Ontario

ONTARIO ENERGY BOARD

BOARD STAFF SUBMISSION

Union Gas Limited Hagar Liquefaction Service
EB-2014-0012

December 11, 2014

The Application

Union Gas Limited ("Union") filed an application on May 16, 2014 with the Ontario Energy Board (the "Board") pursuant to section 36 of the *Ontario Energy Board Act, 1998*, S.O. c.15, Schedule B, for an order or orders approving a new interruptible natural gas liquefaction service. The Board assigned file number EB-2014-0012 to the Application and issued a Notice of Application and Hearing on June 6, 2014.

Union has proposed to provide the new service at its Liquefied Natural Gas ("LNG") facility at Hagar, Ontario where LNG would be made available, on an interruptible basis, to wholesale distributors for use as vehicle transportation fuel or for remote power, marine, mining and/or rail applications[1]. Union's Hagar LNG facility is located near Sudbury, Ontario and has been in operation since 1968. The facility meets the system integrity requirements in Union's Northern service area that can arise as a result of weather variation, supply shortfalls, unplanned pressure drops or outages.

Union has requested a new Rate L1 rate schedule and a cost-based rate effective July 1, 2016, to provide the service at Hagar. Union has proposed to provide LNG to wholesale distributors that is in excess to its system integrity requirements. Union will create the excess capacity by replacing the current mechanical measuring device in the tank with a radar measurement system that is more accurate. The replacement of the device will increase the amount of working storage space by an estimated 7,000 GJ. Union proposes to use this excess capacity to provide LNG to wholesale distributors. Union estimates a total capital cost of approximately $9.9 million to provide the new service. Union is forecasting an increase of approximately $2.0 million to the average annual utility revenue from this new service until the end of 2018 (before rebasing in 2019).

Northeast Midstream L.P. ("Northeast"), an intervenor in the proceeding, filed a motion dated October 15, 2014, pursuant to section 29(1) of the *Ontario Energy Board Act*, 1998 requesting that the Board refrain from regulating and approving the terms, conditions and rates for the interruptible natural gas liquefaction service requested by Union.

Board Process

The Board held an oral hearing on November 24, 27 and December 2, 2014 to address all aspects of the Northeast motion and the Application. The Board directed all parties to

[1] Union Argument-in-Chief, Page 1, December 5, 2014

present their final arguments on the motion at the oral hearing. With respect to the Application, the Board directed all parties to file written submissions. Union was directed to file the argument-in-chief on December 5th followed by written submissions from all parties on December 12th and reply of Union by December 19th.

Board staff has already made a submission on the motion. The Board has reserved its decision on the Northeast motion. Board staff will therefore address the issues with respect to the main Application under both scenarios: (1) the motion under section 29 is granted and (2) the motion under section 29 is denied.

Board Staff Submission

1. Motion under section 29 is granted (the new service is non-utility)

If the Board were to grant the motion filed by Northeast, the new LNG service would be a non-utility service. In such a scenario, Union would be free to charge any rate it wishes. Union would also be responsible for all the incremental costs of the new service, without any support from its ratepayers. With respect to the existing assets allocated to the new service (the costs of which are included in Union's current rates), Union proposes to recover these costs from the users of the new service by way of a "cross charge". [2] Union proposes to include the revenues from this cross charge as part of its utility revenues. During the current IRM period these revenues would be kept by Union, except to the extent that the earnings sharing mechanism ("ESM") was triggered in any given year, in which case a portion of the revenues would be shared with ratepayers[3].

In its argument-in-chief, Union has requested that in case of forbearance, the Board should accept Union's functionalization and allocation of costs for purposes of calculating a utility cross charge to be paid by the non-utility to Union[4]. This is estimated to be \$1.591/GJ (\$5.073 - \$3.482). Using the average annual forecasted liquefaction sales activity, the cross-charge is estimated to be \$656,594 (412,693 X 1.591)[5] annually.

[2] Oral hearing transcript, Volume 1, Page 120, November 24, 2014
[3] Oral hearing transcript, Volume 1, Page 121, November 24, 2014
[4] Union Argument-in-Chief, Page 12, Para. 39, December 5, 2014
[5] Exhibit A, Tab 2, Schedule 6, Updated

Under Union's approach, ratepayers would receive compensation only if earnings sharing is triggered for the contribution the proposed LNG service is making to the recovery of fixed costs that are already recovered in rates from ratepayers. In other words, there would be no compensation to ratepayers for the use of utility assets if the earning sharing is not triggered. Earnings sharing during the IRM term is triggered after the utility earns 100 basis points over the Board approved return on equity (over 9.93%)[6]. In addition, should there be earnings sharing, all ratepayers would receive the benefit. However, Board staff notes that the existing costs of the Hagar facility are being borne by Union North customers.

Board staff submits that ratepayers should receive a guaranteed benefit for the use of utility assets the costs of which are fully recovered from Union's North customers. It would not be fair to Union North in-franchise customers to not receive a direct benefit when it is known that they are bearing a portion of the costs of providing the new service. Board staff submits that Union would be unable to provide the new service without the use of the regulated asset. In addition, if Union were to construct a facility to duplicate the use of the regulated asset, it would be significantly more expensive and possibly uneconomic for Union.

During the IRM period, Board staff submits that the Board should approve the establishment of a deferral account that would capture the revenues for the new LNG service. Board staff further submits that the revenue be shared between Union's North customers and Union. Since Union would be taking the risk of the incremental capital and OM&A as well as any volume shortfalls, Board staff recommends that the revenues be shared 75:25 in favour of Union. This would ensure that Union's North ratepayers receive a direct benefit towards the recovery of the existing costs. Using Union's average estimated liquefaction revenue per year ($2.094 million), Union's North ratepayers would receive $523,398 (25% of $2.094 million) annually. The amount should be credited to Union North in-franchise rate classes in the same proportion as the costs of the Hagar facility.

2. Motion under section 29 denied (determined as a utility service)

[6] Section 11.1, Union Settlement Agreement, EB-2013-0202, July 31, 2013

If the Board were to determine that the new LNG service should be regulated, then Board staff supports Union's rate design proposal. Board staff however disagrees with Union's proposed treatment of the net revenues. Union has proposed that the net revenues from the new service should be added to utility revenues and be subject to earnings sharing during the IRM period. At the time of rebasing, the incremental costs of the new service would be included in rate base and the revenue from the services would form part of regulated revenue.

Board staff submits that there is no certainty that ratepayers would receive any benefit through earnings sharing for the use of utility assets, the costs of which are fully recovered from Union's North customers. As noted earlier, if Union does not exceed a specific return on equity, the earnings sharing mechanism is not triggered during IRM. At the oral hearing, Union agreed that the LNG market is nascent[7] and there is uncertainty with respect to the eventual success of the LNG market in Ontario. In fact, Union considers the Hagar service as a demonstration project that will support pilot projects of customers.

> "Rather, Hagar is intending to support pilot projects
> and demonstrations that will help start a more robust,
> competitive market.[8]"

If ratepayers are expected to underwrite the risk for a service that is not proven or essential to their distribution needs, Board staff submits that they should be eligible for a guaranteed sharing of net revenues similar to the short term storage margins. At the oral hearing, Union disputed the argument that ratepayers would be underwriting the risk as there would be a prudence review[9]. However, if the LNG service is approved as a regulated service, Union would have a reasonable expectation that the incremental capital expenditure would be added to rate base.

In the Natural Gas Electricity Interface Review ("NGEIR") Decision, the Board determined that it would cease regulating the prices charged for certain storage services but the rates for storage services provided to Union and Enbridge distribution customers would continue to be regulated by the Board. In the case of Union, the Board

[7] Oral hearing transcript, Volume 2, Page 19, November 27, 2014
[8] Oral hearing transcript, Volume 1, Page 96, November 24, 2014
[9] Oral hearing transcript, Volume 2, pp. 13-14, November 27, 2014

determined that 100 PJ of storage would be reserved at cost based rates for in-franchise customers[10]. However, Union's in-franchise customers do not require the 100 PJ on an annual basis. The excess capacity is sold by Union on a short-term basis and the margins are shared with ratepayers. In the NGEIR proceeding, the Board determined that Union would receive 10% of the net revenues (revenues less incremental costs) related to the sale of excess utility space.

However, in the case of Hagar, Union has proposed not to share any revenues with ratepayers but rather add it to utility revenues with the possibility of earnings sharing. Board staff submits that there is no difference between short term storage and the proposed Hagar service contrary to what Union claims. Both are storage assets paid for by ratepayers and both (short term storage and the proposed LNG service) services utilize/will utilize excess capacity.

Union has tried to make a distinction by claiming that Hagar is not a firm service unlike storage and therefore an accounting separation like the Dawn assets is not applicable here. Union stated that Hagar is a system integrity asset and the proposed service is truly interruptible. Liquefaction is not available during vaporization or during maintenance. The liquefaction capability is only available on an interruptible basis throughout the year. However, it is not clear to Board staff why the discussion of firm versus interruptible is critical for the purposes of determining a revenue sharing model.

Board staff agrees that the service offered at Hagar is interruptible. However, the concept of interruption for a system integrity event has not prevented Union from developing a reliable volume forecast. Based on its updated schedule, Union has forecasted 170 days of liquefaction in a year[11]. Union conducted a non-binding open season to gauge interest from parties. Although the service may not be firm on a daily basis, Union is confident of providing the committed volumes on an annual basis. Board staff argues that within a specific set of parameters, Union is providing a firm service.

Moreover, system integrity events have not been a regular occurrence at Hagar. In the past five years, there were five instances when Union was required to re-gasify in order to meet a system integrity event[12]. Although past occurrences do not necessarily

[10] Decision with Reasons, NGEIR, Page 83, November 7, 2006 (EB-2005-0551)
[11] Exhibit A, Tab 2, Schedule 6, Updated
[12] Interrogatory Response Exhibit B.BOMA.25

indicate the possibility of future events, Board staff submits that it definitely denotes a trend.

Accordingly, Board staff sees no reason why the Board cannot adopt a sharing mechanism similar to that of the short term storage margin account. Board staff submits that the Board should approve the establishment of a Hagar LNG Revenue Deferral Account and that 75% of the net revenues (revenues less incremental costs) related to the new LNG service should go to Union's North ratepayers. The amount captured in the deferral account should be credited to Union North in-franchise rate classes in the same proportion as the costs of the Hagar facility.

Board staff has recommended a higher proportion for Union in the case of sharing LNG revenues as compared to the sharing of short-term storage margins. In the case of storage, Board staff notes that Union has a pool of existing storage customers and it has to make little or no effort in selling storage services. However, wholesale of LNG is a new service and Union will need to make a greater effort towards succeeding in this business. Accordingly, Board staff has recommended a slightly higher incentive for Union in this case.

Union has also made another argument with respect to new services during the IRM term. At the oral hearing, Union noted that the IRM Settlement Agreement contemplates the development of new services and in fact encourages Union to look for productivity enhancements on the revenue and cost efficiency side. Union has submitted that the proposed liquefaction service is within the considerations of the IRM framework and therefore there was no requirement of a deferral account[13].

Board staff agrees with Union's view that it should be encouraged to look for productivity and efficiency improvements during the IRM term and should be able to enjoy the benefits of such initiatives. However, this does not imply that Union should enter new businesses that are uncertain with ratepayers underwriting the risk. The LNG business in Ontario is untested and presents a degree of risk. Moreover, Union has not indicated that ratepayers will not bear any portion of the costs should the venture fail. Accordingly, Board staff submits that if Union has proposed to enter an uncertain

[13] Oral hearing transcript, Volume 1, pp.67-68, November 24, 2014

business, ratepayers should be entitled to a portion of the revenues that is commensurate to the risks borne by them.

Under both scenarios described above, Board staff suggests that prior to rebasing in 2019, Union should complete a full cost allocation that appropriately allocates all existing Hagar costs to the new LNG service. The Board at rebasing can then determine the approach going forward. In 2019, Union would also have more information on the actual costs of providing the new LNG service at Hagar and the Board would be in a better position to understand the costs and revenue structure attributed to the new service.

– All of which is respectfully submitted –