



RP-2002-0147

EB-2004-0004

IN THE MATTER OF the *Ontario Energy Board Act, 1998*,
S.O.1998, c.15, (Sched. 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 and transmission of gas as of January 1, 2004.

BEFORE:

Paul Vlahos
Presiding Member

Arthur Birchenough
Member

DECISION AND ORDER

April 19, 2004

The Application and Proceeding

Natural Resource Gas (“NRG”) was an applicant in a proceeding (RP-2002-0147/EB-2003-0286) for gas cost changes effective January 1, 2004 as part of the normal Quarterly Rate Adjustment Mechanism (“QRAM”).

As part of that application, NRG had also requested approval to be allowed to recover an additional amount of \$554,050 for gas costs as of December 31, 2003. NRG had proposed to record this amount in a new account, the Gas Purchase Rebalancing Account (“GPRA”).

In its decision and order dated December 23, 2003, the Board approved changes in gas costs, as part of the normal QRAM process, effective January 1, 2004.

However, the Board did not allow the utility to reflect an opening balance in the requested new deferral account for costs incurred prior to the date the Board authorized NRG to establish the account. The Board indicated that NRG could choose to commence a GPRA prospectively with a zero balance, starting January 1, 2004, or bring forward its request at the next main rates case. The Board directed NRG to make its choice by end of January 2004. NRG notified the Board that it would set up the GPRA beginning January 1, 2004, with a zero balance.

On January 20, 2004, NRG applied for authorization to record the above gas costs in the Purchased Gas Commodity Variance Account (“PGCVA”), indicating that its previous request did not make it clear that such costs arose because of an accounting methodology error.

The Board accepted NRG’s application as a request for review of the Board’s December 23, 2003 decision and order. The Board gave this proceeding Board File No. RP-2002-0147/EB-2004-0004.

On February 9, 2004, the Board issued its Notice of Hearing and Procedural Order No.1. In it the Board set April 5, 2004 as the commencement date of an oral hearing. The Board ordered that the Notice and Procedural Order be served on all parties of record in the most recent proceeding, RP-2002-0147/EB-2003-0286. The oral hearing lasted one day. The following witnesses testified on behalf of NRG:

William Blake,	President and General Manager,	NRG
Sandy McCallum,	Financial Manager,	NRG
Randall Aiken,	Aiken & Associates	

Except for Board Counsel’s cross examination, no other party participated in the proceeding. NRG submitted its written argument on April 13, 2004.

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The full record of the proceeding is available at the Board's offices. While the Board has considered the full record, the Board has chosen to summarize and refer only to those portions that it considered helpful to provide context to its findings.

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NRG's Evidence and Submissions

NRG had in the past brought forth gas commodity cost adjustment requests to the Board when a threshold of \$30 per residential customer had been exceeded. With the changes in the *Ontario Energy Board Act 1998*, S.O. 1998 c.15 Sch B, NRG has been obligated to file for quarterly rate adjustments since October 1, 2003.

NRG is an M9 Bundled Transportation customer of Union Gas. The M9 rate requires NRG to deliver a fixed even daily amount of gas over the course of the year into NRG's Banked Gas Account ("BGA") with Union. The daily amount is equal to the forecasted annual usage divided by 365. During the fall and winter, NRG's demand is normally in excess of the amount supplied into its BGA, and as a result the BGA will be a growing negative figure until the spring, when supply starts to exceed demand. This is known as "drafting" the system. Once supply starts to exceed demand, the negative balance in the BGA falls until the end of September (the end of NRG's fiscal year). At this time, if total demand by NRG exactly equalled the amount supplied by NRG, the balance in the BGA would be zero. NRG is required to balance within 4% of its forecast demand by the end of September of each year. If NRG has used more gas than it has supplied, it must purchase additional gas to bring the deficit within 4%. Any residual balance is carried forward to the next year.

During the winter of 2002/2003, the cold weather caused NRG to draft on Union's system more than it ever had before. At the same time, gas prices commenced a rapid increase. This price increase resulted in an upward gas cost adjustment effective March 1, 2003 and again on May 1, 2003.

At the time of each gas cost adjustment, the closing balance in the PGCVA was determined twelve months forward using the forecasted cost of gas for the following twelve months. The PGCVA was then recalculated using a reference price that would bring the PGCVA balance close to zero by the end of the twelve-month period. The twelve-month period was chosen so that NRG's substantial seasonal customer base would also be sharing in the debits or credits arising from the PGCVA.

However, each time the reference price changed, the PGCVA calculation mechanism excluded certain costs from the amount to be recovered from or rebated to customers. Since the M9 rate did not require a monthly BGA balance, the difference in the reference prices charged to the volume not yet purchased were excluded in the calculation of future costs. As a result, the PGCVA did not operate to keep the utility and customers whole.

Once the problem was identified in October 2003, NRG reviewed prior years' gas costs. The review indicated that from fiscal 1999 to fiscal 2002, the gas commodity charges were in relative balance, despite some significant swings from one year to the next. The net overall balance was attributed to chance, not to any inherent corrective attributes of the PGCVA calculation methodology.

NRG calculated the shortfall from October 1, 2002 to December 2003 at \$531,794 resulting from the PGCVA miscalculation. NRG noted that the inability to recover this amount would have serious implications for the utility, as it would cause debt coverage ratios required by covenants that the utility has with its major lender to fall significantly, may impair the utility's current attempts to

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attract new third party financing in order to replace the current financing from its sole shareholder, and could impair the credit facilities that the utility has with its major gas suppliers, possibly resulting in the need to post credit or prepay for gas supplies.

The utility noted that this problem will not re-occur due to the GPRA mechanism approved by the Board. The GPRA mechanism will record the costs or benefits associated with the change in the value of the gas inventory as a result of changes in the PGCVA reference price.

NRG requested that the PGCVA opening balance as of January 1, 2004 be increased by the amount of \$531,794 and that this amount be recovered prospectively over twelve months starting May 1, 2004. NRG also provided evidence to support the specific rate changes required for May 1, 2004. Included in these rate changes is an amount of \$60,312 associated with the re-evaluation of the December 31, 2003 gas inventory shortfall of 2,017,132 cubic metres.

Board Findings

The main issues to be decided are: (a) Has NRG failed to recover prudently incurred costs - that is, was there a miscalculation? (b) If yes, would recovery of these costs as proposed by NRG place an undue burden on customers and, if the costs are to be recovered, what would be a reasonable recovery method?

Given the evidence provided by NRG, we are satisfied that the PGCVA mechanism, as applied by NRG for the period October 1, 2002 to December 31, 2003, did not fully account for the difference between actual gas costs and the gas costs reflected in rates. While NRG's PGCVA mechanism follows general industry practice, it does not take into account the gas purchasing requirement that arises from NRG's commitments as a Bundled Transportation M9 customer of Union Gas.

We are surprised and disappointed with the time that it took NRG to realize that its PGCVA mechanism was incorrect, which exposed the utility and its customers to unnecessary risk and created a difficult situation for the customers and the Board. However, we accept that the mis-recording was the result of error, not a purposeful action by NRG.

The Board accepts that the mis-recording of gas cost differences amounted to \$531,794 for the period October 1, 2002 to December 31, 2003. The appropriate mechanism to avoid a similar mistake in future has now been put in place through the institution of the GPRA commencing January 1, 2004, in addition to the PGCVA mechanism.

In the course of arriving at fair and reasonable rates based on a future test year rate regime, the Board has allowed the establishment of variance accounts for gas costs for all gas utilities. These accounting mechanisms are indispensable in ensuring that the utility recovers and the customers pay the actual cost of gas, no more and no less. Since the Board has authorized the creation of these variance accounts to capture differences in forecast and actual gas costs, the disposition of the balances in these accounts is a common ratemaking practice. In this sense, it is not retroactive ratemaking, regardless of the method of recovery.

The Board has established principles and methodologies to ensure that the balances in variance accounts are disposed of in a timely manner to maintain the financial integrity of the utility and at the same time avoid sudden or otherwise disturbing rate consequences for customers. Under NRG's trigger mechanism, if the accumulated impact for a typical residential customer exceeds or is anticipated to exceed \$30, the utility must seek a rate adjustment.

Under the trigger mechanism, NRG applied for and received approval to change its rates in March and May 2003 for reasons of increased gas costs. It did so again for October 2003, January 2004 and April 2004 under the legislated QRAM process.

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Had NRG recorded gas cost variances properly in the PGCVA, the present conundrum would have been avoided. Also, the inter-generational inequities inherent in disposing of historic balances through prospective ratemaking would have been minimized.

In light of the above, while we accept that the NRG's customers have underpaid by \$531,794 and the 2003 PGCVA balances have not been finalized by the Board, we find that NRG's error has resulted in a substantial and avoidable accumulation of potential customers' charges, through no fault of the customers.

We must therefore look for a balance.

It would not be reasonable in our view to deny NRG recovery of reasonably incurred gas costs of a magnitude of \$531,794, because of an accounting error. These are legitimate costs incurred prudently on behalf of the customers, and are of material consequence to the utility. For fiscal 2003, for example, they represent 6% of gas sales revenue, 8% of gas costs, 20% of gross margin on gas sales, and 260% of net income. To disallow such costs would have detrimental effects on NRG's financial integrity, and consequently its ability to continue to provide good and reliable service to its customers, especially at a time when it is attempting to enter into arms-length debt financing.

NRG proposed to recover this amount over one year. NRG supported this proposal on the grounds that recovery over a shorter time period would not be equitable to NRG's customers since there is a large degree of seasonality in its customer base. Recovery over a longer time period than one year would increase interest charges and inter-generational inequity arising from recovering previously incurred costs through future customers and future consumption volumes.

We note that the charge to a typical residential customer is approximately \$50. In our view, this unexpected charge is too high to be recovered over one year. It is also our view that customers should not be burdened by any interest charges that would not have accrued had the customers been presented with the appropriate timely billing.

Considering the need for NRG to recover its prudently incurred unrecorded gas costs and mitigating the impact on customers, as well as not creating undue inter-generational inequity, we find that a reasonable balance is recovery of the \$531,794 amount over a three year period, in equal portions, without interest.

We also find that it would be administratively easier if such recovery would not be part of the ongoing QRAM process, but rather be part of the NRG's main rates case proceedings, commencing with the next such proceeding. This finding constitutes the only authorization needed by NRG to bring forward its request for recovery. No additional authorization by way of a deferral account is required.

As for the costs associated with the re-evaluation of the December 31, 2003 gas inventory, NRG is authorized to include such costs as part of its next QRAM application.

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Further, NRG shall not include the regulatory costs it incurred in this proceeding in estimating the regulatory costs for future test years.

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The Board orders that NRG shall pay the Board's incremental costs associated with this proceeding, if any, upon receipt of the Board's invoice.

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DATED at Toronto, April 19, 2004.

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Paul Vlahos
Presiding Member

Arthur Birchenough
Member