unionGas
A Spectra Energy Company

May 17, 2010

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Union Gas Limited Distribution Revenue Decoupling Submission
Board File No. EB-2010-0060

On March 22, 2010, the Ontario Energy Board ("the Board") initiated a consultation on distribution revenue decoupling (EB-2010-0060). The purpose of the consultation is to focus on the revenue adjustment and cost recovery mechanisms currently available to energy distributors to address revenue erosion resulting from unforecast changes in the volume of energy sold. The Board noted that it would review the decoupling mechanisms available to utilities to determine whether these mechanisms are adequate and sufficient under current conditions in Ontario. The Board retained Pacific Economics Group Research ("PEG") to prepare a report detailing this topic. Parties were invited to make written submissions on the issue of distribution revenue decoupling and the PEG report.

Union has organized its written comments under the following headings:

1. The PEG Report
2. Current Regulatory Framework and Existing Decoupling Mechanisms For Union Gas
3. Responses to Questions Posed by Board Staff
4. Conclusion

<u>The PEG Report</u>

With the March 22, 2010 letter, the Board released PEG's "Review of Distribution Revenue Decoupling Mechanisms" report. The PEG report noted that electric and gas utilities are facing increased risk of revenue erosion as a result of declining use trends due to a number of factors including reduced growth in system use and the advent of government policies aimed at promoting a cleaner, more efficient energy economy. These policies have led to an increased focus on energy conservation programs for both electricity and natural gas. It is widely accepted that these types of programs not only slow the growth in energy consumption in Ontario but can also reduce utility earnings between rate cases.

Although conventional regulation provides utilities some protection from this reduction in energy consumption and earnings growth, many North American regulators, including the Board, are already using revenue decoupling mechanisms as a means to decouple or separate utility revenues from system use. As stated in the PEG report, these decoupling mechanisms are designed to fully or partially disconnect the link between the volume of energy consumed by customers and the recovery by energy distributors of their approved revenue requirement. By weakening the link between utility earnings and the use of the distribution system, utilities can receive some level of protection from the earnings impact of declining use.

The PEG report describes three established decoupling approaches used by regulators and utilities in North America. They are:

1. Lost revenue adjustment mechanisms ("LRAM") that compensate the utility for lost revenue from Conservation Demand Management ("CDM") and Demand Side Management ("DSM") programs;
2. Straight fixed variable pricing that collects less revenue from charges that vary with system use; and,
3. Decoupling true up plans that adjust revenue for a wider range of demand developments.

These mechanisms are described, including the advantages and disadvantages of each, in detail in the PEG report.

The PEG report identifies the decoupling mechanisms currently in use for gas distributors in Ontario as:

- Rate rebasing using forward test years;
- LRAMs which recover lost revenues arising from distributor DSM programs;
- "Shared Savings" DSM incentive mechanisms are used and these also currently require estimates of DSM savings;
- Partial (weather normalized) decoupling true up plans; and,
- Higher fixed-charges for residential distribution service.

<u>Current Regulatory Framework and Decoupling Mechanisms for Union Gas</u>

Union's regulated distribution, transmission and storage rates are currently set pursuant to a multi-year Incentive Regulation ("IR") mechanism approved by the Board in January of 2008. Rates for individual regulated services are set annually using a price cap formula. The term of the IR framework is five years, ending on December 31, 2012. Under the terms of Union's IR settlement agreement, Union is required to file a rebasing application for rates effective January 1, 2013.

Union's current IR framework defines the price cap formula as:

$$PCI = I - X + Z + Y + AU$$

where, PCI is the price cap index, I is the inflation factor, X is a fixed productivity factor, Z represents certain non-routine adjustments, Y represents certain pre-determined pass-through items and AU is a volume adjustment reflecting changes in average use not attributable to Union's DSM programs for the general service rate classes.

Union's IR framework also provides for earnings sharing. Under the current IR framework, if, in any calendar year, Union's actual utility return on equity ("ROE") is more than 200 basis points above the ROE calculated using the Board's ROE formula, the excess is shared with ratepayers on a 50/50 basis. If Union's actual ROE is greater than the ROE produced by the Board's ROE formula by 300 basis points, Union shares the excess with ratepayers on a 90/10 basis, in favour of ratepayers.

Union's revenues are already partially decoupled. As indicated above, Union's price cap formula includes a volumetric adjustment to reflect the impact of changes in average use not attributable to Union's DSM programs for Union's general service rate classes (residential, non-contract commercial and non-contract industrial customers). The average use adjustment captures changes in use attributable to improved efficiency of furnaces, water heaters and other gas fired equipment, declines in the number of persons per households, tighter building envelopes, changes in building codes, etc. Union calculates the volumetric adjustment for each of its general service rate classes based on the average normalized volume loss over the most recent three-year period. The volume adjustment is then applied to the general service billing determinants used to calculate general service rates. Any differences between the three-year average volume loss and the actual loss in any year are trued up through the average use deferral account. Through the average use volume adjustment and the average use deferral account, Union and its ratepayers are neutral to any changes in rates as a result of changes in average use.

Changes in average use related to Union's DSM activity are dealt with through the LRAM. To determine volumes lost as a result of Union's DSM activity, Union uses the DSM program assumptions and savings estimates included in the Board approved DSM plan adjusted for the audited Evaluation Report results. For Union, the LRAM deferral account captures 50% of the revenue associated with lost volumes for the current year and 100% of revenues associated with lost volumes the following year until the lost volumes are included in rates. Lost revenues are included in rates following the final audit of the LRAM volumes by an external auditor (e.g. lost volumes in 2010 will be audited in 2011 and included in 2012 rates).

In addition to the average use adjustment and LRAM, Union, pursuant to the IR settlement agreement, will increase the fixed monthly charge for its small volume general service rate classes (Rate 01 and M1) by $1.00 per year for each year of the IR term. By 2012, the fixed monthly charge will be $21/month for its small volume general service rate classes. At $21/month all customer-related fixed costs (i.e. emergency response, meter reading, billing, etc.) will be recovered through the fixed monthly charge. The increases in the fixed monthly charge are offset by corresponding reductions in the volumetric charges for these rate classes. Increasing the fixed monthly charge means that Union has greater certainty around the recovery of a portion of its fixed costs attributable to small volume general service customers.

As a result of the average use adjustment for general service rate classes, the LRAM and the planned increases to fixed monthly charges for small volume general service rate classes, Union's revenues are already partially decoupled from consumption. Union, however, still bears the earnings risk associated with weather, unaccounted for gas, industrial demand destruction and other variables. It is Union's view that, although it has

partially decoupled its earnings from volumetric consumption, conditions may exist where further or even full decoupling is appropriate. Union has not determined, at this time, whether or not further decoupling measures are appropriate or required. As Union prepares for its 2013 rebasing proceeding, Union will consider the appropriateness of further decoupling measures, including full decoupling of its earnings, and if necessary will bring forward any proposals in the context of that proceeding.

Responses to Questions Posed by Board Staff

The Board's March 22, 2010 letter included a number questions identified by Board staff as relevant to the issue of revenue decoupling. The Board invited stakeholders to respond to these questions in their written submissions. Union has limited its comments to questions 1, 4 and 7. Union's comments are provided below:

Board Staff Question #1

In light of developments in metering, CDM and demand side management (DSM), among possible others, is the implementation of further or modified revenue decoupling mechanisms for electricity and/or gas distributors warranted at this time and if so, why? For example, is the Board's current Lost Revenue Adjustment Mechanism adequate in light of the contemplated introduction of CDM targets for all electricity distributors in the Province?

Union Response:

The implementation of further or modified revenue decoupling mechanisms for electricity and/ or gas distribution companies depends, in large measure, on each distributor's specific circumstances. As indicated above, Union's revenues are already partially decoupled from volumetric consumption through the average use adjustment, the LRAM and the planned increases to the fixed monthly charge for small volume general service rate classes. Further revenue decoupling for Union would mean implementing mechanisms to remove the volumetric risks associated with factors other than those directly impacting average use. It is Union's view that, when faced with certain market conditions, additional, or even full decoupling may be appropriate for Ontario distributors.

Some of the conditions that Union believes necessary to warrant consideration of revenue decoupling mechanisms beyond those already in use in Ontario for gas distributors are:

1. The expectation that general service average use will continue to decline as a result of conservation and technological improvement;
2. The expectation of sustained low customer additions relative to historical experience;
3. Declines in the overall level of throughput and/or peak day demand;
4. Limited opportunities for revenue growth from new gas consuming technologies;
5. A sustained shift away from energy intensive technologies as industry rationalizes and become more efficient;
6. The use of asymmetrical weather normalization methods; and,

7. Government and regulatory policy objectives to substantially strengthen the culture of conservation in Ontario.

Under these conditions, it may be appropriate to propose the implementation of additional decoupling mechanisms or full decoupling.

Board Staff Question #4

What scope for further or modified revenue decoupling might be appropriate? For example, should the impact of all variances from forecast in commodity demand be eliminated regardless of the cause (i.e. distributor-provided CDM/DSM programs, other CDM/DSM programs, the economy, weather, customer growth, etc.)? Why or why not?

Union Response:

As indicated above, it is Union's view that the level of decoupling required by a distributor depends on the market conditions the distributor faces. To the extent that a distributor is facing some or all of the conditions set out in Union's response to Board Staff Question #1, the distributor should be free to apply to the Board for the revenue decoupling mechanism that best addresses those conditions. Union believes that there should be no restriction in terms of scope when considering further or modified revenue decoupling measures. Union does not support a prescriptive approach to decoupling. Rather, Union believes that flexibility is essential so that when decoupling measures are implemented they are aligned with the underlying market drivers.

Board Staff Question #7

Can or should the preferred approach need to be the same in both the gas sector and the electricity sector? Why or why not? Would any other form of differentiation based, for example, on a specific distributor characteristic(s) be appropriate? If so, what might be the defining characteristic(s)?

Union Response:

Union believes that flexibility is a key element to an effective decoupling mechanism. This flexibility is required to accommodate differences between the natural gas and electricity sectors. The market conditions facing natural gas distributors may be different from those facing electric distributors. Even between natural gas distributors, market conditions may differ such that different levels of decoupling are appropriate for each gas utility. Rather than employ a consistent or "preferred" approach to decoupling, Union believes that the Board should consider a full menu of approaches.

Union is in the third year of an IR term which expires at the end of 2012. As it prepares for rebasing, Union will continue to consider its options specific to decoupling. Union believes it will be important that it be allowed to propose whatever decoupling option or modification it feels best meets the needs of its ratepayers and investors alike. Should Union determine that further decoupling is in the best interest of its ratepayers and investors, Union will bring forward its proposals in its rebasing application.

Conclusion

Union's revenues are already partially decoupled from volumetric consumption. Union, however, continues to bear the earnings risk associated with weather, variations in unaccounted for gas, industrial demand destruction and other factors. It is Union's view that Ontario gas and electric distributors should not be limited to the decoupling mechanisms traditionally used in Ontario. Rather, each utility must be able to propose additional decoupling mechanisms, up to and including full revenue decoupling, if warranted by the market conditions it faces. Union has summarized the conditions it believes necessary to warrant consideration of further decoupling in its response to Board Staff Question #1.

Union does not support a prescriptive approach to revenue decoupling. Differences in circumstances between natural gas distributors and between natural gas and electric distributors in Ontario necessitate an approach that is flexible and able to meet the needs of both distributors and ratepayers.

Should you have any questions, please contact me at (519) 436-5473.

Yours truly,

[Original signed by]

Karen Hockin
Manager, Regulatory Initiatives

c.c.: Crawford Smith
Mark Kitchen
Stephen Cain (Board Staff)