



RP-2004-0167
EB-2005-0188

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 for the
2005 fiscal year commencing October 1, 2004;

AND IN THE MATTER OF a Motion by Natural
Resource Gas Limited for a rehearing and variance of
the decision of the Board as set out in its Decision
with Reasons RP-2004-0167/EB-2004-0253 dated
December 20, 2004.

BEFORE: Gordon Kaiser
Vice-Chair and Presiding Member

Pamela Nowina
Vice-Chair and Member

Paul B. Sommerville
Member

DECISION WITH REASONS

October 6, 2005

On February 23, 2005 Natural Resource Gas Limited filed a Motion with the Ontario Energy Board to rehear and vary certain findings of the Board's Decision dated December 20, 2004.

In that Decision the Board ruled that the deemed long term debt rate for the 2005 fiscal year was 8% and set NRG's cost of unfunded short term debt at 5.5%, which reflected 150 basis point premium over forecast prime of 4.00%. This translated to a weighted cost of debt of approximately 7.07%¹. In this Decision the Board also disallowed the Applicant's request for the recovery of legal expenses incurred in its appeal of the Board's April 19, 2004 Decision. The Applicant seeks a variance of these two aspects of that Decision.

NRG requested that this Motion be heard in writing and by a new panel of the Board. The Board issued its Notice of Oral Hearing and Procedural Order No. 1, dated February 17, 2005 indicating that a new panel had been appointed, and set February 23, 2005 as the filing deadline for further evidence and submissions. The Motion was heard on April 11, 2005.

Relief Sought

The Motion sought a variance of the Board finding:

- a) that the deemed long-term debt rate was 8.00%;
- b) that disallowed the recovery through rates of the legal fees associated with NRG's appeal to the Divisional Court of the Board's April 19, 2004 Decision.

As an alternative to the relief sought in paragraph (a), NRG seeks an Order that it be permitted to recover its actual long-term debt costs; or in the alternative be

¹ Fiscal 2005 weighted average cost of debt, calculated using a Long-Term debt rate of 8% and 5.50% on the Short-Term & Unfunded Debt.

permitted to maintain a deemed debt rate of 9.20% for its deemed debt load based upon a 50% debt, 50% equity capital structure;

As an alternative to the relief sought in paragraph (b), NRG sought an Order that the legal costs be recoverable and a variance account for that purpose or an Order establishing a deferral account to track the legal costs. NRG also requested an Order permitting recovery of such amounts, including interest thereon, over a 12-month period commencing either July 1, 2005 or October 1, 2005.

Cost of Debt

The first issue before the Board in this Motion is whether to vary its finding in the December 20, 2004 Decision regarding the long-term debt rate relied on for rate-making purposes. In this Decision, the Board established NRG's rates using a deemed capital structure. As the Applicant's actual long-term debt ratio is approximately 30%, the Board imputes short term debt in an amount that 'tops' debt up to the deemed 50% level.

The June 27, 2003 Decision

Historically, the Board has used NRG's reported cost of long-term debt and deemed a cost of short-term debt at 150 basis points greater than prime. The Board's Decision of June 27, 2003 dealt with both the 2003 and 2004 test years. For 2003, NRG proposed an 11.38% cost of long-term debt and a 6.17% cost of short-term debt; for 2004 it proposed 11.60% and 7.52% respectively. The Board accepted NRG's cost of debt for the 2003 fiscal year and deemed an overall cost of debt of 9.00% for the 2004 fiscal year. This reflected a Board finding that NRG could reduce its interest expense through the refinancing of its debt and the Board's concern that an affiliate of NRG held a significant portion of its total debt.

In its Decision of June 27, 2003 the Board stated:

The Board is of the view that NRG should be able to refinance its entire debt in a manner which will reduce its carrying costs even when the pre-payment penalties and transactions costs are added to the debt. ...the Board sees no reason to believe that NRG cannot obtain an interest rate of better than 8.75% in the current environment. The Company's financial position has improved greatly in the past few years. The Company is a rate regulated monopoly with a relatively low risk. Interest rates have declined even since NRG's preliminary discussions with two financial institutions. While, as the Applicant points out, this leads to an increase in the pre-payment penalties, it also should mean a reduction in the new rate which NRG can obtain.

The Board accepts the position of the Company that it would not be appropriate to adjust the debt rate for the 2003 test year as it will take some time for NRG to complete a refinancing. The Board is prepared to accept that the 2004 interest rate should be somewhat higher than 8% as this rate will be applied to the current forecast debt, whereas a refinancing will require NRG to incur more debt to fund the pre-payment penalties and the transactions costs....the Board also notes that the calculations during the hearing of carrying costs used a figure for transactions costs of \$250,000 which was at the top of the range of such costs of \$100,000 to \$250,000 cited by NRG. The Board has also used this figure of \$250,000 in making its determinations.

In light of the utility's evidence that a potential lender would be looking to refinance its entire debt, including short-term debt, the Board believes it is appropriate to deem an overall debt rate for the 2004 test year.

The December 20, 2004 Decision

In NRG's subsequent main rates case to fix rates for the 2005 fiscal year, it sought an overall cost of debt of 9.20% on an overall debt of \$4,705,623. The Company stated that the debt instruments for the 2005 fiscal year were the same as the debt instruments for the 2004 fiscal year, with one exception: the instruments previously held by NRG's affiliate were sold to Banco Securities Inc. at the face value of the debt, under the original terms and with no change in the interest rate. The Company testified that it would pursue refinancing over the next several months and that it anticipated being able to negotiate an interest rate of around

8%. These discussions were expected to be completed by February or March, 2005.

In its decision of December 20, 2004 the Board stated:

“The Board does not accept the Utility’s request for the use of a deemed debt rate of 9% or 9.2% in calculating its revenue requirement. The Board does not intend to tie the Utility’s debt rate to the fluctuations of long term interest rates at this point in time. The Board, in its prior decision, set a deemed debt rate in light of the evidence before it that the Utility would be able to reduce its interest expense if it re-financed its existing debt and the fact that much of the Utility’s debt was held by an affiliate.

The Board is concerned about the lack of knowledge exhibited by the President of the Utility as to the identity of a major creditor of the Utility, Banco Securities Inc. The Utility has not brought forward requested evidence to demonstrate that Banco is an unaffiliated, arm’s length party. Thus, there remains no evidence from an actual transaction demonstrating the interest rate that NRG could obtain in the open market.

The Board has heard evidence in this proceeding that the Utility could refinance its debt at an interest rate of approximately 8% and that there would likely be associated penalties and transaction costs (“breakage costs”). The Board will adopt a deemed long term debt rate for the 2005 fiscal year of 8%. The Board will consider the prudence of breakage costs if and when they are incurred. At that time, the Board will also address the recovery of any breakage costs through rates.

The Board sets NRG’s cost of unfunded short term debt at 5.5%, which reflects 150 basis point premium over forecast prime of 4.00%.”

The April 11, 2005 Motion

In the current Motion, NRG requested the Board amend the December 20, 2004 Decision and allow the Company to recover its forecasted debt costs of its actual debt instruments. The Company submitted that the difference between the Applicant’s actual cost of debt and the Board approved cost of debt was approximately \$98,000.

NRG further stated that it has had discussions with two lenders, both of which were chartered banks. It also stated that it is in the process of preparing a five-year capital expenditure forecast in support of the contemplated refinancing of the Company's existing long-term debt. This total package of existing debt and capital expenditure is valued at approximately \$5 million.

NRG stated that in order to get a competitive rate, it must approach the lenders with the complete package (that is short-term debt, long-term debt and costs associated with the capital expenditure program) arguing that if a complete package was not negotiated the premium on a second and third portion of the financing would be very expensive. On further questioning NRG testified that it anticipated that within the next two months, that is May or June 2005, it would have formal discussions with lenders and within four to six months it would be approaching lenders with a final borrowing package.

Board Findings

In the Motion NRG testified that it had not made any progress on refinancing its debt because it was in the process of finalizing its capital expansion plans.

The Board determined that before rendering a decision on the Motion it would be appropriate to obtain an update from NRG as to the status of their capital plans and their financing efforts. Accordingly the Board on August 31, 2005 sent a letter to NRG requesting such an update. NRG responded on September 9, 2005 and indicated that it had still not taken any action with regard to its debt refinancing. The letter did not provide a response on the capital plans.

The Board has on a number of occasions expressed its concern that the loan to NRG is not market based and therefore not all of the interest costs associated with it are properly borne by ratepayers. The fact that the loan is now owned by a

different party does not change this concern. NRG chose to transfer this loan at face value with its high interest rate.

This is not a hearing of the application *de novo*. In considering a motion to vary, the Board considers whether new evidence has been presented by the Applicant, or whether the original panel made an error in law or principle so as to justify the reversal of the original Decision.

After reviewing the evidence and the submissions of NRG, the Board has found no compelling evidence that would cause it to vary its December 20, 2004 Decision. It is also apparent from the Company's September 9, 2005 letter in response to the Board's August 31, 2005 letter, that NRG has made no progress whatsoever with regards to new financing.

The Board therefore finds and confirms that the deemed long-term debt rate for the 2005 fiscal year of 8.00% and an unfunded short term debt rate of 150 basis point premium over forecast prime of 4.00%, as set in the Board's December 20, 2004 Decision is just and reasonable for rate setting purposes.

Legal Expenses

The second issue before the Board in this Motion is whether to vary that aspect of the Board's Decision of December 20, 2004 that disallowed the recovery of \$175,000 in legal fees.

In its original 2005 rates filing, NRG budgeted \$15,000 for legal fees. In its updated filing, in that case this amount was increased to \$190,000 to reflect the anticipated costs of an appeal to the Divisional Court of a previous Board decision.

The background to the Divisional Court Appeal is as follows:

In October 2003, NRG discovered that its gas costs for the period October 2002 to December 2003 were under-recovered, by approximately \$531,000 due to an accounting error. NRG reported the discrepancy to the Board and in November 2003 filed an Application² to recover these costs. In January 2004 the Board issued its decision and authorized NRG to establish a Gas Purchase Rebalancing Account to capture future unrecorded costs, but denied NRG's proposal to recover the \$531,000.

Subsequently, NRG sought and was granted a review of that decision. In an April 19, 2004 Decision³ the Board approved NRG's recovery of these unrecorded gas costs of \$531,000 over three years but disallowed the interest on the outstanding balance and the legal and regulatory costs of that review. The Board stated;

We are surprised and disappointed with the time that it took NRG to realize that its PGCVA mechanism was incorrect, which exposed the utility and its customers to unnecessary risk and created a difficult situation for the customers and the Board. However, we accept that the misrecording was the result of error, not a purposeful action by NRG. [paragraph 33]

The rationale for the Board's initial disallowance of both interest charges and legal and regulatory costs is relevant to the disallowance of legal costs at issue in this proceeding. It is clear that the Board in the earlier decision was motivated by the fact that NRG was responsible for additional costs that should not be borne by the ratepayer. At Paragraphs 38 to 40 of the Decision, the Board stated;

Had NRG recorded gas cost variances properly in the PGCVA, the present conundrum would have been avoided....we find that NRG's error has resulted in a substantial and avoidable accumulation of potential customers' charges, through no fault of the customers.

We must therefore look for a balance.

² RP-2002-0147/EB-2003-0286

³ RP-2002-0147/EB-2004-0004

The Board further stated;

...we find that a reasonable balance is recovery of the \$531,794 amount over a three year period, in equal portions, without interest... Further, NRG shall not include the regulatory costs it incurred in this proceeding in estimating the regulatory costs for future test years. [paragraph 44, 47]

In summary, the Board refused the NRG request that the costs be collected in one year with interest. Instead, the Board held that it should be collected over three years without interest and that the Company would be disallowed its legal and regulatory costs of the review.

NRG then appealed to the Divisional Court seeking recovery of interest and legal costs associated with the review. The Divisional Court dismissed the appeal in its April 21, 2005 Decision⁴.

The Court in upholding the Boards decision accepted the Board's judgement that NRG was partially responsible for the error and its inadvertence had caused costs to consumers. Specifically, the Court stated;

The matter was compounded by the added issue of how to deal with the accumulation of costs caused by the appellant's inadvertence. The Board determined that customers must pay the prudently incurred unrecorded costs of the appellant, but the impact of the recovery of the accumulated total should be ameliorated by allowing recovery over three years. The accumulated cost of the time over which recovery from customers would be required and the appellant's regulatory costs (over and above the \$60,312 allowed it) must be borne by the appellant...The issue before the Board in this case is much more confined: how to deal with the consequences of a failure to identify and report prudently incurred costs, and in determining that question the Board was entitled within its broad mandate to consider both the utility's and customers' interests, as it did. [paragraph 14, 15]

In the 2005 rates case, NRG sought to recover the legal costs of \$190,000 related to the Divisional Court appeal.

⁴ [2005] O.J. No. 1520

The Board in its Decision of December 20, 2004 disallowed these legal expenses on three grounds. First, the legal costs were solely for the benefit of the shareholder; Second, the legal costs were out-of-period; Third, the Board found that the costs were excessive. Specifically, the Board stated;

The Board will not allow the legal expense incurred by NRG in its appeal of Board decision in RP-2002-0147/EB-2004-0004 to be recovered from its ratepayers. The Utility's return on equity compensates the Utility for the risks it incurs - including regulatory risk. This appeal was launched at management's discretion and solely for the benefit of its shareholder. It is inappropriate for ratepayers to support legal actions that, if successful, will benefit the Utility's shareholder exclusively.

By way of comment, \$50,000 of legal expenses has already been invoiced in the prior fiscal year. NRG ought to be aware that its proposal to include this amount in the test year for this Application represents a request for relief for costs incurred out-of-period and therefore would not be recoverable through rates. Further, the Board questions the prudence of a decision to spend \$175,000 for a potential recovery of up to about half that amount. Finally, the Board questions the size of the claimed legal expenses for an appeal the Applicant expects to last no more than two days. [paragraph 3.0.7, 3.0.8]

NRG in its Factum at paragraphs 101 to 110 responded to these findings.

With respect to the ruling that the legal costs were solely for the benefit of shareholders, NRG argues, that if NRG is successful in its appeal, this could have the effect of reducing its borrowing costs because lenders take some comfort from the fact that regulated utilities such as NRG can recover there costs in the regulatory process.

With respect to the Boards findings that the cost award was out-of-period, NRG responded that the cost of the appeal could not be ascertained with greater precision prior to the filing of the updated evidence. The Company argued that at the time it submitted its evidence the \$175,000 amount was the best information it

had. NRG further argued that NRG did not control the timing and was required to accommodate the Courts scheduling.

NRG also argued that claiming 2004 costs during fiscal year 2004 would have necessitated a separate application which would have been unnecessarily expensive and would have given rise to the issue of retro-activity. The Company submitted that waiting for the 2005 rate case was the appropriate business decision as it reduced the regulatory burden to NRG, the rate payers and the Board.

In this Motion NRG also argued that as a regulated utility, it should not be constrained from appealing regulatory decisions it considers inappropriate.

With respect to the ruling that the costs were excessive, NRG introduced new evidence and advised the Board that the costs were now reduced from the original estimate and would be no greater than \$70,000. Board Counsel advised the panel that this new level of costs was reasonable.

Board Findings

Although the Board finds that there is some merit in NRG's arguments with respect to both the out-of-period issue and the amount of the costs, in reviewing all factors, the Board finds that the Board's previous Decision with respect to legal costs should stand and not be varied.

NRG has argued that it should not be penalized when appealing decisions of this Board by disallowance of costs associated with these appeals. This panel agrees with that submission. However, there is no suggestion that the earlier panel was attempting to penalize NRG in this regard.

As to whether these costs were out-of-period, there is merit to NRG's position that these costs were not crystallized at the time they had to be presented in the 2005 rate case.

The Board also notes that the costs have now been finalized and are considerably less than the earlier estimate of \$175,000. The Company now claims that the costs will not exceed \$70,000. This is new evidence that was not before the previous panel, but the quantum of costs was only one of the several reasons given by the panel for disallowance.

The Board's ruling that the appeal was solely for the benefit of the shareholders and therefore the costs should be disallowed is a more difficult issue. It can be argued that all costs that a regulated utility seeks to recover from ratepayers are to the benefit of the shareholders. On the other hand, it can be argued that all Decisions will have an impact beyond the shareholder interest.

NRG argues in this case that lenders will be comforted by the fact that the utility is successful in recovering its costs. However, the more fundamental question is why these costs were disallowed in the first instance.

A careful review of the Decisions indicates that the disallowance of the interest costs and the legal and regulatory costs has been the subject of three separate Decisions. The first was the Board's April 19, 2004 Decision⁵, the second was the Divisional Court ruling on the appeal from that Decision⁶ and the third was the December 20, 2004 Decision⁷.

⁵ RP-2002-0147/EB-2004-0004

⁶ [2005] O.J. No. 1520

⁷ RP-2004-0167/EB-2004-0253

It's clear why the Board disallowed both the interest and legal costs. In the April 19, 2004 Decision, the Board stated;

Had NRG recorded gas cost variances properly in the PGCVA, the present conundrum would have been avoided....we find that NRG's error has resulted in a substantial and avoidable accumulation of potential customers' charges, through no fault of the customers.

We must therefore look for a balance. [paragraph 38-40]

At paragraph 44 and 47 of that Decision, the Board concludes that the "balance" was to allow recovery of the \$531,794, but not over one year as requested by the utility. Rather, the Board said the utility could recover those costs over three years but without interest. The Board added that it was also not going to allow the regulatory costs incurred with respect to the review.

NRG then appealed to the Divisional Court. The Court upheld the Board's Decision indicating, "The matter was compounded by the added issue of how to deal with the accumulation of costs caused by the appellant's inadvertence." The Court further stated " The issue before the Board is much more confined: how to deal with the consequences of a failure to identify and report prudently incurred costs, and in determining that question the Board was entitled within its broad mandate to consider both the utility's and customers' interests, as it did."

On review of the complete record, the Board finds that the principle motivation for the panel in disallowing these costs in both Decisions was that the costs were in part as a result of NRG's own error. This "inadvertence" as the Divisional Court describes it, imposed costs on customers which were the consequences of a failure to identify and report prudently incurred costs. The Divisional Court found at paragraph 15 of its Decision, "The Board's disposition, in seeking and determining a reasonable balance, was not punitive in nature."

This panel agrees with the Divisional Court's assessment. The issue of the costs of the appeal is the same issue that was before the Divisional Court. There, the costs were the costs of the review as opposed to the costs of the appeal. The principle is the same. This Board has consistently ruled that utilities should not be entitled to recover costs where those costs are a result of its own error and that error has imposed unnecessary costs on the ratepayers.

It is true that lenders and others look to the ability of a regulated utility to recover costs from its regulator. But they also look for consistency of Decisions on part of the regulator. The issue before this panel has been before the Board twice and the before the Divisional Court once. We see no reason to alter the findings.

Costs

The costs of, and incidental to, this proceeding shall immediately be paid by the Applicant upon receipt of the Board's invoice.

DATED at Toronto, October 6, 2005

ONTARIO ENERGY BOARD

Original signed by

Gordon Kaiser
Vice-Chair and Presiding Member

Original signed by

Pamela Nowina
Vice-Chair and Member

Original signed by

Paul B. Sommerville
Member