EB-2005-0551

Ontario Energy Board

IN THE MATTER OF the *Ontario Energy Board Act*, *1998*, S.O. 1998, c. 15 (Schedule B);

AND IN THE MATTER OF a proceeding initiated by the Ontario Energy Board to determine whether it should order new rates for the provision of natural gas, transmission, distribution and storage services to gas-fired generators (and other qualified customers) and whether the Board should refrain from regulating the rates for storage of gas.

Final Argument On Behalf Of
Energy Probe Research Foundation

August 28, 2006

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Introduction

Energy Probe's argument addresses only the storage regulation issue identified in Procedural Order #2.

All references are to materials filed in EB-2005-0551 unless otherwise noted.

The starting points for Energy Probe's arguments are the following:

- **OEB Act Section 2**
- **OEB Act Section 29(1)**
- **Key comments of the Board in the NGF**

The mandate of the Ontario Energy Board's is based on the OEB Act. Section 2 provides the objects of the Board with respect to gas.

> **Section 2. The Board, in carrying out its responsibilities under this or any other Act in relation to gas, shall be guided by the following objectives:**
>
> **1. To facilitate competition in the sale of gas to users.**
>
> **2. To protect the interests of consumers with respect to prices and the reliability and quality of gas service.**
>
> **3. To facilitate rational expansion of transmission and distribution systems.**
>
> **4. To facilitate rational development and safe operation of gas storage.**
>
> **5. To promote energy conservation and energy efficiency in a manner consistent with the policies of the Government of Ontario.**
>
> **5.1 To facilitate the maintenance of a financially viable gas industry for the transmission, distribution and storage of gas.**
>
> **6. To promote communication within the gas industry and the education of consumers. 1998, c. 15, Sched. B, s. 2; 2002, c. 23, s. 4 (2); 2003, c. 3, s. 3; 2004, c. 23, Sched. B, s. 2.**

Energy Probe believes that subsection 5 which directs the Board to promote energy conservation received little attention during the hearing but needs to be considered by the Board in disposing of the matters of the hearing (emphasis added).

Section 29 of the OEB Act confers upon the Board the power to refrain from exercising its regulatory oversight, in whole or in part, of the transmitting, distributing or storing of gas:

> **29. (1) On an application or in a proceeding, the Board shall make a determination to refrain, in whole or part, from exercising any power or performing any duty under this Act if it finds as a question of fact that a licensee, person, product, class of products, service or class of services is or will be subject to competition sufficient to protect the public interest.**
> **Scope**
> **(2) Subsection (1) applies to the exercise of any power or the performance of any duty of the Board in relation to,**
> **(a) any matter before the Board;**
> **(b) any licensee;**
> **(c) any person who is subject to this Act;**
> **(d) any person selling, transmitting, distributing or storing gas; or,**
> **(e) any product or class of products supplied or service or class of services rendered within the province by a licensee or a person who is subject to this Act.**

Energy Probe submits that a key factual determination that the Board must make is whether storage service "is or will be subject to competition sufficient to protect the public interest." (emphasis added)

The other key starting point for Energy Probe's argument are the questions from the Board's NGF Report at pages 46, 49 and 50, which were highlighted in IGUA/AMPCO's evidence in this proceeding:

- **Whether the current pricing structure for storage is inappropriately discriminatory;**
- **What additional incentives (if any) are needed to ensure adequate storage and transportation development?**
- **How should storage services be developed for gas-fired power generators?**

• Do Union's transportation rates or its operation of its system discriminate against customers, including independent storage operators?
• Are Union's incentives for operating and expanding storage aligned with the public interest?
• Would additional storage development benefit Ontario gas customers by enhancing the liquidity of trading in Ontario?
• If market-based rates are used to expand utilities' storage, should shareholders be asked to bear the associated greater risk?

Energy Probe draws attention to the second bullet as particularly of concern in this case.

Energy Probe's argument addresses the following topics:

- **What constitutes the public interest in with regard to the storage issues in this case?**
- **Comments on the utility evidence.**
- **Comments on the McConihe evidence.**
- **Comments on the Stauft evidence.**
- **Recommendations.**
- **Costs.**

What constitutes the public interest?

Energy Probe suggests that the key public interest considerations that should guide the Board are three fold:

1. encouraging economically efficient pricing of gas storage services;
2. protecting consumers of monopoly transmission and distribution services; and,
3. promoting the development of cost-effective storage opportunities in Ontario.

A minimum condition for consumers to optimize their usage of gas, including making efficient energy conservation decisions, is that consumers pay prices for competitive or potentially competitive gas services that reflect or approximate the competitive value of those services.

The Board has a duty to protect consumers relying on monopoly transmission and distribution services from unreasonable costs. A particular concern in this case is

that, according to the requests of Union and EGD, extensive and expanding unregulated business activities will be conducted within unregulated businesses. Energy Probe has further submissions on this topic below.

Promoting the development of cost-effective storage opportunities in Ontario is a benefit that received scant attention from the witnesses for Board Hearing Staff and the coalition of groups representing consumers. There has been very little storage development in Ontario for an extended period – several decades. Meanwhile, major storage developments have been going on around Ontario.

There appears to be substantial opportunities for significant future development within Ontario. Ontario has the benefit of favourable geology, extensive pipeline develop, an increasingly liquid market, and the active involvement of many strong commercial firms. The Sproule evidence in the hearing suggest that there is up to 120 Bcf of reef formation development potential in Ontario (Board Hearing Team Undertaking 7e). Salt formation storage represents another area of potential development, particularly for high deliverability storage. Mr. Reed estimated the potential for commercially viable development to be in the order of 50 Bcf. (TR 4 p. 191)

Unfortunately, Energy Probe observes the absence of evidence in this hearing from Ontario's only licensed non-utility storage provider, Tribute, and the limited participation of parties active in the secondary storage market. Only one marketer, BP, presented evidence. These absences may have been due to concerns about commercial confidentiality. Given these absences, it appears possible that there may be more development potential and more competition than meets the eye.

Enbridge and MHP Canada presented extensive evidence indicating their desires to develop new storage services within the Ontario market but only if they are allowed to offer those services at market-based rates and be allowed contracting flexibility.

Enbridge states it will only further develop Tecumseh storage capacity under a forbearance decision.

It is clear from the evidence in this case that storage development in Ontario has been artificially constrained directly due to unfavourable regulatory conditions. The evidence presented by EEA/Schwindt indicates that Ontario lacks a workable framework that offers proper incentives for new storage development (EEA/Schwindt evidence, Exhibit C, Appendix B. pp. 57-59).

The development of further gas-fired generation, developed primarily for peaking purposes, could make significant demands on storage for balancing purposes. Energy Probe suggests that forbearance will drive the enhancement of the physical capacity of Ontario's gas supply system to meet the needs of new gas-fired generators.

The Board's practice of regulating the prices for storage service on the basis of historic depreciated capital costs has resulted in prices far below competitive market values. Over time, the original capital costs associated with developing long-lived storage assets has depreciated toward zero. Since few new assets have been added in recent decades, the regulated prices for storage services have become very low relative to competitive market values.

One particular public interest consideration that received attention during the proceeding was the issue of whether costs associated with storage services for new gas-fired generators, in-franchise or otherwise, ought to be subsidized in some fashion. In-franchise power generators have stated an expectation to have priority access to new storage services (TR. Vol. 10, pp. 209-210).

Energy Probe urges the Board to avoid introducing any regulatory rules that might result in subsidies to new gas-fired generators. Ontario has a host of power generation options available. If one particular generation option is able to

externalize its costs through subsidies then there is a substantial risk that Ontario could move toward suboptimal generation development in future. The Board should pursue a path that eschews subsidies for gas-fired generators.

Comments on the EGD, Union, and MHP Evidence

Union and EGD propose that the Board forbear from regulating storage in Ontario on the basis that there is a workably competitive market for storage. However, the utilities further propose that in-franchise customers continue to receive cost-based rates for storage services. The allocation of storage to in-franchise customers would be frozen at 2007 levels. Any incremental storage required by the in-franchise market would be obtained at market-based rates and averaged in with the cost-based rates going forward. High deliverability storage services for gas-fired generators (and other qualifying customers) would be provided at market-based rates, whether these gas-fired generators are in-franchise or not. The utilities further propose eliminating revenue sharing with ratepayers associated with long-term peak storage margins and short-term storage and balancing services.

Energy Probe agrees with EGD, Union, and MHP that the evidence these parties presented establishes that the incumbent utilities do not have undue market power in the commercially relevant storage market and that the market is sufficiently competitive to protect consumers in the event that the Board forbears from regulating the storage market as requested by EGD, Union, and MHP. High correlations between prices for storage service in and around Ontario indicate that the commercially relevant storage market for consumers in Ontario extends into several nearby U.S. states. Michigan in particular has very large storage capabilities and is strongly interconnected with Ontario.

The GMi evidence was particularly significant in substantiating the views of Union and EGD by demonstrating the competitive nature of the local market. From its own experience, GMi explained the competitive nature of the market. When seeking

to satisfy its own storage needs, GMi looks to both primary and secondary markets. Marketers offer service options using a basket of tools to create competitive services which GMi evaluates when looking to renew services with primary utility suppliers. (TR. Vol. 10, pp. 85-87)

Section 29 requires, among other things, that the Board assess whether the storage market will be competitive in future. Given the prospects of new entrants, ongoing storage development in Michigan and other nearby states, and the protections afforded by federal competition law to prevent improper coordination between storage operators, Energy Probe concludes that the only reasonable expectation is that the market will become even more competitive in future.

Comments on the McConihe Evidence

The OEB Hearing Team witness, Ms. McConihe, offered the view that the storage market in Ontario is uncompetitive. To support her claim that the utilities hold market power, she relies on the fact that there is little uncontracted firm transportation capacity available into or out of the Ontario market place. On this basis, she concludes that storage services outside of Ontario do not represent a competitive alternative for consumers.

This analysis appears inconsistent with previous analysis authored by Ms. McConihe for utility clients (Ex. I.8.1).

Energy Probe believes that it is not necessary for excess, idle import/export transportation capacity to be available in order to have competition for storage services within Ontario.

Excess, idle transmission capacity can only occur in significant amounts if serious regulatory or business errors take place. Excess, idle transmission is costly and not generally in the public interest.

Third party storage services available to consumers from secondary market participants already represent a major force in the market place. Ms. McConihe did not examine what third party services might be available as an alternative to obtaining storage and transportation with the LDCs and pipelines.

New entrants, like Tribute, are another factor expanding competitive options in the foreseeable future.

If transmission constraints related to storage transactions develop, there is every reason to believe that the market will be able to respond to these challenges by adding transmission capacity in a timely fashion.

As demonstrated by Centra Gas Manitoba, backhaul can also be an effective method of acquiring storage services. Backhaul does not rely on excess, idle pipeline capacity, and is typically available. (TR. Vol. 1, pp. 160-161)

Comments on the Stauft Evidence

The evidence of Mark Stauft on various issues associated with Storage Regulation was sponsored by IGUA and AMPCO, the Consumers Council of Canada ("CCC"), the Vulnerable Energy Consumers Coalition ("VECC"), the City of Kitchener ("Kitchener"), the Schools Energy Coalition ("SEC") and the Canadian Manufacturers and Exporters Inc. ("CME").

IGUA and AMPCO prefiled evidence states that "IGUA & AMPCO support and adopt Mr. Stauft's analysis and conclusions and, in particular, support Mr. Stauft's conclusion that there is insufficient competition in Ontario storage services to protect consumers of natural gas in Ontario from the significant market power EGD and Union currently have in the Ontario storage services market."

Mr. Stauft's entire edifice rests on his claim to be following FERC decisions that the appearance of prices 10% above the competitive level is evidence of market power and that "the regulated level is the best proxy we have for the competitive level." (TR10 p. 5)

It would be silly for the Board to use regulated prices as a proxy for competitive prices when competitive prices can be seen directly. Obviously, Ontario's regulated prices are far below competitive prices. This is because prevailing regulatory practices uses a depreciated historic capital cost basis for rates. Competitive prices can be seen in the results of competitive auctions and open seasons that happen routinely in and around Ontario.

In response to questions for the Board Chair, Mr. Stauft claimed ignorance as to whether market prices for storage in Michigan reflect competitive levels. (TR 10, p. 9/10) This admission undermines the credibility of Mr. Stauft's analysis. If the market prices in Michigan arising from auctions do not reflect competitive levels, one wonders what the Michigan market prices could otherwise represent.

Since Ontario's regulated storage prices are definitely not a reasonable indicator of competitive prices, Mr. Stauft's analysis of market power crumbles.

Recommendations

The scope of the hearing has been confined by the utilities' proposal that it would not be appropriate to charge market prices for storage services that are provided as part of a bundled delivery service.

In addition to forbearance, Union proposes to eliminate five S&T deferral accounts (Tr. Vol. 1, pages 66-67, Argument in Chief p. 20/21):

- **Short Term Storage and Other Balancing Services deferral account (179-70)**
- **Long Term Peak Storage Services deferral account (179-72)**
- **Transportation and Exchange Services deferral account (179-69)**
- **Other S&T Services deferral account (179-73), and**
- **Other Direct Purchase Services deferral account (179-74).**

EGD is asking the Board to forbear from regulating transactional services. (EGD Argument in Chief p. 34)

Energy Probe urges the Board to endorse forbearance from storage regulation. Energy Probe suggests that the public interest would benefit from a framework that allows the risks and rewards of storage development and operation to be managed by storage service developers. Like the FERC, no reporting of the return on investment should be required for unregulated operations. (K9.2) However, if unregulated operations are permitted to cohabitate with regulated operations, rules requiring extensive disclosure will have to remain in place.

Energy Probe's disagrees with the utilities and their affiliates with regard to how separation of regulated and unregulated businesses should be managed. Following a forbearance decision, affiliate relations and non-discriminatory access to monopoly transmission facilities should remain topics of regulatory review.

IGUA/AMPCO have suggested that forbearance should be treated by the Board not as absence of regulation but as lighthanded regulation, a proposition that Energy Probe supports.

> **MR. THOMPSON: Your response was you viewed it as more a form of light-handed regulation rather than complete absence of regulation. And we can argue that with the utilities.**
> **But my question is: When the FERC grants market-based authority, what sort of information are the parties that are permitted to operate under market-based authority required to file with the FERC?**
> **MS. McCONIHE: They're required to file everything that a cost-of-service provider must file with FERC. They must have an electronic bulletin board; they must have an Index of Customers; they must show who those customers**

> **are; the terms of contract and the duration. The only thing that they do not have to show is the exact rate that those customers pay. (TR 9 p. 53/54)**

The utilities are proposing only accounting separation of regulated and unregulated businesses. Further, the utilities are relying on current cost allocation methods developed for allocating costs between rate classes to govern the separation of costs and revenues. (Union Argument in Chief p. 4) Union specifically opposes functionally separating storage from transmission and distribution on the basis of "high" costs and "unknown" benefits. (Argument in Chief p. 20)

Any cost allocation work that has been done historically could not have anticipated the dramatic change storage forbearance represents or the prospects for cohabitation of regulated and unregulated businesses. Union's witness, Mr. Baker, appears to have recognized this when he indicated that Union would need to do cost allocation analysis to split the assets, costs and revenues between the regulated and non-regulated portions of the company. (TR 2, p. 117)

Given the substantial gains that might be captured by shareholders by improperly transferring costs to regulated operations and revenues to unregulated operations, the Board must put in place effective controls. Accounting separation, based on accounts developed only for rates purposes, is clearly insufficient to protect ratepayers.

The Board should encourage the utilities to move toward complete separation of regulated and unregulated businesses. The minimum standard should be full structural separation with the objective of achieving separation as complete as would be achieved through divestiture.

Ratepayers must be held harmless for any and all costs associated with achieving and maintaining the separation. Instead, the costs of implementing and maintaining separation are only appropriately borne by shareholders.

If commercial storage operations are separated, the Board should consider adjusting the regulated utility returns on equity downward to reflect the reduction in business risk that will be enjoyed by the remaining streamlined regulated LDCs.

Although Energy Probe is not in a position to provide the Board with a legal interpretation, it appears on its face that Canadian legal principles as determined in the Supreme Court of Canada, City of Calgary v. ATCO Gas and Pipelines Ltd. decision has a significant bearing on this case. The ATCO case confirmed that rate payers have no claim to utility assets, or to the revenues associated with those assets, once the assets are no longer required for the provision of regulated services.

Long term storage premiums and short term storage-related transactional services appear to be utility assets not required for the provision of regulated services. It therefore appears to be appropriate to collapse deferral accounts capturing related amounts. Particularly with respect to Union's long term storage premiums, from a conservation and fairness perspective, it appears difficult to justify transferring the market premium to in-franchise customers simply to off-set costs associated with serving those customers. Removal of a subsidy to in-franchise customers will hurt but the removal of a subsidy is always painful to those directly affected.

While it appears appropriate to discontinue storage-related transactional service deferral accounts, all transmission-related deferral accounts should remain in place since transmission will remain a regulated service, even if the Board decides in favour of storage forbearance.

Union should eliminate two S&T deferral accounts: Short Term Storage and Other Balancing Services deferral account (179-70) and Long Term Peak Storage Services deferral account (179-72). The remaining accounts should remain in place. EGD's equivalent of Union's account 179-70 should be eliminated.

In the case of Union, significant storage capacity now in service is in excess of the storage requirements of in-franchise customers. If the amount of storage required by in-franchise customers in the future is less than the cost-based amount based on the 2007 allocation, whether due to economic downturns, the loss of competitiveness of gas relative to alternative fuels, or natural conservation or demand side management programs overcoming the effect of customer growth, then it appears that the entitlement for any market premium would flow to the utility owner. If a subsequent increase in gas demand within the in-franchise market develops, the proposals of the utilities in this case would indicate a restoration of cost-based storage to the in-franchise market up to the limit of the 2007 allocation.

Costs

Energy Probe Research Foundation, Canada's third-largest environmental policy organization and Canada's largest energy policy organization, has over 30,000 supporters, half of them in Ontario, of which most have tangibly expressed interest in energy issues. Energy Probe also has a strong consumer focus and is frequently acknowledged in the press as a consumer watchdog. Energy Probe has a history of representing the interests of many Ontarians who are not financial supporters.

As the Board considers Energy Probe's submission for costs, Energy Probe wishes to draw the Board's attention to the quality of its focused intervention and its understanding of the issues. Energy Probe urges the Board to award 100% of its reasonably incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

August 28, 2006

Tom Adams
Energy Probe Research Foundation