

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

**AND IN THE MATTER OF** an Application by Union Gas Limited for an Order or Orders approving a multi-year incentive rate mechanism to determine rates for the regulated distribution, transmission and storage of natural gas, effective January 1, 2008;

**AND IN THE MATTER OF** an Application by Enbridge Gas Distribution Inc. for an Order or Orders approving or fixing rates for the distribution, transmission and storage of natural gas, effective January 1, 2008;

**AND IN THE MATTER OF** a combined proceeding Board pursuant to section 21(1) of the *Ontario Energy Board Act*, 1998.

## **WRITTEN ARGUMENT OF UNION GAS LIMITED**

### **PART I – FACTS**

#### **Overview**

1. This is a motion for an order making Union's current rates interim as of January 1, 2008 and setting new, interim rates pending the OEB's final determination of Union's application. Delays in the process of hearing Union's application for an incentive rate mechanism commencing January 1, 2008 have been due to factors having nothing to do with Union or its application. It is now clear that Union's application cannot be decided and implemented prospectively. Accordingly, interim rates are necessary to enable Union to recover the full year effect of the OEB's ultimate decision. *New* interim rates are necessary to avoid substantial accumulated after the fact charges. Union's proposal is supported by principle and by evidence. It is *prima facie* just and reasonable. Further, establishing new interim rates will be completely without prejudice to the OEB's and intervenors' positions on the final determination of Union's application.

#### **Union's Recent Rate History**

2. Union Gas Limited operated under a trial performance based rate mechanism from 2001 to 2003. Union's rates were set through a cost of service proceeding in 2004. In 2005 and 2006,

Union's rates were not subject to review and did not change materially in those years. Union last sought rates for 2007 on a cost of service basis. All monetary issues were the subject of a comprehensive settlement approved by the Ontario Energy Board in 2006.

### **Background to Current Incentive Rate Proposal**

3. In November, 2003, the Ontario Energy Board initiated a process called the Natural Gas Forum to review policies underlying key components of the natural gas regulatory system. The key components identified as being a focus of the NGF were system supply, storage and transportation and rate regulation.

4. The NGF proceedings continued in 2004 with extensive papers, presentations and consultations. These proceedings resulted, in March 2005, in a report of the OEB called "Natural Gas Regulation in Ontario: a Renewed Policy Framework." In this report the OEB expressed its intention to establish incentive rate making mechanisms for Ontario's natural gas utilities. In doing so, the OEB identified three criteria for an incentive rate mechanism:

- (1) to establish incentives for sustainable efficiency improvements that benefit both customers and shareholders;
- (2) to ensure appropriate quality of service to customers; and
- (3) to create an environment that is conducive to investment, to the benefit of both customers and shareholders.

5. The NGF report contemplated a robust cost of service rate setting process in which appropriate base rates for each utility would be determined in separate proceedings. The report initially contemplated that decisions from the OEB on base rates would be provided by the end of 2007. It was also contemplated that a proceeding to address the features of incentive regulation for the natural gas utilities would be concluded by mid-2007 (letter from OEB Board Secretary to Stakeholders dated September 14, 2005).

6. Stakeholder consultations on multi-year incentive regulations for gas distribution utilities in Ontario began in September 2006 and carried on through November of that year. A detailed

discussion paper on multi-year incentive regulation was released to all stakeholders by OEB staff in January 2007.

7. The Board retained the leading expert in incentive regulation in North America, Dr. Mark Lowry of Pacific Economics Group, to prepare a study and recommendations on incentive regulation. The initial draft of Pacific Economics Group's study and recommendations was made available to all stakeholders on March 30, 2007. The final report of Pacific Economics Group was delivered in June 2007.

8. Although it was originally contemplated that the incentive regulation process would take place in an OEB sponsored hearing, as a result of intervenor concerns the OEB asked Union to initiate its own utility specific application. Union did so by filing its present application in these proceedings on May 11, 2007.

9. The OEB's Procedural Order No. 1 established a joint proceeding for Union and Enbridge, required both applicants' evidence to be filed by July 9, 2007 and provided for a joint hearing to commence on October 4, 2007. Union, in fact, filed its evidence on June 28, 2007.

10. As a result of delays in the timetable for this proceeding, Union became concerned that rates could not be set prospectively effective January 1, 2008. In order to avoid retroactive implementation of 2008 rates, therefore, Union asked that its application proceed independently of Enbridge. On July 13, 2007, Union's request was denied by the OEB.

11. In denying Union's request, the OEB said:

With respect to the retroactivity concern, we understand the concern of Mr. Penny on behalf of his client. The Board and intervenors also recognize that concern, but in all likelihood there are mechanisms such as interim rates and rate smoothing to reduce the rate shock he is concerned with, even though the consumption at issue is in the winter months when consumption is high. In short, the Board is convinced there are mechanisms to deal with the concerns Union has with retroactivity.

12. As a result of further delays in the schedule in this proceeding, Union asked for a reconsideration of the OEB's earlier decision, again requesting that its application proceed on a timetable independent of the Enbridge application in order to reduce anticipated retroactivity.

That motion, heard September 13, 2007, was also denied. In rejecting Union's further request to proceed on a separate timetable, the OEB stated:

Of course, we remain concerned, as we were on July 13th, about retroactivity. We said so then and we say it again, retroactivity is not good. It is bad. There are, however, mechanisms, we believe, to reduce its impact. We will explore those mechanisms when and if these two applicants bring forward applications for interim rate increases and deal with it at that time.

13. It is well known that customers abhor increases in rates. Delayed implementation of rates also creates uncertainty for Union and its customers.

14. It is clear that with the evidentiary portion of the hearing not scheduled to be completed until December 21, 2007 at the earliest, it will be impossible for 2008 rates to be set prospectively. To enable Union to recover the rates it is seeking for 2008, and to avoid substantial retrospective charges to customers once 2008 rates are implemented, Union filed this motion on September 21, 2007 for orders:

- (1) making Union's rates for the distribution, transmission and storage of natural gas interim, effective January 1, 2008; and
- (2) implementing new interim rates effective January 1, 2008 in accordance with Exhibit D, Tab 2 of Union's pre-filed evidence in this proceeding.

## **PART II - ISSUES**

15. There are two issues on this motion:

- (1) Should the Board issue an order making Union's current rates interim effective January 1, 2008? and
- (2) Should the Board issue an order implementing new interim rates based on Union's application in this proceeding, specifically as outlined in Exhibit D, Tab 2 of Union's pre-filed evidence?

### **PART III - ARGUMENT**

#### **Issue 1**

16. It is not controversial that the OEB has the jurisdiction to make interim orders. Section 21 (7) of the *Ontario Energy Board Act, 1998*, specifically provides that the OEB “may make interim orders pending the final disposition of a matter before it.”

17. It is inherent in the nature of interim orders that their effect, as well as any discrepancy between the interim order and the final order, may be reviewed and remedied by the final order. It is the interim nature of the order which makes it subject to further retrospective direction. Accordingly, by making an order establishing Union’s rates interim as at January 1, 2008, the Board retains full authority to review and change Union’s rates (whether existing or new during the interim period) upon its final disposition of this application.

*Bell Canada v. Canada (Canadian Radio-Television and Telecommunications Commission)*, [1989] 1 S.C.R. 1722

18. At the very least, Union must be permitted the opportunity to justify changes to its rates to the OEB and to recover those rates retrospectively from January 1, 2008, regardless of when the OEB may issue its decision. Union has not been the cause of any delay in the procedures adopted for the disposition of this application. Indeed, Union has done everything asked of it by the OEB in connection with the NGF proceedings and in connection with the implementation of incentive regulation.

19. Accordingly, there can be no doubt that the Board should issue an order making Union’s rates interim as of January 1, 2008.

#### **Issue 2**

20. The real issue on this motion, therefore, is whether *new* rates should be implemented effective January 1, 2008 on an interim basis and, if so, how those interim rates should be determined pending the OEB’s final disposition of Union’s application. Again, there can be no doubt that the implementation of new interim rates effective January 1, 2008 is without prejudice to any party, or to the OEB, on any matter relating to the final disposition of Union’s 2008 rates.

21. This is not a hardship case. Union is not seeking interim increases due to financial distress. The sole issue is the avoidance of having to collect significant retroactive charges later in the year to the detriment of Union and its customers.

22. Union is seeking interim rates based on Union's incentive rate proposal, as outlined in Exhibit D of Union's evidence. Union's incentive rate proposal consists of two components:

- (1) rate related changes associated with matters previously approved by the Board;  
and
- (2) rate related changes associated with Union's incentive regulation plan.

23. Rate related changes associated with matters previously approved by the Board include:

- (1) implementation of the new rate M1 and new rate M2 classes<sup>1</sup>;
- (2) gas distribution access rule implementation;
- (3) treatment of demand side management costs;
- (4) NGEIR implementation; and
- (5) lost revenue adjustment mechanism.

Rate related changes associated with items previously approved by the Board should not be controversial. These changes are described in detail in pages 1-5 of Exhibit D, Tab 1 of Union's pre-filed evidence.

24. The rate related changes associated with Union's proposed incentive regulation plan include:

- (1) application of the proposed price cap index;
- (2) weather normalization methodology change; and

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<sup>1</sup> The OEB has already approved the M1/M2 rate class separation in EB-2005-0520 and so the M2 rate class will be separated effective January 1, 2008 in any event. It is impractical, regardless of whether those rates are adjusted on an interim basis by Union's incentive rate proposal, to separate the rate class retroactively.

- (3) treatment of forecast storage and transportation margin.

### **Price Cap Index**

25. To calculate the proposed 2008 rates under the price cap index, Union used the average annual percentage change in the GDP IPI FDD for the four quarters ending June 2007. The average change over the most recent four quarters is 2.04%. The calculation of the service group price cap index using this inflation factor for the general service rate class is 2.42%. The price cap index for all other rate classes is 1.30%.

26. Union's price cap index is based on the study and recommendations of the Pacific Economics Group with two exceptions.

27. The Pacific Economics Group added a "stretch-factor" to its productivity analysis. In Union's view, there is no justification for a stretch-factor during its next incentive regulation term. This is essentially on the basis that a stretch factor is a purely subjective add-on that cannot be determined from or justified by the logic of price cap indexing. Further, the inclusion of a stretch factor into the PCI formula would not result in an environment that is conducive to investment, the third criteria for an incentive regulation mechanism identified in the Board's March 2005 NGF report. Union has already been under incentive regulation and/or has not sought rate increases for five of the last seven years. Accordingly, the basis for an ad hoc stretch factor, even if theoretically justifiable, is not present in this case. Stretch factors assume a systemic lack of incentives to achieve efficiency in the utility's operations. As a result of Union's trial PBR rate plan, the absence of any application for rate increases in 2005 and 2006 and the comprehensive financial settlement in 2007, Union has had significant motivation to implement productivity improvements over the last seven years. The addition of a stretch factor, therefore, results in double counting with the X factor and penalizes Union for past productivity improvements.

28. Union also differs from Pacific Economics Group over the recommendation that there be separate price cap indices for each rate class that contains residential customers. Pacific Economics Group's approach cannot be empirically verified without doing a productivity study by rate class, which has not been done and cannot practically be done. Therefore, Union has

recommended a simpler and more intuitive approach to the calculation of the X factor applicable to the general service rate classes.

### **Weather Normalization Method**

29. Union is seeking an adjustment to base rates, effective January 1, 2008 to implement the full effect of a twenty-year trend weather normalization methodology. This results in a rate impact of \$6.197 million. There are essentially three reasons Union is seeking this adjustment.

30. First, the twenty-year trend is simply a more balanced and accurate, and therefore fairer, method of weather normalization. Chart 2 of Union's evidence at Exhibit B, Tab 1, p. 14 makes the point graphically that the thirty year average (Union's current weather normalization is a 45/55 blend of twenty-year trend and the thirty year average) is grotesquely skewed to over forecast heating degree days.

31. The second reason Union is seeking this adjustment is that the OEB implemented a graduated system of implementing the twenty year trend into Union's weather normalization method in 2004. The graduated implementation of the twenty year trend has demonstrated that, the greater the weight of the twenty-year trend in the normalization method, the more balanced and more accurate the normalization methodology becomes. Union, therefore, simply seeks to continue with the principle the OEB has already approved in adopting the partial use of the twenty-year trend by now adopting it fully.

32. Finally, the Board has recently approved the use of the identical twenty-year trend methodology proposed by Union, for use by Enbridge in its 2007 rates. Enbridge and Union face the same risk *vis a vis* fluctuations in weather. It is therefore appropriate that they both employ the same weather normalization methodology.

### **Treatment of Forecast S&T Margin**

33. Currently, 90% of Union's transportation and exchange services margin and other S&T services margin is included in infranchise rates. Union is proposing, consistent with the NGEIR decision, to treat the forecast short-term S&T revenue like any other revenue forecast and, therefore, to embed the full amount of the 2007 revenue forecasted in rates and to eliminate the deferral accounts relating to those services. The impact of Union's proposed changes to the

sharing of forecast S&T transactional margin is a reduction to infrachise rates of \$2.446 million (Exhibit D, Tab 1, p. 7).

**Union's Proposal: Consistent with the OEB's Expert Recommendation and Recent OEB Precedent**

34. Union has presented a reasonable proposal based on applicable principles derived from the OEB's NGF Report. The chief components of Union's rate proposal for incentive regulation are based on the work of the leading expert in this area, Dr. Mark Lowry of Pacific Economics Group, retained by the Ontario Energy Board. The other adjustments Union is seeking are supported not only by the evidence, principle and logic but by recent OEB precedent. There is, therefore, *prima facie* evidence that Union's proposal is just and reasonable.

35. Approval of interim rates based on Union's proposal will eliminate the need for significant retrospective charges in June or July when Union's final 2008 rates will likely be implemented.

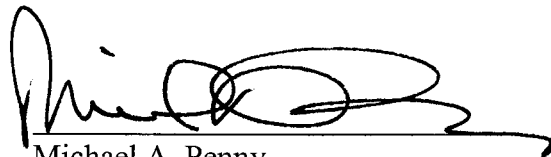
36. And these interim rates increases, precisely because they are interim, are totally without prejudice to the OEB's and intervenors' positions on the final disposition of Union's application.

**PART IV - ORDER REQUESTED**

37. Union respectfully requests an order of the OEB,

- (1) making Union's rates for the distribution, transmission and storage of natural gas interim effective January 1, 2008; and
- (2) implementing new interim rates effective January 1, 2008 in accordance with Exhibit D, Tab 2 of Union's pre-filed evidence in this proceeding.

**All of which is respectfully submitted**

A handwritten signature in black ink, appearing to read 'Michael A. Penny', with a long horizontal flourish extending to the right.

Michael A. Penny

Torys LLP

Of Counsel to the Applicant,

Union Gas Limited