GUIDELINES FOR PRE-APPROVAL OF LONG-TERM GAS SUPPLY AND/OR UPSTREAM TRANSPORTATION CONTRACTS (EB-2008-0280)

OCTOBER 17, 2008

THE OEB'S FOUR QUESTIONS

The OEB's four questions taken from the August 22, 2008 letter identified four questions for discussion in this proceeding:

1. What are the needs and benefits of entering into a LTC?
2. What are the implications of not entering into a LTC?
3. What are the risks of entering into a LTC and how are the risks shared between the shareholders and ratepayers?
4. What would be the impact on competition?

Subsequently, in its October 1, 2008 presentation, the OEB raised a number of additional issues to be discussed.

EGD will address the Board's questions (and related issues) separately in respect of supply and transportation contracts.

EGD's Perspective

- EGD's ability to maintain, grow its distribution system and serve all customers on its system is dependent on its ability to secure reliable access to appropriately priced gas supply.
- EGD's gas supply portfolio provides supply to sales customers and provides daily load balancing for sales and direct purchase customers.
- EGD is the supplier of last resort, system operator and long term market planner for all customers on its system.
- EGD does not profit from its procurement activities, which are a straight pass through cost.

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EGD's Perspective

- EGD and its customers want competitive options for gas supply and transportation.
- Focus on lowest short term cost may inhibit growth of additional transportation and supply to the franchise.
- EGD's approach must strike a balance between:
  - Short term and long term cost, and price volatility.
  - Lowest cost, diversity and reliability of supply.
- Increased supply provides benefits to sales and direct purchase customers.
- EGD should be able to assign the underlying LTCs to customers who migrate from sales to direct purchase.

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EGD’s Perspective

- The need for Long Term Contracts (LTCs) for transport and supply for LDCs has increased due to:
  - Changing North American gas flows.
  - Potential for basis shifts that make some basins less economic than others.
  - Delays in infrastructure connecting to growth basins which could cause greater price volatility.
- LDCs in closer proximity to supply basins likely to be less affected.
- LDCs located further away from supply basins likely to be more affected.

EGD's Perspective

- The North American gas supply landscape is changing significantly:
  - NEB projects that net gas exports from WCSB will decline from 9 Bcf/d in 2007 to 5 Bcf/d in 2015.
  - Rockies production is forecast to increase by 4 Bcf/d by 2015.
  - Shale production in US and Canada is forecast to increase by 5 Bcf/d by 2015.
- Increase in LNG supply needed in North America by 2015 to meet growing demand.
- LDCs need to realign gas supply portfolio.

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LONG TERM TRANSPORTATION CONTRACTS

1) What are the needs and benefits of entering into a LTC for transportation?

Needs

- Long term contracts provide financial assurances underpinning new transportation paths that connect new or capacity constrained supply basins.
  - New facilities build on TCPL and Union require minimum 10 year commitment.
  - New transportation paths also require minimum 10 year commitment.
- Provides a signal to industry (producers and marketers) on validity of project.
  - LDCs recognized as a key signatory to transportation projects.
  - Financial, environmental and regulatory concerns favour larger scale pipeline projects.
  - Scale may exceed immediate transportation requirements.
  - LDC participation can influence pipeline routing and incent other market participants to underpin project to justify scale.
- LTC a driver for further integration of North American pipeline transmission infrastructure.
- Provides continued access to critical transportation paths.

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1) What are the needs and benefits of entering into a LTC for transportation?

Benefits for EGD customers

- LTCs provide benefits to sales and direct purchase customers through beneficial effects on Ontario market supply and price.
- Secure access to multiple supply basins in North America:
  - Add liquidity and favourable price impacts to Ontario marketplace;
  - Mitigate operational risk of single-path deliveries; and
  - Mitigate market risk (price and supply) associated with an individual basin.
- Bidding on primary capacity on FERC regulated pipelines can provide savings through negotiated tolls.
- Bidding on primary capacity on Canadian pipelines provides benefit of rolled in tolling and renewal rights.
- Provide a diversified portfolio mix of long and short-term contracts, anchored by security of long term contracts.
- EGD decision for LTC based on meeting franchise needs while producers decision for LTC based on highest netback.

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2) What are implications of not entering into a LTC for transportation?

- New infrastructure and supply source may not be developed
  - Marketers may have low appetite for long term commitments (some unwilling to commit to even one year firm/long haul contracts).
- New infrastructure/supply source may be developed to a hub/market not connected to EGD's franchise area.
  - Producers likely to underpin projects with the highest netbacks
  - reduced liquidity and increased price volatility relative to other hubs.
- Firm long term gas supply to franchise at stable prices not assured

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3) What are the risks of entering into a LTC for transportation and how are the risks shared between the shareholder and ratepayer?

Risks

- Forecasting risk; decision based on ‘snapshot’ data and information when operating in a dynamic market.
    - Price risk - LTC economics based on expected basis once pipeline is built, basis may shift once connectivity is established.
    - Volume risk – Changes in franchise load and load profile may result in lower utilization of pipe.
- Migration risk – Migration of customers from system to direct purchase may result in stranded capacity; risk can be managed by vertical slice approach.

Risk Allocation

- LTC decisions are made in the best interest of all customers. Pre-approval process allows for examination of costs and benefits of individual proposal.
- Gas costs are a pass through and do not benefit the shareholder.
- Since there is no reward for the shareholder, there should be no risk associated with cost recovery.

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4) What would be the impact on competition?

- Potential increase in retail marketer competition
  - assignment of upstream capacity provides ease of market entry.
- End-user mobility would be unaffected since all marketers would use vertical slice of same portfolio.

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LONG TERM SUPPLY CONTRACTS

1) What are the needs and benefits of entering into a LTC for gas supply?

- Supply LTC may be required to provide secure access to LNG
  - Incremental LNG supplies may be required to meet growing demand (2015).
  - LNG projects are very capital intensive and have higher risks than many domestic supply projects.
- LTC for domestic supply may be needed depending on cost, scale of production, liquidity of marketplace and credit constraints.
- EGD expects that LTC may only be needed for a small component of supply portfolio.
- Benefits all customers by providing security and diversity of supply.
- Supply LTCs are likely to be indexed rather than fixed price
  - LTC for LNG based on North American prices rather than world prices.

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2) What are implications of not entering into a LTC for gas supply?

- Absence of LTC for LNG could cause North American prices to compete for “flexible cargoes” at much higher prices than North American prices.
- Firm long term gas supply to franchise at stable prices not assured
  - A transportation LTC may not assure gas supply under some circumstances.

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3) What are the risks of entering into a LTC for gas supply and how are the risks shared between the shareholder and ratepayer?

Risk

- Forecasting risk – decision based on ‘snapshot’ data and information when operating in a dynamic market. These risks are:
  - Price risk - LTC economics based on price advantage that may not materialize.
  - Volume risk – Changes in franchise load and load profile may result in excess supply.
- Migration risk – Migration to direct purchase can be managed by vertical slice approach.

Risk Allocation

- LTC decisions are made in the best interest of customers. Pre-approval process allows for examination of costs and benefits of individual proposal.
- Gas costs are a pass through and do not benefit the shareholder.
- Since there is no reward for the shareholder, there should be no risk associated with cost recovery.

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4) What would be the impact on competition?

- Increase in competition due to additional supply sources
- Option to allocate LTC gas supply under vertical slice procedure
    - Supply price indexing allow for portability.

Pre-Approval of LTCs

A pre-approval process is appropriate

- LDCs enter into LTCs to benefit customers by ensuring secure gas supply is available in the franchise area.
- LDCs do not benefit from their gas supply arrangements, so should not be at risk either.
- A pre-approval process will give LDCs the necessary confidence and comfort to enter into beneficial LTCs – without such assurance, the risks are asymmetrical.
- Upon approval, an LTC should not be subject to retrospective prudence review.

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How should LTC be defined?

- EGD contracts one year term on pipelines that are not capacity constrained.
- EGD may bid for terms longer than one year for commercial reasons.
  - Pipeline open seasons for existing capacity (awarded on total value) may require bidding on more than one year to acquire needed capacity. (EGD does not foresee needing pre-approvals in this latter instance.)
- New pipeline projects typically require a minimum volume commitment of ten years.

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Eligibility requirements for pre-approval of LTCs

EGD should have the discretion to seek OEB pre-approval based on its assessment of risks associated with contract.

Guidelines for pre-approval of LTCs

EGD supports Union Gas' Incremental Transportation Contracting Analysis as described in EB -2005-0520 Settlement Agreement, Appendix B, with appropriate changes for gas supply LTCs.

Process for pre-approvals of LTCs

EGD envisages the following process for the pre-approval of LTCs.

1.EGD evaluates pipeline open season for relevance, value and security and diversity of supply.

2.EGD bids for capacity subject to conditions

3.On acceptance of bid by pipeline, EGD signs precedent agreement with condition of 'regulatory approval by the Board' by a certain timeline.

4.EGD seeks pre-approval of contract with Board.

- Pre-approval process should allow for timely decision making
- Pre-approval process should respect confidentiality of commercially sensitive information

5.Upon pre-approval, EGD waives regulatory condition and concludes contract negotiations.

EGD does not see the need for a review of the executed contract by the Board.

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