still makes sense for NRG to buy gas from NRG Corp.; (b) NRG and NRG Corp. are still non-arm's length; and (c) the Board still has to establish a pricing methodology governing the purchases of NRG Corp.'s gas (as it has for years).

18. As noted in NRG's Argument-in-Chief, NRG Corp. has never before declined to provide natural gas to NRG at the Board-approved price, even when NRG Corp.'s price was lower than market price or the price for third-party gas. It is only now that the price for natural gas is very low that NRG Corp.'s pricing is a real issue. This could be a very temporary situation, and in NRG's view, does not warrant spending huge quantities of time and money to consider all possible ways to avoid the situation.

(b) Exploring a "Union Gas" Solution

19. In NRG's submission, there is no need to spend any time or money examining this issue.

20. During cross-examination of Mr. Anthony Chan (Senior Engineer at Aecon) and Mr. Graat, the option of resolving the system integrity issue by increasing the amount of gas taken by NRG from NRG's connection points with Union Gas Limited was raised and considered.

21. Both Mr. Chan and Mr. Graat indicated that maximizing the pressure at NRG's supply points from Union Gas Limited would not assist in resolving the system integrity issue because the issue was the ability of NRG's distribution system to move gas into the affected area (i.e., the Town of Aylmer and area south of Aylmer).

22. In Undertaking J1.2, Mr. Chan was specifically asked to run the model with maximized output at the Union supply points, and the response to this undertaking was as follows (at p.8):

> The Union Gas interconnections were reflected in all simulation model runs as having maximum outputs given current facility piping and

> equipment configuration. Additional capacities may be possible for some of these Union Gas facilities but not without substantial upsizing of facility piping and equipment.
>
> Additionally, to get the increased available capacities or volumes, a new pipeline and pressure regulating station will be required to bring gas to the problem-prone region of the NRG Limited distribution system.

23. In other words, the issue is one that is internal to NRG's distribution system (see Hearing Transcript from p. 89, line 15 through p. 91, line 1). Mr. Graat confirmed Mr. Chan's testimony on this point, as noted at p. 50, line 3 of the November 30 hearing transcript:

> [W]e don't have a problem getting gas from Union into our franchise area. It's distributing it in the franchise area.

24. Consequently, there is no "Union solution" to the system integrity issue.

25. Moreover, NRG questions the purpose of exploring a "Union solution". If there were a "Union solution" in place five years ago that eliminated the need for NRG to purchase a minimal amount of gas from NRG Corp., the result would have been to enable NRG to purchase more third party gas at a much higher price (about $2 million more expensive than NRG Corp. gas, even at the $8.486 per mcf price).

(b) Precisely Defining How Much System Integrity Gas is Required

26. VECC and Board Staff want a new engineering study to be prepared that would more precisely define the amount of system integrity gas required.

27. NRG's submission is that engaging in this exercise is pointless. It will be impossible to precisely define a single amount of system integrity gas that is required, given that the system is dynamic (responding to changing weather and customer demand conditions), and continues to evolve. The important point is that under the scenarios examined by Mr. Chan, there is a system integrity issue, and gas is needed. How much is needed will inevitably vary from time to time.

28. Further, a price for natural gas purchased by NRG from NRG Corp. needs to be set in any event, whether or not it is pricing system integrity gas or non-system integrity gas. It is more straightforward to simply set a single price for the commodity transactions between NRG and NRG Corp.

(c) Considering Alternative Wells Being Turned On

29. VECC criticizes the Aecon study because it failed to examine whether there are alternate wells (other than the five identified in the -28°C simulation run) that could be utilized to supply system integrity gas.

30. This critique is directly answered by Mr. Chan's response to Undertaking J1.2 from the November 30th hearing. In his response, Mr. Chan stated that the NRG Corp. wells are set up in such a way that the gas wells cycle in and out-feeding gas into the NRG distribution system depending on wellhead pressure. In other words, a well starts flowing gas into the NRG distribution system when its wellhead pressure builds to a level that is higher than the distribution main it is feeding into. As a result, the 40 NRG Corp. gas wells will cycle in and out at different times during the course of a day (with the wells with the highest wellhead pressure feeding into the system on a more consistent basis).

31. On that basis, if wellhead pressure is similar across NRG Corp. wells then the producing wells will be in the areas of lower system pressure. In other words, the gas production inputs follow the dynamics of the system.

32. Moreover, it is not clear from VECC what would be gained by re-running simulations with other wells operating.

(d) Including a More Robust Sensitivity Analysis

33. VECC argues for a more robust sensitivity analysis. Similarly, Board Staff criticizes the simulation model used by Aecon stating that it only considered a worst case scenario (i.e., temperature of -28°C, with grain dryers operating).

Board Staff goes on to suggest that even with this worst case scenario, “the whole system does not seem to be severely impacted”.

34. To respond to this last point, NRG can only repeat what is in its Argument-in-Chief – namely, that it does not matter that the system integrity issue does not affect the entire NRG system. The bottom line is when gas is needed most, a region of NRG’s distribution system is vulnerable to loss of pressure in the absence of gas from NRG Corp. being injected into the system. This region, according to Aecon, comprises approximately 300 to 3,000 customers (Undertaking No. J1.3, December 16, 2011, p.11).

35. So NRG is unclear what to make of suggestions downplaying the scope of the system integrity issue with statements such as “the whole system does not seem to be severely impacted”. Moreover, the costs and risks associated with a regional outage are significant, as noted in NRG’s Argument-in-Chief (i.e., manually re-lighting the system, potential property damage, replacement heating costs to impacted customers, personal injury risks for vulnerable consumers). These are not acceptable risks and costs, particularly when an ample, available local supply exists.

36. With respect to the specific request that a new engineering study needs to be done that considers alternative simulation scenarios, NRG disagrees for a couple of reasons.

37. First, the “worst case” scenario that was run was exactly the scenario that needed to be run in the circumstances. The fact that there could be other scenarios (slightly warmer temperature, less grain dryer load) that reduce or eliminate the system integrity issue is irrelevant. The only scenario that really matters is a reasonable worst case scenario. Second, Mr. Chan did examine other scenarios both on his own and in response to inquiries from Board Staff and VECC. For example, Mr. Chan ran the simulation with interruptible grain dryer customers shut off but the integrity issue still persists.

38. All that really matters is that the Aecon worst case scenario is a reasonable one—and it is. A temperature of -28°C is cold, but not exceptional, in NRG's service area. In addition, there are a variety of factors that account for significant system demand (e.g., quantity and moisture content of grain, tobacco curing loads, early frosts, wind chill, etc.).

D. PUTTING OUT AN RFP FOR SUPPLY FROM OTHER LOCAL PRODUCERS

39. Both Board Staff and VECC indicate that NRG has done little to search out other suppliers of natural gas. They both ask for the Board to order NRG to put out an RFP for supply from other local producers.

40. There are, in NRG's submission, a couple of problems with this.

41. First, Mr. Graat indicated in his evidence that he has considerable knowledge of where gas is located in the area, and who operates those gas wells. Mr. Graat has been drilling gas wells in the Aylmer region for the purposes of serving NRG for over thirty years (see Hearing Transcript, p.45, starting at line 23, and p.46, starting at line 22).

42. It is Mr. Graat's, and NRG's, evidence that there are no real acceptable supply prospects in the area.

43. Second, notwithstanding that there are lots of gas wells in the region, any RFP ordered by the Board would have to contain numerous conditions, some of which will include:

- geographically, potential suppliers must have wells in an area that could assist with the system integrity issue (i.e., potential suppliers must have wells in NRG's southern service area);
- potential suppliers may have to build and pay for pipelines to connect to NRG's system;

- potential suppliers would need to provide some form of security, letter of credit or performance bond to NRG in order to ensure delivery under the contract;
- potential suppliers would have to be able to supply on demand (and ensure their wells were capable of providing supply); and,
- potential suppliers would have to be prepared to enter into a contract with no fixed quantity (i.e., amounts purchased would be at NRG's complete discretion, dictated by NRG's system requirements) and without any "standby fee".

44. Only if someone could be found to supply on this basis would NRG's ratepayers be better off than the situation being proposed by NRG (i.e., the floor price proposal).

45. It is NRG's strong view, based on Mr. Graat's knowledge and testimony in this proceeding, that there is no acceptable potential supplier that would agree to or be able to supply on such conditions:

- Although there are hundreds of wells in the area, these wells are not connected to the NRG system and owners of those wells are not prepared or able to make the capital investment to connect to NRG's system (which is even more true during periods of depressed gas prices).
- The owners of other wells in the service area are mostly landowners that are not interested in the natural gas business (i.e., they are not in the business of developing wells in order to transact the commodity).
- NRG's concern based on past dealings with other producers or potential producers is that they are unacceptable (i.e., the wells have to be maintained and prepared to flow on demand).

- NRG's experience is that potential suppliers will not agree to a contract with no fixed quantity without a standby charge.

(see Hearing Transcript, p. 46 starting at line 6, through p. 53, line 27)

E. SETTING AN APPROPRIATE PRICE FOR NRG CORP. GAS

46. It is worth noting that neither Board Staff nor VECC took issue with the main arguments made in NRG's Argument-in-Chief on the appropriate pricing methodology, namely that the floor price of $8.486 per mcf may be greater than a published index price but for the past five years was well below the price that NRG pays for third party gas. During that period of time, NRG Corp. did not seek to obtain a price equivalent to the price being paid for third-party gas.

47. As noted in our Argument-in-Chief at para. 69, there is no evidence suggesting that NRG Corp. is demanding an exorbitant price from NRG. NRG Corp. has never before refused to supply gas to NRG because of low pricing. NRG Corp. has simply wanted a fair price that enables it to operate and continue its exploration/development work.

48. Board Staff still insists on claiming that NRG Corp. would earn a huge "premium" of 74% because Board Staff uses a published index at a liquid market hub as the benchmark to compare to the $8.486 per mcf price. However, as explained at length in NRG's Argument-in-Chief, given that the index price does not include transportation to get gas to NRG's service area, a more appropriate benchmark would be the price that NRG pays to third parties to get gas to NRG's franchise area. Indeed, one could easily argue that the true "market price" for gas in NRG's franchise area is the actual cost of third-party gas. It is worth noting that this third-party price is regularly determined as just and reasonable by way of NRG's QRAM decisions.

49. As Ms. O'Meara indicated under cross-examination on November 30, in the past five years the average cost of third-party natural gas purchased by NRG was higher than the price paid to NRG Corp. by approximately $2 million.

50. Further, as noted in NRG's Argument-in-Chief, NRG's ratepayers enjoy a number of other benefits as a result of having NRG Corp. drilling wells and supplying natural gas locally to NRG, including: (a) avoiding having to install costly additional pipeline capacity to the Aylmer region (which, as noted at para. 22 of NRG's Argument-in-Chief would be approximately $8 million, would lead to an average annual residential distribution rate increase of between $175 and $200); and (b) savings in the monthly demand charges from Union Gas Limited.

51. VECC argues that an alternative benchmark for the commodity pricing between NRG and NRG Corp. is the price that NRG Corp. could sell its gas at Dawn. However, this is really just another way of expressing a preference for utilizing an index price at a liquid market hub away from NRG's service area. The point is that the gas from NRG Corp. is available in NRG's service area.

52. VECC also argues that the Board should not approve a floor price for NRG Corp. gas without financial details about NRG Corp. that demonstrates that it would not be in NRG Corp.'s financial interest to ever supply below that floor price. The response to this is that NRG Corp. is not regulated by the Board, and the issue is really what is the fair price for NRG in the circumstances.

53. Finally, Board Staff suggests that if the Board were to approve a "floor price" as requested by NRG to eliminate NRG Corp.'s downside risk, then NRG's ratepayers should have upside protection in the form of a ceiling. In NRG's submission, this misses the point. First, the purpose of the floor is not to mitigate NRG Corp.'s downside risk. NRG Corp. can shut in its wells, so it has no downside risk. The floor price is set at $8.486 per mcf because that's the price that enables NRG to obtain ongoing reliable supply from NRG Corp.

54. Second, a ceiling would presumably just create the same problem (i.e., provide an incentive for NRG Corp. to not sell gas to NRG). As discussed above, this incentive is not in the interests of NRG or its ratepayers.

55. For all of these reasons, NRG asks that the Board reject the arguments of VECC and Board Staff with respect to an additional engineering study and an RFP and adopt the pricing proposal of NRG as set out in the Argument-in-Chief.

All of which is respectfully submitted this 20th day of January, 2012.

NATURAL RESOURCE GAS LIMITED

"Signed"

By its Counsel, Norton Rose OR LLP
Per: Richard J. King