Direct Energy

October 15, 2008

Via E-Mail

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

Re: Guidelines for the Pre-approval of Long-Term Gas Supply and/or Upstream Transportation Contracts ("LTC Guidelines"), Board file No.: EB-20080280

Dear Ms. Walli

Direct Energy (DE) welcomes the Ontario Energy Board's (OEB) decision to invite stakeholder input regarding guidelines for the Pre-Approval of Long-Term Gas Supply and Upstream Transportation Contracts (LTC). DE would also like to thank the OEB for the opportunity to participate in the stakeholder conference hosted on October 15, 2008 at Board offices. As a follow-up to this productive session, DE would like to submit our speaking notes as part of the consultation process.

Please find attached the speaking notes of DE participants from the Marketer session of the LTC Consultation held on October 15th, 2008.

Yours faithfully

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Government & Regulatory Affairs
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Direct Energy's Comments on Long-term Contracting Practices

DE believes that a fair, efficient and openly competitive market is the most desirable outcome for consumers and all market participants. Along with the LTC consultative, DE believes the QRAM and STAR consultatives are all interconnected in supporting the enablement of a truly competitive market place. As such, our responses to the LTC questions posed by Board staff are shaped by our view of ideal market conditions pertaining to supply, pricing, transportation, storage, and distribution.

DE has advocated that any Default Supply Provider (DSP) be treated as any other energy retail provider. The DSP should calculate a default price that is reflective of real, short-term market prices allowing consumers to make informed provider and consumption choices. All costs incurred by the DSP, including a reasonable rate of return, should be included in the default rate. We also believe that utility supply, transportation, and storage transactions should be reported in a transparent and understandable fashion.

When specifically looking at long term contracting practices there should be a segregation of the various wholesale supply components.

A. Physical supply and commodity price:

DE believes that for physical supply, long term contracting is not required.

B. Transportation on existing infrastructure, transportation on new construction, peak day/storage need:

In relation to transportation services, DE believes it is necessary to segregate contracting terms based on whether the infrastructure being contracted for already exists, or if new build is required for surety of supply. For existing infrastructure DE is of the opinion that given there is excess capacity on the current major pipelines, coupled with the one year renewal Right of First Refusal rights on contracts about to expire, that LTC for existing infrastructure is not required. With respect to new build, DE would not oppose long term contracting. Should a utility deem a long term contract in the best interest of customers and stakeholders, a separate application should be made to justify the costs and benefits, and the OEB should either approve or deny the contract on the merits presented, prior to execution of such a contract.

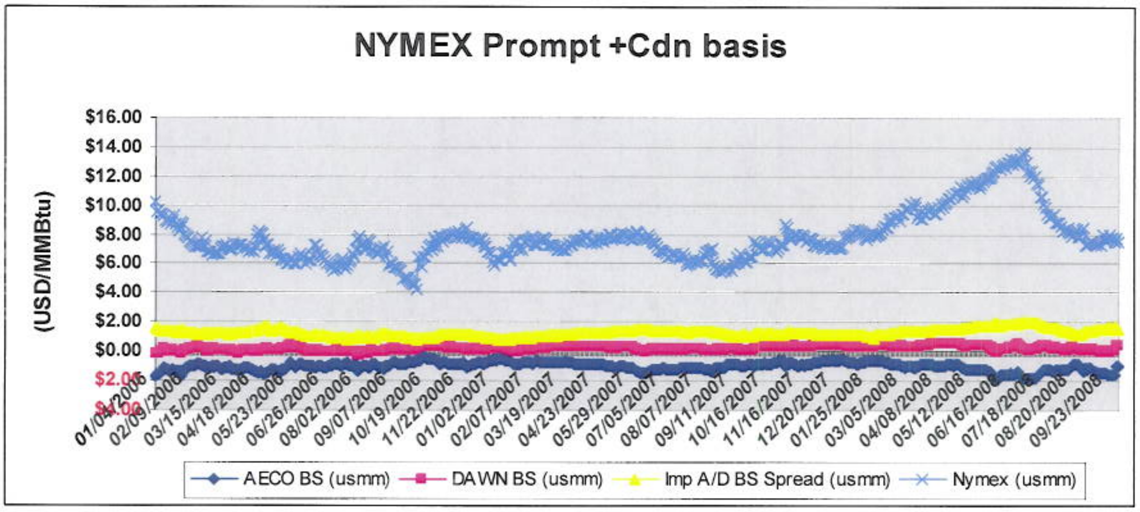
In no case does DE support the pre-approval of Long Term Contracting for either physical supply or transportation and storage.

Supply/Price Overview

When determining the components of an ideal market structure it is important to define what the regulated rate is and equally important to outline what the regulated rate is not.

DE believes that the clear and understandable delineation of alternative pricing schemes for customers is fundamental to the evolution of a robust competitive marketplace. In previous years there has been a portfolio approach applied to gas supply costs, where a combination of fixed and floating pricing structures have been employed. DE is of the view that this does not explicitly give market price indications to consumers to enable them to make provider and consumption choice in response to the "market price". Recent OEB direction supports this view, since any fixed price structure (or fixed proxy) is subject to discretion when viewed through the prism of the retrospective regulatory prudency. From a utility perspective, this after the fact review opens the utility to the possibility of disallowance of expenses, especially in highly volatile wholesale markets.

Figure 1: Nymex Prompt and Canadian basis series



Source: DE extraction of publicly available data.

A key determinant in defining the default rate should be the restriction of this rate to short term pricing exposure. This would be similar to the treatment of mortgages in the banking industry. Upon renewal of a mortgage, if a customer does not choose a fixed rate option, the mortgage is moved into an open, variable rate mortgage as the default product. This is done because it is the most neutral of all pricing options, since the customer can move to a fixed rate option at any time. To replicate this in the natural gas marketplace, the default supply would be a completely open (contract free), variable rate based on the market prices at that point in time. Specifically, system gas would be all short term, all the time. This clearly delineates system supply from fixed price offerings. Should consumers choose the default rate, then they either hold the view that prices should go down over time (worth less tomorrow than today) i.e. a "bearish" market view, or they are not concerned enough about the price of natural gas to take a market view (the "do nothing" scenario). For those consumers who are managing to differing needs or views of the market (bullish), the developed competitive energy retailers offer fixed price solutions.

One significant advantage to the LDC's is that there would be very limited potential for cost disallowance, so all participants should benefit from this market structure. Further, by providing distinct definition of the default rate, it would be a reasonable expectation that retailers would develop (as they have in other jurisdictions), energy products to address their need. Some examples might be a carbon neutral gas program, a fixed winter with floating summer plan, or a partially hedged year round plan.

What are the needs and benefits of entering into a LTC?

DE believes that the risk of entering fixed price long term gas supply should properly be the purview of retailers and those customers desirous of longer term price surety. DE, also being aware of supply security regarding acquisition of the physical gas commodity is supportive of utility purchases under index pricing relationships. The potential benefits are limited to price exposure.

What are the implications of not entering into a LTC?

The utility purchases short term market price gas giving more sensitive wholesale information to consumers allowing them to exercise individual consumption and provider choice through the competitive retail market.

Consumers exposed to market prices will have clear price signals to make consumption decisions. A key component of conservation programs is to link price to a particular behavior. It is suggested that the lack of fixed price LTC for supply contracts could create the proper incentives that would best support Ontario conservation goals.

DE believes that positive benefits will be achieved if LTC are not entered into.

What are the risks of entering into a LTC and how are the risks shared between the shareholders and ratepayers?

The risks of entering fixed price transactions can be significant as the utility is committing one of these two groups to the price contracted. Issues arise when the cost and/ or benefit of these transactions are realized. Should the fixed price position result in an "out of the money" outcome, there may be some question regarding the allowance of these charges by the regulator. Conversely, the result of an "in the money" position may give confusing price messaging to default customers. The risk is heightened in the current fragile credit environment, where many once solid counterparties are on questionable financial footing, raising the specter of default.

What would be the impact on competition?

DE believes no long term fixed price gas contracting would assist in the evolution toward a truly competitive market. This would provide consumers who have chosen the default rate an understanding that their price choice is reflective of short term price going down (i.e. bearish). Consumers holding a neutral price view or one of increasing gas costs would be enabled to canvass the competitive offerings available to find a retail product that would suit their needs.

<u>Services (Transportation and Storage) Overview</u>

The evolution of the North American market has resulted in a mature, dynamic, and responsive wholesale marketplace. The wholesale natural gas market is an exceptional example of competitive forces and sound market dynamics resulting in robust infrastructure build to service industry and consumers. This has been accomplished with private funds working in conjunction with fair regulation.

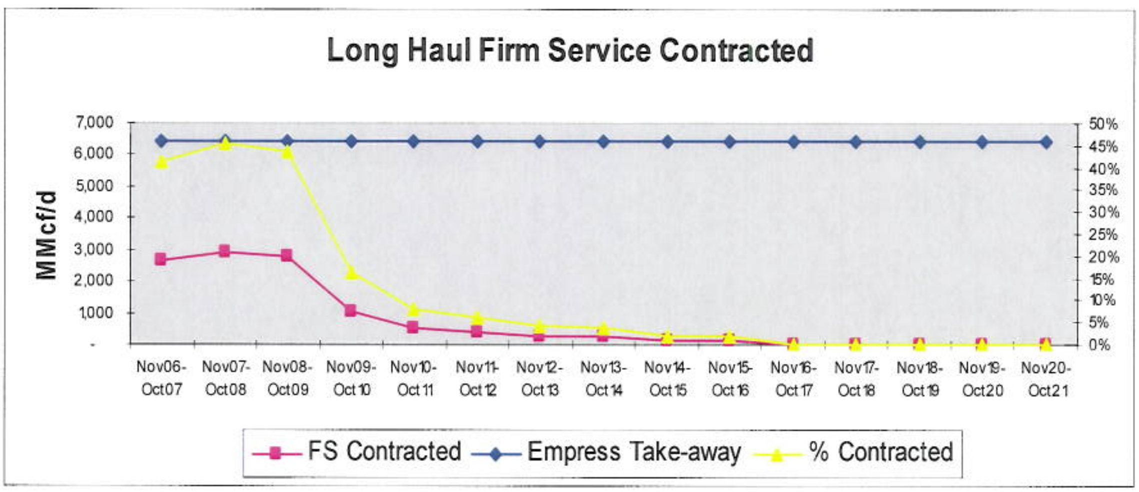
What are the needs and benefits of entering into LTC?

Security of supply has historically been linked to the LTC of transportation. LTC transportation has in essence determined where supply will be acquired. The Board historically asked the LDC to prove whether the amount of transportation was prudent. One of the measures that may be used is the amount of UDC (Unutilized Demand Charges) paid to the pipeline for not using the LTC contracted quantity. For example if a LDC contracted for a 100 GJ of gas and only transported 50 GJ of gas the UDC amount would be 50 GJ. This would result in the flowing volumes incurring two times the stated toll.

Historically pipeline expansions and facility additions have been 'back stopped' by the requirement of those parties requesting expansions and facility additions to sign long term commitments through pipeline open seasons. This process provided the checks and balances to ensure that adequate pipeline capacity was available to meet market demand and ensured that the pipeline system was appropriately 'sized' to connect supply to market. DE holds the view that all contracts entered into under the rationale of security of supply (existing and any new) be made part of the public record, especially those contracts with affiliate companies. This would provide the OEB, consumer representatives and retailers clarity regarding the costs associated with satisfying Ontario gas demand.

The dynamic nature of the natural gas industry has forced both supply basins and markets to re-examine and challenge entrenched beliefs of how markets will be served. Ontario has historically relied on WCSB supplied gas to serve the Ontario market. As new sources of supply are discovered in North America it brings into question whether the historical relationship between WCSB supply and Ontario load will continue to exist. The discovery of new supply sources and the availability of under utilized transportation capacity create opportunities for Ontario to meet its energy requirements from sources other than WCSB. An instructive example is the current contracting situation at the Empress border point on TCPL.

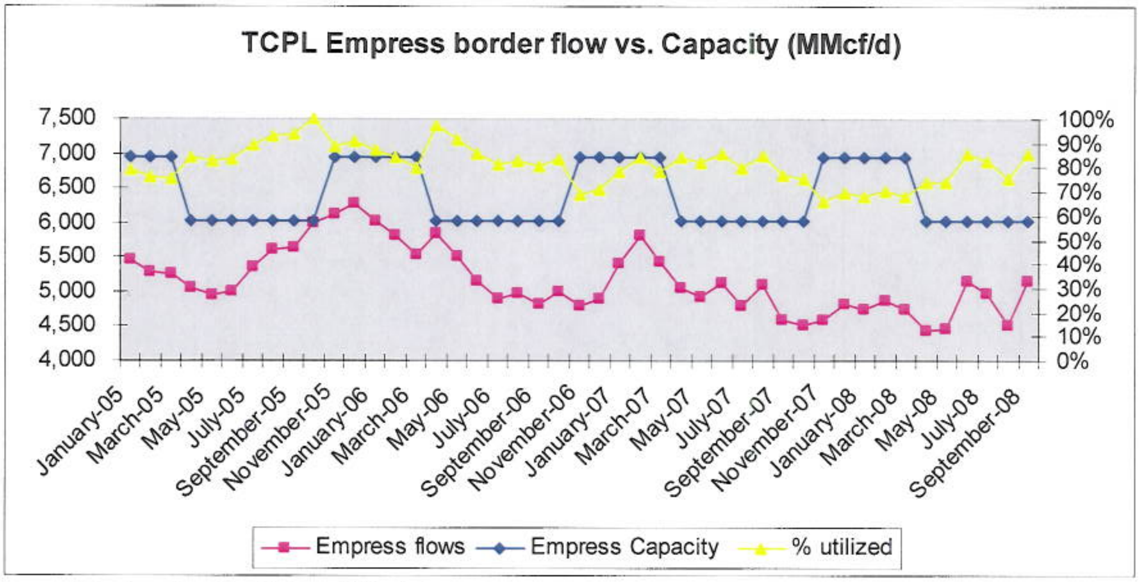
Figure 2: TCPL Contracting at Empress



Source: DE extraction of publicly available data

The requirement to meet the Ontario security of supply goal is a balance between the appropriate level of LTC obligations and economic efficiency. Recent TCPL Mainline total flow (i.e. Firm + IT) suggest more than adequate capacity to satisfy the market demand (volumes shown in MMcf/d):

Figure 3: TCPL Flow vs. Capacity



Source: DE extraction of publicly available data

DE suggests that this balance can be achieved. Ontario historically has largely relied on WCSB gas to supply the Ontario market. As a consequence, Ontario LDCs entered into long-term ten year contracts with TCPL and fifteen year contracts with Alliance and Vector (option expiring 2015). As these contracts expire, there remains the question of whether LTC commitments are still required to meet Ontario load requirements. It is suggested that two different approaches should be utilized; one approach for existing transportation infrastructure and a different approach for situations where new build or expansions are required.

Existing Infrastructure

The expiration of historical TCPL contracts provides LDCs with an option to renew all or a portion of the capacity that was originally contracted. Existing contract holders have the 'right of first refusal' which allow the contract holder to renew their right to utilize transportation infrastructure at the rate and terms in effect as outlined in the TCPL tariff before this capacity is offered to other shippers on the TCPL system. This ability to renew transportation on a year to year basis is the most appropriate approach to meet Ontario's security of supply requirement.

In DE's view there are no benefits obtained by signing LTC arrangements for legacy pipeline capacity given the ability to renew this capacity on a year to year basis and having the 'right of first refusal'.

New Infrastructure

Security of supply by its very nature implies the need for diversification of supply sources. If additional facilities and pipe is required to connect supply to market it may be appropriate for the LDC to enter into a LTC (ten year contract). The benefit of signing these LTC agreements is diversity of supply. DE holds the view that, should a utility deem this to be in customers and stakeholders best interest, a separate application be made justifying the long term contract. The OEB should approve or deny the contract on the merits presented, prior to execution of such a contract.

Storage

The same rules governing the requirement for LTC for transportation service may be applied to the contracting of storage facilities. Existing contracts between the LDC and storage providers have similar 'right of first refusal' provisions which may be utilized to ensure the LDC has adequate access to storage. However, given the required nature of storage in a "market area" such as Ontario, there is a utility requirement to insure viable storage gas, and related peak day withdrawal capacity to satisfy the utilities obligation to serve.

What are the implications of not entering into a LTC?

Provisions in legacy transportation contracts which allow the contract holder an option to renew contracts on a year to year basis before the capacity is made available to all market participants in DE's view offers sufficient protection for Ontario consumers to meet 'security requirements'.

The advantages of not having a requirement to enter into LTC with legacy systems provide Ontario with the flexibility to respond to the dynamic nature of the natural gas industry. Security of supply is achieved by diversifying where gas is sourced.

Decisions with respect to the appropriateness of LTC for transportation need to be determined taking into account current market conditions. LTC is appropriate when there is inadequate transportation and storage capacity available to meet security of supply requirements. In the late 1980s and early 1990s it was appropriate to enter into LTC agreements with pipelines connected to the WCSB. Given the current state of excess transportation from the WCSB there are no foreseeable issues associated with not entering into LTC agreements with pipelines connected to the WCSB. Conversely, entering into LTC contracts with WCSB pipelines will expose Ontario to potentially large rate swings and the assumption of unnecessary risk.

What are the risks of entering into a LTC and how are the risks shared between the shareholders and ratepayers?

In order to enable a fair and open competitive marketplace, all market participants must have equal access to transportation and storage. Therefore, it should be a ratepayer risk. DE holds the view that retail market participants should have the right, but not the obligation to manage their proportionate customer share of the service assets in question.

TCPL transportation rates for example are subject to change determined by the quantity and distance the gas travels on the TCPL system. LTC on this particular system does guarantee access to pipeline capacity but does not guarantee the rate paid for the utilization of the system. The risks associated with LTC agreements on the TCPL system are rate risk and utilization risk. Rate risk is determined by the ability of TCPL to change rates as outlined by the recent negotiated settlement agreement between TCPL and its shippers, while utilization risk is determined by the ability to source supply from the WCSB.

What would be the impact on competition?

DE suggests that if structured correctly in a market sensitive manner, there should be a positive impact on competition. There should be a clear discrimination between the distribution charge (i.e. exclusively the purview of the distributor) and the landed commodity charge (where retailers can and do offer competitive pricing products). Ideally retailers would have the right, but not the obligation to manage their proportionate customer share of the service assets that remain under legacy long term contracts. (Note it is proposed that any new long term assets contracted under the OEB application process described above, would also fall into this category.)

Those "legacy" assets deemed in the public interest (via security of supply) could be hedged financially for 1 year, 45 days prior to flow. The cost or benefit of these long term service arrangements (that is, the degree to which the value is above or below the actual cost of the toll) should be shared by all distribution customers. DE believes that this is just, in that all distribution customers are receiving the benefit of this "security of supply".

If security of supply is a concern and the Board approves, one means to achieve this would be to create a separate distribution rate rider to be added to all distribution customers. For example if the cost to go from Empress to CDA is $1.20 /GJ AND the value spread in the market between the same 2 points is $1.10/GJ , then all distribution customers regardless of retailer should be charged their proportionate share of $ 0.10/GJ through the proposed rate rider.

DE believes that this mechanism would encourage competition and innovation on the wholesale transportation component of the bill, furthering the benefit to the customers in retailers' attempts to increase market share through price competition and new product innovation.