Ontario Energy Board

Commission de l'Énergie de l'Ontario

EB-2010-0018

IN THE MATTER OF the *Ontario Energy Board Act 1998*, S.O.1998, c.15, (Schedule 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, transmission and storage of gas and other discrete issues.

BEFORE: Ken Quesnelle
Presiding Member

Paul Sommerville
Board Member

DECISION AND ORDER – PHASE 2
May 17, 2012

Natural Resource Gas Limited ("NRG" or the "Applicant"), filed an application dated February 10, 2010 with the Ontario Energy Board under section 36 of the *Ontario Energy Board Act*, *1998,* S.O. c.15, for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, distribution, transmission and storage of gas for the 2011 fiscal year, commencing October 1, 2010.

NRG is a privately owned utility that sells and distributes natural gas within Southern Ontario. The utility supplies natural gas to Aylmer and surrounding areas to approximately 7,000 customers with its service territory stretching from south of Highway 401 to the shores of Lake Erie, from Port Bruce to Clear Creek.

The Board issued a Notice of Application dated March 1, 2010. The Town of Aylmer, Union Gas Limited ("Union"), Integrated Grain Processors Co-Operative Inc. ("IGPC")

and Vulnerable Energy Consumers Coalition ("VECC") applied for and were granted intervenor status.

The Board issued a decision and order on December 6, 2010 that determined rates for the 2011 rate year (effective October 1, 2010). The Board also accepted NRG's request to address the IRM component of the Application for 2012 and beyond (and certain other discrete issues) in a second phase to the proceeding ("Phase 2").

Phase 2 Proceeding

NRG filed a revised IRM plan on May 6, 2011 that adopted the same architecture as the Board's 3rd Generation Incentive Rate Mechanism for electricity distributors in Ontario.

In addition, on July 18, 2011, NRG completed its Phase 2 filing requirements by filing an independent system integrity study that identified alternatives to maintaining system pressure in NRG's southern service area as opposed to purchasing gas from the related company, NRG Corp.

A settlement conference was held on September 26, 2011. A settlement agreement was reached on two of the three issues before the Board in Phase 2; the price for gas purchased from NRG Corp. (a related company) remained unsettled. NRG filed a settlement agreement on November 11, 2011. The Board accepted the settlement agreement at the oral hearing held on November 30, 2011.

In addition, on June 7, 2011, IGPC filed a letter requesting the Board to hear a motion (the "Motion") that it had filed on August 3, 2010 related to its dispute over the construction costs of the pipeline built by NRG to serve the IGPC ethanol plant. At the oral hearing in the first phase of the proceeding, the Board determined that its decision would only address issues that had potential rate impacts. The Board indicated at that time that IGPC would be free to recast its Motion on the remaining issues should there be any at a later date.

NRG filed a letter on June 22, 2011 submitting that the Board in its Decision of December 6, 2010 had already determined the capital cost of the IGPC pipeline and that the Board did not have jurisdiction to revisit the issue. NRG maintained that if IGPC

believed that there were issues remaining in the motion then it needed to recast the motion and file the relevant materials.

In a letter filed on July 6, 2010, IGPC clarified the elements of its Motion that were, in IGPC's view, still outstanding. IGPC submitted that the capital cost of the pipeline was still in dispute and before the Board in the Motion filed by IGPC. The specific items listed by IGPC include; (i) the administrative penalty; (ii) NRG's claimed legal costs; (iii) the costs claimed in respect of Mr. Mark Bristoll; and (iv) interest and other costs.

In Procedural Order No. 7, the Board invited submissions from parties on whether the matters raised in the Motion are properly before the Board. IGPC, Board staff and NRG filed submissions on the revised Motion. IGPC filed a supplemental submission on August 19, 2011 in response to the submission made by Board staff and NRG. The Board accepted the supplemental submission of IGPC but provided NRG an opportunity to file a response if needed.

The two remaining issues before the Board in Phase 2 of the proceeding are the cost of gas purchased from NRG Corp. and the Revised Motion brought forward by IGPC.

Cost of Gas Purchased from NRG Corp.

NRG has purchased natural gas from NRG Corp., a related company for over 30 years. During that time, NRG's system has expanded significantly, from essentially a gathering system for local production to a gas utility serving more than 7,000 customers.

NRG Corp. has approximately 41 wells serving NRG and, according to the Argument-in-Chief, NRG Corp. has been drilling its wells and bringing on production for the sole purpose of supplying gas to NRG Distribution Ltd[1]. NRG has argued that this arrangement has worked well for ratepayers and if NRG had not had local supply from NRG Corp., NRG's system customers would have collectively paid an extra $2 million for gas from fiscal 2007 to 2011[2].

[1] NRG Argument-in-Chief December 23, 2011, page 10
[2] NRG Argument-in-Chief December 23, 2011, page 13

NRG has pointed to other benefits of sourcing local gas including reduced charges from Union Gas Limited as a result of requiring less gas at its interconnecting points with Union Gas Limited and lower distribution rates resulting from the avoidance of costly capital additions to supply gas to NRG's southern service area. The second benefit comes from a study undertaken by NRG to identify alternatives to buying gas from NRG Corp. while maintaining system pressure within the southern distribution area. NRG argues that, because of the manner in which its system was developed over time, it can have system pressure issues in the southern part of its service territory on days where demand for gas is particularly high. NRG maintains that the best way to address this issue is to continue to use locally produced gas (in particular that provided by NRG Corp.), as it feeds into the system closer to the problem areas.

The study presented three alternatives to purchasing gas from NRG Corp. All alternatives recommended the construction of a new pipeline of varying lengths with costs ranging from $8 million to $23 million. NRG has estimated the new pipeline costs to be in the range of $200 per customer and it is in this context that NRG believes that purchasing gas from the related company at a premium represents a good deal for customers.

NRG has proposed that it be permitted to buy gas at $8.486 per mcf from NRG Corp. whenever the market price for natural gas is $9.999 per mcf or less, and to pay the market price when natural gas is $10.00 per mcf or more.

Board staff in its submission argued that the price of $8.486 is significantly higher than the current market price and NRG has offered limited evidence of how this premium benefits ratepayers.

Board staff further argued that the system integrity study did not look at all alternatives. There was no discussion with Union Gas on how they could assist in resolving the issue. Board staff argued that a new interconnect with Union in the area experiencing the problem in the simulation might resolve the issue. The study also did not examine the volumes required to maintain system integrity. This made it difficult for the Board according to Board staff to understand the magnitude of the issue and for other potential suppliers to know if they could alleviate the problem.

Board staff further pointed out an apparent conflict of interest that NRG Corp. had in finding other potential suppliers. NRG Corp. confirmed at the hearing that NRG Ltd. does not possess the expertise to source gas and it is NRG Corp. that performs this activity on behalf of NRG Ltd[3]. Board staff was of the opinion that it was not in the best interest of NRG Corp. to source gas from other suppliers for NRG Ltd. when it is in the business of selling gas itself. Board staff submitted that in such circumstances the Board should be cautious in allowing for payment of anything more than a market price for gas, and that the onus for establishing a different price rests firmly with NRG.

The second concern expressed by Board staff was that NRG had made no serious attempt to look for other possible local gas providers in the area. Mr. Graat who as an officer of NRG Corp. is a competitor with other local suppliers, indicated at the hearing that he considered all other suppliers as being unreliable and unable to provide gas on a consistent basis[4].

In light of the above arguments, Board staff submitted that NRG had not sufficiently demonstrated that a price floor for gas from NRG Corp. was the most effective solution to the system integrity issue.

Board staff offered the following recommendations in its submission:

1. To conduct another independent study under the supervision of intervenors (such as an intervenor steering committee) that could assist in developing the scope of the study. The study should conduct a detailed examination of the NRG system, the Union interconnects, local producers within the area and the amount of gas required to maintain system integrity on a daily/weekly/monthly basis.

2. To order NRG to request quotes from all suppliers within the area that are willing to commit to providing the required quantities of gas. NRG Corp. indicated that some producers have shut their gas because of low prices[5]. The Board could allow a premium over the market price (for example: a 10% to 15% premium) in the RFQ considering that it is fulfilling peak demand and this could incite other

[3] Transcript Phase 2, Volume 1, page 51
[4] Transcript Phase 2, Volume 1, pages 53 and 118
[5] Transcript Phase 2, Volume 1, page 136

dormant producers within the area to respond to the request. This premium would still be significantly lower than that proposed by NRG Corp.

3. To keep in place the current maximum of 2.4 million cubic meters representing system integrity gas.

VECC in its submission noted the unusual situation where the sole buyer for NRG Corp.'s gas is a related utility and the gas is being sold at a premium. VECC submitted that it is inappropriate to set floor prices ($8.486 per mcf) that should be paid by a utility to an unregulated related party that guarantees up to a point a premium above market prices. VECC further submitted that the negotiations between NRG Ltd. and NRG Corp. appear to have been dominated by NRG Corp.'s take-it-or-leave-it offer, with the utility having little latitude in the talks. VECC was of the opinion that the floor price was indicative of market power, exercised by a dominant or a critical supplier.

VECC submitted that there was no evidence to substantiate that it was not in the best financial interest of NRG Corp. to sell below the floor price and in that case a market-based methodology was more appropriate. VECC supported the position of Board staff that in the absence of an RFP process, the Board should continue with the current Board approved pricing methodology. VECC also supported Board staff recommendations of another independent engineering study that included a more robust sensitivity analysis and an independent RFP process that included other potential suppliers within NRG's franchise area.

In Reply, NRG dismissed the suggestions of Board staff and VECC to undertake an additional engineering study to consider other technical and physical options to solve the system integrity issue, and ordering NRG to put out an RFP to solicit additional sources of gas supply. NRG submitted that the only issue that needs to be resolved by the Board is the pricing methodology governing gas commodity purchases from NRG Corp. NRG further submitted that the Board should determine a pricing methodology that should stay in place until NRG's next cost of service proceeding.

NRG submitted that Board staff and VECC were suggesting ways to ensure that NRG does not have to buy gas from NRG Corp. NRG clarified that it plans to continue to buy gas from NRG Corp. because it makes good sense for NRG and its ratepayers. NRG

did not consider buying gas from NRG Corp. as a problem and it submitted that it did not make sense to spend a significant amount of time and money to come up with alternatives to buying gas from NRG Corp. NRG submitted that the actual issue was fairly narrow and centered around determining an appropriate pricing methodology.

NRG pointed to several benefits of purchasing gas from NRG Corp. which included a guaranteed local supply, reduced charges from Union Gas, avoidance of costly capital additions and lower gas commodity costs as compared to gas from third parties.

NRG further submitted that the study completed by Aecon Utility Engineering was complete and the terms of reference were approved by the Board prior to initiating the study. NRG submitted that although there could be other alternatives and scenarios to examine, at some point the cost of studying the system integrity issue would outweigh the benefits. NRG indicated that irrespective of there being a system integrity issue, it still made sense for NRG to buy gas from NRG Corp. NRG claimed that it is almost impossible to determine a single amount of system integrity gas that is required given that the system is fairly dynamic.

NRG in Reply refuted Board staff's suggestion that Union Gas could provide a solution. NRG pointed to the hearing transcript in which Mr. Graat confirmed that the problem was not getting gas from Union but distributing it in the franchise area[6].

NRG dismissed the recommendations of Board staff and VECC for seeking alternative suppliers within the area for the simple reason that there were no real acceptable supply prospects in the area. NRG submitted that any RFP ordered by the Board would have to contain numerous conditions including that potential suppliers would need to have wells in the problem area, namely, NRG's southern service area. Potential suppliers would need to build and pay for pipelines to connect to NRG's distribution system and would have to be prepared to enter into a contract with no fixed quantity and be able to supply on demand. NRG further indicated that potential suppliers would need to provide some form of security such as a letter of credit or performance bond to ensure delivery under the contract.

[6] Transcript Phase 2, Volume 1, pg. 50

NRG in Reply reiterated its firm belief that there are no acceptable suppliers that would agree to or be able to supply on such conditions. NRG therefore submitted that the Board should reject the arguments of Board staff and VECC with respect to an additional engineering study and an RFP and adopt the pricing proposal of NRG.

Board Findings

Although NRG Ltd. and NRG Corp. are not technically affiliates as defined in the Board's Affiliate Relationships Code, they share a very close relationship. Mr. Graat is a controlling officer of both companies and this makes NRG Ltd. in effect a vertically integrated utility. NRG buys a portion of its gas supply needs from NRG Corp. and as the evidence as it currently stands suggests that NRG apparently has few options to replace gas purchased from NRG Corp.

The issue before the Board is not so much the fact that it is inappropriate to purchase gas from a related company but rather that the pricing mechanism being sought by NRG seems to demonstrate that NRG Corp. exercises market power within the utility's franchise area. Gas prices are at historical lows and NRG Corp. is unwilling to sell gas at market rates. In fact, NRG Corp. has testified that it is unwilling to sell below the requested rate of $8.486 per mcf and will suspend production if it was asked to sell at market rates. This means that NRG ratepayers could face a situation where supply is suspended and gas not being available in certain areas or in required quantities. The Board is concerned that NRG's customers could face a potential shutdown of services or if service is provided, customers would pay significantly higher than market rates for what could be a material portion of their gas supply.

The evidence indicates that there has been a contract between NRG and NRG Corp, although there does not seem to be an executed copy for the current time period.

Furthermore, under the terms of the agreement, NRG Corp. is not obligated to provide gas to the utility and the contractual obligation can best be described as ambiguous. NRG has testified that it needs gas from NRG Corp. to maintain system integrity and the report submitted by NRG shows that the pressure could drop to unacceptable levels in the southern service area if NRG Corp. wells were shut off on a very cold day (-28 degrees Celsius).

The study however did not identify the volume of gas that is required to maintain system integrity and accordingly system integrity demand is largely theoretical at this stage. In fact, NRG stated in Reply that it is impossible to precisely define a single amount of system integrity gas that is required. Notwithstanding that, NRG is seeking a firm rate of $8.486 per mcf for all gas purchased from NRG Corp, and asks that there be no cap on how much gas NRG can purchase from NRG Corp. at this price.

The issue before the Board is fairly complex and may require a two-step process before a long term resolution emerges. In the meantime, customers will require a reliable supply and an interim solution is required.

NRG has estimated 2.4 million cubic meters as system integrity gas. There is no evidentiary basis for this estimate and the system integrity study has been unable to confirm this number. However, in response to an undertaking[7], Mr. Chan of Aecon Utility Engineering has provided a broad range for the number of customers that could potentially lose service should the temperature dip to -28 degree Celsius and all NRG Corp. wells are shut off. The estimate varies between 300 and 3,000.

The Board believes that the number of 2.4 million cubic meters is fairly high and considers 1.0 million cubic meters to better represent the demand related to system integrity. This number represents the approximate average annual demand of 5% (353) of NRG's Rate 1 customers, an approach that is at least somewhat consonant with the information appearing in the Aecon report.

The Board will allow NRG to recover from ratepayers a maximum annual quantity of 1.0 million cubic meters of natural gas at the rate of 8.486 per mcf. Any additional quantities beyond 1.0 million cubic meters that are purchased from NRG Corp. would only be eligible for recovery from ratepayers at current market rates that would be determined quarterly as per the methodology outlined in the Board's Decision of December 6, 2010.

[7] Undertaking J1.3

The Board is aware that there are several potential suppliers in the franchise area of NRG. The argument of NRG that other potential suppliers will not be able to fulfill the requirements of its system has not been adequately demonstrated, and there is little evidentiary basis to support it. The interest of NRG's ratepayers must be protected where a related company seeks a significant premium to current market rates to supply the commodity and, at least in part, meet its own expansion plans. In addition, the Board does not have any financial information regarding NRG Corp. that demonstrates that the price that it is seeking represents a fair price for NRG customers. The Board is not necessarily opposed to NRG purchasing gas from NRG Corp. The issue is the nature, scope and extent of the premium that ratepayers are being asked to bear for this purchase option.

Board staff and VECC have recommended procurement of an independent study that would look at all relevant alternatives and conduct a more robust sensitivity analysis. The Board sees merit in this recommendation.

Accordingly, the Board will require the formation of a steering committee comprised of Board staff, intervenors and NRG that will be responsible for drafting an RFP and terms of reference for an independent study, the findings of which will be presented to the Board.

The Board invites all intervenors to be a part of the steering committee. Reasonable costs of participation, consistent with the Board's *Practice Direction on Cost Awards* will be recoverable. The committee will be responsible for selecting an independent consultant and providing directions to the consultant as to the scope of the study and the deliverables. NRG must make itself available for the committee meetings and provide all of the required data and assistance that the consultant may require.

The Board expects the study to look at the technical and engineering aspects of NRG's system and arrive at firm conclusions with respect to the amount of system integrity gas that NRG may require under different scenarios, including, but not limited to a single design day. The Board also expects the consultant to review the gas supply available within NRG's franchise area and provide an analysis on whether a competitive market can exist within NRG's franchise area and if so, the mechanics of establishing such a market. This includes identifying other potential suppliers within the area and

determining if they can be a viable and reliable supply option. The study could also examine if the Union Gas system could provide any cost effective solutions. The cost of the study will be borne by ratepayers. The resulting report will be filed with the Board no later than **September 30, 2012**. If for some reason the consultant chosen to prepare the report is unable to do so within this timeframe, the panel can be petitioned to extend it. The Board, as part of this direction approves the creation of a deferral account to capture the costs associated with the study.

Based on the recommendations of the study, the Board may order NRG to issue an RFP that would solicit alternative suppliers within the NRG franchise area.

IGPC Revised Motion

In the Revised Motion IGPC claims that the actual total cost of the pipeline has still not been directly addressed by the Board. The specific items that IGPC believes have yet to be determined include: (i) the administrative penalty; (ii) NRG's claimed legal costs; (iii) the costs claimed in respect of Mr. Mark Bristoll; and (iv) interest and other costs.

The Board sought submissions on the Recast Motion. Board staff, NRG and IGPC filed submissions.

Board staff in its submission referred to Article IX of the Pipeline Cost Recovery Agreement ("PCRA") which states on page 17:

ARTICLE IX – DISPUTE RESOLUTION

9.1 In the event of any dispute arising between the Parties regarding the subject matter of this Agreement, then the parties shall negotiate in good faith to resolve such matters.

9.2 In the event the Parties are unable to resolve a dispute, then either Party may refer to the matter to the OEB for resolution.

Board staff submitted that neither IGPC nor NRG appear to have consulted with the Board regarding the Board's proposed role of dispute arbitrator, nor was the Board aware of this provision until the PCRA was filed with the Board after it had been executed.

Board staff submitted that the Board is a quasi-judicial regulatory tribunal. Its powers, like those of all tribunals, are granted through legislation. The Board can only act in accordance with those powers specifically provided by legislation, either directly or through the doctrine of necessary implication. The Board has no legislative authority to act as an arbitrator for contractual disputes, and no provision in a contract (such as Article IX to the PCRA) can give the Board such a power. To a certain degree, the Board has already acted to resolve this dispute by determining the appropriate costs of the pipeline for ratemaking purposes. However, the Board has no further statutory powers to resolve the remaining issues concerning the total costs of the pipeline. Board staff therefore submitted that the Board should decline the invitation to act as an arbitrator.

Section 11.2(b) of the PCRA indicates that the courts of Ontario shall have exclusive jurisdiction to determine all disputes arising out of this agreement. Board staff in its submission suggested that to the extent the parties cannot come to an agreement on the total cost of the pipeline, the courts are the appropriate forum in which this dispute should be resolved.

Contrary to Board staff's submission, IGPC was of the view that the Board did have jurisdiction to determine the issues that were raised in the Motion. IGPC submitted that the powers of the Board were fairly broad and pursuant to section 19(6) of the OEB Act, the Board has exclusive authority over matters within its jurisdiction. IGPC submitted that where a capital expenditure is required by the utility for the distribution of natural gas, the process includes the potential for a one-time payment in the form of a contribution in aid of construction, combined with a series of periodic payments. IGPC submitted that a utility cannot escape regulatory oversight and charge rates that are not just and reasonable by forcing a customer to pay a contribution in aid of construction relating to unreasonable and imprudently incurred costs.

In reviewing the actual capital expenditures of NRG, IGPC submitted that certain of the expenditures claimed by NRG were imprudent and unreasonable. IGPC was thus owed a refund by NRG.

IGPC quoted Part VII.1 of the OEB Act that provides the Board with the authority to take steps to remedy the contravention, or potential contravention of an enforceable provision. IGPC submitted that in the current context, NRG had failed to fulfill the requirements of the charges it was authorized to impose and has thereby contravened an enforceable provision within the meaning of the OEB Act.

Rejecting the submission of Board staff, IGPC submitted that Board staff's position was discriminatory as it permits consumers who do not pay a contribution in aid of construction to be able to review all capital expenditures related to their project whereas consumers that pay a contribution in aid of construction are limited with respect to capital expenditures that can be reviewed (those costs that only impact rates).

IGPC further noted that Article IX of the PCRA not only appointed the Board as an arbitrator but more importantly recognized the role of the Board as the industry regulator.

NRG in its submission quoted the PCRA that confirms that the courts of Ontario have exclusive jurisdiction to determine all disputes arising out of the agreement between NRG and IGPC. Section 11(2)(b) of the PCRA states:

> 11.2 This Agreement
>
> *(b) shall be construed and enforced in accordance with, and the rights of the parties shall be governed by the laws of the Province of Ontario and the laws of Canada applicable therein, and the courts of Ontario shall have exclusive jurisdiction to determine all dispute arising out of this Agreement;*

NRG referred to the 2004 Supreme Court of Canada decision, *Garland v. Consumers' Gas Co.* [2004] 1 S.C.R. 629, that was a class proceeding started in 1994 by the plaintiff against Consumers' Gas Company Limited ("Consumers"). The plaintiff sought a restitutionary payment of $112 million, representing late payment penalties ("LPPs") paid by over 500,000 of Consumers' customers since 1981. The plaintiff also sought declaratory relief that the LPPs charged contravened s. 347 of the Criminal Code and need not be paid by the proposed plaintiff class. The rates and payment policies including the late penalty payments were governed by the Board.

Chief Justice McMurtry of the Ontario Court of Appeal noted that the restitutionary issue arising from the receipt of LPPs by Consumers for the past twenty years was an issue over which the courts have jurisdiction. He further added that the Board's jurisdiction to fix rates for gas and to set penalties for late payment does not empower it to impose a restitutionary order of the type sought by the plaintiff. Justice Iacobucci writing for a majority of the Supreme Court adopted the findings of the Court of Appeal and noted that although the dispute involved rate orders, the primary issue here was a private law matter suited to civil courts and the Board did not have jurisdiction to order the remedy sought by the plaintiff.

NRG cited this case and noted that the Supreme Court was very clear that the disputed issues are private law matters and the Board does not have jurisdiction to hear them. NRG also supported the arguments made by Board staff which noted that many of the issues in IGPC's Motion were beyond the purview of the Board.

Based on the above arguments, NRG submitted that the matters raised in IGPC's Motion were not properly before the Board.

Board Findings

The Board has already determined the rates for NRG and as part of that process addressed many of the issues raised by IGPC.

The Board substantially agrees with the submissions of Board Staff on this issue.

The Board can only act in accordance with those powers specifically provided by legislation, either directly or through the doctrine of necessary implication. The Board has no legislative authority to act as an arbitrator for contractual disputes, and no provision in a contract (such as Article IX to the PCRA) can give the Board such a power. The Board has no further statutory powers to resolve the remaining issues concerning the total costs of the pipeline.

Section 11.2(b) of the PCRA indicates that the courts of Ontario shall have exclusive jurisdiction to determine all disputes arising out of this agreement. Board staff in its submission suggested that to the extent the parties cannot come to an agreement on

the total cost of the pipeline, the courts are the appropriate forum in which this dispute should be resolved.

IGPC is seeking a refund. The issue between IGPC and NRG is essentially a contractual dispute between two private entities. The Board does not have jurisdiction to consider or remedy contractual disputes.

DATED at Toronto May 17, 2012

ONTARIO ENERGY BOARD

Original Signed By

Kirsten Walli
Board Secretary