RP-2003-0063
EB-2003-0087
EB-2003-0097

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 Union Gas Limited for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, distribution, storage, and transmission of gas for the period commencing January 1, 2004.

BEFORE: Paul B. Sommerville
Presiding Member

Art Birchenough
Member

DECISION WITH REASONS

March 18, 2004

9.3 CORAL ENERGY ISSUES

Background

Coral Energy Canada Inc. ("Coral") intervened in this proceeding to seek the Board's approval for a rate to govern the supply of gas by Union to the Brighton Beach Gas-Fired Electricity Generation Facility located at Windsor Ontario.

Coral has entered into a tolling agreement with the owners of the Brighton Beach facility, pursuant to which it provides gas to fuel the generation equipment, and then sells the electricity generated into the IMO-administered electricity market. Accordingly, the price of gas was a consideration for Coral in the overall profitability of its undertaking in connection with the Brighton Beach facility.

The Brighton Beach facility itself is a joint venture between OPG and ATCO. It is designed to deliver electricity into the IMO-administered market at times when a premium price was being offered for incremental generation. This will normally occur at times when other sources of supply are unable to meet the system demand.

Coral and Union engaged in a negotiation respecting the terms and conditions that would govern Coral's supply of gas to the facility. At one point, because negotiations had not been fruitful, Coral filed an application with this Board for Leave to Construct a gas connection, which would have bypassed Union's distribution system. Union filed a competing Leave to Construct application. Negotiations resumed and Coral withdrew its application, and Union's was granted.

Coral and Union entered into a Carriage Service Contract ("CSC") on April 30th, 2002, the purpose of which was to define the terms under which Union would transport gas to the Brighton Beach facility. The parties subsequently entered into a related Clarification Agreement.

A key component to the pricing arrangement codified in the contract was the Delivery Commitment Credit ("DCC"). The DCC was an artifact of the rate structure governing direct purchase arrangements, which rewarded direct purchase

customers who had met their contractual obligations to Union with payments which were, in effect, rebates. The DCC had been put in place in the early stages of the unbundled marketplace as a financial device intended to encourage system customers to opt for the unbundled direct purchase option. As the unbundled market developed, all participants came to appreciate that the DCC should in some fashion be eliminated, insofar as it represented a device whose utility had been overcome by the development of the market.

In the Alternative Dispute Resolution conference leading up to the RP-1999-0017 case, an agreement was reached between all participants that the DCC should be eliminated. Union made a proposal to do so in RP-2001-0029, which would have eliminated the DCC per se, but which would have also retained the value of the rebates made attendant to the program by building them into the very rate structures governing the direct purchase customers. That same proposal was made in RP-2002-0130. Many interveners rejected Union's proposal as not genuinely eliminating the device, insofar as it built the rebates back into the rate structures. This was not, they contended the termination of the program, but rather its entrenchment. In RP-2002-0130 the Board found that the DCC should be eliminated in its entirety, so that the rebates rewarding direct purchase customers for meeting their contractual obligations to Union would be discontinued and not re-entrenched in the rate structures. In order to mitigate the effect of the elimination of the rebate on direct purchase customers, the Board determined that its elimination should be transitioned over a five year period, one fifth of the rebate to be eliminated in each year until the DCC was completely eradicated.

It was clear that the DCC rebate program was an important feature of the original contract for carriage between Union and Coral. It even appears that the Daily Contract Quantity ("DCQ") figures represented in the agreement were unnaturally high in order to increase the extent of the DCC rebate, and hence lower the overall cost of gas supply to Coral. It also appears that the full extent of the DCQ may not have been unequivocally obligated.

Once the DCC had been eliminated, the attractiveness of the initial contract for carriage to Coral was compromised. Indeed, the Clarification Agreement contained a provision which addressed the possibility that the Board would eliminate the DCC

in a manner different from that proposed by Union in RP-2002-0130. That provision required Union to use its best efforts to arrive at a new rate proposal for Coral which would preserve the essential economics of the transaction for Coral, given that now, following the Board's decision in RP-2002-0130, the DCC was not an ongoing source of rate rebate.

Union stated that it had examined the issue, and had concluded that there was no basis upon which it could establish a non-DCC rate that was as attractive to Coral as was the original arrangement.

Coral sought the Board's intervention to compel a rate treatment from Union that approximated its original expectation as to the cost of gas for the Brighton Beach facility.

Union's Position

Union submitted Coral's request was without merit and not supported by the principles of sound rate design.

Union submitted that Coral's request amounted to a request for the Board to vary its decision with respect to the elimination of the DCC for Coral alone among Union's other customers.

Union stated that the Board recognized the significant net rate impact resulting from the elimination of the DCC by directing Union to phase out the DCC over a period of five years.

Union argued that whether Coral was a credible bypass candidate was speculative since Coral withdrew its application for leave to construct before written interrogatories in respect of Coral's evidence were delivered. It was never the subject of cross-examination nor was this evidence put before the Board by Coral in this case.

Coral provided no evidence relating to its costs. Coral stated that gas distribution charges represented just 1% of Coral's total operating costs and just 2% of the total gas costs.

Union stated that the rate offered in the CSC was not a bypass rate, it was the T1 posted toll in effect at the time, adjusted to reflect Union's proposal to eliminate the DCC. Union did not offer any inducement for Coral to drop its bypass application.

Union presented evidence on the difference between Union's and Coral's understanding of the obligated DCQ.

Union argued that Coral's profile was not unique and its load and load profile were similar to other T1 customers. The firm transportation demand provided to Coral was approximately 87% in the CSC. It was only the total load factor which was projected to be 47%. Even at this level, it was within the T1 class average.

Union submitted that it had other high volume, low load factor customers. The costs associated with serving these customers were typically higher because capacity becomes idle. Accordingly, Union submitted that assuming Coral did display such unique characteristics, it should pay a higher as opposed to a lower rate.

Union strongly supported the Board's recognition of postage stamp rates as the basic building block of utility regulation in Ontario.

Union denied Coral's claim that the Board should consider other additional factors forming part of the 'public interest' argument.

Union submitted that there was no legislative support that 'the proposed rate appropriately balances the interests of natural gas and electricity market." If this amounted to the M2 or other Union customers subsidizing the cost of electricity across Ontario, then it may not necessarily be in the public interest.

Union questioned Coral's assertion that Ontario electricity customers will save $5 to $9 million per year, which divided by the 2001 census number of household in Ontario would result in an alleged savings of $1.20 to $2.15 per household. Coral

claimed that this would cost the Union customer $1.6 million which translated to $1.90 per household in the Southern Operations area.

Union submitted that Coral's argument of 'unforeseen consequences of rate decisions' was also without merit since Coral took no active part in either the RP-2001-0029 or the RP-2002-0130 case.

Union also rejected Coral's assertion that Union was engaged in some sort of 'Gotcha' game with Coral. Union was indifferent as to the specific rate charged to Coral as long as Union recovered its revenue deficiency.

Union submitted that it had considered Coral's request for rate relief in the context of the Board's decision with respect to the DCC, accepted principles of rate design, and Board precedent related to bypass competitive and postage stamp rates. Union could not find any reasonable rate-making alternative that would allow Union to provide Coral with the relief sought.

Coral's Position

Coral entered into the 20-year Carriage Service Contract with Union on the understanding that: a) the DCC was to be applied to reduce the Monthly Demand Charge and b) Coral would not be required to deliver the DCQ at Dawn except for design days.

Coral stated that following the Board's RP-2002-0029 decision to phase out the DCC, Coral modified the CSC with a Clarification Agreement dated October 1, 2002. The parties agreed to add Section 5(e), which read: "If the OEB eliminates the DCC in a manner not consistent with Union 's proposal ....then Union will use all reasonable and prompt efforts to propose and implement promptly an alternate rate-making solution which shall provide a comparable economic benefit to Customer as that provided by the DCC." However, Union's position was that "Given the clarity of the Board' s Decision on the DCC... there was no reasonable rate-making justification or defense for providing to Coral demand charge relief which cannot be provided to any other similarly situated customer, namely the full benefit of the pre-RP-2002-0130 DCC payment in rates."

Coral submitted that in view of its position as a credible bypass threat to Union, its distinctive gas profile and operating characteristics as the first gas-fired wholly merchant generator in Ontario, and its reliance on the pricing mechanism contained in the CSC to withdraw its LTC application", Coral requested the Board to approve the rates for transportation service contained in the CSC.

Coral reiterated that it was not seeking to vary the Board's order but was seeking an alternate rate-making solution which would provide a comparable economic benefit to Coral as that provided for by the DCC.

Coral submitted that "..the traditional bypass competitive rates framework applied in pre-1998 cases requires further evolution to take into account of the changes wrought by the Energy Competition Act, 1998." Coral requested the Board to consider the following:

1. is Coral's load profile unique,
2. is it in public interest to approve a different rate for Coral, and
3. is Union's existing rate for Coral just and reasonable.

Coral submitted that it was a credible bypass candidate. Since being a member of the Royal Dutch/Shell family of companies, it had the required resources and capabilities to finance, construct, own and operate lateral pipelines. Coral stated it only withdrew its Leave To Construct Application on the basis that it relied on the pricing mechanism offered by Union in the CSC.

Coral submitted that even without DCC, Union will recover its incremental costs of constructing and operating the gas lateral pipeline and as such, it was in the public interest to approve Coral's proposed rates to reduce the price of electricity.

Coral submitted that during negotiations with Union in 2001, Union was unable to lower the net delivery costs to match the economics of Coral building its own pipeline. On April 30, 2002, Coral and Union entered into the CSC and Coral withdrew its National Energy Board and OEB LTC applications. Coral stated that the two key points in the CSC were the application of the DCC to the Monthly Firm

Demand Charge and that Coral would not be required to deliver the DCQ at Dawn except on design days.

Coral submitted that the operating characteristics of the merchant generator were unique due to its high volume/low load factor profile, and therefore, justified a different rate.

Coral argued that, in the past, the Board has stated in the 1993 Cardinal Power case "The question of public interest in not a question of fact, but it was a question of judgement based on the facts and circumstances before the Board. Since the facts and circumstances change from case to case, so will the depiction of the public interest."

Coral submitted that in Coral's case, the Board should take into account two factors involving the interplay between the natural gas and electricity markets namely, the impact of gas delivery costs on electricity prices and the relationship between gas delivery rates and the siting of generation plants.

Coral submitted that if the cost difference between the rates in the CSC and Union's 2004 T1 rates of $1.6 million in 2007 (based on Exhibit 22.4) was passed onto electricity consumers they will have to pay between $5 to $9 million more for electricity. Coral submitted that Ontario energy consumers will benefit by approximately $3.4 million to $7.4 million.

Coral submitted that the siting of the Brighton generation plant should reduce congestion constraints on the electricity transmission system. This could lead to avoided costs in constructing transmission lines. Coral urged the Board to take into account the broader picture of the energy market instead of looking at the gas sector in isolation.

Coral submitted that the public interest requires that Ontario's regulatory structure incorporate some flexibility to deal with unforeseen consequences of regulatory decisions.

Coral submitted that the Board's Decision in RP-2002-0130 did not, and could not, foresee the impact on the CSC between Union and Coral. Coral did not place the confidential CSC before the Board at the time because it was relying on Union to defend its DCC elimination proposal and its contract with Union to provide an alternative rate making solution in the event the Board did not accept Union's proposal.

Coral submitted that by accepting Coral's proposal, the Board will "signal to investors that the regulatory regime in Ontario can deal with the unintended consequences of regulatory decisions, thereby providing investors with confidence that regulatory charges will not undermine the fundamental tenets of contracts that define the understandings upon which investments were made."

Coral requested the Board approve revenue requirements for gas transportation service to Brighton Beach for a term of 20 years commencing January 1, 2004, equivalent to the revenue levels originally contemplated by the terms of the CSC. Alternately, Coral requested the Board to approve either Rate Structure 1 or Rate Structure 2 described on pages 13 and 14 of the Elenchus Report.

Intervenors' Positions

The majority of the intervenors agreed that the Board should not be involved in contracts between parties and should only be interested in the rate design issues. VECC submitted that a bilaterally negotiated price was clearly outside the scope of posted rates. The majority of the intervenors were concerned that if a special rate was offered to Coral, it would pose additional costs to other customers.

VECC submitted that Coral did not provide enough analysis of the existing T1 customer load profile, contract demand levels, or load factor to justify a special rate.

VECC and CAC submitted that Coral had missed the opportunity to request a competitive bypass rate. Coral withdrew its leave to construct application and also did not intervene in the previous two Union rate cases when the DCC was under attack. The Board was well aware of the consequences of the elimination of the DCC, and suggested phasing in the elimination over 5 years.

VECC and CAC suggested that Coral was using the Energy Competition Act, 1998 to persuade the Board to consider awarding Coral a special rate in consideration of sound public policy to lower the price of electricity.

CAC further submitted that it was not up to the Board to decide on having gas users subsidize electricity users. Such a decision should rest with the government. The stand-alone obligation for gas users to subsidize electricity users without reference to other forms of energy was incorrect.

VECC submitted that if the Board approved a special rate for Coral, any deficiency should be assumed by the T1 class and not by all rate classes as Union suggested.

VECC and TCPL submitted that Union's shareholders and not the ratepayers should be responsible for the deficiency from actions concluded in private negotiations without regulatory scrutiny, including a prudence review of the contract.

CAC and LPMA agreed with Union's rate making principles and felt that Coral's request was a fundamental challenge to class rate-making principles. CAC stated that granting relief to Coral would inevitably result in a flood of applications by other members of the existing rate class, claiming that their end-use characteristics justified the creation of a distinct rate class.

CAC stated that Coral was aware of the regulatory risk in RP-2001-0029 to eliminate the DCC, and in the Clarification agreement, Coral did not withdraw from the agreement and accepted a "best efforts" undertaking on the part of Union.

A number of intervenors requested the Board to require a separate process to address the issues of gas distribution rate design and infrastructure requirements as they relate to gas fired electricity generation.

Board's Findings

The Bypass Argument

Coral's position begins with the suggestion that the rate arising from the Contract for Carriage was a rate that specifically responded to Coral's application for leave to construct the requisite gas connection facility, or in other words, was a bypass-competitive rate. At a minimum, in order for this argument to succeed, Coral must demonstrate that it was, and in some respects continues to be, a viable owner and developer of the gas connection, and that it fully intended to undertake this work on its own behalf. There was clear evidence that both Coral and later, Union, made respective applications for leave to construct the gas connection. Coral abandoned its application once the contractual negotiation bore fruit in the form of an acceptable rate structure, codified in the Contract for Carriage. Union proceeded to construct the gas connection. This would support a finding that the negotiated rate was, if not necessarily a bypass competitive rate, at least was a rate which was attractive enough to quell any interest that Coral had in developing the gas connection on its own account.

The Contract for Carriage captured that rate structure, which, appears to have been predicated on a high, non-obligated DCQ, resulting in DCC rebates to support the net cost of gas supply.

Prior to the execution of the Contract for Carriage, Coral could have, and perhaps should have, made application to the Board for a bypass competitive rate to govern gas supply for Brighton Beach. Instead, it entered into the Contract for Carriage and accepted the rate structures and contingencies associated with it.

The next step in the process involved the realization that the DCC itself, with the full endorsement of all parties in the Union rate proceedings, including Union itself, was to be eliminated. The specific scope and manner of its elimination had not been agreed upon. Union had made a proposal for its elimination, which had not been unreservedly endorsed by all interested parties. Coral's response to this

development was to secure the Clarification Agreement, which, inter alia, provided for the "best efforts" clause referred to above.

Union advanced its original proposal for the elimination of the DCC in RP-2001-0019. Coral did not intervene in that case. Its sole engagement in the regulatory process respecting the issue was to file a single letter of comment urging the Board to implement Union' s proposal for DCC elimination.

When the DCC was eliminated by the Board's decision in that case on a basis that did not entrench the DCC rebate into the respective direct purchase rate classes, Coral then directed Union to fulfill its obligation under the "best efforts" clause of the Clarification Agreement. Union stated that it has done so.

Having voluntarily organized its relationship with Union through contract, it is not now reasonable for Coral to insist upon the imposition by the Board of a bypass-competitive rate when the circumstances first underlying, then undermining the contractual arrangement have themselves been anticipated and addressed in contract.

It is conceivable that under some circumstances where the relative positions of the parties was different, or where a customer of the utility has been clearly overwhelmed by the resources and expertise of the Utility, that the Board could impose a rate solution, notwithstanding the existence of a binding contract between the parties. None of those circumstances are present here.

The Creation of a Unique Rate For Gas-Fueled Merchant Generation Plants

It is not surprising that Union has been unable to construct a post-DCC rate structure that offers anything like an equivalent financial prospect to Coral. The original rate structure captured in the Contract for Carriage was heavily dependent on the DCC rebates. Now that the DCC has been eliminated, there is, under existing rate structures, little scope for the creation of a similarly tuned rate.

Coral's argument urges the Board to determine that the unique nature of the operation of the Brighton Beach facility, that was the profile of its gas usage, justifies

the creation of a unique rate class. Coral goes on to say that there was an important issue of public policy which was engaged by its dilemma, and that the public interest in the development of new generation requires the establishment of a unique rate treatment for plants of this nature, including, if necessary, the creation of a so-called end use rate structure which would be applicable to any like operations, simply on the basis of their conformity with a stipulated business category. Union currently has no end-use rates in its array of rate structures, and such rates are a rarity in regulated markets.

Coral's argument is rooted in the fact that virtually all observers of the energy market in Ontario have identified a shortfall of generation supply as a key contributor to destabilizing concerns respecting the adequacy of supply for Ontario's current residential and industrial needs, creating an unwelcome dependence on out-of-province supply, which is a possible inhibitor of economic growth, and a contributor to significant price volatility.

Plants such as the Brighton Beach facility are designed to contribute significant levels of electricity to the IMO-administered grid at times when premium prices are available for incremental supply. Such plants are intended to operate only when the demand for electricity for the grid has created a price environment where a premium was paid for incremental supply. Such plants do not operate constantly, but intermittently, according to the demands and opportunities presented by the electricity market.

Natural gas-fueled generators are uniquely capable of responding to demand and price cues. Unlike other generation assets, they can move from inactivity to full contribution very rapidly. This usage profile also distinguishes them from other industrial customers. While most operations draw gas on a consistent and substantially predictable hour-over-hour basis, gas-fueled generation operations such as Brighton Beach are largely unpredictable, and move from zero usage for most of the time to full capacity draw over a short period, depending on electricity market price cues. A concern was expressed that conventional industrial users ought not to be required to pay more within the T1 rate class to accommodate a unique treatment for the gas-fueled generation operations.

The current rate class applicable to the Brighton Beach facility was T1. This rate applies to a very wide range of industrial users, with varying load profiles. Union's rate proposal invoked T1 rates applied in two blocks. This, Coral suggested, was a recognition by Union that the Brighton Beach profile was unique, and justified a very different rate treatment, outside of the normal restrictions imposed by the T1 rate rules.

The development and design of a rate or rate class is a process that is governed by principles which have been developed by scholars and practitioners. Principles are necessary because of the high degree of interdependence of gas distribution system participants. Of all the principles governing the establishment of rates and rate classes, the most fundamental is that requiring that rate classes should be responsible for a reasonable proportion of the costs they cause the system to incur.

The revenue requirement established by the Board in rates cases such as the present case represents the system's overall financial burden. In order for rates to be just and reasonable, which is the statutory requirement, each rate class should bear a proportion of that burden roughly coincident with the costs incurred by the system operator, in this case Union Gas, in providing the necessary infrastructure and services to arrange for, store and transport the commodity to that rate class' members. Where a disproportionate amount of the revenue requirement is visited upon a rate class, that rate class is either subsidizing or being subsidized by other system participants. Rates are developed to avoid any such disproportionality to the extent reasonably possible. For this reason, so-called end-use rates have not been a common feature of regulated markets. In order to ensure that the appropriate cost causation allocation is made respecting a specific category of user, the regulator must first establish the demands placed upon the system by the consumer arising from the consumer's usage profile, not the category of its business undertaking. It is also important to note that there may be important sub-categories of generation end-users. Co-generation plants for example, where the plant produces steam for industrial users as well as electricity, have markedly different operational considerations, compared to pure merchant operations, such as the one at Brighton Beach.

A number of parties in this proceeding urged the Board to avoid making a decision on the fundamental issue of rate design for gas-fueled generators, on the grounds that the manner in which the issue was presented, and its timing within the proceeding, meant that there has been an insufficient opportunity for a thorough presentation and examination of the very complex and important private and public issues raised by Coral's intervention.

The Board considers that the important public interest issues invoked by the Coral intervention are of such a nature that they warrant a more expansive opportunity for presentation and examination of detailed evidence regarding the specific load profile presented by the Brighton Beach facility and other like or similar operations. The public interest consists in large part of the perceived requirement for additional electricity generation in Ontario. This aspect alone distinguishes this case from typical gas rate applications, where the interests which dominate the proceeding typically involve a private contest between the monopolist utility and its customers. Further, the Board does not have sufficient evidence before it now to assess the extent to which this load profile justifies, on the basis of generally accepted rate design principles, a unique rate class for such undertakings, nor the implications such an approach may have for members of the current T1 rate class, or other rate classes. In addition, the Board considers that it does not have sufficient material before it with respect to the consideration of so-called end user rates.

The public interest in the matter carries a measure of urgency. The development of new generation assets has been identified as a high priority for the government in an environment that has been characterized as being short of electricity supply. Coral, too, is facing pressures respecting the commissioning of the Brighton Beach facility.

Accordingly, pursuant to Section 21, of the Act, the Board directs Union to begin immediately to prepare and submit detailed evidence respecting the reasonably anticipated load profile associated with the Brighton Beach facility, based on the extrapolation of available data, in consultation with Coral and other interested parties. It is the Board's expectation that Union will use the cost allocation methodology approved in EBRO 499. Union should determine if there is a basis, consistent with applicable ratemaking principles, for establishing a new rate class for

customers with Coral's load profile and if so, apply for Board approval. Union shall do this by no later than August 1, 2004. The procedure timeline to be followed will be established in a Procedural Order, which will include provision for late intervention requests by interested parties who are not currently intervenors.

Notwithstanding this unresolved issue, the Board intends to finalize rates for 2004 as soon as possible. If there is a basis for establishing a new rate class, that will be implemented on a prospective basis, no earlier than as part of the 2005 rates. While the issue is important and should be addressed as soon as possible, the Board notes that the DCC is still being phased out and a significant portion of it continues to be available to Coral for 2004. Furthermore, as Coral advised, gas distribution costs only represent approximately one percent of Coral's anticipated operating costs.