



# **ONTARIO ENERGY BOARD**

## **BOARD STAFF SUBMISSION**

### **NATURAL RESOURCE GAS LIMITED**

**APRIL 1, 2014 QRAM – PHASE 2**

**EB-2014-0053**

**November 12, 2014**

## Introduction

Natural Resource Gas Limited (“NRG”) filed an application dated March 11, 2014, with the Ontario Energy Board for an order or orders approving or fixing just and reasonable rates and other charges for the sale and distribution of natural gas commencing April 1, 2014.

The application was made in accordance with the Quarterly Rate Adjustment Mechanism (“QRAM”) established by the Board for dealing with changes in gas costs for all rate regulated gas distributors (EB-2008-0106).

NRG asked the Board for approval to recover from customers the costs of incremental natural gas purchases made by NRG in February 2014 and the costs associated with a penalty charge applied to NRG by Union Gas Limited (“Union”).

On April 1, 2014, the Board issued its Decision and Interim Order on the application. In its Decision and Interim Order, the Board stated that the incremental natural gas purchases made in February and the penalty charge applied to NRG had not been sufficiently examined in the QRAM process. The Board decided to establish a process to further consider these issues.

The Board issued a Notice of Application on May 2, 2014. In the notice, the Board stated that as part of Phase 2 of NRG’s QRAM proceeding it would review the incremental gas purchases made by NRG in February 2014, including the penalty charge and its recovery from NRG’s ratepayers. By letter dated May 8, 2014, the Board indicated that it would review the prudence of these purchases.

In Procedural Order No. 1, dated October 10, 2014, and as revised in Procedural Order No. 2, dated October 20, 2014, the Board set out the schedule for discovery and argument for Phase 2 of NRG’s April 2014 QRAM proceeding. NRG filed its argument-in-chief on November 5, 2014.

The following is Board staff’s submission.

## Background

NRG noted that it is a direct purchase customer of Union. As part of its contract with Union, NRG is required to rectify imbalances in its banked gas account prior to the winter checkpoint (February 28, 2014). Based on the Direct Purchase Status Report (“DPSR”) received from Union for the month ending January 31, 2014, NRG was notified that it was required to purchase 115,523 Gigajoules (“GJ”) of gas in order to rectify the imbalance in its banked gas account at the end of February 2014.

NRG attempted to purchase the gas required to fulfill its contractual obligations in late February 2014. NRG managed to purchase 90,027 GJ of natural gas prior to the winter checkpoint but was unable to purchase the remaining shortfall of 25,496 GJ in February. NRG claimed that there was no gas available to be purchased and delivered to Union's system prior to February 28, 2014. Union provided the remaining shortfall quantity to NRG. As a result, Union applied a penalty charge to the 25,496 GJ of natural gas that NRG was short at the time of the winter checkpoint.

NRG requested that the Board approve the recovery of costs from its ratepayers of the following:

- (1) The purchase of 90,027 GJ of natural gas at a total cost of \$2,455,576 (\$27.276 / GJ).
- (2) The penalty charge applied to NRG by Union of \$2,007,250 for the 25,496 GJ of natural gas that NRG was short at the time of the winter checkpoint (\$78.728 / GJ).

In the Board's Decision and Order in EB-2014-0154, dated October 9, 2014, the Board approved a proposal from Union to reduce the penalty charge applied to NRG and other direct purchase customers that did not meet their contractual obligations in February 2014 to \$50.50 / GJ. As such, the penalty amount owed by NRG to Union is reduced to \$1,287,548 (i.e. 25,496 GJ \* \$50.50 / GJ). NRG has appealed the EB-2014-0154 Decision and Order. The appeal has not yet been heard by the Divisional Court.

### **Board Staff Submission**

Board staff submits that NRG did not act prudently with regard to its gas supply procurement over the 2014 winter. As a result of NRG's lack of action in managing its gas supply procurement, the gas purchase costs incurred by NRG over the 2014 winter were exorbitant. Board staff submits that NRG, as a monopoly utility operator, has the responsibility to manage the purchases of gas for its customers in a reliable, prudent and cost-effective manner. As NRG did not manage its gas supply procurement during the 2014 winter in a prudent fashion, Board staff submits that NRG's shareholder should be required to pay some portion of the gas supply costs incurred by NRG.

NRG expects that its ratepayers will be required to pay the high costs associated with its incremental natural gas purchases and the penalty charges incurred by NRG. At paragraph 83 of its argument-in-chief, NRG submitted that the gas supply costs resulting from the spike in natural gas prices in the winter of 2013 / 2014 was "never part of the risk that an Ontario utility was meant to take under the *Ontario Energy Board*

Act regime.”<sup>1</sup> Board staff acknowledges that gas commodity costs are generally passed directly through to sales service customers without any reduction. However, Board staff submits that this general rule does not mean that the prudence of these costs can never be tested. Board staff submits that the Board may deny recovery of gas supply costs where those costs are found to be imprudently incurred. Nothing in section 36 of the OEB Act restricts the Board’s ability to determine rates for the sale of gas or whether and how amounts recorded in commodity deferral or variance accounts are to be recovered in rates.

Board staff notes that in the Decision with Reasons in E.B.R.O. 486-04, the Board made a finding to disallow recovery of certain gas costs associated with spot gas purchases made by Union. The Board in that decision said:

The Board would have expected Union to have undertaken a plan to spread its spot gas purchases more evenly over the winter period. The Board is of the view that once Union had identified the 12 Bcf shortfall, it should have taken immediate steps to purchase at least 3 Bcf of spot gas in December to accomplish a more even spreading of spot gas purchases...

The Board finds that the amount of \$5.140 million is most appropriately borne by the shareholder and directs that this amount be removed from the PGVA debit.<sup>2</sup>

Board staff submits that if the Board finds that NRG acted imprudently in regard to its gas purchases, the Board has the power to deny recovery of some portion of the gas purchase costs. Board staff also submits that if the Board finds that NRG incurred gas costs imprudently, the Board can and should consider the effect that recovery, or denial of recovery, of these costs will have on NRG and its customers.

Board staff accepts that the gas supply decisions made by NRG cannot be judged using knowledge that came to light only after those decisions were made. However, Board staff does not agree that the Board’s jurisdiction in undertaking such a review in this case has been restricted by the Board’s procedural or substantive decisions in the Union penalty proceeding (EB-2014-0154), as NRG argues in paragraphs 20 – 22, 90 and 96 – 99 of its argument-in-chief.

Board staff submits that the Board should consider the prudence of NRG’s actions at the time its gas purchases were made, in light of the knowledge available to NRG at

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<sup>1</sup> NRG, Argument-in-Chief, November 5, 2014 at p. 16.

<sup>2</sup> Decision with Reasons, E.B.R.O. 486-04, April 12, 1996 at p. 16 and 17.

that time. In Board staff's view, the Board does not need to have reference to the penalty decision to determine the prudence of NRG's gas purchasing decisions. If the Board finds that NRG incurred gas purchase costs imprudently, the Board can then determine whether NRG should be denied recovery from ratepayers of some or all of those costs. The fact that the original penalty of \$78.728 / GJ has been reduced to \$50.50 / GJ does not affect the Board's consideration of NRG's actions at the time it made the gas purchase decisions which led to the imposition of the penalty.

Board staff submits that there are reasonable grounds to challenge the prudence of the decisions made by NRG's management over the 2014 winter. NRG's decision to wait until the end of February to purchase gas to meet its balancing obligations with Union ignored information that NRG either had or ought to have had during the 2014 winter.

Firstly, NRG was aware as early as November 2013 that it was expected to be short of gas at the time of the winter checkpoint. This is evidenced by the fact that NRG receives a DPSR from Union each month, which sets out the expected balance in its banked gas account with Union at the time of next balancing checkpoint (in this case, the winter checkpoint). NRG's December 2013 DPSR, which NRG would have received in early January 2014, indicates that, beginning in October 2013, NRG's actual monthly consumption was higher than its contracted forecast monthly consumption, which would lead to a deficit in the banked gas account at the time of the winter checkpoint if no incremental gas purchases are made.<sup>3</sup> The DPSRs indicate that for each month throughout the winter period, NRG's expected shortfall at the time of the winter checkpoint was growing larger. NRG would have received DPSRs in November (for October), in December (for November), in January (for December), and in February (for January), each showing that NRG was expected to be short of gas at the time of winter checkpoint. Board staff notes that at no point during the 2013 / 2014 winter period did NRG take any preemptive action to mitigate its balancing shortfall.

Secondly, Board staff notes that the 2013 / 2014 winter started off colder than normal and the weather forecasts throughout the winter continued to indicate that it was going to be a long, cold winter.<sup>4</sup> Given the weather forecasts, NRG should have been aware that the price for natural gas was likely to be higher than historic norms due to increased demand for natural gas.

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<sup>3</sup> In addition, NRG started its contract year (October 2013) with a negative balance in its banked gas account.

<sup>4</sup> In EB-2014-0050 (Union's April 2014 QRAM Application), Tab 1 at pages 14 & 15, Union filed evidence which states that it was seeing persistent colder than normal weather forecasts. Board staff expects that NRG would have sought and received the same information. If NRG did not seek out this information, this would constitute further evidence of the lack of oversight by NRG with regard to its gas supply planning.

Board staff submits that it would have been prudent of NRG to have heeded the weather forecasts and begun to mitigate the variance in its banked gas account earlier in the winter by making incremental gas purchases. This would have spread the spot gas purchases over the winter period thereby diversifying the risk associated with the incremental purchases. Instead, NRG chose to delay its purchases until the end of February 2014, so that it had to attempt to purchase its entire shortfall in a compressed time period, which increased the risk borne by ratepayers. The result of NRG's actions, or more accurately lack of action, was a purchase of 90,027 GJ at the price of \$27.276 / GJ and the inability to purchase the remaining gas necessary to meet its contractual obligations with Union (which resulted in Union applying a penalty charge). For comparative purposes, the highest price spot gas purchase made by Union over the 2014 winter was at a price of \$12.31 / GJ and the average price of gas at Dawn, based on the highest daily traded price, for the period January 1, 2014 to February 28, 2014 was \$17.33 / GJ.<sup>5</sup>

Board staff submits that, in order to hedge the risk of high gas costs at the end of February, it would have been prudent for NRG to have made incremental gas purchases throughout the winter period. If NRG had done so, it would have avoided the risk of high prices (and the risk that no gas would be available for purchase) at the end of February and attained a more reasonable cost of gas to pass onto its ratepayers. A layering approach to incremental gas purchases over the 2013 / 2014 winter months was the lower risk option for the management of variances in the banked gas account given the unique circumstances of this past winter.

Overall, Board staff is of the view that NRG did not fulfill its duty to its customers to manage natural gas procurement in a reliable, prudent and cost-effective manner. As such, Board staff submits that the Board should disallow recovery from ratepayers a portion of the costs associated with NRG's incremental gas purchases in accordance with one of the following options.

A 50 / 50 sharing between NRG and its customers of the difference between what NRG paid for its incremental gas supply (including the penalty charges) and either the highest priced spot gas purchase made by Union or the average of the highest daily traded price of gas (for the January 1, 2014 to February 28, 2014 period) at Dawn. The calculation of the proposed disallowance under each option is as follows:

1. Highest priced spot gas purchase made by Union - The total cost of the incremental purchases made by NRG and the penalty applied was \$3,743,124 (90,027 GJ \* \$27.276 + 25,496 GJ \* \$50.50). The highest price spot gas purchase made by Union was priced at \$12.31 / GJ. If NRG had managed to

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<sup>5</sup> Derived from NGX database based on the highest priced trades at Dawn for each day over the cited period.

purchase the incremental gas that it required at this price, it would have paid \$1,422,088 (115,523 GJs \* \$12.31 / GJ). This option results in the disallowance of the recovery of \$1,160,518 ( $\$3,743,124 - \$1,422,088 \div 2$ ) from ratepayers.

2. Average of the highest daily traded price - The total cost of the incremental purchases made by NRG and the penalty applied was \$3,743,124. The average price of gas at Dawn, based on the highest daily traded price for the January 1, 2014 to February 28, 2014 period, was \$17.33 / GJ. If NRG had layered its incremental purchases over the cited period, the total costs would have been \$2,002,014 (115,523 GJs \* \$17.33 / GJ). This option results in the disallowance of the recovery of \$870,555 ( $\$3,743,124 - \$2,002,014 \div 2$ ) from ratepayers.

Board staff recommends option 2 as the price of \$17.33 / GJ is an average of the highest daily traded prices at Dawn, over the cited period, and is a price which could have been achieved by NRG by layering its incremental gas purchases over the January 1, 2014 to February 28, 2014 period. As noted previously, NRG was well aware in January (and in fact, even prior to that) that it was going to be short of gas at the winter checkpoint (February 28, 2014). Board staff submits that the prudent course of action would have been to diversify the risk associated with making incremental natural gas purchases by spreading those purchases over an extended period of time beginning at least as early as January 2014. Board staff is of the view that the disallowance of 50% of the incremental costs incurred by NRG above the average price of gas at Dawn for the cited period is reasonable in terms of balancing the need to protect NRG's ratepayers from the harm caused by NRG's imprudent gas supply management over the 2014 winter and the need to consider the effect of the disallowance on NRG's financial viability.<sup>6</sup> The 50 / 50 sharing recommended by Board staff takes into consideration that the winter of 2013 / 2014 was an exceptional weather event, while still recognizing that NRG could have mitigated the risk associated with making incremental gas purchases with prudent gas supply management.

Board staff also submits that the Board should consider requiring NRG to transition to a system gas arrangement with Union in as short a timeframe as possible, while avoiding any contract cancellation penalties. Board staff submits that its performance related to gas supply management over the 2014 winter suggests that NRG may not be well equipped to be a direct purchase customer. Board staff notes that while there is no question that the 2014 winter was exceptional, direct purchase customers (especially NRG which is purchasing gas, in the role of a utility, for its own system gas customers) must be capable of reacting to changing market dynamics, including the impact on

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<sup>6</sup> Board staff notes the NRG filed evidence regarding its annual profits in its answer to Board staff interrogatory 4(a). The average annual profit of NRG, based on the past 3 years, is approximately \$460,000. Board staff acknowledges that the Board, in determining the allowed recovery, may need to consider the effect of various levels of disallowance on NRG's financial viability.

natural gas prices of a persistently cold winter. Board staff submits that NRG failed in this regard. Board staff submits that the Board should order NRG, at the earliest possible time, to file a gas supply plan which includes the option of moving to a system gas arrangement with Union.

For all of the above reasons, Board staff submits that the Board should order that NRG is not permitted to recover \$870,555 from its ratepayers related to the cost of incremental gas purchases that it made in the 2014 winter and the penalty charge applied by Union. NRG's shareholder should be required to bear the costs disallowed for ratepayer recovery due to its imprudent management of gas supply procurement over the 2014 winter.

All of which is respectfully submitted.