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Our File # 339583-000180

By electronic filing

December 12, 2014

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
27th floor
Toronto, ON M4P 1E4

Dear Ms. Walli

Re: Union Gas Limited ("Union")
Hagar Liquefaction Service Rate
Board File #: EB-2014-0012

Please find attached the Written Argument of Canadian Manufacturers & Exporters ("CME") in the above-noted proceeding.

Yours very truly

Borden Ladner Gervais LLP

Peter C.P. Thompson

PCT\slc
enclosure
c. Karen Hockin (Union)
Intervenors EB-2014-0012
Paul Clipsham and Ian Shaw (CME)
Vince DeRose and Emma Blanchard (BLG)

OTT01: 6705063: v1

EB-2014-0012

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

AND IN THE MATTER OF an application filed by Union Gas Limited, pursuant to section 36(1) of the *Ontario Energy Board Act, 1998* for an order or orders approving rates and other charges for an interruptible natural gas liquefaction service.

ARGUMENT OF CANADIAN MANUFACTURERS & EXPORTERS ("CME")

December 12, 2014

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A. INTRODUCTION

1. Union Gas Limited ("**Union**") owns and operates a liquefied natural gas ("**LNG**") facility in Hagar Ontario (the "**Hagar Facility**" or "**Hagar**"). The Hagar Facility is a regulated asset which currently serves Union's system integrity requirements by providing a reserve of LNG which can be vaporized and injected into Union's system in response to higher than forecasted weather variations, supply shortfalls, unplanned pressure drops or outages.

2. Union now proposes to provide to third parties a gas liquefaction and LNG dispensing service at Hagar (the "**New LNG Service**"). This service will be offered to wholesalers of LNG for use as vehicle fuel or for remote power, marine and/or rail applications.

3. The question central to CME's concerns with Union's proposal is whether a gas liquefaction and dispensing service to enable LNG to be sold as transportation fuel or other forms of fuel is a utility activity. We submit the answer to this question is a clear 'no.'

4. If Union or any other utility were proposing to construct a stand-alone facility to liquefy LNG for sale as a fuel, the owning and operating costs of such a facility would fall outside the ambit of utility regulation. The price to be charged for the liquefaction service would be unregulated.

5. Third parties wishing to access stand-alone liquefaction services would need to get natural gas to the liquefaction facilities. To do this they would either have to buy utility system gas at the facilities or enter into appropriate direct purchase agreements to get gas to those facilities. The agreements with a utility to get the gas to the facilities would be utility services, separate from the unregulated liquefaction service and the price of the LNG commodity processed at the liquefaction facility.

6. We submit that the foregoing facts are critical to any analysis of the approvals which Union is seeking in this Application.

7. The only difference between the foregoing facts and the facts related to Union's proposals is that Union plans to use the existing regulated LNG facilities at Hagar in combination with new LNG facilities to support the sale of liquefaction and dispensing services to third parties.

8. Union proposes to have its sale of liquefaction and dispensing services treated as a "utility" activity.

9. Union is subject to the Undertakings approved by the Lieutenant Governor in Council on December 9, 1998 which contain the following restriction on Union's participation in non-utility business activities:

> **Restriction on Business Activities**
>
> Union shall not, except through an affiliate or affiliates, carry on any business activity other than the transmission, distribution or storage of gas, without the prior approval of the Board.[1]

10. The New LNG Service represents a departure from Union's utility gas transmission, distribution and storage business and will allow Union to participate in the emerging competitive market for LNG as an alternative fuel for heavy duty transportation vehicles. It is clearly a non-utility business activity caught by the above language.

11. Given the foregoing, Union will require the prior approval of the Board before embarking on its proposed venture into the emerging market for LNG as transportation fuel.

12. Although Union did not address the requirements of the Undertakings in either its Application materials or its Argument-in-Chief, a request for Board approval thereunder is implicit in its alternative proposal for the New LNG Service to be treated as a non-utility service subject to an appropriate cross charge from the utility.

13. We submit that the implicit approval being requested should be granted on terms which ensure that ratepayers are fairly compensated for the benefit which the non-utility New LNG Service derives from its use of existing regulated assets at Hagar.

14. Since liquefaction and LNG dispensing services are a non-utility business activity, the price charged for these services and the LNG fuel commodity should not be regulated. Such regulation would be inappropriate and prohibited by Section 29 of the *Ontario Energy Board Act, 1998* (the "*Act*").

15. The foregoing circumstances comprise the factual foundation for CME's contention that the central regulatory issue in this proceeding is the appropriate 'charge' to be recovered by the utility from the owner of non-utility New LNG Service business for its use of <u>existing</u> utility LNG facilities at Hagar.

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1 A copy of the 1998 Order in Council incorporating Union's Undertaking is included in Exhibit K.1.2., CME Compendium at Tab 1.

B. FORBEARANCE MOTION

16. During the Oral Hearing portion of this proceeding the Board heard argument on a Motion by Northeast Midstream LP ("**Northeast**") seeking an order under Section 29 of the *Act* and requesting that the Board forebear from regulating the New LNG Service. Northeast is a company established to produce and market LNG for use as transportation fuel and is in the process of developing a new gas liquefaction plant for this purpose in Thorold Ontario at an estimated cost of $130 Million.[2]

17. CME supported Northeast's motion and concurred with Board Staff's submission that the acknowledged existence of an emerging competitive market for LNG for use as transportation fuel which is sufficiently robust to protect the public interest[3] engages the Board's obligation[4] to forbear from approving a regulated rate for the New LNG Service.

18. We submit that Section 29 of the *Act* precludes the Board from granting Union's request for a regulated rate for the New LNG Service. Moreover, even if the Board was permitted to approve a regulated rate for the New LNG Service, it should refrain from doing so because this would allow Union seek to add its incremental costs of providing the service to rate base.[5] Given the limitations on the review of past expenditures in the context of rebasing, specifically the prohibition on the use of hindsight, the provision of a regulated rate for the New LNG Service would effectively require ratepayers to underwrite the New LNG Service or assume the risk that Union's venture into an emerging market will not be a commercial success.

C. CALCULATING THE NON-UTILITY CROSS CHARGE: ENSURING THAT THE NON-UTILITY NEW LNG SERVICE IS HELD RESPONSIBLE FOR ITS USE OF UTILITY ASSETS

19. The fully allocated costs of the existing Hagar Facility were established by the Board in EB-2013-0202. Excluding costs which are directly assigned to Hagar's system integrity function,

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2 Northeast Notice of Motion at p.2.
3 Transcript Volume 1, pp.114-115.
4 Section 29 of the *Act* provides that "the Board **shall** make a determination to refrain, in whole or in part, from exercising any power or performing any duty under this Act if it finds as a question of fact that a ... product [or] service ... is or will be subject to competition sufficient to protect the public interest.
5 Reply Affidavit of Stephen Gaske, November 6, 2014 at p.4.

these costs total $4,789 Million annually over the 2014-2018 IR term (the "**2013 Board Approved Costs**").[6]

20. The established method for determining the amount that should be charged to a non-utility business activity for its use of utility assets is to hold the non- utility business activity responsible for a share of the fully allocated costs of any regulated asset underpinning the unregulated business activity. This share should reflect the extent to which the regulated asset is used by the unregulated business. Incremental facilities to provide an unregulated service are not the ratepayers' responsibility.

21. The incremental costs incurred by Union to deliver the unregulated New LNG Service at Hagar, including the capital investment of approximately $9.9 Million[7] which Union will make in new facilities for dispensing LNG fuel, are the responsibility of Union's shareholders.

22. In the case of the New LNG Service, the cross charge must reflect a share of the 2013 Board Approved Costs proportionate to the use of the existing Hagar Facilities by the New LNG Service.

23. Union takes the position that, in the event that the Board determines that the New LNG Service is not a utility service, "the portion of rate design set out in its application that represents the contribution the proposed service is making to the recovery of fixed cost remains [a] valid [method of identifying the appropriate non-utility cross charge for the New LNG Service]."[8]

24. Underpinning the proposed cost allocation methodology is a "functionalization of net plant" which seeks to divide costs as between the liquefaction, storage and vaporization functions of the plant at Hagar.[9]

25. The cost allocation approach advanced by Union as a means of identifying a non-utility cross charge for the New LNG Service does not result in the attribution of an appropriate share of the fully allocated costs of the existing Hagar Facility to the non-utility New LNG Service because Hagar is an integrated facility whose functions cannot be reasonably disaggregated to the extent Union is proposing.

6 Prefiled evidence, Exhibit A, Tab 2, Schedule 1, Line 31.

7 Prefiled evidence, Exhibit A, Tab 1, p.21, Table 3.

8 Union Argument-in-Chief at p.12.

9 The proposed allocation of existing liquefaction and storage costs at Hagar to the New LNG Service is outlined in a report prepared by Union's consultant, KMPG, dated May 12, 2014 and titled "Identification of Liquefaction Service Cost" (the "**KMPG Report**").

26. The shortcomings of a cost allocation approach which relies extensively on the functionalization of the costs of the existing integrated Hagar Facility are acknowledged by the consultant who developed the cost allocation approach which Union advances in support of the development of a regulated rate for the New LNG Service including:

i. There are many common costs at Hagar including costs associated with providing around the clock operating staff, maintaining safety and security systems, controls systems and general building and site envelop, and plant administration.

ii. Hagar plant costs have not previously been functionalized and as a result limited operational data is available.

iii. Actual plant costs at Hagar are significantly affected by the operating regime. The 2013 Board Approved Costs for the Hagar Plant are based on recent operating history which has seen the liquefaction process at Hagar used to only a limited extent. Union has acknowledged that aspects of the New LNG Service will present a significant change or change in the operating regime at Hagar.[10]

27. The functionalized approach significantly understates the usage of the <u>existing</u> Hagar Facility by the New LNG Service. This is demonstrated by the fact that after allocating 58% of net plant to the storage function, Union proceeds to allocate only 1% of the annual "functionalized storage cost", or $39,000 of an annual Hagar Storage Revenue requirement of $2,690 Million[11], to the New LNG Service.

28. Union justifies the very limited allocation of storage costs to the New LNG Service on the grounds that the New LNG Service is designed to only use 7,000GJs of storage representing only 1% of the total storage capacity at Hagar. However, based on Union's estimate average volume of LNG for the New LNG Service of 412,693 GJs, the New LNG Service will cycle through this same 7,000 GJs of capacity an average of 59 times over the course of a year.[12] Taking cycling into account, the usage of storage capacity by the New LNG Facility is much greater than 1% of the total usage of this facility annually.

10 Transcript Volume 2, pp.46-47.
11 Prefiled evidence, Exhibit A, Tab 2, Schedule 6.
12 Transcript Volume 2, p.67.

29. More broadly, Union is effectively asserting that very little storage capacity is required as a component of facilities whose purpose is to liquefy natural gas and then dispense it as LNG for use as a fuel. We regard that contention to be without merit.

30. We submit that, as a pragmatic matter, significant storage capacity is invariably a component of LNG liquefaction and dispensing facilities. The many LNG dispensing terminals throughout the world, in which significant above ground storage facilities are an obvious component, attest to this fact. Moreover, we submit that any arm's length third party constructing natural gas liquefaction and LNG dispensing facilities would include significant LNG storage capacity within the ambit of the facility's design. To do otherwise would likely be imprudent.

31. Storage capacity is a feature of liquefaction facilities used for the purpose of dispensing LNG as a fuel, as well as for liquefaction facilities used for the purpose of supporting gas distribution utility system integrity. We submit and urge the Board to find that the existing storage capacity at Hagar is an integral and indivisible component of facilities required to support both utility and non-utility liquefaction purposes.

32. For the foregoing reasons, we submit that the non-utility cross charge applicable to the New LNG Service should more appropriately be based on the extent to which that service uses the integrated Hagar Facility taken as a whole, including its indivisible storage component.

33. The extent to which the New LNG Service uses that integrated facility should be expressed as a percentage. There are reasonably simple ways of determining this percentage. One is to express the annual New LNG Service output as a percentage of total liquefaction capacity and to apply that percentage to the 2013 Board Approved Costs to determine the amount of existing LNG costs for which the unregulated New LNG Service is responsible.

34. Another option might be to consider the number of days on which the LNG facilities at Hagar are being operated to support the New LNG Service as a percentage of the 344 days in the year in which the facilities are operable and not shut down for maintenance. For example, if the facilities are used to support the New LNG Service for 170 days of the 344 operable days in a year, then 170/344 would represent the proportionate share of the fully allocated costs of the existing Hagar Facility which should be the responsibility of the New LNG Service.

35. Using the first approach that we have suggested, the New LNG Service's usage of Hagar would be derived from the volume of LNG which will be dispensed year over year. Under

this approach, the amount of the non-utility cross charge for the New LNG Service would be calculated as follows:

$$\frac{\text{Annual Forecast Sales Volume New LNG Service}}{\text{Net Annual Liquefaction Capacity}} \times \text{2013 Board Approved Costs for } \underline{\text{Existing}} \text{ Hagar Facility Less Costs Directly assigned to System Integrity.}$$

36. Applied to forecast LNG sales provided by Union, the above methodology would produce <u>lump sum</u> cross charges for the years 2016, 2017 and 2018 as follows:

<u>2016</u>: (152,640[13] GJ/992,000[14] GJ) x $4,789,000[15] = $737,000
<u>2017</u>: (474,880[16] GJ/992,000[17] GJ) x $4,789,000[18] = $2,293,000
<u>2018</u>: (610,560[19] GJ/992,000[20] GJ) x $4,789,000[21] = $2,945,000

37. At annual LNG transportation fuel sales volumes of 413,000 GJs, being the average annual sale estimated by Union, the cross charge which Union asks the Board to approve of a $1.591/GJ would produce a lump sum of $657,083. This is an unreasonably low amount because Union ascribes to the New LNG Service very little responsibility for costs related to existing storage capacity at Hagar. This storage is an indivisible component of the integrated facilities which will support the liquefaction of natural gas at Hagar for LNG fuel and other purposes. Under a usage approach which makes the New LNG Service responsible for an appropriate portion of these costs, the cross charge for 413,000 GJs/annum would be $1,993,807 (413,000/992,000 x $4,789,000 = $1,993,807). The cross charge Union is proposing of $657,083 is about 30% of the amount of the cross charge which we submit is required to satisfy the just and reasonableness standard.

38. Under the second approach for determining the responsibility of the New LNG Service for the fully allocated cost of the existing Hagar facility described above, where the facilities are

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13 Prefiled evidence, Exhibit A, Tab 2, Schedule 5, Line 9 (2016 column).
14 Transcript Volume 1 at pp.61-62 (reflecting an estimated 3 weeks of maintenance annually).
15 Prefiled evidence, Exhibit A, Tab 2, Schedule 1, Line 31.
16 Prefiled evidence (2014-10-09), Exhibit A, Tab 2, Schedule 5, Line 9 (2017 column).
17 Transcript Volume 1 at pp.61-62 (reflecting an estimated 3 weeks of maintenance annually).
18 Prefiled evidence, Exhibit A, Tab 2, Schedule 1, Line 31.
19 Prefiled evidence (2014-10-09), Exhibit A, Tab 2, Schedule 5, Line 9 (2018 column).
20 Transcript Volume 1 at pp.61-62 (reflecting an estimated 3 weeks of maintenance annually).
21 Prefiled evidence, Exhibit A, Tab 2, Schedule 1, Line 31.

used on 170 of their 344 usable days to support LNG fuel dispensation, the cross charge amount would be about $2,366,657 (170/344 x $4,789,000 = $2,366,657).

39. The cross charge amount should be determined as an estimated annual amount when Union's rates are set, prospectively, for a particular year. That amount, less any incentive payment amount allowed to Union's shareholder for optimizing the assets for the benefit of ratepayers, should be recorded in a tracking/deferral account and adjusted yearly to reflect actual usage. At the end of each year, the actual lump sum cross charge amount should be cleared to those ratepayers who are paying the existing Hagar LNG Facility costs in their rates.

40. The dollar per GJ cross charge approach, which Union is proposing, is inappropriate because it implies that the Board is fixing a charge per unit to be imposed on and paid by those who acquire LNG fuel from Union. This is not the case. The Board is not fixing any amounts to be paid by LNG fuel consumers. That activity is unregulated. Rather, in determining the cross charge, the Board is imposing annual cost responsibility on Union in its capacity as the owner and operator of the New Non-Utility LNG Service business activity. That cost responsibility should be measured and imposed by way of an annual fixed charge amount. Union's dollar per GJ approach should be rejected. The lump sum tracking and clearance approach is the appropriate approach to apply.

D. THE APPROPRIATE SHAREHOLDER INCENTIVE FOR ENGAGING IN NON-UTILITY ACTIVITIES WHICH OPTIMIZE UTILITY ASSETS

41. Rates for Union's utility gas transmission, distribution and storage services are currently governed by an Incentive Regulation Mechanism established by the Board in EB-2013-0202 (the "**IRM**") and resulting from a settlement between Union and its stakeholders concluded in the summer of 2013 (the "**IRM Agreement**").

42. The introduction of the New LNG Service Union did not form part of the negotiations which ultimately produced the IRM Agreement[22] as Union only began discussing the New LNG Service a few months later in the fall of 2013.[23]

43. While the IRM Agreement specifically addresses the introduction of new utility services during the IRM term[24], it is silent about unregulated utility services. This reflects the fact,

22 Transcript Volume 2 at p.57.
23 Transcript Volume 1 at p.92.
24 Settlement Agreement at p.30, Section 13.2.

acknowledged by Union, that a new unregulated service would "[fall] outside the ambit of the IRM itself."[25]

44. Union also acknowledges that to the extent that the non-utility New LNG Service is generating revenue for the utility through the payment of a cross charge, the application of the IRM, specifically the earnings sharing mechanism which provides that all earnings within 100 basis points above the Board approved return on equity accrue solely to Union, could produce a scenario where ratepayers receive no compensation for the use of regulated assets by the non-utility New LNG Service.[26]

45. Had the issue of new non-utility services been raised during settlement discussions in the summer of 2013, ratepayers would not have accepted the application of an earnings sharing mechanism which could produce such an outcome for non-utility services which are underpinned by regulated assets.

46. Union's venture into the LNG market is consistent with a business diversification strategy endorsed by senior executives of Union[27] as a means of responding to slowing growth in distribution volumes and has been characterized by Union as a "way of optimizing existing assets to the benefit of shareholders and ratepayers."[28]

47. As the non-utility New LNG Service is outside the ambit of the IRM, the IRM Agreement does not apply and the Board should consider the treatment of any shareholder incentive to be deducted from the non-utility cross charge for the New LNG Service as a new cost of service issue.

48. In Union's 2013 cost of service rebasing case, the Board determined that the appropriate shareholder incentive for optimizing utility transportation assets was 10% of the benefits realized for ratepayers. This is the percentage amount which Union's shareholders should realize from engaging in non-utility activities which optimize utility assets.

49. Ratepayers should receive 90% of the non-utility cross charge each year and shareholders should receive 10%.

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25 Transcript Volume 1 at p.86.
26 Transcript Volume 2 at p.60.
27 Exhibit K.1.2, CME Compendium, Tab 9.
28 Transcript Volume 1 p.94 lines 14-16.

50. The earnings sharing mechanism in the IRM Agreement does not apply to determine the shareholder incentive in this case. All matters pertaining to the non-utility cross charge including the shareholder incentive component are outside the ambit of the IRM Agreement.

E. COSTS

51. CME requests that it be awarded 100% of its reasonably incurred costs in connection with this matter.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 12th day of December, 2014.

Peter C.P. Thompson, QC
Vincent J. DeRose
Emma Blanchard
Counsel for CME

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