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BY EMAIL and RESS

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Our File: EB20140012

Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, Ontario
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Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2014-0012 – Union Hagar LNG – SEC Submissions

We are counsel for the School Energy Coalition ("SEC"). These are SEC's final submissions in this proceeding.

SEC's principal reason to intervene in this proceeding was to address the scope and application of the section 29 motion brought by Northeast Midstream LP. Then, if that motion was granted, in whole or in part, SEC wanted to be in a position to address issues of implementation and cost allocation.[1] Argument on the motion was held on November 24th and 27th, and the Board panel reserved its decision. These are SEC's submissions on implementation and cost allocation issues that may arise if the Board determines it will forbear from regulation of Union Gas Limited's ("Union") proposed Liquefied Natural Gas ("LNG") service at its Hagar facility.

A. Rate Impacts in the IRM Context

If the Board implements a section 29 order in this matter, it must in any case do so in the context of Union's current 2014-2018 Incentive Regulation Mechanism ("IRM Plan") approved by the Board in EB-2013-0202. The IRM Plan as set out in the Settlement Agreement is a complete framework for Union's rate-setting during the plan term.

The IRM Plan does not directly address the rate implications of a section 29 order during the IRM term, whether generally, or specifically one brought by a third-party. SEC believes that a section 29 order arising, as here, out of a motion brought by a third-party would generally meet

[1] Notice of Intervention of the School Energy Coalition, dated October 24, 2014.

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the requirements of a Z-Factor which is symmetrical under the Settlement Agreement, if the materiality threshold is met ($4M in annual net delivery revenue requirement).[2] If that threshold is met, then the entire impact of the section 29 order flows through to rates.

If the materiality threshold is not met, which is the case here, then the only rate component impacted by a section 29 order in this proceeding is the Earnings Sharing Mechanism ("ESM"). The ESM, which shares Union's earnings above the benchmark return on equity, based on a pre-determined formula, requires that all revenues and expenses (i.e. costs) be calculated as if it were based on a cost of service application.[3] The calculation of regulated earnings must therefore reflect the section 29 order. Until 2019, the impact of the section 29 order will only be through the ESM.

Since the ESM is a sharing mechanism between ratepayers and Union, even the perfect cost allocation methodology will lead to some cross-subsidization between ratepayers and LNG consumers, and more importantly, ratepayers and Union. SEC accepts this reality until rebasing in 2019, as it is consistent with the IRM Plan which acts in part to allocate risk of changing circumstances between ratepayers and Union.

B. Cost Allocation Methodology

Since the Board has only granted forbearance in one proceeding, it has only that precedent to draw upon in determining an appropriate way to implement forbearance in this proceeding. With that being said, the Board's decision in the Natural Gas Electricity Interface Review ("NGEIR") regarding its implementation of forbearance of ex-franchise natural gas storage includes a fulsome discussion and can act as an important model for the Board to consider.[4]

In NGEIR, the Board determined that it would forbear from regulating the rates of natural gas storage to ex-franchise customers, while maintaining regulated rates for in-franchise customers. After the Board made the determination to forbear, it also had to decide what that actually means as it relates to rates and revenue. The Board implemented forbearance in two distinct ways based on two different categories of storage assets: those that would be derived from non-utility assets and those that would be derived from utility assets.[5]

Non-Utility Asset Model. The Board determined in NGEIR that non-utility storage - that is, all space in excess of what it determined was required for in-franchise customers - would be considered wholly outside of the regulated environment. The entirety of the costs would be borne by the unregulated utility (i.e. the non-utility), determined through a cost allocation study, and correspondingly all of its revenues (including margins) would flow to the shareholder.[6] The Board made this determination in part on the basis that the underlying non-utility assets had not generally been "paid for" by utility ratepayers, since market-based rates for long-term storage to ex-franchise customers had been in place for a long time.[7]

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[2] EB-2013-0202, Union Gas Limited Settlement Agreement, dated July 31, 2013, at section 8(5)
[3] EB-2013-0202, Union Gas Limited Settlement Agreement, dated July 31, 2013, at section 11.1
[4] *Natural Gas Electricity Interface Review* (EB-2004-0551), *Decision with Reasons*, dated November 7th 2006 ["*NGEIR Decision*"]
[5] For the purpose of these submissions, SEC is using the same terminology as was used in the NGEIR decision. "Non-utility" is the same as the unregulated activities of a utility and "utility" has the same meaning as the regulated activities of a utility.
[6] *NGEIR Decision*, p.71-74
[7] *NGEIR Decision*, p.104-105

Utility Asset Model. The non-utility model approach should be contrasted to the Board's approach in NGEIR with short-term storage services that are underpinned by utility assets. The Board required that margins (less an appropriate incentive) accrued on short-term storage contracts that are based on temporary surplus of utility storage assets be credited to ratepayers. The rationale is that the underlying utility assets utilized are being paid for by ratepayers through regulated rates, and should benefit from transactions that utilize temporary surplus space created by those assets.[8]

C. Cost Allocation Application

In the current proceeding, the question of which model to follow is not so obvious, since there are plausible and convincing rationales for both to be applied to a forbearance order. What is clear, though, is that Union's proposal would not be appropriate, as it cherry-picks the benefits to the unregulated entity of both approaches.

SEC submits that, conceptually, the Board in this case should separate two distinct categories of assets, and their related expenditures and revenue requirement, for the purpose of the appropriate cost allocation. Those two categories are: i) the proposed incremental expenditures, and ii) the current Board-approved Hagar costs already built into rates.

Incremental Costs. If forbearance is ordered, the proposed incremental expenditures should be considered a non-utility asset, as they will be completely utilized and incurred for the benefit of what would now be an unregulated activity - the sale of LNG. This is the approach the Board took in NGEIR regarding storage that was not underpinned by utility assets.

Common Hagar Costs. The second category of assets, the current Board-approved Hagar costs built into rates, is more complicated. Union is proposing that the non-utility would recover the costs of these utility assets through a cross-charge. The cross-charge, which would be based on the same methodology as Union's regulated rate proposal, would represent the cost for the non-utility to compensate the utility for Hagar's fixed costs built into rates. This approach is similar to the NGEIR approach to short-term storage, except Union is not proposing to share the margins of any unregulated LNG sales with ratepayers. SEC submits this is inappropriate since it accrues the entire benefit of any profits on LNG sales entirely to the shareholder when the Hagar facility has been paid for entirely by ratepayers who have until now borne the entire risk of the facility.

SEC submits there are only two fair methods of implementing a forbearance order that properly allocate the risk and reward.

First, for the purposes of the ESM calculation, Union should remove from its expenses the revenue requirement associated with a fair share of the Hagar facility currently built into rates. That fair share should not be based on actual sales as currently proposed, but based on a capacity-type allocation. This approach is similar to the NGEIR non-utility model. A certain amount of liquefaction capacity or capability above what will be required for ratepayers is kept in rates, and all costs in excess of that are transferred to the non-utility business. In turn, <u>all</u> revenues are kept by the non-utility business as it fairly bears the risk.

If the Board does adopt this approach, then it should properly adjust Union's forecast available annual LNG service capacity from 678,400 GJ[9] to a more appropriate amount. Dr. Gaske's

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[8] *NGEIR Decision*, p.100-101

[9] J2.4. Tr.2, p.47. Exhibit B.Energy Probe.10

evidence shows that if the 5 year average actual system integrity use were utilized, the minimum available capacity for LNG service would be 1,018,765 GJ per year.[10] This represents over 95% of the liquefaction capacity at Hagar.

In this approach, the ratepayers essentially pay for what they need, and the unregulated business pays for the rest. It is then up to the unregulated business to generate sales to cover those costs.

The second approach, which is more similar to the utility asset model, is that ratepayers are only compensated for the non-utility use of the Hagar facility when the non-utility business actually uses it. This is similar to what Union is proposing through its cross-charge proposal[11], with one major difference. Unlike in NGEIR, Union is not proposing to share any margins (i.e. revenue above costs) with ratepayers. SEC submits this is an unfair allocation of risk. If Union is not willing take on all the risk associated with an unregulated LNG service, by paying for use of the common Hagar costs based on forecasted or potential use, then it should not be allowed to keep <u>all</u> of the associated revenues.

The Board's rationale for sharing margins in NGEIR for short-term storage utilizing utility assets is similarly applicable in this case. Union has consistently stated that the Hagar assets are primarily for system integrity purposes, and that an LNG service is essentially a way to optimize the assets.[12] Regardless of any unregulated LNG service that Union may begin, Hagar will still exist as it does today, and those costs will be paid by ratepayers, for their benefit. Union would not be able to offer the unregulated LNG service without building its own duplicative facilities; it could not utilize the Hagar facility that is a regulated asset paid for by ratepayers.

SEC submits that the second approach outlined above – sharing of actual costs and margins – is more appropriate, but with certain modifications that reflect the facts of the current situation.

Union has taken the position that it would not be appropriate to share the margins with ratepayers of an unregulated LNG service since it would be bearing the costs and risks of the incremental capital and O&M.[13] While SEC agrees that it would not be appropriate to share the entire margin for those reasons, it would be unfair not to credit to ratepayers a portion of the margin that represents the amount of utility assets that underpin the LNG service. SEC estimates that appropriate sharing methodology be 77-23 in favor of ratepayers, which represents the percentage of the total costs (incremental and common costs) that ratepayer assets are underpinning in rates (see table below).

Total Rev. Req. for LNG Service			
2013 Board-Approved Hagar Rev. Req. excluding directly assigned to System Integrity costs	$4,789,000	(1)	A-1-Schedule 1, Ln 31
Incremental Rev. Req. (Annual Average)	$1,437,000	(2)	A-2-Schedule 5, Ln 8
Total Rev. Req.	**$6,226,000**	(3)	1+2
% of Total Rev. Req. currently in rates	**76.92%**	(4)	1/4

[10] Reply Affidavit of J. Stephen Gaske on Behalf of Northeast Midstream LP (Sworn November 6, 2014), p.2
[11] Union Argument-in-Chief, p.12
[12] Reply Affidavit of J. Stephen Gaske on Behalf of Northeast Midstream LP (Sworn November 6, 2014), p.2
[13] Tr.2, p.125

No Incentive Required. SEC submits that no additional utility incentive is required. In NGEIR[14], and in certain other asset optimization or transactional services activities undertaken by gas utilities[15], a portion of the margin is provided to the utility shareholder as an incentive to undertake the activity in the first place. Such an approach is not required in these circumstances. This is because the utility already has an incentive to undertake the activity to both recoup the costs associated with its non-utility expenditures (the incremental costs) as well as retaining a portion of the margin on top of costs that are underpinned by those non-utility assets.

Cross-charge**.** SEC also has a concern with how the cross-charge has been calculated. Union's proposal is to include a cross-charge, which would be a payment from the non-utility to the utility as compensation for the use of the regulated assets already included in rates by contributing to their fixed costs. Union has calculated the cross-charge on the same basis as its rate design proposal for its regulated L1 rate.

Core to the design of the cross-charge, and the L1 rate design, is that it is based on the forecast liquefaction sales activity. While using the forecast demand to allocate costs between LNG and system integrity functions is a conceptually appropriate method, because of the uncertainty around the viability of the service[16], and no past history to draw from, there is significant forecast risk. Union's own evidence is that due to the lack of regulatory certainty surrounding the proposed service, it has had trouble getting customers to commit. In fact, its forecasted sales volume has decreased since its initial filings.[17] Once there is regulatory certainty, either by way of a regulated rate, or Union's ability to charge any rate it sees fit, the forecast may dramatically change. This problem is compounded by the early stages of the LNG transportation fuel market in Ontario. Significant growth may occur in a short-time, or the market may simply never materialize as planned. SEC submits because of this, it may be appropriate to have a variance account established to ensure that if the Board utilizes the cross-charge method for Union recovering utility costs from the non-utility, the actual costs will be recovered from 2016 to 2018.

SEC also does not believe all costs have been properly allocated to the cross-charge.

First, since there will be a significantly greater use of the liquefaction facility than in previous years, it is likely that there will be incremental O&M costs related to maintenance that have not been accounted for in the incremental costs, as they are not purely a function of liquefaction capacity. That is, it is not a pure linear relationship between each additional GJ liquefied, and increased maintenance costs. While during the IRM Plan those costs will be borne by Union, if they are not properly allocated to the non-utility then it will lower the amount of earnings to be shared with ratepayers by increasing the expense category in the ESM.

Second, there appears to be no allocated cost for the LNG service's customer billing and gas supply functions, which are likely to be done using the staff that are currently allocated for cost purposes to regulated operations.

[14] *NGEIR Decision*, p.102-103
[15] *NGEIR Decision*, p.102-103
[16] Tr.1, p.115
[17] J2.3. Application Addendum, Ex.A

Third, since Hagar has not previously been functionalized, there is limited operational data for which KPMG could draw from to allocate the costs from LNG use.[18] Further, since LNG service will dramatically change the utilization of Hagar, there will be significant changes to the operations of the facility that have not been accounted for.[19]

***2019 Review*.** Regardless of the approach the Board takes, SEC believes the Board should make it clear to Union that a full review of the allocation of costs and appropriate treatment of any margins will take place as part of its next rebasing proceeding. This will allow intervenors and the Board to have a more sophisticated understanding of the actual usage of the Hagar facility, when it will be used for both system integrity and LNG service purposes.

All of which is respectfully submitted.

Yours very truly,
Jay Shepherd P.C.

Original signed by

Mark Rubenstein

cc: Wayne McNally, SEC (by email)
Applicant and intervenors (by email)

[18] Union retained KMPG to undertake a study to allocate existing Hagar liquidation and storage costs. See *Identification of Liquefaction Service Cost* dated May 12th 2014 (Ex.A-2-Attachment A)
[19] Tr.2, p.46-47