



EB-2010-0018

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

AND IN THE MATTER OF an Application by Natural
Resource Gas Limited for an Order or Orders approving or
fixing just and reasonable rates and other charges for the
sale, distribution, transmission and storage of gas
commencing October 1, 2010.

BEFORE: Ken Quesnelle
Presiding Member

Paul Sommerville
Board Member

DECISION AND ORDER

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.

NRG referred to the table¹⁰ in Ms McShane's report and noted that if data for the Ontario electric distribution utilities was omitted, the average equity ratio for the rest of the individual companies was 41.6%.

NRG also referred to the "fair return standard" in the Cost of Capital Report and noted that ultimately the Board determined capital structure and ROE should provide the utility with a fair return. NRG submitted that in an attempt to move to a standardized approach for establishing capital structure and ROE, the Board needed to consider whether the standards provided the utility with a fair return. NRG further argued that mechanically applying the standards would amount to a fettering of the Board's legal discretion.

NRG submitted that the capital structure and ROE established by the Board do not provide a fair return and there was no evidence in the proceeding that supported a different finding from the Board's determination in NRG's previous rates case (EB-2005-0544)

Board Findings

There is no consensus on how to determine NRG's capital structure. NRG has itself provided the capital structure on a gross versus net basis. The issue is further complicated by the nature of its shares, which are retractable in nature and classified as a liability according to Canadian Generally Accepted Accounting Principles. The Board is not confident that a definitive number can be established from the Applicant's evidence and record in this proceeding.

The Board has a Cost of Capital policy in place that is applicable to all electric utilities and NRG's size and profile is similar to a number of electric utilities as opposed to the other two large gas utilities (Enbridge and Union). The Board policy on the appropriate equity ratio is 40% and is not considerably different from the ratio sought by NRG.

NRG has submitted that due consideration should be given to the fact that over the term of the five-year IR plan, the actual debt-equity structure would average 53:47 on a gross debt basis. However, the Board in this proceeding is making a determination on 2011 rates. The Board duly notes that an IR plan remains an issue before the Board but the base year rate determination process does not take into account average forecasts for

¹⁰ McShane's Opinion on Capital Structure and Equity Risk Premium for NRG Exh. 2/Tab1/Sch.1, Table 4, page 21

the entire IR period. This is not done for other areas such as capital expenditures or OM&A. The argument that capital structure should, alone among all other elements, be an area where a five year forecast should be considered in determining an appropriate ratio for the Test Year seems inappropriate.

The Board has determined that the appropriate capital structure for NRG is 40% equity, 56% long-term debt and 4% short term debt in accordance with the Board's 2006 Cost of Capital Report¹¹.

NRG has requested a risk premium of 50 basis points over the Board determined ROE. The Board's current ROE applies to all regulated utilities in Ontario and the Board's 2009 Cost of Capital Report does not make any distinction on the basis of size or risk. The Board during the evolution of setting the ROE already knew that the utilities that it regulates were of different size and risk profiles. This distinction was considered when the 550 basis points premium was determined. NRG has presented no evidence that its risk profile was significantly different from other utilities in Ontario. The Board believes that 9.85% is appropriate and orders NRG to incorporate this ROE in the Draft Rate Order.

NRG alludes to the fair return standard as a legal obligation on the Board. The Board's Cost of Capital Report¹² identifies the elements to ascertain a fair return standard. The Report on page 18 states:

A fair or reasonable return on capital should:

- be comparable to the return available from the application of invested capital to other enterprises of like risk (the comparable investment standard);
- enable the financial integrity of the regulated enterprise to be maintained (the financial integrity standard); and
- permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the capital attraction standard).

¹¹ Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors, December 20, 2006

¹² Report of the Board on Cost of Capital for Ontario's Regulated Utilities, EB-2009-0084

NRG has provided no evidence that a 9.85% ROE will impact the organization adversely. In fact, at the oral hearing, NRG considered itself to be a stronger utility and provided evidence to its financial viability. NRG referred to the Union Cessation of Service Proceeding and specifically noted that it had never missed a payment to Union. NRG has presented no evidence that its financial viability would be at risk if it receives the Board recommended Cost of Capital. In fact at the oral hearing NRG's witness noted that the asset base had increased substantially and the debt was being reduced aggressively¹³.

Although NRG has added the IGPC pipeline, NRG did not face any difficulty in raising the significant amount of capital required to construct the project. There is no evidence to suggest that NRG's lender will change its position if NRG received an ROE that is lower than requested. With respect to equity, NRG has already indicated that the shareholder does not intend injecting any further equity and this was not dependant on the return that is provided. The shareholder has also not provided any evidence that the invested capital can provide a greater return elsewhere with a similar risk profile.

Although NRG has referred to the fair return standard, it has provided no evidence or demonstration how the Board's use of the Cost of Capital parameters will adversely impact NRG or impinge on the fair return standard.

Cost of Debt

The debt portfolio of NRG 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 Guaranteed Investment Certificate ("GIC") with the Bank of Nova Scotia. The amount has been borrowed for the purposes of investing in the GIC.

Board staff submitted that by removing the compensating balance, NRG was using a fairly unusual method to calculate the cost of capital. Although NRG was paying a total rate of 6.69% on its long-term debt, the rate that it was seeking to recover from

¹³ Oral Hearing Transcript, Volume 3, page 91 (lines 2-6)

ratepayers was 8.26%. Board staff noted that NRG was seeking to recover its actual cost of debt (\$662,642) rather than the interest rate. Board staff submitted that NRG would benefit under this methodology as it obtains a higher interest rate on its debt which actually forms a much larger portion of the capital structure but is lowered by the compensating balance. Board staff therefore submitted that NRG should be allowed a rate of 6.69% on the debt portion of the deemed capital structure.

The arguments of Board staff were echoed by all other intervenors. VECC submitted that the GIC was not a specific requirement imposed by the Bank of Nova Scotia as a prerequisite to obtain funding. In fact, the GIC was considered by NRG as an alternative to meet one of the covenants imposed on it by the Bank. VECC submitted that ratepayers should not bear the cost of NRG borrowing an additional \$2.75 million for the sole purpose of creating an asset to balance its books as a result of a failure to maintain an adequate amount of actual equity in the company.

VECC submitted that Board deduct the amount of the GIC from the principal owed on the fixed rate loan (7.55%) and then recalculate the effective cost of debt. Using this methodology, VECC submitted that the long-term debt rate for the 56% long term debt component of NRG's capital structure should be 6.36% for the Test Year. The argument put forth by VECC was adopted by the Town and IGPC.

In Reply, NRG submitted that if the rate proposed by Board staff and intervenors was accepted then it would not be able to recover its actual interest expense which was an unreasonable outcome. NRG argued that the compensating balance was required to maintain the covenants of the utility's loan arrangements. NRG submitted that maintaining a good working relationship with its lender was in the best interests of NRG and its ratepayers.

VECC also made a submission on the short term debt portion. In its Application, NRG used a notional amount of short term debt to fill the gap between its deemed amount of long term debt and its deemed amount of equity. The rate applied by NRG to the notional amount of short term debt is 0.5%. VECC submitted that the Board should order NRG to use a rate of 2.07% for the short term debt component in accordance with the Cost of Capital Parameters issued by the Board on February 24, 2010.