September 10, 2007

Kirsten Walli
Board Secretary
Ontario Energy Board
Suite 2700
2300 Yonge Street
Toronto, ON M4P 1E4

Re: Union Gas Limited – 2006 Deferral Account and Earnings Sharing Disposition (EB-2007-0598)

Dear Ms. Walli:

This letter is Union's response to comments received on Union's draft EB-2007-0598 Rate Order. Union received comments on the draft rate order from Board staff, the Consumers Council of Canada ("CCC"), the Industrial Gas Users Association ("IGUA"), the London Property Management Association ("LPMA"), the School Energy Coalition ("SEC"), and the Vulnerable Energy Consumer's Coalition ("VECC"). Generally, these parties argued that the Board did not intend in its EB-2007-0598 Decision and Order to permit Union to adjust its 2006 earnings for purposes of the earnings sharing calculation to reflect the deferred tax cost of $10.524 million ($16.475 million pre-tax) that the Board had found should be removed from the Long-Term Peak Storage Services Deferral Account. These arguments result from a selective reading of the Board's Decision and Order and ignore the evidence filed in these proceedings.

There are essentially three reasons why Union adjusted the earnings used in the 2006 earnings sharing calculation to reflect the removal of the deferred tax cost from the Long-Term Peak Storage Services Deferral Account. These reasons flow from the Board's explicit direction in making its Order in this case and from the evidence available to the Board in making its disposition of the deferred tax issue.

1. In paragraph 3, page 11 of the EB-2007-0598 Decision and Order, the Board directed Union to "file an updated version of the Earnings Sharing Calculation table (Exhibit A, Tab 1, Schedule 4) to include the "non-utility adjustment" in earnings sharing, *as well as any effects attributed to the revised balance of the Long-Term Peak Storage Services Account as set out in this order*"[emphasis added]. There are no such effects except the treatment of deferred taxes. Had the Board not intended for Union to adjust the earnings used in the 2006 earnings sharing calculation to reflect the removal of the deferred tax cost from the Long-Term Peak Storage Services Deferral Account, the Board would not have provided Union with this directive. This is

because no adjustment to the earning sharing calculation would have been required if all the Board intended in its decision on deferred taxes was for Union to remove the deferred tax cost from the Long-Term Peak Storage Services Deferral Account. Union expressly explained this in Exhibit B3.19 which states:

> "Hypothetically, if the Board found that it was not appropriate to treat the deferred tax entry as a cost to provide storage services in 2006 as described in Exhibit A, Tab 1, page 11 and subsequently also found that it was not appropriate to reflect the deferred tax entry in the 2006 earnings sharing calculation, the earnings sharing amount would not change."

2. Union's evidence was clear that should the Board decide that it was not appropriate to record the deferred tax cost in the Long-Term Peak Storage Services Deferral Account, it was Union's position that the earnings sharing calculation would need to be adjusted accordingly. The only place in the Board's August 17, 2007 Decision and Order which addresses this is in paragraph 3, page 11 as described above. As indicated earlier, the only meaning to be placed on this directive in the Board's Order is that the deferred tax cost was intended to be included in the earnings sharing calculation. The relevant Exhibits include interrogatory responses provided at Exhibits B3.4, B3.5, B3.6 and B3.19 which have been attached. Further, the issue was discussed at the hearing at pp. 16 and 39 - 40:

> "MS ELLIOTT: That's correct. The other line on that schedule that changes, if it's disallowed in the deferral account calculation, it will be a cost in the earnings sharing calculation. So the earnings sharing line on that schedule is lower than its shows on the pre-filed evidence schedule. (p. 16)…
>
> MR. THOMPSON: You tell us in your evidence, responses to interrogatories -- and we touched on this a moment before -- that if you don't get it from the deferral account, then you are proposing an adjustment to the earnings sharing calculation.
>
> MS. ELLIOTT: That's correct; yes.
>
> MR. THOMPSON: Is that because of what the annual report says? This should be a charge to earnings?
>
> Ms ELLIOTT: This is a charge to earnings. And to the extent that it is a charge to earnings as a result of the storage operation, it should be part of the earnings sharing calculation, if it's not recovered through the deferral accounts." (pp. 39 - 40)

There was no finding by the Board rejecting this evidence.

3. It was clear in Union's evidence and in Union's 2006 Annual Report that the deferred tax cost was an expense that affected 2006 earnings (i.e., this was not a balance sheet entry). This was identified in the evidence at Exhibit A, Tab 1, p. 14 which states "the revenue required to recover the deferred tax expense is grossed up by $5.951 million to $16.475 million to recognize the current tax expense". Union's 2006 Annual Report included both the cost of the tax (in the Operating Revenue summary at page 5, in the $37 million of "Income tax") and, on the assumption that the amount of the cost would be recovered through the deferral account offset applied for, in 2006 revenues (again in the Operating Revenue summary on page 5, in the $191 million of "Storage and transportation" revenue). Page 6 of The Annual Report is explicit in saying: "Storage and transportation net revenue increased by $19 million compared to 2005 primarily due to recovery of additional deferred tax charges incurred during 2006."

The core of the IGUA argument is that the Board's finding that: "any liabilities associated with these assets should properly be associated with Union's newly formed ex-franchise storage service business," must be taken to mean that the deferred tax cost should also be excluded from corporate earnings for earnings sharing calculation purposes. This is simply not so. Just because Union cannot recover the deferred tax cost directly from customers does not mean, in accounting, legal or regulatory terms, that this cost must be excluded from corporate income for purposes of calculating earnings sharing. In fact, all of Union's experience and precedents to date are to the opposite effect. The Board has to date specifically and consistently held that the basis for earnings sharing is "all in" corporate earnings, subject only to two adjustments, one to normalize weather for the general service volumes (for 2005 and 2006 only) and the other to exclude revenue already subject to another sharing mechanism.

The fact is that in every year in which Union has been subject to earnings sharing (2001 to 2003, 2005 and 2006) the amount subject to earnings sharing has been total corporate earnings (with pre-determined adjustments stipulated by the Board), irrespective of how various individual amounts might be characterized. Union's attempts to adjust total corporate earnings (in 2005 regarding Lennox and in 2006 regarding the $1.278 million after tax payment) have, in fact, been rejected by the Board. It is not appropriate, therefore, for IGUA and other parties to be arguing for further special adjustments merely because it suits their interests to do so. Accordingly, Union submits the Board, in declining recovery of the deferred tax cost through the S&T deferral account, did not determine that this cost (which the Board accepted was a cost which was appropriately recognized for financial reporting purposes in 2006), could not form part of corporate income for purposes of calculating earnings sharing.

Finally, the LPMA submission seeks clarification of the inclusion of the deferred tax cost in the 2006 corporate income calculation in relation to Union's Annual Report and suggests that Union is, in any event, seeking to recover "too much" of the deferred tax cost through the earnings sharing calculation.

The reconciliation is as stated above. The Operating Revenue summary at page 5 of the Annual Report reflects both the deferred tax cost and, on the assumption that the cost would be recovered through the deferral account, the revenue effect of the recovery of that cost. Because the cost was not recovered through the deferral account, Union's revenue was, in fact, reduced by $12.356 million (i.e., 75% of the deferred tax cost).

In arguing that Union is seeking to recover "too much" of the cost in any event, LPMA has confused after-tax amounts with pre-tax amounts. The LPMA's reference to $10.5 million is to an after-tax number. That number, grossed up for taxes, is $16.475 million. The $8.5 million number also referenced by the LPMA is a pre-tax, after earnings sharing number, i.e., 50% of the pre-tax total of $16.475 million. There is no discrepancy. Because Union notionally (due to a biased weather normalization methodology) earned more than its regulated rate of return in 2006, it has retained only half of the notional additional earnings and been credited only half of the relevant costs.

In conclusion, Union submits that its draft EB-2007-0598 Rate Order properly reflects the Board's August 17, 2007 EB-2007-0598 Decision and Order and should be accepted as filed.

Yours truly,

[original signed by]

Mike Packer, CMA, CIM
Director, Regulatory Affairs

Attachments

cc. EB-2007-0598 Intervenors
Michael Penny (Torys)
Adrian Pye (OEB staff)
Vincent Cooney (OEB staff)
Duncan Skinner (OEB staff)

UNION GAS LIMITED

Answer to Interrogatory from
Industrial Gas Users Association ("IGUA")

***Question:***

Please show the extent to which Union's after tax Actual Earnings for 2006, subject to earnings sharing, before weather normalization of $98.023M shown at Ex. A, Tab 1, page 24, line 19, and after weather normalization of $117.936M shown at Ex. A, Tab 1, page 27, line 6, as well as the earnings amount payable to ratepayers of $12.579M shown at Ex. A, Tab 1, page 27, line 9 increases, if there is no recording in Union's 2006 Financial Statements of deferred taxes allegedly attributable to the Board's NGEIR Decision.

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***Response:***

The attached Schedule A contains the hypothetical earnings sharing calculation assuming the deferred tax entry was not required.

However, given that the deferred tax entry was required to remain compliant with generally accepted accounting standards and policies, the attached Schedule B is a more accurate representation of the 2006 earnings sharing calculation assuming that the deferred tax cost is excluded from the long-term peak storage services deferral account (No. 179-72).

# UNION GAS LIMITED
## Earnings Sharing Calculation
## Year Ending December 31, 2006

| Line No. | Particulars ($000's) | Calendar 2006 (a) | Adjustment | Calendar 2006 as Adjusted |
|---|---|---|---|---|
| 1 | Corporate earnings | $ 98,636 | $ 2,631 (1) | $ 101,267 |
| | Adjustments required for Earnings Sharing (net of tax): | | | |
| 2 | Add back provision for earnings sharing | 8,521 | | 8,521 |
| 3 | S&T base revenue - shareholder portion (10%) | (1,655) | | (1,655) |
| 4 | S&T revenue in excess of base - shareholder portion (25%) | (3,846) | (2,631) (2) | (6,477) |
| 5 | Shared savings mechanism incentive (SSM)[1] | (2,356) | | (2,356) |
| 6 | Other non-utility adjustment | (1,278) | | (1,278) |
| 7 | Earnings subject to sharing before weather normalization (lines 1 through 6) | 98,023 | (0) | 98,023 |
| 8 | Weather normalization [3] | 19,913 | - | 19,913 |
| 9 | Earnings subject to sharing (lines 7 + 8) | $ 117,936 | $ (0) | $ 117,936 |
| 10 | Average corporate common equity | $ 1,141,528 | | $ 1,141,528 |
| 11 | ROE used for earnings sharing (line 9 / line 10) | 10.33% | | 10.33% |
| 12 | Benchmark ROE [2] | 8.89% | | 8.89% |
| 13 | Earnings sharing % (line 11 minus line 12) | 1.44% | | 1.44% |
| 14 | Earnings sharing amount (line 13 x line 10 / 2) | $ 8,226.9 | | $ 8,226.9 |
| 15 | Pre-tax earnings sharing amount (line 14 / (1 minus tax rate)) | $ 12,879 | | $ 12,879 |

Notes:

| | | |
|---|---|---|
| 1 | Remove deferred tax entry | 10,524 |
| | After-tax ratepayer impact associated with S&T deferral entry (16,475 x 75% x (1 - 36.12%)) | (7,893) |
| | | 2,631 |

2 After-tax shareholder portion of deferral impact ($16,475 X 25% X (1 - 36.12%))

# UNION GAS LIMITED
## Earnings Sharing Calculation
## Year Ending December 31, 2006

| Line No. | Particulars ($000's) | | Calendar 2006 (a) | | Adjustment | | Calendar 2006 as Adjusted |
|---|---|---|---|---|---|---|---|
| 1 | Corporate earnings | $ | 98,636 | $ | (7,893) (1) | $ | 90,743 |
| | Adjustments required for Earnings Sharing (net of tax): | | | | | | |
| 2 | Add back provision for earnings sharing | | 8,521 | | | | 8,521 |
| 3 | S&T base revenue - shareholder portion (10%) | | (1,655) | | | | (1,655) |
| 4 | S&T revenue in excess of base - shareholder portion (25%) | | (3,846) | | (2,631) (2) | | (6,477) |
| 5 | Shared savings mechanism incentive (SSM) | | (2,356) | | | | (2,356) |
| 6 | Other non-utility adjustment | | (1,278) | | | | (1,278) |
| 7 | Earnings subject to sharing before weather normalization (lines 1 through 6) | | 98,023 | | (10,524) | | 87,499 |
| 8 | Weather normalization | | 19,913 | | - | | 19,913 |
| 9 | Earnings subject to sharing (lines 7 + 8) | $ | 117,936 | $ | (10,524) | $ | 107,412 |
| 10 | Average corporate common equity | $ | 1,141,528 | | | $ | 1,141,528 |
| 11 | ROE used for earnings sharing (line 9 / line 10) | | 10.33% | | | | 9.41% |
| 12 | Benchmark ROE | | 8.89% | | | | 8.89% |
| 13 | Earnings sharing % (line 11 minus line 12) | | 1.44% | | | | 0.52% |
| 14 | Earnings sharing amount (line 13 x line 10 / 2) | $ | 8,226.9 | | | $ | 2,964.9 |
| 15 | Pre-tax earnings sharing amount (line 14 / (1 minus tax rate)) | $ | 12,879 | | | $ | 4,641 |

Notes:
1 After-tax ratepayer impact associated with S&T deferral entry (16,475 x 75% x (1 - 36.12%))

2 After-tax shareholder portion of deferral impact ($16,475 X 25% X (1 - 36.12%))

EB-2007-0598
Exhibit B3.5

UNION GAS LIMITED

Answer to Interrogatory from
Industrial Gas Users Association ("IGUA")

***Question:***

Please revise Ex.A, Tab 2, Schedule 1 entitled "Allocation of 2006 Deferral Account Balances and 2006 Earnings Sharing to Rate Class" to reflect the elimination of any and all deferred taxes allegedly attributable to the Board's NGEIR Decision from Union's 2006 Storage Revenue Deferral Accounts and the 2006 Earnings Sharing amount payable to ratepayers.

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***Response:***

Please refer to attached revised Schedule 1.

EB-2007-0598
Exhibit A
Tab 2
Schedule 1

UNION GAS LIMITED
Allocation of 2006 Deferral Account Balances and 2006 Earnings Sharing to Rate Classes

| | | | Northern and Eastern Operations Area | | | | | | Southern Operations Area | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Line No. | Particulars | Acct No. | Rate 01 ($000's) | Rate 10 ($000's) | Rate 20 ($000's) | Rate 77 ($000's) | Rate 100 ($000's) | Rate 25 ($000's) | M2 ($000's) | M4 ($000's) | M5A ($000's) | M7 ($000's) | M9 ($000's) | M10 ($000's) | T1 ($000's) | T3 ($000's) | M12 ($000's) | M13 ($000's) | C1 ($000's) | M16 ($000's) | Total (1) ($000's) |
| | | (a) | (b) | (c) | (d) | (e) | (f) | (g) | (h) | (i) | (j) | (k) | (l) | (m) | (n) | (o) | (p) | (q) | (r) | (s) | (t) |
| | Gas Supply Transportation-Related Deferrals: | | | | | | | | | | | | | | | | | | | | |
| 1 | Unabsorbed Demand Cost (UDC) Variance | 179-108 | (874) | (261) | (59) | | | | 481 | 5 | | | | 0 | | | | | | | (708) |
| 2 | Heating Value | 179-89 | (1,655) | (750) | | | | | | | | | | | | | | | | | (2,405) |
| | Storage and Transportation-Related Deferrals: | | | | | | | | | | | | | | | | | | | | |
| 3 | Transportation and Exchange Services | 179-69 | (157) | (47) | (11) | - | (7) | | (630) | (63) | (3) | (68) | (4) | (0) | (199) | (41) | (2,648) | | (126) | | (4,004) |
| 4 | Balancing & Short Term Storage Services | 179-70 | (2,860) | (854) | (194) | - | (129) | | (10,957) | (1,098) | (53) | (1,181) | (61) | (3) | (3,462) | (711) | - | - | - | - | (21,565) |
| 5 | Long-Term Peak Storage Services | 179-72 | (398) | (119) | (27) | - | (18) | | (1,533) | (154) | (7) | (165) | (9) | (0) | (484) | (100) | | | | | (3,015) |
| 6 | Other S&T Services | 179-73 | (52) | (15) | (3) | - | (2) | | (198) | (20) | (1) | (21) | (1) | (0) | (63) | (13) | | | | | (390) |
| 7 | Other Direct Purchase Services | 179-74 | (49) | (15) | (3) | - | (2) | | (190) | (19) | (1) | (20) | (1) | (0) | (60) | (12) | | | | | (373) |
| 8 | Total Gas Supply Transportation-Related | | (6,045) | (2,061) | (298) | - | (158) | - | (13,027) | (1,348) | (66) | (1,456) | (75) | (4) | (4,268) | (877) | (2,648) | - | (126) | - | (32,460) |
| | Delivery-Related Deferrals: | | | | | | | | | | | | | | | | | | | | |
| 9 | Deferred Customer Rebates/Charges | 179-26 | - | - | | | | | - | | | | | | | | | | | | - |
| 10 | Comprehensive Customer Information Program | 179-56 | - | - | | | | | - | | | | | | | | | | | | - |
| 11 | Direct Purchase Revenue and Payments | 179-60 | | | | | | | (118) | (11) | (0) | (8) | (1) | (0) | (23) | (10) | - | - | - | - | (171) |
| 12 | Lost Revenue Adjustment Mechanism (2) | 179-75 | 1,069 | 418 | 50 | - | 49 | - | 2,037 | 263 | 64 | 26 | - | - | 4 | - | - | - | - | - | 3,980 |
| 13 | Intra-period WACOG | 179-102 | 2,247 | 532 | 130 | - | 848 | | 8,211 | 990 | 800 | 1,268 | 47 | 1 | - | - | - | 183 | 429 | 55 | 15,742 |
| 14 | Unbundled Services Unauthorized Storage Overrun | 179-103 | - | - | - | - | - | | - | - | - | - | - | - | - | - | | | | | - |
| 15 | Storage Rights Compensation Costs | 179-110 | 54 | 16 | 4 | - | 3 | | 299 | 17 | 7 | 13 | 2 | - | 77 | 19 | - | - | - | - | 511 |
| 16 | Demand Side Management Variance Account | 179-111 | 1,262 | 292 | 278 | - | 278 | | 3,992 | 278 | 278 | 278 | - | - | 278 | - | - | - | - | - | 7,213 |
| 17 | Gas Distribution Access Rule Costs | 179-112 | - | - | - | - | - | | - | - | - | - | - | - | - | - | - | - | - | - | - |
| 18 | Late Payment Penalty Litigation | 179-113 | 68 | 3 | 0 | - | 0 | 0 | 231 | 0 | 0 | - | - | - | 0 | - | - | - | - | - | 303 |
| 19 | Incremental OEB Cost Assessment | 179-114 | 273 | 27 | 11 | 0 | 21 | 7 | 933 | 30 | 19 | 26 | 1 | 0 | 64 | 8 | 118 | - | 3 | 0 | 1,541 |
| 20 | Shared Savings Mechanism Variance Account | 179-115 | 468 | 400 | 672 | - | 668 | | 2,508 | 1,008 | - | 376 | - | - | 899 | - | - | - | - | - | 7,000 |
| 21 | Total Delivery-Related | | 5,441 | 1,689 | 1,146 | 0 | 1,866 | 7 | 18,093 | 2,576 | 1,168 | 1,979 | 49 | 1 | 1,299 | 17 | 118 | 183 | 432 | 55 | 36,119 |
| 22 | Total 2006 Deferral Account Disposition | | (604) | (372) | 848 | 0 | 1,708 | 7 | 5,065 | 1,228 | 1,102 | 523 | (27) | (3) | (2,970) | (860) | (2,530) | 183 | 306 | 55 | 3,660 |
| 23 | Earnings Sharing for 2006 | | (886) | (145) | (47) | (0) | (119) | (45) | (2,173) | (87) | (54) | (76) | (3) | (0) | (159) | (25) | (807) | (1) | (12) | (1) | (4,641) |
| 24 | Grand Total | | (1,489) | (517) | 801 | (0) | 1,588 | (38) | 2,893 | 1,141 | 1,048 | 446 | (30) | (3) | (3,129) | (885) | (3,337) | 183 | 294 | 54 | (981) |

Notes:
(1) EB-2007-0598, Tab 1, Schedule 1
(2) Per Exhibit A, Tab 1, Schedule 2, Page 1 of 5, column (e)

UNION GAS LIMITED

Answer to Interrogatory from
Industrial Gas Users Association ("IGUA")

***Question:***

It is IGUA's position that the portion of the Board's NGEIR Decision which characterized Union's ex-franchise storage business as a non-utility line of business was never intended to affect the ratepayers' share of 2006 Storage Revenue Deferral Accounts, nor their share of Union's 2006 Normalized Earnings. To obtain an estimate of the impact on Union's shareholder of a Board Decision refusing Union's attempt to recover, from Union utility ratepayers, deferred taxes allegedly attributable to a Board-determined non-utility line of business having an effective date no earlier than January 1, 2007, IGUA seeks the following:

(a) Production of that part of Ex.B, Tab 3, UGL Undertaking K.2.2 in the NGEIR proceedings showing that, in the end-state it was proposing, Union would earn $44.530M of additional revenue (based on a 2007 forecast) and an adjusted ROE of 86.41%. A copy of UGL Undertaking K.2.2 is attached. IGUA understands that the current price for market-based storage is considerably higher than that originally forecast by Union.

(b) Please revise the revenues, costs, and return on rate-base calculation for ex-franchise storage services provided above to reflect the end-state of the Board's NGEIR Decision with respect to "non-utility" storage revenues, costs, assets and the higher forecast prices for market-based storage.

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UNION GAS LIMITED

Undertaking of Steve Baker
To Peter Thompson

The company will perform a calculation of the costs of capital in the 30 cents shown in undertaking U.16 from the technical conference in this hearing.

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As a result of the EB-2005-0520 Settlement Agreement, the cost based storage rate will be approximately 30 cents/GJ which is made up as follows:

| | Cents/GJ |
|---|---|
| Return - Equity | 5 |
| Debt & Preference Shares | 7 |
| Income Tax | 2 |
| Capital & Property Tax | 1 |
| Accumulated Deferred Tax Drawdown | (1) |
| Depreciation | 6 |
| O&M | 10 |
| Total | 30 |

In Union's view the storage market in and around Ontario is competitive and the Board should refrain from regulating rates for ex-franchise storage services. To refrain from the regulation of rates pursuant to Section 29, it is Union's view that this would require all revenues and costs associated with competitive services to be outside of regulation. As such, the calculation of return on rate base would no longer be meaningful or appropriate.

However, if 2007 forecast revenues and costs were used to complete a return on rate base calculation for ex-franchise storage services the following would be the result. Union notes that storage services are valued by the market, largely based on seasonal natural gas commodity pricing spreads which fluctuate widely from year to year. The revenues forecast for 2007 represent a point in time estimate of storage service values. As seasonal natural gas commodity pricing spreads change so will the value of storage services. Union also notes that the rate base associated with ex-franchise storage services in 2007 reflects depreciated assets that were developed years ago.

| | |
|---|---|
| Witness: | Steve Baker |
| Question: | June 20, 2006 |
| Answer: | June 26, 2006 |
| Docket: | EB-2005-0551 |

| | $000's |
|---|---|
| Rate base – ex-franchise storage | 102,916 |
| Equity component @ 36% | 37,050 |
| | |
| Return @ 9.63% | 3,568 |
| Add $44.5 million additional revenue | 44,530 |
| Less tax @ 36.12% | (16,084) |
| Adjusted net income | 32,014 |
| | |
| Adjusted return on equity | 86.41% |

| | |
|---|---|
| Witness: | Steve Baker |
| Question: | June 20, 2006 |
| Answer: | June 26, 2006 |
| Docket: | EB-2005-0551 |

***Response:***

The impact on Union of a Board's decision refusing to allocate ratepayer costs to ratepayers will have no impact on the information provided in Union's reply to undertaking K.2.2 from the NGEIR proceeding.

Should the Board decide that the deferred tax cost be excluded from long-term peak storage costs but included in the 2006 earnings sharing calculation, Union's earnings would be $2.631 million lower. The impact is summarized in the table below:

| $Millions | S&T Deferral Accounting | 2006 Earnings Accounting | Shareholder Impact |
|---|---|---|---|
| Deferred tax | 10,524 | 10,524 | |
| Union sharing (25%) | (2,631) | - | |
| Sub-total | 7,893 | 10,524 | |
| Union sharing (50%) | - | (5,262) | |
| Ratepayer sharing | 7,893 | 5,262 | (2,631) |

Should the Board decide that the deferred tax cost should be excluded from both long-term peak storage costs and earnings sharing, Union's earnings would be $7,893 million lower.

UNION GAS LIMITED

Answer to Additional Interrogatory from
Industrial Gas Users Association ("IGUA")

***Question:***

If the Board decides to treat deferred taxes as a "non-utility" elimination, does the ratepayers earnings sharing amount stay at $12.879M rather than declining to $4.641M as shown in Ex.B3.4?

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***Response:***

Hypothetically, if the Board found that it was not appropriate to treat the deferred tax entry as a cost to provide storage services in 2006 as described at Exhibit A, Tab 1, page 11 and subsequently also found that it was not appropriate to reflect the deferred tax entry in the 2006 earnings sharing calculation, the earnings sharing amount would not change. However, Union's response as provided at Exhibit B3.4, Schedule B identifies what the more appropriate earnings sharing calculation would be assuming that the deferred tax cost is excluded from the long-term peak storage services deferral account.

uniongas

A Spectra Energy Company

## OPERATING RESULTS

| | For the Years ended December 31 | | |
|---|---|---|---|
| *($millions)* | **2006** | 2005 | 2004 |
| Gas sales and distribution revenue | **1,855** | 1,876 | 1,635 |
| Cost of gas | **1,249** | 1,237 | 986 |
| Gas distribution margin | **606** | 639 | 649 |
| Storage and transportation revenue | **191** | 172 | 171 |
| Other revenue | **33** | 36 | 35 |
| Expenses | **536** | 521 | 511 |
| Other income | **2** | 1 | 12 |
| Interest expense | **155** | 156 | 164 |
| Income taxes | **37** | 50 | 40 |
| *Net income* | **104** | 121 | 152 |
| *Earnings applicable to common shares* | **99** | 116 | 147 |

*Gas Distribution Margin*

Revenue and cost of gas from gas sales and distribution services is recorded on the basis of regular meter readings and estimates of the unbilled customer usage. The unbilled estimate covers the period of the last meter reading date to the end of each month and is calculated using the number of days unbilled, heating degree-days ("HDD") and historical consumption per heating degree-day. Unbilled revenue recorded at December 31, 2006 and 2005 was $115 million and $149 million, respectively.

The gas distribution margin decreased $33 million in 2006 as compared to 2005 primarily due to warmer weather. 2006 was an unusually warm year experiencing 436 fewer HDD than 2005 and 573 fewer HDD days compared to normal.

In 2005 the gas distribution margin decreased $10 million as compared to 2004 due to:

- unfavourable gas measurement differences resulting from: higher unaccounted for volumes ($8 million), the increased cost of gas ($7 million) and the discontinuation of deferring gas measurement differences ($10 million);
- 2005 earnings sharing provision that was not in effect during 2004; and
- a decrease in usage;
- these unfavourable variances were partially offset by favourable other margin variances, which is an accumulation of several individual less significant variances, customer growth, lower system operating costs, and a revised methodology for the estimate of the monthly fixed customer charge.

*Storage and Transportation Revenue*

Storage and transportation customers are primarily Canadian natural gas transmission and distribution companies. Approximately 94% of the Company's annual storage and transportation revenue is generated by fixed demand charges under contracts with remaining terms of up to 16 years and an average outstanding term of 5 years.

Storage and transportation net revenue increased by $19 million compared to 2005 primarily due to recovery of additional deferred tax charges incurred during 2006 (see Income Tax discussion below). The remaining increase is primarily due to an increase in natural gas storage prices driven by warmer weather, offset by a marginal decrease in transportation revenues.

*Expenses*

Expenses include operating and maintenance expenses, depreciation and amortization, and property and capital taxes.

Expenses were $15 million higher in 2006 as compared to 2005 consisting of:

- $7 million higher operating and maintenance costs primarily due to higher salary and wage costs and pension and post retirement benefit costs. In large part pension and post retirement benefit expenses are based on long-term bond yields. A decline in bond yields has resulted in increased pension and post retirement benefit expense. This is due to the use of a lower discount rate to calculate the present value of the pension and post retirement benefit costs. These higher costs were partially offset by lower bad debt costs.

- $7 million higher depreciation costs due to a net increase in capital assets.

Expenses were $10 million higher in 2005 as compared to 2004 consisting of:

- $3 million higher operating and maintenance costs in 2005 primarily due to higher pension and post retirement benefit costs, salary and wage costs in 2005, partially offset by lower regulatory hearing costs. The higher pension and post retirement benefit cost is due to use of a lower discount rate to calculate the present value of the pension and post retirement benefit costs.

- Depreciation costs increased $4 million in 2005 due to a net increase in capital assets.

*Other Income*

Other income decreased $11 million in 2005 as compared with 2004. In 2004 the Company recognized a gain of $13 million on the sale of base pressure gas and a loss of $1 million on the sale of the corporate aircraft. The base pressure gas sale is currently the subject of a regulatory review by the OEB.

*Income Taxes*

The Company records income taxes for its regulated operations using the flow through tax accounting methodology as approved by the OEB. Under flow through tax accounting, income tax expense is recorded on the basis of income taxes currently payable. Generally, rates and revenues for regulated utility operations include recovery of only such income taxes as are currently payable. Accordingly, except for the items in the next paragraph, the Company does not provide for deferred income taxes.

Deferred income tax is calculated on temporary differences between the approved cost and the actual cost of gas and on temporary differences arising on certain employee future benefits deferred in accounts.

On November 7, 2006 the Company received a decision from the OEB concluding that the OEB will not regulate the prices of storage services to customers outside of Union's franchise area or the prices of new storage services to customers within its franchise area. This decision has created a further exception to the use of flow through tax accounting noted above. During the fourth quarter of 2006, the Company recorded a $10 million charge to income for deferred income taxes related to those storage operations that are no longer subject to regulation. The charge represents the deferred income tax that would have been recorded up to and including 2006 had the Company been subject to normalized income taxes on those storage operations. The amount is offset by higher storage revenues. The Company will continue to record deferred income taxes on these assets in future years.

Prior to 1997, the Company utilized the tax allocation method to account for income taxes. Under this method, provision was made for income taxes deferred principally as a result of claiming capital cost allowance for income tax purposes in excess of depreciation provided in the accounts. As approved by the OEB, this balance is reduced as the timing differences that gave rise to these deferred income taxes reverse. The timing differences are expected to fully reverse by 2018.

The effective tax rate was 26.2% in 2006 and 29.4% in 2005. The decrease in the effective rate was primarily due to the elimination of the Large Corporations Tax in 2006 and a difference in deductions claimed for income tax purposes compared to amounts recorded for accounting purposes. These items are mitigated by the recognition of a long-term deferred tax liability related to gas storage.

## QUARTERLY RESULTS

| *($millions)* | **Q1 2005** | **Q2 2005** | **Q3 2005** | **Q4 2005** | **Q1 2006** | **Q2 2006** | **Q3 2006** | **Q4 2006** |
|---|---|---|---|---|---|---|---|---|
| Gas sales and distribution revenue | 772 | 286 | 247 | 571 | 834 | 304 | 196 | 521 |
| Storage and transportation revenue | 44 | 41 | 43 | 44 | 46 | 46 | 44 | 55 |
| Other revenue | 8 | 9 | 8 | 11 | 8 | 7 | 7 | 11 |
| Total operating revenues | 824 | 336 | 298 | 626 | 888 | 357 | 247 | 587 |
| Net income (loss) | 83 | 6 | (10) | 42 | 75 | 5 | (10) | 34 |
| Net earnings (loss) applicable to common shares | 82 | 4 | (11) | 41 | 74 | 3 | (11) | 33 |

### *Seasonal Trends*

The natural gas distribution business is highly seasonal due to volume-based rates and the significant effect of the winter heating season on volumes. This is typically reflected in strong first quarter results, second and third quarters that show either small profits or losses and strong fourth quarter results, subject to the impact of warmer than normal temperatures on demand during the winter heating season. Changes in natural gas prices that are charged to customers result in corresponding changes in gas sales and distribution revenue. These increases or decreases in revenue are completely offset in the cost of gas, resulting in no impact to net income.

An increase of 1% in the assumed health care trend rate would result in an increase of $4 million to the other employee future benefit obligation. A decrease of 1% in the assumed health care trend rate would result in a decrease of $3 million to the other employee future benefit obligation.

For 2006 and 2005, all of the defined benefit pension plans have accrued benefit obligations that exceed the fair value of plan assets. The other post-retirement benefit plans are not pre-funded.

## 19. Income Taxes

The provision for income taxes consists of the following:

| *($millions)* | **2006** | 2005 |
|---|---|---|
| Current | **128** | 30 |
| Deferred | **(91)** | 20 |
| | **37** | 50 |

The year-over-year change in the components of current and deferred income taxes is primarily due to the difference in the treatment of the approved cost and the actual cost of gas for income tax and accounting purposes.

Net income taxes paid in 2006 were $29 million (2005 - $29 million).

Reconciliation between the combined Federal and Ontario statutory tax rate and the effective rate of income taxes is as follows:

| *($millions)* | **2006** | 2005 |
|---|---|---|
| Income before income taxes | **141** | 171 |
| Statutory income tax rate (percent) | **36.1** | 36.1 |
| Statutory income tax rate applied to accounting income | **51** | 62 |
| Increase (decrease) resulting from: | | |
| Large corporations tax | – | 6 |
| Deductions claimed for income tax purposes lower than (in excess of) amounts recorded for accounting purposes | **(6)** | 1 |
| Recognition of long-term deferred tax liability associated with the OEB decision to deregulate gas storage services in Ontario (note 1) | **10** | – |
| Change in rate for long-term deferred income taxes | **2** | – |
| Amortization of deferred income taxes | **(20)** | (19) |
| Provision for income taxes | **37** | 50 |
| Effective rate of income tax (percent) | **26.2** | 29.4 |

The deferred income taxes recorded in current assets of $71 million (2005 – current liabilities of $10 million) arise from temporary differences primarily related to regulatory deferral accounts.

The long-term deferred tax liability of $233 million at December 31, 2006 (2005 - $233 million) includes $19 million (2005 - $19 million) arising from temporary differences related to regulatory deferral accounts, and $10 million (2005 – nil) arising from temporary differences recognized as a result of the OEB decision on the regulation of gas storage services (note 1). The remaining $194 million (2005 -

$214 million) arose from using the tax allocation methodology related to utility operations prior to 1997. After 1997, the OEB required the use of the flow through method of accounting for taxes. As approved by the OEB, this balance of $194 million (2005 – $214 million) is reduced as the timing differences that gave rise to these deferred income taxes reverse. These timing differences are expected to fully reverse by 2018. Differences between the flow through method, used by the Company, and the liability method are as follows:

| | Liability Method | | Flow Through Method | |
|---|---|---|---|---|
| *($millions)* | **2006** | 2005 | **2006** | 2005 |
| Current deferred income tax asset | **73** | – | **71** | – |
| Current deferred income tax liability | – | 8 | – | 10 |
| Long-term deferred income tax liability | **405** | 422 | **223** | 233 |
| Recovery of deferred income tax | **98** | – | **91** | – |
| Deferred income tax expense | – | 33 | – | 20 |

**20. Related Party Transactions**

The Company purchases gas and transportation services at prevailing market prices and under normal trade terms from commonly controlled companies. During the year ended December 31, 2006, these purchases totalled $10 million (2005 - $44 million). The Company also provides storage and transportation services to commonly controlled companies under normal trade terms. During the year, this revenue totalled less than $1 million (2005 - $5 million).

The Company provided administrative, management and other services to commonly controlled companies totalling $6 million (2005 - $6 million), which were recovered at cost. Charges from related parties for administrative and other goods and services were $12 million (2005 - $12 million).

At December 31, 2006 the Company has intercompany receivable balances of $1 million (2005 - $2 million) and intercompany payable balances of $1 million (2005 - $17 million), which are recorded in accounts receivable and accounts payable, respectively.

During the year, the Company obtained from and provided unsecured loans to its parent company, Westcoast. There was no balance outstanding on these loans at December 31, 2006 (2005 - $56 million payable). These loans are classified as short-term borrowings in 2005. Interest received on these loans was less than $1 million (2005 - $1 million) and the interest paid on these loans totalled less than $1 million in 2006 and 2005. Interest on these loans is calculated based on the monthly average of 30-day banker's acceptance rates.

**21. Contingencies**

The Company, in the course of its operations, is subject to environmental and other claims, lawsuits and contingencies. Accruals are made in instances where it is probable that liabilities will be incurred and where such liabilities can be reasonably estimated. The Company has no reason to believe that the ultimate outcome of these matters would have a significant impact on its financial position, cash flows or results of operations.