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BY E-MAIL

June 16, 2017

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

Dear Ms. Walli:

RE: OEB STAFF SUBMISSION
APPLICATION BY NATURAL RESOURCE GAS LIMITED
EB-2016-0351

In accordance with the OEB's directions, please find attached OEB staff's submission with respect to the above referenced application.

Yours truly,

Original Signed by

Judith Fernandes
Project Advisor
Applications Division

Attachment

cc: All Parties to the Proceeding

ONTARIO ENERGY BOARD

OEB Staff Submission

EB-2016-0351

June 16, 2017

1 INTRODUCTION

Natural Resource Gas Limited (NRG) has entered into an Asset Purchase Agreement (APA) with EPCOR Natural Gas Limited Partnership (EPCOR) whereby NRG has agreed to sell and EPCOR has agreed to purchase NRG's natural gas distribution system in its entirety.

To effect this agreement, NRG filed an application with the Ontario Energy Board (OEB) on December 1, 2016, amended on January 25, 2017, seeking the following relief from the OEB:

- Approval to sell its natural gas distribution system to EPCOR under section 43(1)(a) of the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B) (the Act)
- Transfer of NRG's existing franchise agreements, certificates of public convenience and necessity, and rate orders under section 18 of the Act

2 REGULATORY PRINCIPLES

In its assessment of applications relating to electricity distributor and transmitter consolidation transactions, the OEB has applied the no harm test. The OEB considers whether the no harm test is satisfied based on an assessment of the cumulative effect of the proposed transaction on the attainment of its statutory objectives in its regulation of Ontario's electricity sector. If the proposed transaction has a positive or neutral effect on the attainment of these objectives, the OEB will approve the application.[1]

In the application filed by NRG, the grounds for relief are framed on the assumption that the no harm test will be applied, with assertions made by the applicant that NRG's customers will not be adversely affected by the proposed sale transaction.

In its August 31, 2005 Decision in the Combined Proceeding, which was convened for the purpose of addressing common issues that "largely relate to the scope of the issues that the Board will consider in determining applications under section 86 of the Act", the OEB established that the no harm test is the appropriate test for section 86 applications.[2] Since then, this test has been consistently applied by the OEB in its assessment of electricity consolidation applications.

The test to be applied by the OEB in its assessment of natural gas-related consolidation transactions is not as clearly defined. While OEB staff considers that it is not inappropriate to apply the no harm test to the specific circumstances of this case, this is not meant to imply that the no harm test should be applied to future applications made to the OEB for the approval of gas-related consolidation transactions.

The OEB's statutory objectives in relation to its regulation of the natural gas industry are set out in section 2 of the Act, and replicated below:

1 To facilitate competition in the sale of gas to users.

[1] Handbook to Electricity Distributor and Transmitter Consolidations, p.4
[2] Combined Proceeding Decision – OEB File No. RP-2005-0018/EB-2005-0234/-0254/-0257, pp.2,6

2 To protect the interests of consumers with respect to prices and the reliability and quality of gas service.

3 To facilitate rational expansion of transmission and distribution systems.

4 To facilitate rational development and safe operation of gas storage.

5 To promote energy conservation and energy efficiency in accordance with the policies of the Government of Ontario, including having regard to the consumer's economic circumstances.

5.1 To facilitate the maintenance of a financially viable gas industry for the transmission, distribution and storage of gas.

6 To promote communication within the gas industry and the education of consumers.

OEB staff's submissions are set out in relation to the impact of the proposed transaction with respect to Objectives 2 and 5.1 (considering price, service quality, reliability, and financial viability) that are of principal relevance to this application. In OEB staff's view, it is unclear how the other objectives could be considered in the context of the proposed transaction.

3 SUBMISSIONS

3.1 Impact on the OEB's statutory objectives

Price

The applicant submits that the proposed transaction will not cause consumer prices to increase.

Cost to serve

The evidence states that based on EPCOR's underlying cost structure, the costs to serve NRG's customers post transaction are not expected to be higher than they otherwise would have been with NRG. OEB staff sought confirmation of this assertion, requesting a comparison of the costs to serve customers by NRG versus the anticipated costs to serve customers by EPCOR. The applicant's response is that EPCOR is unable to provide a detailed breakdown of future costs to serve customers in advance of finalizing an amended rate application to enable such a comparison of costs.

NRG filed a rate application (EB-2016-0236) in August 2016. At NRG's request, the OEB placed the rate application in abeyance until a determination is made on this application concerning the proposed sale of the gas distribution business by NRG to EPCOR. EPCOR is expected to file an amended rate application within six to nine months of the closing of the proposed transaction. The applicant states that based on EPCOR's review of NRG's rate application, it is expected that individual cost categories may be impacted but that the total revenue requirement will be in line with that presented in NRG's rate application.[3]

OEB staff submits that the OEB can accept the assertions of the applicant that costs will not be higher than would be the case if the transaction had not occurred on the basis that costs will be fully reviewed in the amended rate application to be filed by EPCOR. The OEB's detailed review of costs in the amended rate application provides sufficient protection of consumers' interests with respect to price as the OEB can disallow the

[3] OEB Staff Interrogatory No. 1

recovery of costs if any costs are found not to be reasonable. OEB staff further submits that the OEB indicate in its decision on this application that EPCOR may be expected to provide an explanation for any increased costs in individual cost categories in the amended rate application.

NRG also states that EPCOR does anticipate achieving some modest cost efficiencies, although not quantifiable at this time, from the use of affiliate services. These affiliate services would take advantage of economies of scale and scope not available to NRG given its smaller size as compared to EPCOR Utilities Inc. (EUI), EPCOR's parent company. It is also anticipated that EPCOR may be able to leverage the existing supplier relationships of EUI to reduce items such as insurance and future capital project costs.

OEB staff notes that the applicant has presented anticipated directional changes in certain cost categories – regulatory, legal, consulting – suggesting longer term cost efficiencies which would benefit customers.[4]

Supply from NRG Corp.

The application states that gas production wells owned by NRG Corp. (a related company to NRG) provide enhanced supply reliability on NRG's distribution system. The APA requires NRG Corp. to negotiate in good faith to conclude a gas purchase agreement (GPA) for supply from the wells with EPCOR, which must be executed by the closing of the proposed sale transaction.

In previous NRG rate applications, the cost and quantity of NRG Corp. gas purchases have been of interest to parties and the OEB. The OEB required NRG in its decision on NRG's rate application (EB-2010-0018) to conduct an independent system integrity study to address certain system integrity issues within its franchise area that require NRG to purchase gas from NRG Corp. This study has been filed as part of NRG's current rate application that has been placed in abeyance pending the determination of this application.

[4] OEB Staff Interrogatory No. 2

Several interrogatories were filed in this proceeding by OEB staff and the Vulnerable Energy Consumers Coalition seeking further information on the NRG Corp. gas supply, including the cost of this gas supply, the long term plan for this supply arrangement, whether or not other local gas suppliers have been approached to replace or reduce NRG Corp. sourced gas, whether the APA is contingent upon purchase of gas from NRG Corp., and the terms and conditions of the GPA.

Responses to interrogatories confirm that the APA is contingent upon the GPA being concluded. The responses also indicate that the term of the GPA is from completion of the proposed sale transaction until September 30, 2020, and is extendable upon agreement by the parties.[5]

With respect to the cost of the supply from NRG Corp., the applicant states that it purchases gas at a fixed price above the current market rate for natural gas and that this was approved by the OEB in the EB-2010-0018 decision. In its response to interrogatories, the applicant states that the terms of the GPA sets out that the price for the first 35,314 cubic metres is $8.496/cubic meter and the Union Dawn reference price applies thereafter.[6] These prices are incorporated into the commodity cost as part of NRG's Quarterly Rate Adjustment Mechanism application and remains subject to OEB approval.

The applicant submits that the independent study concluded that while sufficient natural gas supply exists within NRG's franchise area from local natural gas producers other than NRG Corp. that could meet NRG' system integrity needs, the supplies are owned by two producers who were not incented to enter into an arrangement to supply natural gas to NRG. The applicant further submits that evidence filed in its now suspended rate application, demonstrates that one of those producers, Tribute Resources Inc., failed to respond when approached by NRG regarding such an arrangement.

The applicant states that, therefore, EPCOR is entering into the GPA with NRG Corp. with the purpose of ensuring continuity of supply as required for system integrity. The applicant indicates that EPCOR plans to undertake further review of the system, as well as the

[5] OEB Staff Interrogatory No. 4 and VECC Interrogatory No. 5
[6] OEB Staff Interrogatory No. 4

findings and recommendations of the system integrity study, to develop a comprehensive system integrity plan.

OEB staff submits that the GPA condition requiring EPCOR to purchase gas from NRG Corp. until 2020 is of concern for two reasons.

First, this agreement presumes that the premium paid for this supply will continue to be recovered from customers. OEB staff observes that subsection 36(1) of the Act provides that:

> **Order of Board required**
>
> 36(1) No gas transmitter, gas distributor or storage company shall sell gas or charge for the transmission, distribution or storage of gas except in accordance with an order of the Board, **which is not bound by the terms of any contract**. [emphasis added]

In OEB staff's view, the OEB permitted NRG to purchase gas from NRG Corp. at a premium as a short-term measure. The OEB's EB-2010-0018 Decision and Order states:

> *The Board considers this to be a unique situation and it is difficult to determine at this point in time whether a cost effective alternative exists. The Board also notes that NRG's proposal of $8.486 per mcf is fairly high considering that current gas prices are under $5.00 per mcf and not expected to fluctuate significantly in the short term. However, considering the unique circumstances of this issue the Board will allow NRG on a temporary basis to pay NRG Corp. a price of $6.80 per mcf or market price, whichever is higher, for gas required to maintain system integrity.*[7]

Second, the length of the term of the GPA does not appear to allow EPCOR to explore other supply options and look for a long-term cost-effective solution to the system integrity gas supply matter until at least 2020. OEB staff notes that Tribute Resources Inc.'s submission indicates that it has extensive pipelines in the area, including a high-pressure pipeline connected to a 700 psi Union Gas mainline, and that it can provide additional system supply capacity to the NRG gas distribution system. OEB staff submits that the

[7] OEB Decision and Order (EB-2010-0018), p.21

OEB will have an opportunity to consider the appropriate rate for system integrity gas supply after a detailed review of the costs of the NRG Corp. supply is undertaken and having assessed the costs of other supply options.

OEB staff submits that the OEB is expected to undertake a detailed examination of the costs of the NRG Corp. gas supply in the rate application to be filed by EPCOR and notes that it is possible the OEB may not allow EPCOR to recover the premium paid to NRG Corp. through interim rates.

Service Quality and Reliability

The application states that service quality and reliability will be maintained.

NRG provides the following evidence in support of these assertions. The applicant submits that EPCOR will be bound by all current and future regulatory requirements of the OEB (e.g. reporting obligations, gas distribution access, affiliate relations, etc.). EPCOR will also operate the distribution system in accordance with regulatory standards, such as Technical Standards and Safety Authority requirements regarding fuel safety, and Measurement Canada obligations regarding metering.

NRG was asked to describe EUI or EPCOR's experience in natural gas distribution. In its response, the applicant states that EUI and EPCOR do not presently own natural gas distribution operations. However, EUI has employees with experience in natural gas distribution utilities in the areas of health and safety, regulatory, communications, engineering, planning and capital project management and EPCOR is in the process of recruiting an independent board member that will have experience in natural gas distribution.[8]

NRG indicates that its general manager as well as the operations and administrative personnel have accepted offers of employment from EPCOR which ensures the retention of the knowledge of NRG's operations and distribution system and will enable continuity of

[8] OEB Staff Interrogatory No. 15

service for customers. These employees bring extensive natural gas experience to EPCOR, including the general manager with over 17 years of experience in the business, and seven other employees who each have more than 20 years of experience in the natural gas business.

The application states that EUI and its subsidiaries have extensive experience in utility businesses that provide essential public services. The application provides examples of its businesses which have consistently met or exceeded service quality metrics in the areas they serve.[9] The applicant's interrogatory response indicates that many of EUI's programs that currently support its electric transmission and distribution systems, and water and wastewater treatment and distribution/collection systems, can be directly applied to natural gas distribution. These include programs relating to capital construction and asset management, health and safety management, stakeholder consultation, and regulatory compliance.[10]

In its application, NRG indicates that it holds a number of contracts with Union for the transportation, delivery and sale of natural gas to NRG's system that are not assignable without the prior written consent of Union. NRG indicates that it was seeking consent from Union to assign these contracts on the same contractual parameters. When asked whether any impediments have been encountered with respect to the required consents, the applicant confirms that no substantial impediments have been encountered to date and that there is no indication that consents will not be granted.[11] OEB staff requests that NRG provide an update on the status of these consents in its reply submission.

OEB staff submits that based on the evidence, it appears that EPCOR will have the capabilities in place to ensure that service quality and reliability are maintained through the resources and expertise available from EUI and NRG personnel. OEB staff also notes that all rate regulated gas utilities are required to maintain and file information under the OEB's *Reporting and Record Keeping Requirements* which encompasses information on financial statements, service quality, and compliance with the *Affiliate Relationships Code for Gas*

[9] NRG Application –Exh1/Tab1/Sch.4/p.2
[10] OEB Staff Interrogatory No. 15
[11] VECC Interrogatory No. 8

Utilities, among other things.

OEB staff suggests that the OEB require EPCOR to further review the independent system integrity study that was undertaken and to file a comprehensive system integrity plan with the OEB regarding long term system integrity gas supply and addressing access to the gas distribution system by other producers in conjunction with the filing of its rate application.

Financial Viability

According to the application, NRG has agreed to sell, and EPCOR has agreed to purchase, NRG's natural gas distribution system in its entirety for $21 million, exclusive of taxes, and subject to the adjustments provided for in the APA. The estimated net book value of the purchased assets is $14.6 million. The applicant states that EPCOR has the financial capacity necessary to fund the purchase price, and that the amount of consideration paid will not have a material impact on EUI's financial position. The applicant also states that EPCOR will not seek to increase its future revenue requirement recovered from customers in order to recover these transaction costs. The purchase price represents an amount that is less than 0.5% of EUI's total assets.

When asked what financial capacity EPCOR has to fund the purchase transaction and any future capital projects on its own, and without EUI, NRG states that EPCOR was formed for the purpose of owning and operating the NRG utility and that EUI has committed to fund the purchase price.[12]

With respect to future capital requirements, NRG indicates that EPCOR will have financial capacity both through the revenue earned via distribution rates paid by customers and through access to funding from EUI as an indirect wholly owned subsidiary. The applicant states that EUI provides funding support to its subsidiaries on an ongoing basis through an annual capital budgeting process and ongoing capital management. The applicant submits that EUI has confirmed that it will provide funding for future capital projects that

[12] OEB Staff Interrogatory No. 5

have been approved by the OEB.

The applicant states that EUI's consolidated revenues and other income for 2016 was $1.9 billion with $379 million in operating income and $412 million in funds from operations. The requirement to fund future capital projects for the system will not impact the financial viability of EUI. NRG provided a comparison of various financial ratios (liquidity, leverage and profitability) between EUI and NRG which lends support to the applicant's assertions that the proposed transaction allows a new entrant with strong financial capacity to participate in the Ontario natural gas distribution industry.

OEB staff notes that in its assessment of financial viability, the OEB examines the financial capacity of the acquiring utility. In this case, the applicant acknowledges that EPCOR, at the time of NRG making this application, is relying on EUI's financial capacity. OEB staff agrees that the proposed transaction permits a new entrant, with the support of a parent company possessing strong financial capacity, to participate in the Ontario natural gas distribution industry. However, assuming the transaction is approved, OEB staff notes that, unlike EPCOR which will be regulated by the OEB, EUI is not regulated by the OEB.

At the time NRG filed its application, the OEB requested that a financial guarantee from EUI be provided to demonstrate its responsibility for the financial viability of the acquired entity. However, EUI has not provided a financial guarantee. OEB staff notes that the OEB has required a parental guarantee to be provided in licensing new entrants to the Ontario gas and/or electricity market, where a parent company assumes the responsibility for the financial viability of the new entrant or newly formed company that is to participate in Ontario's gas and/or electricity market. OEB staff suggests that the OEB consider requiring that a parental guarantee or some other assurance or undertaking be provided by EUI for at least some time until EPCOR is fully operational.

OEB staff also submits that the OEB clarify that the premium paid by EPCOR for the proposed acquisition, all incremental costs incurred relating to completion of the proposed sale transaction, and costs associated with the necessary regulatory approvals cannot be recovered through future distribution rates.

3.2 Transfer of Existing Regulatory Approvals

Franchise Agreements

NRG has listed in its application several existing franchise agreements, approved by the OEB, that permit it to operate its gas distribution business.[13] NRG is requesting that these agreements be transferred to EPCOR.

In its application, NRG indicates that it is in the process of renewing its franchise agreement with Oxford County. In response to questions on the status of this franchise agreement renewal, the applicant states that it believes it has reached an agreement with Oxford County and that a recommendation was to be made to Oxford County Council to execute the negotiated franchise agreement. NRG states that if the recommendation does not take place by the May 24th meeting of the Council, it will file an application with the OEB to approve a franchise agreement with Oxford County. On June 12, 2017, NRG filed an application requesting approval of a proposed franchise agreement between NRG and Oxford County.

OEB staff supports the transfer of the existing OEB-approved franchise agreements from NRG to EPCOR. OEB staff submits that the franchise agreement between NRG and Oxford County requires the OEB's approval before this agreement can be transferred to EPCOR.

Certificates of Public Convenience and Necessity

NRG holds a number of certificates of public convenience and necessity, approved by the OEB that are required to construct any works to supply natural gas in a municipality.[14] NRG requests that these certificates be transferred to EPCOR to enable EPCOR to properly carry on the gas distribution business.

[13] NRG Application – Exh1/Tab1/Sch.5/p.1
[14] NRG Application – Exh 1/Tab 1/Sch. 1/p.2

OEB staff supports the applicant’s request for the transfer of all NRG certificates to EPCOR, with the exception of the certificate granting NRG the right to construct works to supply gas and to supply gas in Oxford County (E.B.C. 111 and 119, issued May 5, 1982). OEB staff submits that this certificate forms part of the proposed franchise agreement between NRG and Oxford County discussed above.

Rate Orders

In its application, NRG advises that it is subject to the following OEB rate orders:

- Decision and Order in OEB File No. EB-2015-0115 (2016 IRM rate adjustment, which established NRG’s current distribution rates, made interim via Procedural Order No. 1 in EB-2016-0236 dated September 28, 2016)
- Decision and Order in OEB File No. EB-2016-0266 (order approving quarterly rate adjustment for the period October 1 to December 31, 2016, which reflects NRG’s current commodity rates)
- Decision and Order in OEB File No. EB-2016-0330 (interim order approving NRG’s proposed rates to recover the cost consequences of its Cap and Trade Compliance Plan effective January 1, 2017).

OEB staff supports the transfer of the rate orders arising out of the Decisions and Orders outlined above.

OEB staff notes that the rates approved for NRG as part of the OEB’s Decision and Order in EB-2016-0266 have been superseded by rates approved on an interim basis in the OEB’s Decision and Order in EB-2017-0110 for the period April 1, 2017 to June 30, 2017.

NRG is expected to file its next quarterly rate adjustment application for the period July 1, 2017 to September 30, 2017 shortly. OEB staff submits that it is more appropriate for the OEB to transfer to EPCOR the most recently approved OEB decision and order relating to the quarterly rate adjustment at the time the OEB makes its decision on this application.

3.3 Other Matters

Tracking of Deferral and Variance Accounts

NRG currently has six deferral and variance accounts as indicated in NRG's EB-2016-0236 rate application.[15] NRG has not made any requests or submissions relating to the future tracking of balances in these accounts in this application.

OEB staff notes that EPCOR is assuming these accounts as part of the proposed purchase of NRG. OEB staff submits that EPCOR should continue to track these accounts as the regulated circumstances that established the need for these accounts have not changed. OEB staff notes that although no requests or submissions have been made by NRG, requests to track balances in the deferral and variance accounts of acquired utilities have been made as part of other previous acquisition applications and have been granted by the OEB.[16]

Accounting Standard

NRG uses the Canadian Accounting Standards for Private Enterprises (ASPE) for regulatory accounting purposes. NRG states that if the proposed sale transaction with EPCOR is approved, it plans to follow Modified International Financial Reporting Standards (MIFRS) for regulatory accounting purposes.[17]

EPCOR does not currently have audited financial statements as it was formed for the

[15] NRG Rate Application - Exh 5/ Tab 1/ Sch.1
[16] LDC Co. (EB-2016-0025), Hydro One and Haldimand County Hydro Inc. (EB-2014-0244), Hydro One and Woodstock Hydro Services Inc. (EB-2014-0213)
[17] OEB Staff Interrogatory No. 9

purpose of owning and operating NRG.[18] EPCOR may wish to confirm in its reply submission that it plans on using IFRS for external reporting. If this is the case, OEB staff has no concerns with the proposed change in accounting standard. OEB staff also notes that the majority of regulated utilities use MIFRS and only a limited number use another accounting standard such as ASPE or USGAAP. EPCOR's use of MIFRS will allow for greater consistency and comparability in the regulated environment.

The application indicates that EPCOR will file an amended rate application within six to nine months of the closing of the APA. OEB staff submits that the amended rate application should be filed under MIFRS and any transitional impact to revenue requirement and rates be identified and discussed in that application.

[18] OEB Staff Interrogatory No.5

4 CONCLUSION

OEB staff submits that the approvals requested to effect the sale transaction should be granted, with the exceptions noted earlier relating to the regulatory approvals required for Oxford County. OEB staff recommends that the OEB set out its expectations regarding information that it may require relating to the long term system integrity plan and advise NRG and EPCOR that it will consider all costs (including the system integrity gas supply costs), of serving customers in the acquired franchise areas when EPCOR's amended rate application is filed with the OEB.

All of which is respectfully submitted.