ONTARIO ENERGY BOARD

EB-2015-0166
EB-2015-0175

IN THE MATTER OF: The Ontario Energy Board Act, 1998, S.O. 1998, c. 15, Schedule B, and in particular, S. 36 thereof;

IN THE MATTER OF: an application by Union Gas Limited for: Pre-approval of the cost consequences of long-term natural gas transportation contracts with NEXUS Gas Transmission.

IN THE MATTER OF: an application by Enbridge Gas Distribution for: Pre-approval of the cost consequences of long-term natural gas transportation contracts with NEXUS Gas Transmission.

FINAL ARGUMENT
of
ENERGY PROBE RESEARCH FOUNDATION ("Energy Probe")

November 26, 2015

I. SUMMARY OF ENERGY PROBE'S POSITION

- The proposal by Union Gas Limited ("Union") and Enbridge Gas Distribution Inc. ("Enbridge") for the pre-approval of all costs related to long-term transportation contracts on the NEXUS pipeline are reasonable and, largely, beneficial to Ontario ratepayers. The contracts give ratepayers direct access to two of the cheapest and most plentiful natural gas basins in North America – putting them front-and-centre at one of the fastest-growing sources of natural gas on the continent.

- While the pre-approval request does transfer risk from shareholders to ratepayers, it does so as a by-product of current regulatory policy. Neither of the companies is allowed to earn a rate-of-return on gas supply contracts, as commodity costs are passed on directly to ratepayers. Without pre-approval, the companies leave themselves exposed to the risk that regulators will periodically disallow the costs of those contracts, while being unable to earn a return for taking that risk.

- Pre-approval, on the other hand, lets ratepayers enjoy the benefits of large volumes of lower-cost gas from the Marcellus and Utica basins, while also contending with the risk that cheaper sources of gas or transit may become a reality over the life of the contract. The risk-reward for ratepayers is clearer under the pre-approval proposal.

- Denying pre-approval and pushing the companies towards shorter contracts is, itself, a risk for ratepayers. If gas supply sources actually turn out to be more expensive over the next 15 years, then ratepayers will be paying a higher price for gas than they would have had the NEXUS contract received pre-approval. Denying pre-approval doesn't equate to eliminating risk for ratepayers.

- With gas prices having fallen dramatically in recent years, the greater risk appears to be that prices and transit costs will rise in the future. Having gas companies use short-term contracts for all their supply heightens that risk.

- The risk to both companies of signing a long-term contract without pre-approval in the current regulatory and political environment is large. The risk that the province – at any point over the next 15 years – will introduce policies that will have a negative impact on the economics of the natural gas sector and participating companies are real and significant. Pre-approval for the long-term contracts on the NEXUS pipeline allows both Union and Enbridge to mitigate those risks to some degree.

- The owners of a competing pipeline, Rover, have not made a 15-year offer to the gas companies on similar terms to NEXUS, offering an inference that the NEXUS contracts are competitive.

- The Ontario Energy Board's (Board") policy for pre-approval is unclear and open to a wide degree of interpretation. If the current proposal doesn't fall under the Board's pre-approval policy, it's difficult to see when, if ever, the pre-approval process will apply. If the Board does deny the current application, it should reconsider its pre-approval regulation and either, scrap it altogether, or clarify it.

- The Board currently doesn't have a clear policy on what constitutes a "greenfield" project, begging the question on whether the NEXUS project – a portion of which consists of pipelines already in place – is, in fact, a greenfield project. We believe the Board should clarify what constitutes a "greenfield" project or "frontier" gas.

- If it's the sheer size of the contracts – more than $1 billion combined – that is the real driver for pre-approval, then granting that pre-approval may create a foundation of moral hazard, where gas companies only consider very large and expensive projects on the assumption these are more likely to get regulator support. In the process, gas companies may ignore smaller, more economic projects – a number of interveners already believe this to be the case. Bigger, in this case, would always be better from the perspective of the gas companies and their shareholders. The Board should address this risk by clarifying its pre-approval guidelines.

- The relationship between Union and Spectra (Union's parent company) is problematic. If Rover – a competing pipeline is built – and NEXUS is granted pre-approval, the Board will be ensuring that ratepayers fully bear the risk of one pipeline and not the other. Is that equitable? Should the Board not pre-approve contracts for any pipeline and let the market determine which would be the most economic and beneficial? Is Union pushing hard for pre-approval for a contract on NEXUS and not Rover because of its relationship with Spectra? Does this have long-term implications? The Board should clarify whether ownership structures should play any role in pre-approval applications.

- In pre-approval, the Board is allowing the companies, in essence, to hedge their gas supply by locking up a third of their supply (in Union's case, at least) to one basin. Gas companies are currently not allowed to hedge the costs of supply, so this could be considered a shift in policy. The Board may want to clarify whether this is, indeed, the case and, if so, whether it should be allowed.

II. THE PROJECT AND ASSOCIATED TRANSPORTATION CONTRACTS

Union and Enbridge are requesting the Board to pre-approve all costs related to a 15-year contract to purchase capacity on the yet-to-be-built NEXUS natural gas pipeline. In Union's case, the cost of the contract is $715 million, while for Enbridge the cost is $420 million. The total capital cost of the NEXUS pipeline is estimated to be $2.019 billion.

The proposed NEXUS pipeline consists of a greenfield pipeline that will run for about 250 miles (400 kilometers) from Kensington, Ohio to a pipeline at Willow Run, Michigan. Union has signed a Precedent Agreement (PA) for the delivery of 150,000 dekatherms (Dth) per day of gas over the 15-year contract, while Enbridge has agreed to 110,000 Dth per day with the option to increase that volume to 150,000 Dth per day. Once at Willow Run, the two companies will take different paths on existing pipelines to move the gas into Ontario through the Dawn trading hub.

The negotiated rate for Union is between $0.67 US/Dth and $0.87 US/Dth18 (plus fuel), while the toll for Enbridge is $0.70 US/Dth per day (plus fuel), with $0.65 of that toll related to the greenfield portion of NEXUS and subject to capital cost adjustment of +/- 15%.

III. IS PRE-APPROVAL NECESSARY?

Both Union and Enbridge argue that pre-approval is necessary for them to move forward with their PAs to ship gas on the NEXUS pipeline.

From Union:

> MR. ISHERWOOD: $700 million dollars is a significant amount of money, so it is a business decision really. It is a risk we would have if it is not pre-approved, and we're not comfortable with taking that risk.[1]

From Enbridge:

> MS. ALEXANDER: But I just want to be clear that, you know, the shareholders would not approve you proceeding with the project if there were no benefits to Enbridge?
>
> MR. LeBLANC: I think that's maybe almost precisely why we're here. We're looking for pre-approval, because the shareholder is not willing to take the risk of the costs without some indicator that the Board is going to approve the costs. And so pre-approval would allow us to move forward. Otherwise we would not – I think we've been clear on that.[2]

While the companies may decide to move ahead with the project even if pre-approval isn't granted, we believe that both companies would strongly favour backing away from the project rather than having their decision to move ahead questioned repeatedly over the next 15 years, particularly in light of the significant changes taking place in the natural gas sector.

[1] Oral Hearing Transcript, Volume 1, page 70
[2] Oral Hearing Transcript, Volume 2, Page 178

Furthermore, the applicants have repeatedly said they are unsure whether the NEXUS pipeline will even be built without those PAs – signalling that the companies proposing the pipeline won't move ahead unless they have 100% guarantee there is long-term demand for the new gas.

> MR. ISHERWOOD: …If Union and Enbridge don't get pre-approval and we don't contract on NEXUS, I think it does put NEXUS at risk…and I think the same risk of being producer only project on NEXUS would apply to Rover as well.[3]

The risk that NEXUS won't get built without pre-approval is real, but far from a certainty. The companies have repeatedly highlighted the benefits of the project and the strong demand for shale gas in Ontario. The two companies building the pipeline – Spectra and DTE – are certainly well aware of these benefits and so could move ahead regardless. Furthermore, other pipelines, such as Rover, appear to be moving ahead without pre-approval contracts.

Both companies also maintain that they don't benefit from gas supply, as they simply pass this cost on to ratepayers at cost. Therefore, the companies argue, they should receive pre-approval from the Board to mitigate any future risk that the Board or other regulatory policies will leave them with stranded costs related to the proposed contracts.

> MR. ISHERWOOD: I think the other point to consider though, Mr. Millar, is really a fact when we buy gas supply, we don't have a mark-up on gas supply. We don't make money selling gas. We make money by moving gas through our facilities.
>
> MR. MILLAR: You don't make money or your O&M costs either, but those are still subject to review.
>
> MR. ISHERWOOD: They are subject to prudence review, absolutely. So the fact we would be exposed to any cost disallowance when we don't make money on gas supply is something we can't expose ourselves to.[4]

And again:

> MR. RUBENSTEIN: And am I correct that you're compensated for risks that a utility takes through a return on equity?
>
> MR. ISHERWOOD: Not gas supply, no.
>
> MR. RUBENSTEIN: So is it your view that has supply --you're not compensated at all for any risk on gas supply?

[3] Oral Hearing Transcript, Volume 2 page 6
[4] Oral Hearing Transcript, Volume 1, page 71

MR. ISHERWOOD: Yes.[5]

From Enbridge:

MS. ALEXANDER: And I believe that you noted that Enbridge Gas Distribution doesn't have any benefits from the project? Is that correct? Or...

MR. LeBLANC: Yes, gas supply is passed on to ratepayers with no mark-up or no benefit for the utility.[6]

This remains the strongest argument in favour of pre-approval. Neither of the companies fully and directly benefit from these supply contracts, as the benefits of cheap gas that the contracts are intended to facilitate will be passed fully on to ratepayers. Is there a risk that those benefits are overstated? Certainly. But, just as pertinent, isn't there a risk that by not moving ahead with the contracts that ratepayers will be left paying a higher price for gas sometime in the future? Certainly. In this case, the pre-approval process attempts to better align the risk-reward of a long-term gas supply contract.

IV. SHOULD NEXUS EVEN QUALIFY FOR PRE-APPROVAL?

A central issue is whether this project qualifies for pre-approval at all.

According to the Board, the pre-approval "of the cost consequences of long-term contracts should be limited to those that support the development of new natural gas infrastructure."[7] Furthermore, the Board has said that "…no substantive issues were raised and stakeholders generally agreed to a pre-approval process for long-term contracts that support the development of new natural-gas infrastructure (e.g., new pipeline facilities to access new natural-gas supply sources such as LNG plants and frontier production)".[8]

The companies argued that the term frontier gas is so vague that they're "not sure what frontier gas is"[9] and that the Utica and Marcellus shale deposits are "as frontier as you're probably ever going to see coming to Ontario, unless they discover gas, say, in the middle of Algonquin Park and they build a pipe from there."[10]

In cross examination, it became clear that even Board staff was unclear about the policy of pre-approval and what constitutes a greenfield project (a % of the overall project, for example?) or when a gas basin is considered frontier.

[5] Oral Hearing Transcript, Volume 1, page 77
[6] Oral Hearing Transcript, Volume 2, page 178
[7] Filing Guidelines for the Pre-Approval of Long-Term Natural Gas Supply and/or Upstream Transportation Contracts, page 3
[8] Filing Guidelines for the Pre-Approval of Long-Term Natural Gas Supply and/or Upstream Transportation Contracts, page 2
[9] Oral Hearing Transcript, Volume 1, page 24
[10] Oral Hearing Transcript, Volume 2, page 160

It’s evident that the Marcellus and Utica basins are still developing, particularly in the case of Utica. Compared to other natural gas basins that have been around for decades, it’s entirely reasonable that the Marcellus and Utica basins be viewed as “new” resources. The term “frontier” is so vague that it’s essentially meaningless and, if it used in future applications, should be further explained. As it currently stands, it doesn’t clarify the pre-approval process.

Ultimately, we believe the companies have offered a compelling case that the pre-approval contracts being considered do bring a large volume of gas from natural gas basins that are, relative to other basins, new to the North American market. But the Board may want to consider whether pre-approval should apply only to contracts that bring a certain volume of gas (over 100,000 Dth per day, for example) or connect to a basin that has been in production for a certain period of time (less than a decade, for example).

V. CONCLUSION

Energy Probe largely supports the request from Union and Enbridge for pre-approval for the cost consequences related to supply contracts on the yet-to-built NEXUS pipeline. While we agree with the arguments that pre-approval is a transfer of risk from shareholders to ratepayers, we also believe that ratepayers have an opportunity to benefit significantly from this project and so that transfer of risk is reasonable and appropriate under current regulatory policies.

As was mentioned repeatedly throughout the proceedings, the Marcellus and Utica gas basins will continue to be significant and growing sources of cheap natural gas for decades to come – barring any regulatory changes around the production of shale deposits. Ontario ratepayers will rightfully benefit from having direct access to those basins.

The NEXUS project gives ratepayers access to those basins at, for the most part, a competitive price. And while some participants in the proceeding believe that the companies could access those basins through short-term contracts on other routes at an even lower costs, those options are, themselves, a risk for ratepayers.

Over the next 15 years, if the companies were to source their gas on yet-to-built-out hubs (Algonquin) or on existing trading points (Niagara), there is no guarantee that those prices will be lower than what is being offered on the NEXUS pipeline. They may be, but that is not a certainty. Furthermore, gas prices have fallen significantly in recent years, offering ratepayers an opportunity to lock in a portion of that discount for a long period of time, while using remaining percentages of their portfolios to take advantage of any short-term price movements.

The Board repeatedly heard talk about the “transfer of risk” as it relates to pre-approval. We believe the Board should also acknowledge that by denying pre-approval, it will also transfer risk to ratepayers, not eliminate it.

The risk to ratepayers if pre-approval is denied is that spot or short-term gas prices at those trading hubs will remain higher than prices at the basin, which are currently lower. The cost to ratepayers of that higher price then becomes the risk that has been transferred to ratepayers if the Board were to deny pre-approval. But if pre-approval is granted and gas prices at the trading hub do move or remain higher than at the basin, then ratepayers are protected from that shift.

Additionally, if pre-approval is not granted and the NEXUS pipeline gets built, is there not the risk that the tolls on the pipeline will be significantly higher over the next 15 years? And, if that is the case, isn’t that equivalent to transferring all of the risk to ratepayers and away from shareholders?

Even if gas prices move lower, the NEXUS contract is only a percentage of the overall portfolio of the two companies – one-third in the case of Union and less than that for Enbridge. The companies will have ample opportunity over the 15-years to take further advantage of arbitrage opportunities and falling natural gas transportation or spot prices, should they occur. Under this situation, risk to ratepayers has been mitigated – one of the main points in the pre-approval guidelines.

As was pointed out above, asking the companies’ shareholders to bear the risk of gas supply contracts when they can’t benefit directly from those contracts is unreasonable.

Furthermore, it seems to Energy Probe that any of the investors behind the Rover pipeline could have – at any point in the last few years – approached Union or Enbridge with a better deal than that being offered by on NEXUS. As far as we know, such an offer was never tabled, leading us to infer that the rates being offered to both companies are competitive. If they weren’t, we would expect one of either Union or Enbridge to approach Rover or vice versa to sort out another, more favourable deal. Under this premise, the current contract is a competitive one.

Both gas companies also face significant risk as it relates to the regulatory environment. The province’s push to implement a cap and trade program is the most obvious risk as it pertains to the natural gas sector. Even if the benefits of a long-term contract were a certainty, the regulatory risk to the companies could, at any moment, offset those benefits. Under such a regulatory environment, asking the gas companies to take any risk as it relates to new supply without also offering them some certainty seems inequitable.

Our argument in favour in the project does come with some areas of concern. The Board should consider clarifying what consists of a “greenfield” pipeline or “frontier” gas. Both of those concepts were repeatedly raised throughout the proceedings, with none of the companies, interveners or Board staff clear on what, exactly, they mean. While we agree that the Marcellus and Utica basins are “new” – particularly if one considers the date in which the project first came to fruition – and the pipeline is largely a greenfield one, we recognize the lack of clarity surrounding this issue.

The Board should also consider whether pre-approval is prudent when one of the companies is owned or has a relationship with the company building the pipeline. Is the relationship between Union and Spectra problematic and should it affect the pre-approval application? We believe that the Board might want to consider this situation and clarify the rules for pre-approval going forward.

And finally, we understand that, in essence, the gas companies are using the pre-approval process to hedge their future purchases of gas – making a strategic bet that the gas from the Marcellus and Utica basins, when bought in the basin, will be cheaper or as competitive as buying it at any of the hubs surrounding Ontario. While the cost of gas purchased in the basin will be passed directly onto ratepayers – and so is not a direct hedge – the fact that the companies have agreed to purchase a certain amount for the next 15 years means they are making a long-term bet on shale gas from this basin. We believe that is a reasonable decision, considering the potential benefits, but also recognize that it may go against the policy of not hedging gas purchases.

V1. COSTS

Energy Probe requests that it be awarded 100% of its reasonably incurred costs associated with its participation in this proceeding.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

November 26, 2015

Energy Probe Research Foundation