EB-2011-0038
Exhibit K3.1

Union Gas Limited

Compendium for Oral Argument

Tab 1

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September 13, 2011

Ms. Kristen Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: EB-2011-0038 - Motions by Canadian Manufacturers & Exporters ("CME") and Union Gas Limited ("Union")

We are writing further to our letter dated September 9, 2011 and with the consent of intervenors to advise that the parties have now agreed to the terms of minutes of settlement resolving the motions brought by CME and motion in the above-noted matter. As referenced in our earlier letter, the minutes of settlement provide, among other things, that CME and Union withdraw their motions. A copy of the minutes of settlement is attached and will be filed with the Board.

Yours truly,

Crawford Smith

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CS/tmEnclosure
cc: Michael Millar/Kristi Sebalj, Board Staff
All EB-2011-0038 Invervenors

EB-2011-0038

THE ONTARIO ENERGY BOARD

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 amending or varying the rate or rates charged to customers as of October 1, 2011.

MINUTES OF SETTLEMENT

WHEREAS Canadian Manufacturers & Exporters ("CME") filed a Notice of Motion (the "CME Motion") seeking a Board Order requiring Union Gas Limited ("Union") to provide the amount of a one-time adjustment to the balance of Deferral Account No. 179-72 (Long-Term Peak Storage Services) to reflect corrections for Union's use, in its calculations of deferral account balances for 2008, 2009 and 2010, of certain items that CME alleges were unauthorized and do not constitute "costs" of providing unregulated storage services.

AND WHEREAS the CME Motion also requests an Order of the Board requiring Union to provide calculations of the Return on Equity it earned from its unregulated storage assets for 2008 and 2010 in a particular format.

AND WHEREAS Union filed a Notice of Motion (the "Union Motion") for a Board Order granting Union leave to file the affidavit of Chris Ripley sworn August 31, 2011 in response to the motion brought by CME.

AND WHEREAS the parties listed below have agreed to the terms of these Minutes of Settlement..

Union and CME have agreed to withdraw their respective Motions on the following terms:

1. Union will file all of the information sought in the CME Motion;

2. The parties will not seek, directly or indirectly, any relief with respect to the Decisions of the Board in EB-2009-0052 and EB-2010-0039 regarding Deferral Account Nos. 179-70 or 179-72 or related thereto, including through a one-time adjustment to the balances in those accounts as contemplated by the CME Motion or otherwise;

3. Union will not take the position that acceptance by the parties in the settlement agreement in EB-2010-0039 of the disposition of Deferral Account Nos. 179-70 or 179-72 precludes the parties from challenging the correctness of the methods used in EB-2009-0052 and EB-2010-0039 in determining the balances in Deferral Account Nos. 179-70 or 179-72 and will not take the position that the Board is precluded from approving in this application a different method of calculating the deferral account balances in those accounts in 2010;

4. Subject to paragraph 2 above, the parties will be at liberty to examine on the material filed by Union and to argue that the methods of calculation used by Union, in determining the balances in Deferral Account Nos. 179-70 or 179-72, in 2008 and 2009 were incorrect, and that a different method or methods should be used in calculating the deferral account balances in those accounts in 2010;

5. Subject to its right to contest the amount of costs claimed, Union agrees that it will not contest a claim for costs, by the CME or other parties, with respect to the time spent in dealing with the CME Motion and the Union Motion.

Dated this 13th day of September, 2011.

The Parties to this agreement are:

UNION GAS LIMITED

CANADIAN MANUFACTURERS AND EXPORTERS

CONSUMERS COUNCIL OF CANADA

VULNERABLE ENERGY CONSUMERS COALITION

SCHOOL ENERGY COALITION

FEDERATION OF RENTAL-HOUSING PROVIDERS OF ONTARIO

INDUSTRIAL GAS USERS ASSOCIATION

LONDON PROPERTY MANAGEMENT ASSOCIATION

ENERGY PROBE RESEARCH FOUNDATION

CORPORATION OF THE CITY OF KITCHENER

3831552.2

Tab 2

UNION GAS LIMITED

Undertaking of Mr. Quinn
To Mr. Ferguson

To provide a breakdown of Return identified at Exhibit B, Tab 3, Schedule 3, Attachment 3, line 10 in order to establish the nature of its increase.

Please find attached the Calculation of the Long-Term Storage Return.

UNION GAS LIMITED
Calculation of Long-Term Storage Return
($000's)

Line No.	Particulars	Rate Base	(1)	Return and Interest		2007 Board Approved	2008 Actual	2009 Forecast
1	2007 Board Approved	102,794		7.93%	(2)	8,155		
2	2007 Board Approved	102,794	(3)	7.93%			8,155	
3	Less 6 PJ's Sold as Short Term	(9,070)	(4)	7.93%			(720)	
4	2008 New Investment and Purchased Storage	74,395	(5)	9.29%	(6)		6,913	
5	2007 Board Approved	102,794	(3)	7.93%				8,155
6	Less 6 PJ's Sold as Short Term	(9,070)	(4)	7.93%				(720)
7	2008 & 2009 New Investment and Purchased Storage	216,664	(5)	8.70%	(6)			18,840
9	Total					8,155	14,348	26,275

Notes:

(1) Rate base additions determined using the average of monthly averages methodology.

(2) EB-2009-0101, Appendix A, Schedule 4, page 1, column (d), line 6 divided by EB-2009-0101, Appendix A, Schedule 4, page 1, column (a), line 6 times 100.

(3) Excludes the annual impact of depreciation on 2007 Board approved rate base and return.

(4) Calculated as ($102,794/68 PJs) x 6 PJs

(5) New Investment and Purchased Storage

	2008 Actual In-Service	2008 Actual $000's	2009 Actual In-Service	2009 Actual $000's
1 Washington 10	Jan-08	21,000		
2 St Clair	Apr-08	12,000		
3 Huron Tipperary	Jun-08	23,000		
4 Delta Pressure	Sep-08	5,400		
5 Dawn Deliverability	Nov-08	99,200		11,600
6 Replacement Capital	2008 Ongoing	3,400	2009 Ongoing	10,100
7 Sarnia Airport			Jun-09	58,000
8 Heritage			Jul-09	12,300
9 Delta Pressure			Nov-09	4,000

(6) Estimated

UNION GAS LIMITED

Answer to Interrogatory from
City of Kitchener ("Kitchener")

Ref: Exhibit A, Tab 1, page 8, Table 2

Please separately quantify the three cost components to "Interest, return and income taxes" for 2009 and 2008 and provide the detailed calculations which support each cost component. Please explain why "Interest, return and income taxes" disproportionately increased by $ 15.003 million, or about 82%, from 2008 to 2009 while "Storage revenue" increased by $ 24.866 million, or about 23%.

Response:

The table below quantifies the cost components of interest, return and income taxes for 2009 and 2008.

	2009			2008		
	Investment ($000's)	Weighted Average Rate	Cost ($000's)	Investment ($000's)	Weighted Average Rate	Cost ($000's)
Interest	232,557	4.95%	11,507	142,861	4.95%	7,069
Return	317,617	4.48%	14,220	183,691	3.96%	7,278
Income taxes		34.56%	7,510		34.81%	3,886
			33,237			18,233

Interest and return = Investment x weighted average rate.

Income taxes = [Return / (1 – tax rate)] – Return.

The increase in interest, return and income taxes in 2009 results from a full year impact of the storage investment and purchased storage capacity from 2008 and the new investment and purchased storage capacity in 2009.

TAB 13

Tab 3

Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

EB-2007-0598

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 amending or varying the rate or rates charged to customers as of July 1, 2007.

BEFORE: Paul Sommerville
Presiding Member

Ken Quesnelle
Member

DECISION AND ORDER

1. Introduction

1.1. The Application

Union Gas Limited ("Union" or the "Company") filed an application on April 27, 2007 with the Ontario Energy Board (the "Board") seeking approval for final disposition and recovery of certain 2006 year-end deferral account balances and the 2006 year-end earnings sharing amount. Union also proposed that the resulting impacts from the disposition be implemented on July 1, 2007 to align with other rate changes expected to result from the Quarterly Rate Adjustment Mechanism ("QRAM") proceeding. Union revised the proposed timing to align with the October QRAM.

1.2. The Proceeding

The Board issued a Notice of Written Hearing and Procedural Order No. 1, dated May 16, 2007, setting the dates for submissions on Union's evidence and other procedural matters. As part of the Order, any parties that objected to proceeding by way of written hearing were required to provide good reason why any issues should proceed by way of an oral hearing.

On May 24, 2007 the Industrial Gas Users Association ("IGUA") requested that a matter concerning the treatment of certain deferred taxes, totaling $10.524 million, proposed for recovery via the Earnings Sharing Mechanism ("ESM") be considered as part of an oral hearing (the "Deferred Taxes Issue"). The Deferred Taxes Issue is outlined in Account No. 179-72 Long-Term Peak Storage Services, Ex. A, Tab 1 of Union's evidence which states, "Included in the actual cost to provide storage services in 2006 is an increase in deferred income tax expense of $10.524 million resulting from the Board's decision in the Natural Gas Electricity Interface Review ("NGEIR")."

On June 22, 2007 the Board issued Procedural Order No. 2 involving a confidentiality request, to schedule an oral hearing, and to amend scheduling with regards to this proceeding. The oral hearing with respect to the Deferred Taxes Issue was set for July 9, 2007.[1] All other issues remained part of the written hearing.

On July 6, 2007 Union provided a list of witnesses to all parties and the Board also received a position paper from ratepayer representatives as guidance for the oral hearing. The paper was submitted by IGUA and written on behalf of the London Property Management Association ("LPMA"), the School Energy Coalition ("SEC"), the Vulnerable Energy Consumers Coalition ("VECC"), the Consumers Council of Canada ("CCC"), and IGUA.

On July 9, 2007 the Board held an oral hearing concerning the Deferred Taxes Issue. All other issues in this proceeding were dealt with by way of a written hearing. This decision deals with the matters heard both orally and in writing.

[1] As defined in Procedural Order No. 2

disposition of the historic costs or who bears them in a regulatory context. This remains the purview of the regulator.

The Board finds that the deregulation of Union's storage assets is notionally equivalent to a divestiture, and that any liabilities associated with these assets should properly be associated with Union's newly formed ex-franchise storage service business.

The taxes associated with this line of business, including the deferred taxes residing in the account should form a part of this new undertaking. This is the same treatment afforded to like liabilities associated with the divestiture of the ancillary services, detailed in Undertaking J1.3.

The Board is also concerned that the treatment requested by Union would result in a significant cross-generational subsidy. The deferral account has been in operation since 1997. It is inequitable that today's ratepayers should be burdened with costs that have accumulated over that period.

The Board finds that Union must eliminate any and all deferred income tax expense from the LSS account. The balance in the LSS account shall be revised from of a debit of $9.341 million to a credit of $3.015 million to ratepayers.[3]

4. Earnings Sharing

Union proposed to clear the Demand Side Management Variance Account ("DSMVA") using 2004 allocation factors by rate class. Given the fact that Union has the 2006 actual allocation factors at its disposal, the Board finds that Union must update the DSMVA amounts to reflect 2006 actual allocation factors. This does not affect the balance for disposition.

Intervenors expressed concern that the Lost Revenue Adjustment Mechanism Account ("LRAM") reflects unaudited amounts, and argued that Union should wait until the final 2006 audited statements become available. In the previous disposition of deferral accounts (EB-2006-0057) the Board approved Union's

[3] As stated in Interrogatory Response to IGUA, Exhibit B3.3.

2005 unaudited LRAM amounts prior to final audited financial statements. The Board finds it appropriate that the 2006 LRAM forecast be used subject to true-up of the audited amount.

Union proposed a "non-utility adjustment" to corporate earnings to exclude $1.278 million from earnings subject to sharing. LPMA requested further details on the adjustment through interrogatories. In connection with Rules 10 and 29.02 of the OEB's Rules of Practice and Procedure, Union requested that any interrogatories be held in confidence by the Board. The Board granted Union's request.

Respecting the confidential nature of the claim, and the evidence and argument presented, the Board finds that the proposed adjustment is directly attributable to the utility's regulated business, and would not possibly have been made otherwise. Union shall include $1.278 million associated with the "other non-utility adjustment" as part of the 2006 Earnings Sharing Calculation (Exhibit A, Tab 1, Schedule 4).

5. Costs

A decision regarding cost awards will be issued at a later date. The eligible parties shall submit their cost claims by August 30, 2007. A copy of the cost claim must be filed with the Board and one copy is to be served on Union. The cost claims must be done in accordance with the Board's Practice Direction on Cost Awards.

Union will have until September 14, 2007 to object to any aspect of the costs claimed. A copy of the objection must be filed with the Board and one copy must be served on the party against whose claim the objection is being made.

The party whose cost claim was objected to, will have until September 21, 2007 to make a reply submission as to why their cost claim should be allowed. Again, a copy of the submission must be filed with the Board and one copy is to be served on Union.

UNION GAS LIMITED

Undertaking of Union Gas
To Mr. J. Shepherd (SEC)

Please advise whether at any time any party challenged whether the audit was carried out correctly for any of the relevant years.

Since the EB-2006-0021 Decision Union has filed the annual Demand Side Management ("DSM") Annual Report, the annual Audit Report and the Summary Report with the Board per Section 2.1.12 of Board's Reporting and Record Keeping Rule.

In each of the past years, the DSM audit has been discussed as part of the review process with Union's Evaluation and Audit Committee ("EAC"). The annual review process has included numerous discussions and debates about the audit. However, in each year since EB-2006-0021, with the exception of 2010, the DSM audit has been filed with EAC support.

In 2010, the EAC and Union did not reach consensus. Union understands that the EAC has concerns about the auditor selection and how the audit was carried out (September 19, 2011 transcript, p.31, lines 22-23). Union is unaware of any specific EAC concerns with respect to the audit results (SSM, LRAM).

Tab 4

Ontario Energy Board

Commission de l'Énergie de l'Ontario

EB-2005-0551

NATURAL GAS ELECTRICITY INTERFACE REVIEW

DECISION WITH REASONS

November 7, 2006

The Board concludes that it is in the public interest to maintain and enhance the depth and liquidity of the market at the Dawn Hub as a means of facilitating competition. One way to do this is to encourage the development of innovative services and to ensure access to those services. Choice is the bedrock of competition. The evolution of the transactional services market is an example where innovative and flexible services have evolved within a market-based pricing structure.

Enbridge argued that forbearance will foster innovation by facilitating the provision of storage services in the competitive market. The Board agrees that regulating storage rates does place constraints on the development of flexible and innovative services; forbearance, within a framework of non-discriminatory access, can remove these constraints.

In the current industry structure, the gas utilities both acquire storage for their own customers and operate storage for their own needs and for other customers. The utilities also operate integrated storage and transportation systems. The Board considers later in this decision whether forbearance requires that there be greater separation between these operations or whether other procedures should be developed to ensure non-discriminatory access to storage and transportation.

4.2 TO PROTECT THE INTERESTS OF CONSUMERS WITH RESPECT TO PRICES AND THE RELIABILITY AND QUALITY OF GAS SERVICE

The interests of consumers were a primary focus for many intervenors. The submissions addressed issues related to the direct and indirect impacts of forbearance and competition. Interestingly, no ex-franchise customer opposed paying market-based rates; nor was there any evidence of a price impact on this market segment in the event of forbearance. This is consistent with the Board's finding that these customers have alternatives and that competition will provide adequate protection for these customers.

With respect to in-franchise customers, two rate impacts were discussed: the direct impact on storage rates and the indirect impact on the sharing of the storage premium. With respect to the direct impact, the utilities proposed to freeze the allocation of in-franchise storage and to acquire incremental storage at market-based prices. This would have the effect of increasing in-franchise storage rates (under current market conditions), albeit only marginally given the relatively slow growth of in-franchise storage demand. The utilities were of the view that this afforded in-franchise customers a significant level of protection. The other direct storage rate impact arises from the proposal that Enbridge be treated as an ex-franchise customer in respect of its contracts with Union. This would have the effect of raising Enbridge's storage rates.

However, attention of the parties was primarily focussed on the indirect impact arising from the premium which exists between the price of market-based storage and the underlying costs. Currently, that premium is shared between utility ratepayers and utility shareholders. Under the utilities' proposals for forbearance, the premium would be retained by the shareholders. This would result in significant transfer of funds in the case of Union (2007 estimate is $44.5 million); less so in the case of Enbridge (2007 estimate is $5 million to $6 million). The intervenors in general rejected these proposals and, as a result, opposed forbearance.

IGUA/AMPCO argued that there should be no forbearance if there will be any adverse impact on ratepayers. Similarly, they argued that the level of return under forbearance should be no greater than the regulated return; otherwise the level of competition is not sufficient, because the regulated return is a proxy for a competitive result. The Consumers Council argued that there should be no forbearance if a material increase in price is not offset by the prospect of decreasing prices.

Union argued that on IGUA/AMPCO's and the Consumers Council approach, the Board would never forbear, no matter how competitive the market. It argued that the financial impact is not a factor as to whether forbearance is warranted. Union argued that the

The Board concludes that long-term consumer protection in terms of price, reliability and quality of service is best achieved through thriving competition for the competitive elements of the storage market and effective regulation of the non-competitive elements of the market. The Board is of the view that refraining from rate regulation and contract approval in the ex-franchise market has the potential to foster more competition in the storage market, to the benefit of all customers, provided there are clear rules and non-discriminatory access by all market participants. In a competitive market, customers have choices, resources are distributed efficiently, and there are incentives to innovate and respond to customer needs.

4.3 TO FACILITATE RATIONAL DEVELOPMENT AND SAFE OPERATION OF GAS STORAGE

Discussion in this area focussed on the impact of forbearance on the development of new storage in Ontario, through the utilities directly, through their affiliates, or through independent storage developers. The estimates of new storage potential ranged from 50 Bcf to around 120 Bcf.

The Board has as an explicit objective to facilitate the rational development of gas storage. The Board therefore must look for means by which to achieve this objective. A number of authorities have identified the need to develop additional storage. For example, FERC has acknowledged that additional storage development will mitigate commodity price volatility and improve winter peak availability. The utilities and their affiliates took the position that this should be a key consideration for the Board and argued that new storage development will not take place in Ontario under the current regulatory regime. In their view, forbearance from setting rates and approving contracts would encourage storage development and the development of storage services. Nexen agreed with the utilities that forbearance will allow needed new services to develop.

Energy Probe also agreed and argued that there has been limited recent storage development despite the appearance of significant opportunities and that this can be contrasted with the level of development elsewhere. In Energy Probe's view, Ontario storage development has been artificially constrained due to unfavourable regulatory conditions. Energy Probe argued that forbearance will drive enhancements to meet the needs of gas-fired generators and that the public interest will benefit from having storage developers manage the risks and rewards of development.

Others, primarily consumer groups, took the view that new storage, to the extent that it is needed, can be stimulated by allowing market-based rates for new storage developers only. The position of these groups, including the London Property Management Association (LPMA), the Wholesale Gas Service Purchasers Group (WGSPG), VECC, and Consumers Council, can be summarized as follows:

- The existing facilities are more than sufficient to meet Ontario's needs.
- The utilities could further develop existing facilities under the current regulatory framework if additional capacity is needed. There is evidence that they have done so in the past.
- Forbearing from setting storage rates and transferring the rents to the shareholders will not provide an incentive to non-utility developers, and continued regulation of the utilities will not provide a disincentive to third-party storage development. The way to stimulate new storage development by third parties is by forbearing or regulating at market rates, which is consistent with FERC Order 678.
- There is no evidence that forbearing from regulating the utilities will cause them to increase capacity. The Enbridge evidence is that even with forbearance it might not invest in storage enhancements.

The evidence suggests that there is no need for significant new storage within Ontario to serve the traditional requirements of Ontario consumers. However, there is a demonstrated desire for more specialized services to meet the load characteristics of power generators. The Board also agrees that further development of storage in Ontario would be of benefit to Ontario consumers in terms of reduced price volatility, enhanced security of supply and an overall enhanced competitive market at Dawn. There is also evidence that new services, once they are generally available, can enhance the service offerings of other parties, such as marketers, thereby increasing the liquidity of the market.

The Board concludes that it is appropriate to facilitate the development of storage to offer these services without undue risk for ratepayers. The issue is how this objective is best achieved. At a minimum, for third-party storage development, whether independent or affiliated, the Board agrees that it should refrain from setting storage rates and approving storage contracts. There was no significant opposition to this approach.

The more contentious issue concerns the utilities and whether forbearance on price setting is necessary to stimulate their investment in storage. The utilities claimed they would only develop storage under a forbearance scenario but would not commit to doing so. On the other hand, the evidence shows the utilities have been willing to invest in the past under regulation, and indeed, the Board has the authority to order the utilities to provide storage services. The Board concludes that while there is no guarantee that the utilities will develop storage under forbearance, it is apparent they will not develop it under a regulatory framework unless ordered to do so. The Board does not believe that the best way to stimulate development of storage assets and services is to order utilities to develop these resources. The Board's preferred approach is to use market mechanisms where possible, and under forbearance, the Board concludes, the utilities will have an incentive to develop assets and services.

A related question is whether it continues to be appropriate for storage to be developed as part of the regulated utility business or whether it should in the future be developed separately. The Board accepts the evidence of Enbridge Inc. that storage development is more akin to exploration and development and is riskier than other distribution activities. Some parties disagreed that enhancements to existing storage facilities were as risky as new storage development. However, the Board is convinced by the evidence that storage investments are generally riskier than other regulated activities, such as distribution or transmission expansions, given the difficulty, for example, in accurately predicting the achievable operating parameters related to storage projects. This evidence was not significantly challenged. The Board therefore agrees with Energy Probe's view, namely that the risks associated with new storage development are best borne by storage developers. This approach is consistent with a rational development of storage in the Board's view. Under forbearance, the utility shareholders would be expected to bear the risk of any storage development for the competitive market.

The issue of automatic renewal rights was also raised. Enbridge indicated that it is not considering automatic renewal rights for storage contracts under its Rate 316 proposal, since that service will be acquired by Enbridge through a tender. APPrO maintained that Rate 316 is a companion service to Rate 125 and that if a customer renews its Rate 125 service, that customer should have the right to renew its Rate 316 service as well.

Board Findings

There was no disagreement that these services are needed and should be developed. The generators have convincingly expressed the importance of these types of service to the effective functioning of their operations – both physically and financially. The issue for the Board, within a section 29 context, is how best to achieve this objective. APPrO and the GTA Generators (supported by the consumer intervenors) advocated a regulated framework; the utilities argued for a competitive framework.

These services are not currently offered, indeed they need to be developed, and investments must be made in order to offer them. Union has been conducting open seasons for its new offerings and is committed to providing these services if the Board refrains from regulating them. The Board concludes that these services are substantially different from the bundled, unbundled and semi-unbundled distribution services offered by Enbridge and Union. There is demand for these services from marketers (for example, BP and Nexen) and likely others. In addition, when the capacity generators hold is excess to their needs, they expect to be able to offer this excess into the competitive market. It follows that they expect to be able to acquire these services through the competitive market as well as sell them.

The Board could order the utilities to provide these services on a regulated basis. However, the Board concludes that this would not be the best approach to ensuring the development of these services. The key consideration is to ensure that new innovative services are developed and offered into the market. The Board concludes that the best way to ensure this public interest is met is to refrain from regulating these services. This will stimulate the development of these services, by the utilities and by other providers. The Board finds that competition in these services will be sufficient to protect the public interest.

The Board does have a duty to protect the interests of consumers using these services with respect to price and reliability and quality of service. In this context we find that the crucial factor is the availability of the service itself – namely its reliability and quality. The Board notes that Enbridge committed to offer Rate 316, whether or not the Tecumseh enhancement project goes ahead, and to price it on a cost pass-through basis. The Board expects Enbridge to fulfill this commitment. Union has proceeded with its open season, and the Board expects Union to offer these services on an open season basis, without withholding capacity. These commitments will ensure a level of consumer protection.

Pricing considerations are relevant, but the Board finds that the development of competitive options will provide appropriate price protection for these consumers. The Board will also be developing a reporting mechanism and complaint process, discussed at the end of this chapter, and we expect that parties will bring any issues of market failure to the Board's attention.

The Board will refrain from regulating the rates for new storage services, including Enbridge's high deliverability service from the Tecumseh storage enhancement project and Rate 316, and Union's high deliverability storage, F24-S, UPBS and DPBS services.

Although this issue was discussed in the context of high deliverability services, the Board finds that its conclusions have general application, namely that any new storage which is developed by the utilities will be included as part of the competitive market. The utilities will bear the risk of these investments, not ratepayers. Similarly, the Board will not regulate the rates, nor approve the contracts, arising from these investments. If the utilities provide storage to their regulated business through these investments, the ratemaking implications of that approach will be considered in the context of a rates proceeding.

5.2.4 Forbearance in the Ex-Franchise Market

Most parties argued that ex-franchise customers should pay market-based rates. Some parties took the position that the Board could refrain from regulating the prices in this market (if the Board determined the market was competitive), and others were of the view that the Board should continue to approve market-based range rates.

For example, the Consumers Council argued that the Board should not refrain from regulating storage but that it is appropriate for the utilities to charge market rates for Transactional Services and long-term storage services to maximize revenue from the assets for the benefit of ratepayers.

Board Findings

The evidence shows that other than for in-franchise customers, the storage market is competitive. With the exception of Enbridge, the customers in this competitive part of the market (commonly referred to as ex-franchise) have been acquiring storage at market-based rates for some time. The Board sees no benefit from continuing to regulate the prices of these services; on the contrary, competition in this area is sufficient to protect the public interest. The Board will therefore refrain from regulating rates or approving contracts for Union's short- or long-term ex-franchise storage services and will refrain from regulated the rates or approving the contracts for Enbridge's Transactional Storage Services.

5.2.5 Separation of Unregulated Storage Costs and Revenues

Both Union and Enbridge proposed to separate the unregulated costs and revenues from the regulated costs and revenues using a cost allocation study. The issue is whether a cost allocation approach is sufficient, or if a greater degree of separation is required. Further, if a cost allocation approach is sufficient, there is an issue as to whether Union's current cost allocation study is adequate.

During the oral hearing, Union's witnesses indicated that Union would be preparing a new cost allocation study as the basis for revising the allocation of the costs of its storage assets between in-franchise (regulated) and ex-franchise (unregulated). In its final argument, however, Union submitted that the cost allocation necessary to split the costs of its storage assets between in-franchise and ex-franchise has already been completed in its 2007 rates case. According to Union, that allocation would result in the total storage rate base being split as follows ($ million):

Included in regulated rate base	$380.703	(79%)
Allocated to ex-franchise activities	$102.916	(21%)
Total	$483.619	(100%)

Enbridge proposed to separate the costs and revenues associated with its Transactional Storage Services at the next rates proceeding. It was Enbridge's position that no adjustment to rate base would be required if the Board were to forbear from price regulation.

Some parties argued that a greater degree of separation was required; others argued that Union's cost allocation study was inadequate.

Energy Probe argued that accounting separation is not sufficient because the historic cost allocation work could not have anticipated the dramatic change of storage forbearance. It took the position that the Board should encourage full structural separation at least, and that ratepayers should be held harmless for any associated costs.

The Board Hearing Team also recommended that Union's transmission and storage operations should be functionally separated, and that both Union and Enbridge's regulated and non-regulated storage should be functionally separated. The Board Hearing Team was of the view that this separation is necessary to ensure the development of the competitive storage market and to encourage new entrants. However, if no separation were required, the Board Hearing Team suggested that there should be a generic cost allocation review to examine the cost allocation thoroughly and to ensure no cross-subsidization.

LIEN argued that it would be difficult to separate costs for Union's integrated storage business. In LIEN's view, the current cost allocation study may be adequate to set rates, but it is not sufficient to separate price-regulated storage from non-price-regulated storage. LIEN proposed that an alternative would be to transfer assets which are surplus to distribution needs to a separate entity at fair market value which, in LIEN's view, would put Union on an equal footing with other storage providers.

Similarly, LPMA/WPSPG argued that Union's current cost allocation is not necessarily appropriate; there may be fundamental methodology issues to be addressed and there are storage-related costs that are included in distribution costs that should be considered for allocation to Union.

Board Findings

The Board finds that functional separation is not necessary. The evidence before the Board is that it would be costly and difficult to establish a functional separation of utility and non-utility storage, and there was no evidence to suggest that there would be significant benefits from such a separation. To the extent there may be concerns regarding the integrated operations, these will be addressed through the reporting requirements set out in section 5.4.

We also conclude that Union's current cost allocation study is adequate for the purposes of separating the regulated and unregulated costs and revenues for ratemaking purposes. The Board agrees with the Board Hearing Team that it is important to ensure that there is no cross-subsidization between regulated and unregulated storage. However, the Board is content that with its findings on the treatment of the premium on short-term storage services (Chapter 7) Union will have little incentive to use the cost allocation for purposes of cross-subsidy.

The issue of Enbridge's cost allocation is addressed in Chapter 7.

5.3 CONCLUSIONS ON FORBEARANCE

In the previous sections, the Board has found that it will refrain, in part, from regulating storage rates under section 36 (as that section relates to storage) of the *OEB Act* and refrain from approving certain storage contracts under section 39(2) of the *OEB Act*. Specifically:

- The Board will refrain from regulating the storage rates or approving the contracts of new storage providers.
- The Board will continue to regulate storage rates for bundled, unbundled and semi-unbundled customers of Union and Enbridge (up to the allocated amount).
- The Board will refrain from regulating the storage rates or approving the contracts of cross-franchise, or ex-franchise, storage customers of Union and Enbridge.
- The Board will refrain from regulating the rates or approving the contracts for new storage services offered by Union and Enbridge.

5.4 REPORTING

A number of parties made recommendations regarding ongoing reporting by utilities and other storage operators. The utilities and their affiliates generally agreed to provide the type of reporting required by FERC for interstate pipelines (FERC Regulations, §284.13) although to some extent they challenged whether it was necessary. FERC Regulation §284.13 contains requirements for regular reporting on customer and system information.

Kitchener suggested that the Board develop a Storage and Transportation Access Rule or "STAR" to ensure non-discriminatory access to storage and transportation services, following on from the Gas Distribution Access Rule.

The Board Hearing Team identified four principles in this area:

- Create a level playing field for market participants,
- Adopt rules and practices to govern affiliate behaviour that protect the public interest,
- Support open and non-discriminatory access to transmission, and
- Establish a transparent storage/transmission market so market participants can make informed decisions.

The Board Hearing Team supported the development of a STAR. It also proposed that the ARC be amended to control the interaction between the utilities and their storage affiliates and that reporting requirements be put in place for all storage providers in order to enhance transparency in the market.

Board Findings

The Board agrees with the Board Hearing Team's principles and shares the concerns related to forbearance raised by a number of parties. Specifically, in refraining from regulating storage rates or approving storage contracts, the Board must:

- Ensure consumer protection within the competitive market for storage in Ontario.
- Ensure access to Union's transportation system on a non-discriminatory basis to new and existing storage operators.

The Board concludes that it is necessary to develop appropriate operating and reporting procedures to ensure these objectives are addressed. The Board finds that Kitchener's proposal for the development of a STAR (Storage and Transportation Access Rule) has merit.

The Board will initiate a process to develop rules of conduct and reporting related to storage. The Board will ensure that the process addresses the following:

- Requirements to ensure that Union cannot discriminate in favour of its own storage operations or those of its affiliates and cannot discriminate to the detriment of third-party storage providers;
- Reporting requirements for all storage providers, although the requirements may vary as between utility and non-utility storage providers, and which may include: terms and conditions, system operating data, and customer information;
- A complaint mechanism for customers (or other market participants).

6. ALLOCATION OF STORAGE AVAILABLE AT COST-BASED RATES

Having decided that Union and Enbridge should retain regulated, cost-based rates for storage used by in-franchise customers, the question becomes how much of the existing storage space should be reserved for those customers. There are two issues arising from this allocation matter.

First, should the amount of storage available to Union's in-franchise customers at cost-based rates be fixed at an amount less than the total working gas capacity of Union's storage pools, currently 152 Bcf? Union proposed to fix the amount of existing storage allocated to in-franchise customers at the amount Union estimates those customers will use in 2007.

Second, what method should Union and Enbridge use to allocate the amount of storage available at cost-based rates to individual unbundled and semi-unbundled customers? The evidence shows that, for various reasons, many of Union's T-service (semi-unbundled) customers have been allocated amounts of storage that are inconsistent with amounts determined under Union's standard "aggregate excess" method. In addition, Kitchener argued that as a gas distributor embedded in Union's distribution system, it requires more storage space at cost-based rates than the amount calculated under the aggregate excess method.

6.1 UNION'S TOTAL COST-BASED STORAGE ALLOCATION

Union proposed to freeze, on January 1, 2007, the amount of its storage capacity available to in-franchise customers at cost-based rates. The frozen amount would be 92.1 PJ (approximately 87 Bcf), Union's estimate of in-franchise requirements for 2007.

Incremental in-franchise storage requirements due to load growth would be met by Union purchasing the required additional amounts in the market and passing through the contract costs to its in-franchise customers.

Union noted that the in-franchise storage requirement has been very stable over the past seven years, increasing from 88.2 PJ in 2000 to 90.6 PJ in 2006, an annual growth rate of just 0.45%.

In its evidence, Union explained the rationale for its proposal as follows:

> Under the current regulatory framéwork, any future increase to in-franchise storage requirements would be provided through a reallocation of the portfolio of storage capacity owned and managed by Union.
>
> This current practice is not appropriate as it does not reflect the fact that the storage market is competitive, nor does it encourage or support the development of new storage capacity. Specifically, Union would not be incented to assume the risk and commit the capital and resources to develop new storage capacity with economics premised on competitive market pricing, when there is a risk of this storage being reallocated in the future to meet in-franchise requirements at a cost of service rate.[35]

In argument, Union summarized the reasons for its proposal as follows:

- "Claw-back" of assets etc. allocated to ex-franchise sales would undermine development of new storage capacity premised on market pricing.
- "Claw-back" would also make cost allocation issues more complex.
- Meeting incremental demand with services sourced from competitive markets is consistent with a transition to competition and a step toward sending better "price signals" to in-franchise customers.
- This proposal will not result in "rate shock" of any kind.[36]

Kitchener, LPMA/WGSPG, Consumers Council, VECC, and IGUA/AMPCO argued that there should be no freeze on the amount of Union's storage available at cost-based

[35] Union Pre-filed evidence, Exhibit C, Tab 1, page 15.
[36] Exhibit Y2.1, outline of Union reply argument, page 4.

rates to in-franchise customers. GMi and the Board Hearing Team supported Union's proposal.

Board Findings

Under the existing regulatory framework, Union's in-franchise customers have had first call, at cost-based rates, on Union's storage capacity. Said differently, Union has sold storage services to ex-franchise customers only when it can demonstrate that the storage being sold is surplus to in-franchise needs.

From an operational perspective, it is not necessary (nor would it appear to be feasible) for Union to physically split its storage facilities between "in-franchise" and "ex-franchise" uses. And until now, Union has been able to offer storage services in the ex-franchise market without capping or freezing the amount of capacity that is available for in-franchise uses.

Giving in-franchise customers a priority call at cost-based rates on all of Union's storage may be supportable if one takes the view that every Bcf of Union's storage capacity is a "utility asset" and is required to provide "utility services." But that view needs to be re-examined in light of the evidence presented at this hearing about the development and use of Union storage in recent years, and the Board's determination that the storage market is competitive.

Amount of Union's "surplus" capacity

There is no doubt that Union's existing storage capacity far exceeds the current requirements of its in-franchise customers. Some 40% of the current capacity has been sold in the ex-franchise market. And the requirements of in-franchise customers have grown slowly (less than 0.5% per year over the past six years according to Union's evidence). The excess is so large that it would take several decades for all of the current capacity of 152 Bcf to be required for in-franchise customer needs if those needs grow at 1% per annum, and more than 100 years at the current rate of growth.

In past decisions on storage, the Board has required Union to file forecasts of storage capacity and in-franchise needs to demonstrate that space being sold to ex-franchise customers is surplus to in-franchise needs. For example, in the EBRO 494-03 decision, the Board approved four long-term ex-franchise storage contracts based on Union's 10-year forecast of capacity and in-franchise needs. The Board considered, but did not require, Union to insert a clause into the contracts that would allow Union the right of recall because the Board "found...that the Company's forecast of its in-franchise storage needs is reasonable."[37]

Union's storage development

During the hearing, a common argument from many parties on several different issues (particularly on the issue of sharing the premium on ex-franchise sales) was that in-franchise customers have "paid for" or "substantiated" the storage assets of the utilities. If true, is this a basis for continuing to grant in-franchise customers a perpetual call on all of Union's storage capacity at cost-based rates?

This argument breaks down on two fronts. First, Union's rate base excludes capital costs of storage that underpins long-term ex-franchise sales. Second, the sheer magnitude of the current surplus makes it unlikely that Union's expansion of its storage facilities in the recent past has been driven primarily, or perhaps even to any significant extent, by the anticipated needs of in-franchise customters. For example, since 1999 Union has added almost 18 Bcf of capacity through greenfield developments and enhancements to existing pools, capacity that was not necessary to cover in-franchise needs. This additional capacity has been directed to, and taken up by, the "ex-franchise" market, not distribution customers of Union.

Ex-franchise customers have contracted for Union's long-term surplus space and have paid market-based rates, rates that have been much higher than cost-based rates. Rather than bearing the costs of surplus Union storage space that is offered long-term

[37] EBRO 494-03 Decision with Reasons, September 26, 1997, paragraph 2.2.29.

to the ex-franchise market, Union's in-franchise customers have in fact benefited through receiving most of the premium on long-term sales.

Union's rationale

Union claims that development of new storage capacity would be undermined unless the amount of storage allocated to in-franchise customers is capped. This claim appears to have little merit. First, no party to this proceeding has opposed market rates for new storage capacity by third parties. Second, a freeze on space for in-franchise customers would have a neutral effect on the development of the competitive market. This was illustrated by LPMA/WGSPG, which put forward the following scenario in its argument: Assume the incremental storage requirement for the in-franchise customers is, say, 2 Bcf in a particular year. Under Union's proposal, Union would purchase that 2 Bcf from third-party providers. Under the existing framework, that 2 Bcf would be supplied by Union, leaving it with 2 Bcf less for ex-franchise sales. That 2 Bcf shortfall could be provided by third-party providers. The net impact on third-party providers is 2 Bcf of additional storage in either case.

Union also claims that meeting incremental in-franchise demand at market prices is consistent with a "transition to competition" and would send "better price signals to in-franchise consumers." No one in this proceeding, however, has advocated that any in-franchise customers, except for some of the largest gas customers, should be obligated to take a service that might require them to participate directly in the competitive storage market.

GMi, currently Union's largest ex-franchise customer, and Nexen expressed concerns about "claw-back" that the Board finds more compelling than Union's argument. GMi opposed any storage allocation rules that could result in "clawing back storage capacity held by ex-franchise customers for the benefit of in-franchise consumers." It said it would view any such measure as unfair discrimination. Nexen submitted that "claw-back" of storage services from ex-franchise customers would be "discriminatory and detrimental to not only GMi but to the very existence of the secondary market that Ontario currently supports and benefits from."

Conclusion

The Board finds that there should be a cap on the amount of Union's existing storage space that is reserved for in-franchise customers at cost-based rates. In the Board's view, Union's existing storage assets are, in substance, a combination of "utility assets" required to serve Union's in-franchise distribution customers and "non-utility assets" that are not required for regulated utility operations and that are sold in the competitive storage market. This distinction is supported by the significant excess of total capacity over in-franchise needs for the foreseeable future and by the fact that development in recent years has been driven by the ex-franchise market, not in-franchise needs. The Board does not accept IGUA/AMPCO's submissions that the entire amount of Union's storage is a "utility asset" and that ex-franchise customers (such as gas marketers and utilities in the U.S. Northeast) are buying "utility services" when they purchase storage from Union. The Board has determined that the ex-franchise market is competitive and that it will refrain from rate regulation or contract approval; these will no longer be "utility" services.

The Board concludes that its determination that the storage market is competitive requires it to clearly delineate the portion of Union's storage business that will be exempt from rate regulation. Retaining a perpetual call on all of Union's current capacity for future in-franchise needs is not consistent with forbearance. As evidenced by the arguments from GMi and Nexen, two major participants in the ex-franchise market, retaining such a call is likely to create uncertainty in the ex-franchise market that is not conducive to the continued growth and development of Dawn as a major market centre.

The Board concludes that it would be inappropriate, however, to freeze the in-franchise allocation at the level proposed by Union. Union's proposal implies that a distributor with an obligation to serve would be prepared to own, or to have under contract, only the amount of storage needed to serve in-franchise customers for just the next year. In the Board's view, it is appropriate to allow for some additional growth in in-franchise needs when determining the "utility asset" portion of Union's current capacity.

The Board acknowledges that there is no single, completely objective way to decide how much should be reserved for future in-franchise needs. The Board has determined that Union should be required to reserve 100 PJ (approximately 95 Bcf) of space at cost-based rates for in-franchise customers. This compares with Union's estimate of 2007 in-franchise needs of 92 PJ (87 Bcf). At an annual growth rate of 0.5% each year, which Union claims is the growth rate since 2000, in-franchise needs would not reach 100 PJ until 2024. The limit would be reached in 2016 if the annual growth is 1%; at a very annual high growth rate of 2% per annum, the 100 PJ limit would be reached in 2012.

The 100 PJ (95 Bcf) amount is the capacity that Union must ensure is available to in-franchise customers if they need it. Union should continue to charge in-franchise customers based on the amount of space required in any year. If Union's in-franchise customers require less than 95 Bcf in any year, as measured by Union's standard allocation methodology, the cost-based rates should be based on that amount, not on the full 95 Bcf reserved for their future use. Union will have the flexibility to market the difference between the total amount needed and the 95 Bcf reserve amount.

6.2 ALLOCATION OF COST-BASED STORAGE: METHODOLOGY AND APPLICATION

Union and Enbridge have developed methods of allocating cost-based storage space to their in-franchise customers – both bundled customers as a group, and individual unbundled and semi-unbundled (T1 and T3) customers. The amount allocated currently has two implications for customers:

7. TREATMENT OF THE PREMIUM ON MARKET-BASED STORAGE TRANSACTIONS

Union and Enbridge ratepayers have received a significant portion of the premium over cost-based rates that results from the sale of storage services to ex-franchise customers at market-based rates. Chapter 2 provided information on the magnitude of the margins in recent years and the basis on which these margins are shared between the utilities and ratepayers. Union's ratepayers have received 90% of the forecast margins related to both long-term ex-franchise sales (contract terms of two years or more) and short-term transactions (contract terms of less than two years). Ratepayers also receive 75% of any margins that are greater than forecast amounts. Enbridge ratepayers have received approximately 75% of Enbridge's Transactional Services margins.

Union proposed to end the sharing of long-term and short-term margins with ratepayers. Specifically, Union proposed that the Board adjust distribution rates effective January 1, 2007, to exclude all storage costs and revenues associated with ex-franchise sales from 2007 rates and to eliminate five existing storage and transportation deferral accounts that currently capture market-based margins in excess of amounts incorporated into rates. Union has forecast 2007 margins at $29.9 million (long-term) and $14.6 million (short-term).

Enbridge also proposed to end margin sharing with ratepayers. It is seeking approval to exclude revenues and expenses associated with Transactional Storage Services from its distribution rates commencing in 2007. All Transactional Storage Service revenues, forecast to be $5 to $6 million in 2007, would accrue to Enbridge. The costs to be excluded from distribution rates in 2007 would be some portion of the approximately

$800,000 of O&M costs of Enbridge's Transactional Services business. Enbridge proposed to continue to include the entire net book value of its storage facilities in rate base.

The Board Hearing Team and Energy Probe supported the Union and Enbridge proposals. LPMA/WPSPG, Consumers Council, LIEN, VECC, IGUA/AMPCO, and Schools generally objected to any change in how margins are shared.

7.1 MARGINS ON SHORT-TERM STORAGE TRANSACTIONS

During the hearing, most parties presented views on the rationale for requiring the utilities to credit most of their storage margins to ratepayers. Several parties opposing the Union and Enbridge proposal to cease margin sharing referred to earlier Board decisions that they believed supported margin sharing.

The Board first dealt with margin sharing in the context of Union's short-term storage services, which Union started to sell at market-based rates in 1989. In 1996, the Board considered essentially the same issue when Enbridge proposed to start marketing its Transactional Services more aggressively and retain some of the margin. The Board has expressed a consistent view that Union's short-term storage transactions and Enbridge's Transactional Services involve sales at market-based rates of services derived from utility assets that are temporarily surplus.

In its decision in EBRO 492, dated September 10, 1996, the Board stated:

> The Company [Enbridge] stated that the objective of offering transactional services is to make additional use in off-peak periods of the Company's physical and contractual storage and transportation assets acquired in the first place to serve the in-franchise customers. [Paragraph 3.3.2, emphasis added]
>
> The Board does not agree that an incentive to provide these services should be necessary, and notes that the Company has offered both peak and off-peak services, along with assignments and exchanges in prior years without

> the need for an incentive. However, the Board acknowledges that the Company does incur some risk associated with its participation in these activities, and finds that a 10 percent incentive will be adequate to address these modest risks. [Paragraph 3.3.30]

In 1997, the Board for the first time approved Union entering long-term storage contracts at market-based rates with ex-franchise customers. In its decision in EBRO 494-03 dated September 26, 1997, the Board described the basis for allowing Union's short-term transactions as follows:

> Short-term storage for ex-franchise customers has been marketed on the basis that it is <u>space required to provide in-franchise service</u>. Due to weather and other variables part of the space is temporarily surplus to in-franchise needs. Customers already pay the costs of this storage in rates. Any revenue from short-term sales of storage services that is beyond the direct marginal cost to provide the service is a benefit to in-franchise consumers. [Paragraph 2.3.19, emphasis added]

Board Findings

The Board concludes that its decision to refrain in part from regulating rates for storage services does not invalidate the basis for sharing margins with ratepayers on short-term deals. Union's short-term storage transactions and Enbridge's Transactional Services storage sales are sales of services derived from utility assets that are temporarily surplus to in-franchise needs. The Board concurs with VECC's final argument on this point:

> In Union's case, the assets underpinning the short-term storage and balancing services sold in the ex-franchise market are presently included in rate base. In the case of Enbridge, all of the assets underpinning their transactional services sold in the ex-franchise market are included in rate base. As stated earlier, VECC views it as highly inappropriate for the utilities to seek the entire margin associated with these assets given that they have been "substantiated" by captive ratepayers who have paid in rates for the full opportunity cost of the associated capital investment (including a fair return on equity) along with overhead costs and direct operational costs associated with providing the services. In VECC's view, the utilities should be required to provide a rationale for receiving any of the associated margins given their earlier mentioned obligation to optimize the use of utility assets. [Page 16]

Requiring the utilities to share these margins with ratepayers is not in any way inconsistent with a finding that the storage market is competitive. The basis for sharing these margins is the nature of the assets that underpin the transactions, not the prices at which the transactions occur.

The Board finds that the entire margin on storage transactions that are underpinned by "utility asset" storage space, less an appropriate incentive payment to the utilities, should accrue to ratepayers. Ratepayers bear the cost of that space through the regulated storage rates and should benefit from transactions that utilize temporarily surplus space. The Board finds that shareholders will retain all of the margin on short-term transactions arising from the "non-utility" storage space.

Short-term margins derived from "utility assets"

The decision to require Union to notionally divide its existing storage into two pieces – a "utility asset" (maximum of 100 PJ) and a "non-utility asset" (the balance of Union's capacity) is set out in Chapter 6. Union's storage facilities will not be physically split into two pieces and Union is likely to continue operating its storage assets in much the same way as it does today. Union presumably will determine its ability to execute short-term deals based on the amount of temporarily surplus space in the entire storage facility. As long as the utility and non-utility storage is operated as an integrated asset, it will not be possible to determine that any particular short-term transaction physically utilizes space from either the "utility asset" or the "non-utility asset."

Given the impossibility of physically linking a short-term transaction to a specific slice of storage space, the Board considered other methods of determining the amount of storage margins that should accrue to Union's ratepayers. The Board has decided that the calculation should be based on how the costs of the storage facilities are split between the utility and non-utility businesses. Specifically, Union's revenues in any year from short-term storage transactions, less any incremental costs incurred by Union to earn those revenues, should be shared by Union and ratepayers in proportion to Union's allocation of rate base between utility and non-utility assets.

As indicated in Chapter 5, the allocation is currently 79/21 utility/non-utility. Union's existing policy on what constitutes a short-term storage transaction will continue to apply. As and when Union requires more capacity for in-franchise needs (up to the 100 PJ cap) or adds storage capacity or enhances deliverability of its storage facilities, the cost allocation will presumably change. Once a revised cost allocation has been approved in a Union rates case, the basis on which margins on short-term storage transactions are shared will also change.

All of Enbridge's current storage assets (storage facilities and contracts) are required to serve its in-franchise customers. Thus, all of Enbridge's storage-related transactional services revenues today are derived from "utility assets." If and when Enbridge increases the capacity of its Tecumseh storage facilities, it will be necessary for the company to adopt a method of allocating storage-related Transactional Services revenues between utility and non-utility assets.

Incentive payments to utilities for short-term transactions

The Board has considered whether to continue allocating a portion of the margins from short-term transactions to the utilities as an incentive to optimize the use of the "utility assets" of each company.

The Board has decided that Enbridge should continue to share in margins on Transactional Services storage deals. Eliminating any sharing would leave Enbridge with no financial incentive to market temporarily surplus storage space. An incentive mechanism aligns Enbridge's interest with the interest of ratepayers. The size of the incentive is a matter of judgement and that issue has been debated in several past rates cases. The Board finds that the current 25% incentive is excessive given that ratepayers bear all of the costs of the existing storage assets. The Board believes a

10% incentive is sufficient. In the future, 10% of the storage component of Enbridge's Transactional Services revenue, less any incremental costs incurred by Enbridge to earn those revenues, will be for the account of Enbridge. The remainder will be for the benefit of ratepayers. As a result, Enbridge will not be required to separate its revenues and costs for Transactional Storage Services.

With respect to Union, an argument might be made that an incentive is not necessary. Union will receive margins from short-term storage deals that are deemed to arise from the "non-utility" portion of its storage facilities. Thus, Union will already be motivated to maximize the revenues on all short-term transactions. The Board has decided, however, that it would be appropriate for Union and Enbridge to be treated consistently and to each receive 10% of the net revenues deemed to arise from the "utility asset" portion of storage.

The Board is currently undertaking a process to determine a multi-year incentive ratemaking framework for Union and Enbridge. That process will address how best to implement the Board's findings on the sharing of short-term storage transaction margins within an incentive ratemaking framework. Enbridge's 2007 rates case is in progress; the Board's finding with respect to short-term margin sharing will be implemented through that proceeding.

7.2 MARGINS ON UNION'S LONG-TERM TRANSACTIONS

Margins on both Union's short-term storage transactions and its long-term deals historically have been shared with ratepayers in essentially the same way. Although the Board has devoted considerable time to long-term contracting issues in past Union cases, it has not determined that margins on the two types of transactions should be shared on fundamentally different bases. In its decision on Union's 2000 rates (RP-1999-0017), the Board described the rationale for sharing the margins on all of Union's storage sales:

> The Board recognizes that the assets necessary to provide both transactional services and long-term storage services have been paid for by Union's customers. Providing that the Company has a financial incentive to maximize revenues for these services should increase the benefits to both the customer and the shareholder. Consequently the Board authorizes a sharing of net revenues for transactional services and market premium for a long-term storage services in the ratio of 75:25 between ratepayer and shareholder as an incentive to maximize the revenue associated with both these services. [Paragraph 2.505]

Union's rationale for the sharing of storage margins has changed over time. In 1996, when it was unsuccessful in obtaining Board approval for long-term storage sales at market-based rates, Union had submitted that all of the margins would be credited to ratepayers "since in-franchise customers had paid for the development of the storage." In Union's 2000 rates case (RP-1999-0017), the Board noted that "Union's position was that ratepayers have paid for the services from the assets, not for the assets themselves." This is the position that Union advanced in this proceeding.

IGUA/APMCO claimed Union is estopped from changing its position on margin sharing. The argument is that the Board was persuaded to allow market-based rates on the condition that the bulk of the proceeds would go to the ratepayer. Accordingly, IGUA/AMPCO argued that it is now improper for Union to change its mind and to argue that these proceeds now need to go to the shareholder in order to promote the development of new storage.

Board Findings

The Board has determined that storage space in excess of the amount made available at cost-based rates (which is to be capped at 100 PJ – see Chapter 6) can be considered a "non-utility" asset. This is the space that will support Union's long-term storage sales. The Board finds that profits from new long-term transactions should accrue entirely to Union, not to ratepayers.

In comparing this decision with the past Board decisions on the sharing of margins on long-term storage sales, it is important to remember the context in which the Board made its earlier decisions. Until this proceeding, the Board had never reviewed the state of competition in storage and had not considered whether to refrain, in whole or in part, from regulating storage prices. Thus, there was little basis for the Board to treat the margins on short-term and long-term sales differently. Further, the Board's decision in RP-1999-0017 to allow all then existing cost-based contracts with ex-franchise customers to be renewed at market rates has resulted in a substantial growth in long-term margins, margins that have been largely for the benefit of ratepayers. It is certainly not possible today to assert that ratepayers have "paid for" the space that underpins Union's long-term storage contracts.

The Board does not accept IGUA/AMPCO's estoppel argument. Estoppel as a principle of contract law is sometimes called "detrimental reliance". IGUA/AMPCO's theory seems to be that when the Board made its decision on the sharing of long-term margins it relied upon an undertaking by Union to continue the sharing. Perhaps that might have been part of the Board's rationale at the time but the Board itself has now questioned the continuing need for the practice and whether the rationale developed at that time continues to exist.

This after all, is the purpose of section 29. Section 29 requires the Board to re-examine the need for regulation or the degree of regulation where market structures have changed. This Board in the Natural Gas Forum Report recognized that market conditions in energy markets have in fact changed. When such changes occur, regulators, particularly those such as the Board and the CRTC with statutory forbearance mandates in their governing legislation, must re-examine the regulatory construct in light of the current market conditions. That is what this proceeding seeks to accomplish. The concept of estoppel has no meaning in such a framework.

7.3 TRANSITION RELATED TO LONG-TERM MARGINS

IGUA/AMPCO and LPMA/WGSPG argued that in the event the Board decides to eliminate the sharing of any margins with ratepayers there should be some mitigation. As a precedent, LPMA/WGSPG referred to the 2003 decision by the Board on the phase-out of the Delivery Commitment Credit (DCC). There the Board recommended a five-year period based on a cost increase of 11.3 cents per GJ on a specific class of customers. LPMA/WGSPG argued that the phase-in period in the current case should be eight years, because the cost impact is a greater impact of 17.5 cents per GJ across all customer classes.

Board Findings

The Board recognizes that, particularly in recent years, Union's ratepayers have had a significant benefit due to sharing the bulk of the margins on long-term deals. The Board would prefer to have a smooth transition away from the status quo rather than an abrupt change in rates.

The Board finds, however, that there is no basis for retaining a requirement that Union share the margins on new long-term storage transactions, that is, long-term deals executed after the Board's forbearance decision. To continue sharing those margins with ratepayers would conflict with the Board's decisions (a) to recognize that part of Union's storage capacity constitutes a non-utility asset, and (b) to forbear from regulating the prices of ex-franchise transactions. Union should reap the benefits and bear the risks of those new transactions.

The margins that will be recorded in future years in respect of existing long-term deals are different. Those margins flow from long-term contracts that were negotiated and priced prior to the Board's forbearance decision and prior to the Board's decision that there is a non-utility part of Union's storage facilities. When those contracts were signed, Union had no reason to expect that it would receive anything more than 10% of the margin. The Board has concluded that ratepayers should continue to receive some of the margin on those existing contracts.

The Board considered whether to require Union to record the margins on existing long-term contracts separately from the margins on new long-term contracts. Under this approach, ratepayers would be credited with 90% of the margins on existing contracts for the remaining terms of those contracts. This approach conceptually has appeal but could give rise to ongoing implementation questions. For example, the Board might have to consider how contract re-negotiations or defaults by customers are to be treated. This level of complexity and potential ongoing review is unwarranted.

The Board has concluded that it should adopt a simpler phase-out mechanism that is a rough sort of "proxy" for the conceptual approach described above. The phase-out of the sharing of margins on Union's long-term storage transactions will take place over four years. The share accruing to Union will increase over that period to recognize that contracts will mature and a larger part of Union's total long-term margins will be generated by new transactions. For 2007, forecast margins (on long-term and short-term transactions) now included in the determination of Union's rates will remain unchanged. After 2007, Union's share of long-term margins will be as follows: 2008 – 25%, 2009 – 50%, 2010 – 75%, 2011 and thereafter – 100%.

The Board is currently undertaking a process to determine a multi-year incentive ratemaking framework for Union and Enbridge. That process will address how best to implement the Board's findings on the transition for long-term storage transaction margins within an incentive ratemaking framework.

7.4 ATCO DECISION

During the oral hearing and in final argument, several parties referred to the recent Supreme Court of Canada decision on the proceeds of an asset sale by ATCO Gas and Pipelines Ltd. Some parties claimed the case supported a cessation of margin sharing by the utilities, while other parties questioned whether the facts of that case were relevant to the Ontario storage market.

ATCO, a public utility in Alberta, applied to the Alberta Energy and Utilities Board (AEUB) as required by the Alberta *Gas Utilities Act*[40], for the approval of the sale of buildings and land located in the City of Calgary. The utility argued that the property was no longer useful and the sale caused no harm to ratepayers. The AEUB agreed that the customers would not be harmed and approved the sale.

In a second decision, the AEUB determined that it would allocate the net profits from the proceeds of the sale between the utility and ratepayers. The AEUB held that it had jurisdiction to order this allocation because it had authority to attach conditions to the order approving the sale to protect the public interest.

The Alberta Court of Appeal set aside the AEUB's decision[41] referring the matter back to the AEUB to allocate the entire proceeds from the sale to ATCO. The City of Calgary, representing the customers' interest, appealed to the Supreme Court of Canada, which upheld the Court of Appeal finding that the AEUB did not have the requisite jurisdiction. On February 9, 2006 the Supreme Court of Canada released its decision in the ATCO case.[42]

Board Findings

The Supreme Court of Canada found as follows:

> The customers pay an amount for the regulated service that equals the cost of the service and the necessary resources...The payment does not incorporate acquiring ownership or control of the utility's assets.[43]

[40] R.S.A. 2000, c. G-5, s.26
[41] ATCO Gas & Pipelines Ltd. v. Alberta (Energy & Utilities Board), [2004] 24 Alta. L.R. (4th) 205 (C.A.)
[42] ATCO Gas & Pipelines Ltd. v. Alberta (Energy & Utilities Board), [2006] S.C.J. No. 4, 2006 SSC 4.
[43] Ibid, par. 68

There are differences between the ATCO case and the present case. The ATCO case involved the sale of a capital asset (land), while this case involves providing a service (storage).

The Alberta case related to section 26 of the *Gas Utilities Act* in Alberta, which required ATCO to apply to the AEUB for approval to sell any asset. The sharing of the premium from the sale of storage services to ex-franchise customers at market-based rates has been decided in the context of rates cases.

The findings of fact in this case indicate that there are certain storage assets in rate base that are used to provide storage service to in-franchise ratepayers. This decision also finds that those services should be provided at cost-based rates as they have been in the past.

The utility also uses these assets to generate profits from sales to ex-franchise customers. The bulk of the revenues have historically flowed to ratepayers and a small share has gone to the utility. That share represents a "fee" that provides an incentive to the utility to generate these sales and profits from what at certain times of the year is excess capacity. This does not give rise to any claim by the utility under the ATCO principles. The ratepayers are receiving service relating to assets in rate base. No sale of assets is involved. The utility is being compensated for certain services.

At the same time, this decision finds that there are certain storage assets that are not part of the utility rate base and finds that the return from those assets, in terms of profit on sales to ex-franchise customers, should accrue entirely to the utility and its shareholders. Again, no claim arises under the ATCO principles. There is no appropriation to the benefit of the ratepayer of any utility assets or for that matter any proceeds from that asset. Accordingly, the Board finds that ATCO decision has no application to this decision.

7.5 STORAGE AND TRANSPORTATION SERVICE DEFERRAL ACCOUNTS

The deferral accounts at issue in this proceeding are the following:

- Short-Term Storage and Other Balancing Services Account (179-70)
- Long-Term Peak Storage Services Account (179-72)
- Transportation Exchange Services Account (179-69)
- Other S&T Services Account (179-73)
- Other Direct Purchase Services Account (174-74)

On March 15, 2006, the Board notified Union and the intervenors that Union's proposal to eliminate the five deferral accounts, made as part of the rate application EB-2005-0520, had been moved to this proceeding. The relevant evidence from EB-2005-0520 was re-filed in this proceeding.

Union explained that of the five accounts in question, the storage accounts (179-70 and 179-72) are directly related to the storage forbearance issue, while the remaining three transmission accounts (179-69, 179-73 and 174-74) are not directly related to the storage forbearance issue.

Union proposed to eliminate the Short-Term Storage and Other Balancing Services Account (179-70) and Long-Term Peak Storage Services Account (179-72) on the basis that these accounts would no longer be necessary if the Board decides to forbear from regulating ex-franchise storage service sales.

Union also proposed to eliminate the other three transmission-related deferral accounts (179-69, 179-73 and 179-74). Union advanced two reasons for this proposal. First, Union stated that the forecast of S&T revenue should not be treated any differently than the forecast of any other source of revenue. Second, Union submitted that its proposal is consistent with the Board's policy direction, as outlined in its Natural Gas Forum Report, that in an incentive regulation framework there should be no earnings sharing and transactional services revenues should not receive special treatment. Union also expressed concern that there may not be another opportunity or forum to deal with this issue prior to the beginning of the proposed incentive regulation framework.

Most intervenors took the position that the storage related accounts (179-70 and 179-72) should continue if the Board determines that it will not refrain from regulating the prices of ex-franchise storage sales services. However, intervenors also acknowledged that if the Board were to forbear from regulating the prices of ex-franchise storage services, then these accounts would no longer be needed and under those specific circumstances should be eliminated. For example, the Board Hearing Team argued that under forbearance, gas utilities' shareholders will be bearing the risk associated with storage transactions in the ex-franchise market and any premium or shortfalls should accrue to the shareholder.

With respect to the transmission-related deferral accounts (179-69, 179-73 and 179-74), most intervenors were of the view that these accounts should not be eliminated because transmission will remain a regulated service. LPMA/WGSPG supported the objective of reducing the number of variance and deferral accounts but took the position that a comprehensive review of all such accounts should be undertaken as part of the incentive regulation mechanism that is still to be determined. Many intervenors adopted the LPMA/WGSPG position.

The Board Hearing Team supported Union's proposal. It argued that because transactional transportation services are part of the gas utility's monopoly service, these revenues should be treated no differently than any other regulated revenue.

Board Findings

With respect to the storage related accounts (179-70 and 179-72), most intervenors were of the view that the resolution of this issue depends on whether the Board refrains from regulating ex-franchise storage. The Board has determined that it will refrain from regulating rates in this area. However, we have also concluded that there should continue to be a sharing of the premium arising from short-term storage transactions, for both Union and Enbridge, and that there should be a phase-out of the sharing of the premium arising from Union's long-term storage transactions. Accordingly, the Board concludes that the accounts should be maintained for now. As outlined in sections 7.1 and 7.3, we have determined that the gas incentive ratemaking process is the best place in which to determine the precise implementation of these findings.

With respect to the transmission-related accounts, there was general acknowledgement that the issue related to the structure of the incentive regulation framework and not the issue of storage regulation. Union was concerned that this proceeding would be the only opportunity to deal with its proposal before the introduction of incentive regulation. The Board does not agree. On September 11, 2006, the Board issued a letter indicating its intent to establish a consultation process to use in relation to the development of the gas incentive regulation framework. This process is specifically designed to address issues about the framework prior to the commencement of incentive regulation for natural gas utilities. The Board finds that the proposed elimination of these three transmission-related accounts should be considered as part of a comprehensive review that includes all deferral accounts under an incentive regulation mechanism.

The Board therefore concludes that all of the accounts will be maintained and will be reviewed as part of the process for setting the incentive regulation mechanism for natural gas utilities.

8. OUTSTANDING ENBRIDGE RATES ISSUES (RATES 125 AND 300)

The unresolved issues arising from the Enbridge Settlement Proposal relate specifically to the allocation of implementation costs and migration revenue deficiencies attributable to changes in Rates 125 and 300, and the Rate 125 eligibility criteria.

Early in the proceedings, there were two threshold issues. The first issue was whether the allocation of implementation costs and migration revenue deficiencies should be addressed in this proceeding or Enbridge's next rates proceeding. The Board determined that the issue should be addressed in this proceeding, and that decision was rendered orally on June 27, 2006. The second issue was whether residential customers should be allocated any of the implementation costs or migration revenue deficiencies. The Board rendered its decision orally on July 14, 2006, in which it stated that both the implementation costs and the migration related revenue deficiencies should be recovered from large volume customers as they are the main beneficiaries of these services. (The transcript of the Board's oral decisions on these issues is included at Appendix C.)

The remaining issues before the Board are the following:

- Smoothing of Migration-Related Impacts:
- Rate 125 Eligibility Criteria

8.1 SMOOTHING OF RATE MIGRATION IMPACTS

Enbridge stated that the offering of new services, such as Rate 125 and Rate 300, typically leads to the migration of customers from the existing rates to the new rates, if there is an economic advantage or a reduction in rates, for these customers. This

unionGas
P.O. Box 2001
50 Keil Drive North
Chatham, Ontario
N7M 5M1

August 11, 2006

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

Attention: Ms. Kirsten Walli, Board Secretary

Re: EB-2005-0551 – Argument – Issue II Storage Regulation

Dear Ms. Walli:

Per Procedural Order No. 9, attached please find in electronically searchable format Union's argument (Exhibit Y2) with respect to Issue II Storage Regulation. Also, fourteen (14) hard copies will be couriered today.

If you have any questions concerning this filing please call me at (519) 436-5382.

Yours truly,

Connie Burns, CMA, PMP
Manager, Regulatory Initiatives

cc: Glenn Leslie, Blakes
All EB-2005-0551 Intervenors

its powers under subsection 39(2) in respect of such sales (Union evidence, Exhibit C, Tab 1, pp. 3-4).

In order to prospectively implement forbearance related to ex-franchise services and the separation of storage service between in-franchise and ex-franchise customers, Union proposes to fix the allocation of storage capacity allocated to in-franchise requirements effective January 1, 2007 (Union evidence, Exhibit C, Tab 1, p. 26). No one other than Kitchener has objected to the use of the approved aggregate excess methodology to determine the appropriate allocation of storage for these seasonal balancing purposes (Union evidence, Exhibit C, Tab 1, p. 26; Union reply evidence, Exhibit D, Tab 1, p. 22; Union Hearing Undertaking response K.12.10, Exhibit B, Tab 3). Any additional in-franchise requirements after this allocation has been made will be procured by Union in the market so that in the future, to the extent any more storage space is required, the cost of storage for all in-franchise customers will be a blend of cost of service and market prices leading, perhaps, to a more efficient use of storage by those customers (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, p. 9 and 33; TR. Vol. 4, p. 125). New storage capacity required for ex-franchise sales will be developed or acquired outside of regulation (Union evidence Exhibit C, Tab 1, p. 3).

Union is, in accordance with these proposals, seeking an order from the Board to adjust rates effective January 1, 2007 to exclude all storage costs and revenue associated with ex-franchise sales from the determination of 2007 rates. Further, Union is seeking to eliminate the existing S&T deferral accounts that currently capture market-based margins in excess of amounts incorporated into rates.

There is no need for another proceeding to determine the allocation of costs and revenues. The allocation can be based on the 2007 cost study filed in Union's most recent rate case and accepted by the Board for determining 2007 rates in EB-2005-0520.

The cost allocation necessary to determine the appropriate allocation of assets to ex-franchise sales has already been completed (Union Undertaking K.4.3, Exhibit B, Tab 3). Union has been allocating storage costs between in-franchise and ex-franchise customers for some time (TR. Vol. 4, p. 110) and can provide whatever additional records the Board requires to document the allocations (TR. Vol. 2, p. 117).

History

As indicated above, Union began selling transactional storage services to ex-franchise customers at market prices in 1989. The impetus at the time was the existence of a functioning competitive market that valued storage higher than cost of service rates combined with a desire to allow Union to capture any difference between cost of service and market values (premiums).

In accordance with the Board's decision in RP-1999-0017 dated July 21, 2001, Union began to transition all long term ex-franchise customers to market rates (Union evidence, Exhibit C, Tab 1, p. 10).

Market values for ex-franchise storage services are typically established through "open season" offerings similar to an auction. The market value of storage is determined on an annual basis from the seasonal commodity differentials. Any storage which is not sold in the current year has no future value. Consequently, Union has no incentive to "inventory" or withhold capacity from these auctions (Union Reply evidence, Exhibit D, Tab 2, pp. 24-25; EEA/Schwindt Reply evidence, Exhibit D, Tab 3, p. 11). Accordingly, the prices obtained by Union through these auctions reflect market values, and not any exercise or attempted exercise of market power on the part of Union.

The normal measure of the market value of storage is the winter/summer price differential for natural gas. The value of storage is therefore impacted by North American gas inventories, weather and the overall availability of natural gas supplies. Generally, the values that Union has received in connection with its sales of storage, either through auctions or negotiation reflect these factors (EEA/Schwindt Report, Exhibit C, Appendix B, Table 5 at p. 38; Appendix J to Union's Reply evidence, Exhibit D, Tab 2).

EB-2005-0551

Ontario Energy Board

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

AND IN THE MATTER OF a proceeding initiated by the Ontario Energy Board to determine whether it should order new rates for the provision of natural gas, transmission, distribution and storage services to gas-fired generators (and other qualified customers) and whether the Board should refrain from regulating the rates for storage of gas.

Final Argument On Behalf Of
Energy Probe Research Foundation

August 28, 2006

are; the terms of contract and the duration. The only thing that they do not have to show is the exact rate that those customers pay. (TR 9 p. 53/54)

The utilities are proposing only accounting separation of regulated and unregulated businesses. Further, the utilities are relying on current cost allocation methods developed for allocating costs between rate classes to govern the separation of costs and revenues. (Union Argument in Chief p. 4) Union specifically opposes functionally separating storage from transmission and distribution on the basis of "high" costs and "unknown" benefits. (Argument in Chief p. 20)

Any cost allocation work that has been done historically could not have anticipated the dramatic change storage forbearance represents or the prospects for cohabitation of regulated and unregulated businesses. Union's witness, Mr. Baker, appears to have recognized this when he indicated that Union would need to do cost allocation analysis to split the assets, costs and revenues between the regulated and non-regulated portions of the company. (TR 2, p. 117)

Given the substantial gains that might be captured by shareholders by improperly transferring costs to regulated operations and revenues to unregulated operations, the Board must put in place effective controls. Accounting separation, based on accounts developed only for rates purposes, is clearly insufficient to protect ratepayers.

The Board should encourage the utilities to move toward complete separation of regulated and unregulated businesses. The minimum standard should be full structural separation with the objective of achieving separation as complete as would be achieved through divestiture.

Ratepayers must be held harmless for any and all costs associated with achieving and maintaining the separation. Instead, the costs of implementing and maintaining separation are only appropriately borne by shareholders.

Tab 5

Ontario

ONTARIO ENERGY BOARD

FILE NO.: **EB-2011-0038**

VOLUME: **1**

DATE: **September 19, 2011**

BEFORE: **Ken Quesnelle** **Presiding Member**

Cathy Spoel **Member**

EB-2011-0038

THE ONTARIO ENERGY BOARD

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 amending or varying the rate or rates charged to customers as of October 1, 2011.

Hearing held at 2300 Yonge Street,
25th Floor, Toronto, Ontario,
on Monday, September 19th, 2011,
commencing at 9:39 a.m.

VOLUME 1

BEFORE:

KEN QUESNELLE	PRESIDING MEMBER
CATHY SPOEL	MEMBER

has undertaken.

I am going to take them in a different order than they appear on the page, and I am going to begin with the third bullet item.

Mr. Rosenkranz says:

"Union errs by shifting 1.662 million of fixed cost of service from long-term storage to short-term storage for purpose of calculating margins."

And for your assistance, he elaborates on that point at pages 11 and 12 of the same document.

First of all, panel, if you could assist me in defining or determining, from your perspective, what is the issue that Mr. Rosenkranz -- first, what is the issue Mr. Rosenkranz is addressing, and secondly, what is your response to his critique on that point.

MS. ELLIOTT: The issue he is addressing is where the costs of the excess utility space should be treated in the deferral account, so should they be long-term costs or short-term costs.

And the 1.6 is the differential between the cost of the 7.9 -- which is $2.3 million, or $2,261,000 -- and the costs that were showing in the Board-approved cost allocation study in 2007.

The difference is at that point in time, there was only 2 PJ of short -- of space being sold short-term, and subsequent to the NGEIR decision, that 2 PJs of space became the 7.9 excess utility space.

And it's our view that the costs of that space should be deducted before the revenue is shared. Those costs were not allocated to the in-franchise customers in their rates, so they have to be covered first before the margin can be shared.

MR. WARREN: And I then take you to the bullet point above that. Mr. Rosenkranz's critique is:

> "Union adds an arbitrary premium to the Board-approved return on equity for new storage investments. This high target return reduced the margin shared with the ratepayers and is inappropriate for purposes of calculating storage service margins."

And he is -- a fuller description of that critique appears on page 13 of the same prefiled evidence, and it is in this context in which the term "hurdle rate" appears. Perhaps we could begin, if you wish, by your telling me what is meant by "hurdle rate" and how it is used in this calculation.

MR. ISHERWOOD: When Union Gas looks at acquiring capital from our parent company, we will take a project to be evaluated relative to other projects within the corporate family. And corporately, we have a minimum threshold; it's not to say that any project above that will go forward, but we have a minimum threshold in terms of what projects will at least go to be reviewed.

And the minimum threshold is an economic measure. We call it an internal rate of return, or IRR, and our minimum threshold rate is 8.5 percent.

So we use that in the calculation in terms of for us to acquire capital for incremental investments, we would have at least, at a minimum, had to meet that threshold. And the 8.5 percent translates into an ROE of about 14.4 percent.

So throughout the evidence, you will see both numbers, and primarily you will see the 14.4 number.

So when we look at making incremental investments in storage after the NGEIR decision, it is really based on the premise that we were in a forbearance environment and that we would have exposure to the regulated market.

And to the extent that we needed an offset to the incremental risk that the shareholder was adopting in terms of investing in storage assets, we went to the minimum threshold as a number that would be used to calculate an incremental return, in addition to the Board-allowed return for regulated assets, again, these being non-regulated storage investments.

MR. WARREN: Mr. Isherwood, if I could ask you to turn up -- just in connection with that last response -- Mr. Rosenkranz's answer to a Board Staff interrogatory, it's Exhibit I1.2.

And if you go to the second page of that response, I quote his response as follows:

> "Even under forbearance, margin sharing on storage services is a rate-setting activity under the jurisdiction of the Board. Union should therefore calculate costs for margin sharing

purposes using the Board-approved rate of return."

What is Union's response to that critique?

MR. ISHERWOOD: I think throughout the NGEIR hearing, the evidence and the testimony we led was -- and I think the Board agreed as well -- the storage development market is a more risky capital investment than a utility asset, and Mr. Baker testified, as well, that in the normal regulated rate of return framework, Union is not encouraged to develop any incremental storage, but that we certainly would consider that in a forbearance model.

So from a point of view of having a return that accurately reflects the risk, it's our view that we need to go to that minimum threshold IRR of 8.5 percent.

MR. WARREN: Now, if I go a little further down in this response from which I have just quoted, to the last:

"Using the Board-approved return for the margin-sharing calculation during the brief freeze-out period required by the NGEIR decision."

Is it Union's -- does Union agree with the proposition that using the Board-approved rate of return is required directly or by necessary implication by the NGEIR decision?

MR. ISHERWOOD: We would disagree with that. In fact, I would go as far as saying those investments likely would not have happened at the regulated rate of return. I think Mr. Baker was pretty clear when he testified that the regulated rate of return does not provide enough risk balance, risk/reward balance, to justify a risk-use storage investment in that framework. So you really do need the market exposure. You need the market rates to support the incremental costs and incremental risk of those assets.

MR. WARREN: The third point of Mr. Rosenkranz's critique -- I am returning to the first page of his testimony -- pre-filed evidence, I am sorry -- is as follows:

"Union substantially reduces the reported margins on long-term storage services by including a return on purchased assets expense for third-party storage service contracts on top of the actual charges paid to the third-party storage operators. These additional costs are inappropriate and must be eliminated."

And the fuller statement of that critique appears on page 12 of his pre-filed evidence.

What is -- first of all, what is Mr. Rosenkranz talking about when he talks about the return on purchased assets, and what is your response to his critique?

MR. ISHERWOOD: When we look at purchasing storage assets, they are typically purchased long-term, so ten years is a common term. When we buy those storage assets or services, we are actually buying them long-term to support the ex-franchise market. So it's not being bought at all for the regulated market. It's all for ex-franchise activity.

And when we go to make a decision on, should we build or should we buy, it's almost the same decision. It's the same people involved for sure. And when we looked at the NGEIR decision at the end of '06 and early '07, there was an incentive to try and get as much new storage developed in Ontario as possible, and one way to do that, and a very quick way to do that, is to actually buy incremental storage on a long-term basis.

We actually did that. We bought a fair bit in '07 and '08, and we use that in the ex-franchise market. But because we are signing long-term contracts, there is definitely a market risk, which is identical, the same market risk as if you had built storage.

So again, the shareholder is taking that risk, in terms of, the market will definitely fluctuate over the term of the contract, and to compensate the shareholder -- compensate the shareholder for taking that risk, we have added a cost component around that same 8.5 percent threshold number to reflect the risk that the shareholder is taking.

Even with that 8.5 percent cost added, the ratepayer is still sharing in the benefit of those contracts. So going back to our decision, should we invest in those contracts or not, or sign those contracts or not, had we chosen not to sign those contracts because we thought the risk was too great, then there would be no sharing today.

Given that we have signed the contracts and are into long-term contracts now, even with that premium we are still sharing revenue with the ratepayer, who in this case is enjoying a benefit without having any risk exposure whatsoever.

And our concern, really, is the sharing mechanism goes over, depending on when those contracts were signed, would have had two or three years of sharing. But at the end of that the shareholder is still exposed to the next six or seven years or eight years of the contract.

And the storage market definitely has cycles to it. In fact, we are in a very poor storage cycle right now. And to the extent that we are sharing margin in the first few years with the ratepayer, there is really no one to share the loss in the future years.

So that premium we built in is to compensate the shareholder for the risk and the return again. But it is very similar to the same discussion we had on the incremental developed assets.

MR. WARREN: If you would turn up page 12, please, of the pre-filed evidence of Mr. Rosenkranz. He says in the very last sentence on that page:

> "More importantly, however, there is no basis for Union to include in the storage margin calculation any costs other than the direct payments Union makes to third-party storage operators for these storage services."

Now, at the risk of misinterpreting Mr. Rosenkranz, and I'm sure my friends will correct me if I am wrong, it would appear that Mr. Rosenkranz is saying you are, in effect, double-counting the costs of the purchased assets. What is your response to that?

MR. ISHERWOOD: That -- I would disagree with that. I think the pure cost of the asset is the price we are paying the third party for the contract on an annual basis. What the incremental margin calculation is doing is really assigning a risk/reward to the contract.

And again I go back to the fact that the market cycles a lot in storage, and if all we are doing is sharing for two or three years, if the rate -- it's going to be the shareholder in the future years that is going the take the loss, and when we make the decision to go into a long-term contract, we're fully expecting the market to cycle, but we're expecting to be able to capture some premiums in early years, because we know -- the storage market early years. But in later years, when we may actually start losing money, we will have at least made money in the early years, so it really compensates for the cycle of the storage, whereas the fixed price is pretty much fixed. It may have in some cases an escalator in it from year to year, but for the most part it's a fixed price each year for ten years.

MR. WARREN: Those are my questions. Thank you very much.

MR. QUESNELLE: Thank you, Mr. Warren.

Mr. Aiken?

CROSS-EXAMINATION BY MR. AIKEN:

MR. AIKEN: Thank you. I am going to be referring extensively to my compendium, so I hope you all have a copy of it. I am going to be talking about the account 179-72, MS. ELLIOTT: It does not.

MR. AIKEN: Okay. And if you can turn up Exhibit K1.4, this is the September 15th letter from Union with the two attachments to it. And I am specifically looking at attachment 1.

MS. ELLIOTT: I have that.

MR. AIKEN: Can you reconcile the 229 million we just talked about on B3.17 with the 264,173 shown in the 2010 column?

MS. ELLIOTT: Yes, the difference is the Huron-Tipperary investment.

MR. AIKEN: So that accounts for the difference of about 35 million.

MS. ELLIOTT: Yes.

MR. AIKEN: Okay. Back on Exhibit B3.15, compendium page 9, at the bottom of this exhibit there is a calculation that shows how Union's arrived at the 6.63 million return on equity associated with the assets of the services, sorry.

MR. ISHERWOOD: That's correct.

MR. AIKEN: One of the assumptions is the capital cost of $10 per GJ if Union were to develop the assets. Has Union provided any evidence in this proceeding to support that figure?

MR. ISHERWOOD: We have not.

MR. AIKEN: Okay. I am going on to the hurdle-rate issue now. Same page 9 of the compendium, right at the bottom. It is shown as 14.4 percent, and there is an equity component of 36 percent, to get the 5.8 percent that's used to calculate the 6.63 million. Where does the 36 percent come from?

MS. ELLIOTT: That's Union's approved common equity percentage.

MR. AIKEN: So that's the current Board-approved equity component.

MS. ELLIOTT: Yes.

MR. AIKEN: Okay. What is the relationship, if any, between the hurdle rate of 14.4 percent and the Board-approved return on equity, which I think is 8.54 percent?

MR. ISHERWOOD: Actually, we do talk about the source of the 14.4 in Exhibit B3.54, and it's actually part of the A response. So I had mentioned earlier on this afternoon that as spectra the minimum threshold for taking a project forward is an IRR of 8.5 percent, and when you convert the IRR into an ROE, it's a 14.4.

MR. AIKEN: So I take it from that response that there is really no direct relationship between the 14.4 and the Board-approved rate of 8.54?

MR. ISHERWOOD: I think the relationship here is, again, we are into the unregulated world, so we actually have a choice of building an asset or buying, I am going to call it an asset, but only because there's a long-term storage deal. So whether you buy or build, we are using the same threshold decision, and for me to attract capital to a storage investment I would need to have an IOR of at least 8.5 percent or higher. So this whole calculation is really a deemed calculation to reflect the risk of doing these purchase storage deals.

MR. AIKEN: So you are essentially saying that the Board-approved return on equity is not relevant for the investment, the new investment, after the NGEIR decision.

MR. ISHERWOOD: That's correct.

MR. AIKEN: Okay. So if that -- if the Board-approved return on equity is not relevant for the calculation used for the deferral account, why is the equity component of 36 percent relevant to the unregulated business and to the calculation?

MS. ELLIOTT: We continue to use the 36 percent equity component for the unregulated operation just for simplicity's sake, rather than moving to a different equity component. Operationally, that's in fact what we are doing, in terms of maintaining equity within Union Gas.

MR. AIKEN: So your equity component underpinning your unregulated storage is in the 36 percent range?

MS. ELLIOTT: It is, yes.

MR. AIKEN: Okay. Now, Exhibit B3.54 -- this is page 16 of the compendium. And I think this is what you were talking about, Mr. Isherwood, the 8.5 percent internal rate of return.

Can you provide the costs and weights of the other sources of financing referred to in this response? In other words, we have 36 percent of 14.4, and there are other sources of financing to get you the 8.5. Can you provide the debt and whatever other sources of financing you are using and what those rates are?

MS. ELLIOTT: We don't have that information with us at this point.

MR. AIKEN: Would you undertake to obtain it? I mean, somebody must know how the 8.5 percent was calculated, given that you know some of the components already.

MS. ELLIOTT: Yes, we can do that.

MR. SMITH: Just, I missed the reference to the interrogatory you were at, Mr. Aiken. So --

MR. AIKEN: B3.54.

MR. SMITH: Okay. I see.

MS. SEBALJ: So we will mark that as Undertaking J1.3,subject to -- Mr. Smith, are you --

MR. SMITH: Yes, that's quite all right. I just wanted to make sure for my own notes I had it.

MS. SEBALJ: It's J1.3.

UNDERTAKING NO. J1.3: TO PROVIDE THE DEBT AND WHATEVER OTHER SOURCES OF FINANCING ARE BEING USED AND WHAT THOSE RATES ARE

MR. AIKEN: I am turning now to the response to Exhibit B3.18. It is at pages 17 and 18 of my compendium. First, am I correct that the figures shown on the attachment to the response shows the difference in the cost used to calculate the net revenue account 179-72, and only the difference related to the return?

MS. ELLIOTT: That's correct.

MR. AIKEN: So the return on purchased assets is included in both sets of calculations.

allocation study, which specifically sought to separate or allocate costs between the regulated and unregulated storage businesses.

MR. GRUENBAUER: Thank you for that.

With respect to Mr. Aiken's line of questioning and his characterization of the deemed return on purchased storage asset as a phantom cost, does that not give you some discomfort with respect to maintaining the integrity of cost causation in a cost allocation study?

MR. FEINGOLD: First off, again, I don't see that within the context of a cost allocation study. That is another aspect of the deemed cost that Ms. Elliott referred to earlier, that is directly attributable to the long-term storage activities.

And secondly, I am not sure I agree with the characterization of it as a phantom cost. I think from the standpoint of investment decisions on the part of Union those are real considerations.

MR. GRUENBAUER: But you would have to agree with me if I put it to you that Mr. Aiken is right, they are not a real cost, they haven't been tangibly incurred and paid out of cash by Union, and in that sense they are phantom. Can you not agree with that?

MR. FEINGOLD: They are certainly not in a booked cost like an O&M cost or an O&M expense.

MR. GRUENBAUER: Ms. Elliott, does this not give you some discomfort as a chartered accountant and a member of the Institute of Chartered Accountants, where a deemed return on equity is added to a purchased service as if the party purchasing that service actually shelled out capital up front? Does that not violate accounting principles that you would be very familiar with?

MS. ELLIOTT: No, it doesn't. It's not an accounting transaction, but it is to recognize that the shareholder made investments in either long-term contracts or in constructed assets and expected a return. So the return that's included in a utility revenue requirement, that's included in the calculation of the deferral account, is a calculation of what the shareholder expects to earn to compensate them for the investment. It's the product on the income statement, not -- it's not a cost line. It's the result of the revenues less the expenses.

So in recognizing the purchase contracts, there is an expectation of a return requirement for those long-term commitments that we entered into.

MR. GRUENBAUER: Correct me if I am wrong, Mr. Isherwood. These long-term contracts that you have entered into that Mr. Aiken walked you through, none of those contracts for a ten-year period required any 100 percent up-front take or pay capital outlays that would be equivalent to the shareholder actually plunking down some cash to build, right?

MR. ISHERWOOD: What the shareholder is plunking down cash on, though, is the cost of the storage over the life of ten years. So if you take, for example, an 80 cents storage cost, which I have said is quite common on this list of contracts, over ten years that's $8 per MCF, which is not too far from the $10 calculation that we have used elsewhere in the books. So it's not investment in capital, but it's still, a shareholder is risking real dollars on those contracts.

And to kind of summarize where Ms. Elliott was, you can calculate that risk premium in many different ways, but because for us it is either a buy or build, going back, and you're trying to equate it back to what the capital expense would have been is, I think, a very fair way of doing it, instead of picking some random percent premium to put on top of the cost. It makes it very much equivalent to being a buy or build type of decision.

MR. GRUENBAUER: I understand your answer. It will not surprise you that we don't agree.

Thank you. Those are my questions, thank you, sir.

MR. QUESNELLE: Thank you, Mr. Gruenbauer.

PROCEDURAL MATTERS:

Mr. Quinn, can we get a time check? I'm just trying to get an estimate as to whether or not we have any hope of completing today or not, so yourself or Mr. Thompson.

MR. QUINN: Yes, sir. I think that I am going to be probably 45 minutes to an hour, and with your indulgence there, I had some discussion with Mr. Smith at the break regarding a request I made of Union this morning. If it pleases the Board, we could deal with that and then break, because then Union may be able to provide some numbers that will be helpful tomorrow and carry on from there.

MR. QUESNELLE: Yes, that might be helpful.
Mr. Thompson, how long will you be going tomorrow?
MR. THOMPSON: Yes, sir. I expect to be about an hour as well.
MR. QUESNELLE: Okay. Yes, I think, unless you have other ideas, Mr. Smith, I think I will take Mr. Quinn up on his suggestion that we deal with some of the matters that we want to have the witnesses consider overnight, perhaps, and then Mr. Quinn can finish off tomorrow morning, but at least we will start and get some things advanced that will assist us in the morning as well.
MR. SMITH: No, I think that's a sensible solution, given where we are and what I anticipate will be the length of Mr. Rosenkranz's evidence. I don't think we are in any danger of not being done the evidentiary portion by lunch break tomorrow, so no concerns at all.
MR. QUESNELLE: Thanks, Mr. Smith.
Mr. Quinn?
MR. QUINN: Yes, and to add to that, to further assist, I can review what Mr. Aiken went through, and that will make -- may cut down some of my time, as I won't need to go over some things that he has covered ably at this point.
But this morning I was trying to get some understanding which would be helpful to the evidence we have put forth and an understanding of what cost allocation methodologies could be available to us in a rebasing situation or, potentially, a better cost allocation

to the shareholder. And that shift each year, as a result of the NGEIR decision, there is more revenue to the shareholder coming through existing assets, and that's embedded in this calculation.

So some of this growth will be increases on existing assets, and some of it will be the return on new assets, and we don't have those calculations split out.

MR. THOMPSON: Right, but isn't that exactly the way an unregulated business would look at it? It would look at the asset pool, and say: On a pooled basis, I am making 18.13 percent with this incremental investment that I made in 2008. That's well over my hurdle rate of return. Let's go for it?

MR. ISHERWOOD: But I would say that it's as Ms. Elliott pointed out, that these percentages of return on equity are on the entire rate base -- if I can use that term -- for the non-utility storage operations.

It is not to say that the new investment would earn that. In fact, it's far from that.

So new investment, even recognized in the NGEIR decision, new investments cost more than the existing cost of service would, have whole different cost structures.

So you wouldn't expect or extend that number to include new investments. And before you make any new investment, it's always looked at on an incremental basis.

MR. THOMPSON: Well, my experience, it's always been done on a rolling basis.

But in any event, looking at the 2008, the 18.13

percent, and that's in a year of 75 percent sharing, and if we just ask yourselves what would that number be if the long-term storage premium was eliminated, we could add the 10,676, I suggest, at line 7, to 11,675 at line 10, get the total, which I make to 22,351, which would produce a return in the end state of 34.7 percent; isn't that something that a prudent unregulated business would take a look at?

MR. ISHERWOOD: I guess I disagree with your statement that incremental assets are looked at on a rolled-in basis in a non-utility operation.

Any new investment in new storage pools is looked at incrementally. It's that pool has a cost to develop of X, and it has a return of Y. And if that doesn't meet the threshold, then it doesn't go ahead.

So it's absolutely looked at on an incremental basis.

MR. THOMPSON: All right. Well, I am looking at this on a rolled-in basis, because I think this is what the Board gave you in NGEIR.

In 2009, the number is 38.91 percent. That's more than -- that's almost three times your hurdle rate, right?

MR. ISHERWOOD: If you are asking me if 38.9 is three times 14.4, it's approximately that.

MR. THOMPSON: Right. And if you ask yourself what is it going to be in the end state, by then taking line 7 and adding it to line 10, I make it that it increases to about 46 percent; would you take that, subject to check?

MR. ISHERWOOD: Okay.

MR. THOMPSON: And then in 2010, we are now at 50.67

deviated beyond that, which would be highly unlikely, I wouldn't expect there to be a cost in adjusting the utility customers.

MR. QUINN: That's helpful. We will get to contingency space later on, as that came up yesterday.

Maybe if I can ask you can move on to a definition of space encroachment.

MR. ISHERWOOD: Space encroachment is, if you look at our non-utility business and if you look at that business over a number of years, the trend that you see is, in total, the non-utility customers do not always fill their capacity full. So there is an opportunity to take the stuff -- sorry, the storage space that's not filled and resell that in the market.

It's not unlike Air Canada selling extra seats, trying to keep the plane full. They sell extra seats to try and optimize their fixed costs, as well. And we do the same with space.

Having said that, if there an issue where we sell space because of that type of encroachment, and the other customer does show up, then it's the non-utility business that takes that risk, and we would have to, again, move gas off the system or do something to mitigate the physical impact.

MR. QUINN: So if I understand what you are relating to us, you essentially are -- well, I don't want to put word in your mouth, so I will ask the question.

Are you accounting for this with two separate sets of books, for the space for non-utility and utility?

MR. ISHERWOOD: We only encroach on non-utility space.

MR. QUINN: So to be able to determine it, are you tracking utility space different from non-utility space?

MR. ISHERWOOD: What we are actually tracking is we know the contracts that make up, in total, the non-utility space, so we are actually following those contracts throughout the injection season to see if there is any room left towards the end of the season to do that type of encroachment. So it's really focussed on the non-utility customers.

MR. QUINN: It may be focussed on the non-utility customers, but how are you tracking the utility position?

MR. ISHERWOOD: In that case, we are not, because we are not encroaching on the utility position; we are encroaching on the non-utility position.

MR. QUINN: I understand, again, the distinction, but when you determine that storage is more full on an integrated basis, how do you know if it is the utility that's long or it's the non-utility that's long?

MR. ISHERWOOD: Well, if we are encroaching on space, it's because it's partially empty, not long. When we are encroaching on space, it's because we are following whatever there is. Call it 20 customers that make up the non-utility ex-franchise storage customers, and we are following those 20 contracts in detail, day to day to day, to see where they are in their fill pattern.

And towards the end of the season, we will make a call that we can encroach or not encroach. We can make a call well in advance, knowing that historically they don't fill contracts.

This is opposite of what we talked about in terms of gas loans. In this case, we are actually encroaching on space that is not full.

MR. QUINN: I understood that, and that is why I was going to allow you to finish, but I had gone back to the gas loan scenario when you were long, when you had found that in November it was milder than expected and there is too much gas in storage or planned to be in storage.

How do you determine who is responsible for that? How do you determine whether you use the system integrity space, or you must do a gas loan?

MR. ISHERWOOD: Again, we are able to track the non-utility customers independent of the utility customers, so we would know -- we would know what the problem is and where it's being created or caused.

MR. QUINN: So prior to the NGEIR decision, did Union entertain those similar types of deals? They may not have had separate accounting, but did you do both gas loans and space encroachment prior to the NGEIR decision?

MS. CAMERON: Yes, we did some encroachment and some gas loans.

MR. QUINN: So there was an undertaking where the amount of resource optimization was provided in the winter of 2006, 2007. I don't have it handy, but that would reflect gas loans and space encroachment prior to NGEIR?

MS. SEBALJ: Yes, so it is J2.1.

MR. QUESNELLE: Thank you.

MR. QUINN: So I will accept the premise at this point that you are only doing optimization with non-utility space. And if I understand the previous testimony by this panel, that all of the 7.9 PJs which was deemed excess is being only sold short-term; is that accurate?

MR. ISHERWOOD: That's correct.

MR. QUINN: So what about the remaining in-franchise space? Is it optimized?

MR. ISHERWOOD: I guess every year in our gas supply plan we calculate how much space the in-franchise customers need. So the 7.9 number came from the cost allocation study, and as we said through our interrogatories in evidence, every year that number changes slightly. It might be 8-point-something or 9-point-something. So whatever the number is deemed not needed for in-franchise, we would optimize that. But in terms of the core amount, we do not optimize it.

MR. QUINN: I guess my concern would be, historically prior to NGEIR you optimized your storage space in totality; is that accurate?

MR. ISHERWOOD: I think the whole storage model, the whole framework, changed, fundamentally changed, at the NGEIR decision starting January 1st of '07, so I am not sure it is fair to compare what happened before and after.

MR. QUINN: Okay. Well, if we just stay with after, what I am understanding you to say is in-franchise space is

"...if the returns aren't adequate from the storage development perspective of simply coming to the Board for some approvals when you are developing storage? Why can't you put forward what you suggest is the reasonable return for this line of business? What's wrong with that?"

And Mr. Baker said:

"You have got to step back again. Our view is the market is competitive. Union doesn't have market power, and there is no need for Board oversight to regulate Union as a specific developer of storage capacity relative to other third-party storage developers."

Do you agree with that response?

MR. ISHERWOOD: I do.

MR. THOMPSON: So Union was telling the Board at that time: We will take the difference between the market price and the expenses, producing the service for which we are seeking forbearance.

And that would, as I understood it, be sufficient to compensate the storage services provider for the increased level of risk it faced. That was the pitch in NGEIR; fair?

MR. ISHERWOOD: That was the pitch, and I guess from the point of view of our deferral accounts in 2010, if we had full -- if we had full access to the market price, we would have not done the calculation we did. We would have been at risk for the price being up or down, and in 2010 we would have had the full market price.

The difficulty we have is, we don't have the full market price. We have a sharing of the market price. So to compensate the shareholder for an incremental investment, we were quite clear in NGEIR as well that we wouldn't and couldn't invest at the regulated rate of return, and I think the Board agreed that it is more risky and is more costly to develop storage.

So the incremental margin that we are adding is to compensate the shareholder for that incremental risk during the sharing period. Obviously once we get past the sharing period there is no more review of market price for storage assets, so the shareholder is fully exposed to the market price, and we are willing to take that exposure.

MR. THOMPSON: Well, we don't -- we now know what you did. We obviously say it was not in accordance with NGEIR, and you seem to be saying, 'Well, we could do whatever we wanted until we get the full market price.' Is that what you are saying?

MR. ISHERWOOD: No, I think the exchange that you went through with Mr. Baker and Mr. Poredos was around, if Union has exposure to the full market price, would you invest in storage, and I think our answer was, Yes, we would. And when we went to our shareholder with storage projects, they would not have accepted a regulated rate of return.

So in order to compensate the shareholder for the higher risk and higher development cost, we used the concept of the minimum threshold.

MR. THOMPSON: All right. Well, that's -- I will move on, because what does an unregulated business do when it assesses investment opportunities, in terms of feasibility? Would you agree with me that an unregulated business estimates the revenues from the activity as being considered, less real expenses, and considers whether they are sufficient to produce a profit that satisfies the threshold profitability requirement that the owner sets?

MR. ISHERWOOD: I would agree with that with one slight addition, I guess, is from a storage market point of view, you can look at the market data. The market is very liquid going out two or three years.

So when you are looking at the market data around storage, you can predict with some certainty what the price or value of storage will be for the first two or three years.

Beyond the two or three years, which is essentially in this case through to 2011/2012 time frame, beyond that you have a forecast, to your point, Mr. Thompson, a forecast of storage -- value storage price, but you have a lot less certainty, because the market -- the market data points you can rely on, NYMEX and others, don't go beyond really a three-year horizon. It becomes a much riskier forecast.

MR. THOMPSON: Okay. So? You still do a forecast --

MR. ISHERWOOD: But the part of the forecast that has more certainty is the very part that we are sharing.

MR. THOMPSON: All right. Now, in terms of the market prices versus cost-based rates at the time of NGEIR, would it be fair to suggest that they were roughly in the ratio

Tab 6

Filed: 2011-06-08
EB-2011-0038
Exhibit B3.12

UNION GAS LIMITED

Answer to Interrogatory from
Federation of Rental-housing Providers of Ontario ("FRPO")

Short-Term Storage Service O&M

Reference: Exhibit A, Tab 1, Schedule 6, Page 2, Line 14

What is the relationship between this \$2.261 million and the base revenue requirement of \$0.599 million that was allocated to short-term C1 storage in the 2007 Cost Study? Is the \$0.599 million included in the \$2.261 million?

Response:

The \$2.261 million found at Exhibit A, Tab 1, Schedule 6, Page 2, Line 14 replaces the \$0.599 million from the 2007 cost study.

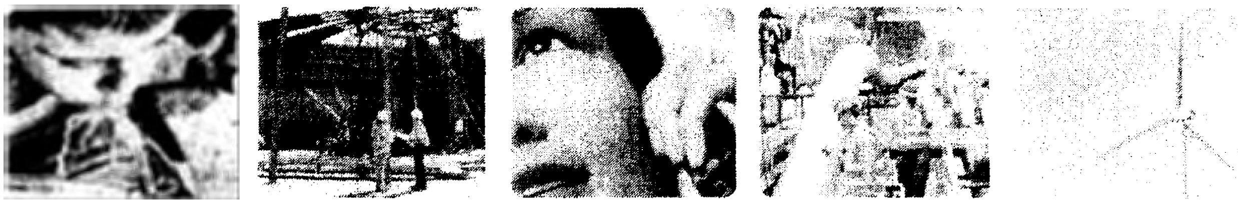
The 2007 Board-approved revenue requirement of \$0.599 million represents the forecasted demand costs associated with approximately 2 PJ of short-term storage space. Please see Exhibit B1.2 for the derivation of these costs.

The \$2.261 million represents the revenue requirement associated with 7.9 PJ of excess utility storage space. The 7.9 PJ is sold on a short-term basis by the unregulated storage operations. This actual cost is allocated to the short-term storage account.

Tab 7

EB-2011-0038
Filed: 2011-04-18
Exhibit A
Tab 4
Attachment 1

BUILDING A WORLD OF DIFFERENCE®



Union Gas Limited

Independent Review of the Accounting and Cost Allocation for Unregulated and Regulated Storage Operations

Final Report

March 2011

BLACK & VEATCH
Building a world of difference.

The purpose of this report is to present the results of Black & Veatch's review and evaluation of Union's cost allocation process and accounting for its regulated and unregulated storage operations.

1.1 Scope of the Review

Black & Veatch understands that Union required a review of the cost allocation and accounting for its unregulated and regulated underground storage operations. In addition, Union requested that Black & Veatch review the revenue and cost allocations between, and the underlying assumptions used in the calculation of, two deferral accounts used to track short and long-term storage contracts, and to reconcile the storage sold to the physical storage owned by Union.

Based on these requirements, Black & Veatch structured its review to include the following work tasks:

1. Review and evaluate Union's current cost allocation and accounting processes for its unregulated and regulated underground storage operations and make recommendations on any changes to the underlying assumptions and/or methodologies.
2. Review and evaluate Union's revenue and cost allocations between its two deferral accounts used to track short and long-term storage contracts and make recommendations on any changes to the underlying assumptions and/or calculations, and reconcile the storage sold by Union to the physical storage space owned by Union.
3. Prepare a written report which sets forth in detail the findings and recommendations of the review with respect to all material issues and methodologies, and which is structured in an appropriate format for submission to the Board and Union's external stakeholders.

1.2 Guiding Considerations and Areas of Concentration

In conducting our review of Union's cost allocation and accounting processes for its unregulated and regulated storage operations, we were guided by the following considerations:

1. The fundamental and underlying philosophy applicable to every utility cost of service study pertains to the concept of cost causation for purposes of allocating costs to customer groups or service types.
2. Cost causation (or cost causality) addresses the question – *Which customer or groups of customers cause the utility to incur particular types of costs?* To answer this question, it is necessary to establish a linkage between a utility's customers and the particular costs incurred by the utility in serving those customers.
3. *A Key Consideration* – the ability to establish operating relationships between customer service requirements and the costs incurred by the utility in meeting those requirements (e.g., satisfying a customer's peak demand requirements through the incurrence of capacity-related costs to provide the required level of gas delivery service).
4. The three broad steps most often followed to perform utility cost of service studies: (1) cost functionalization; (2) cost classification; and (3) cost allocation will be utilized for this review as a framework for evaluating the various steps involved in Union's current cost allocation process.

5. A utility's cost allocations should stand on their own objective merits (i.e., costs should be assigned to the classes or categories of service based on the design and operational considerations of the utility's system rather than on achieving results that support a desired outcome for the allocation of revenues to classes and/or rate design).
6. Consistency of structure, methodology, and computational details between Union's cost allocation process used for separating its storage-related assets and expenses and the cost allocation study it utilizes to evaluate the costs of serving its in-franchise customers and service offerings.

We saw our primary roles and responsibilities in this project as follows:

- To solicit from Union's external stakeholders during the project kickoff meeting any concerns or comments on the subject matter of this review;
- To understand the system planning, operation, and utilization of Union's underground storage facilities to confirm that cost causation is properly reflected in its cost allocation and accounting processes;
- To understand the differences between the accounting for Union's unregulated and regulated storage operations;
- To understand the revenue and cost transactions that comprise Union's unregulated and regulated storage operations, including the allocation of costs of its current integrated storage system and its incremental storage facilities;
- To reconcile the storage space sold by Union to in-franchise and ex-franchise customers compared to the total physical space owned by Union; and
- To provide sufficient commentary on our recommendations and supporting information pertaining to alternative cost allocation and accounting processes and the related treatment of costs so that Union can adequately evaluate our findings and decide whether or not to propose changes in its subsequent rate and regulatory filings with the OEB.

These above-described elements defined the focus areas in which Black & Veatch concentrated its review and evaluation in this project. In our review of Union's cost allocation process and accounting for its storage lines of business, Black & Veatch conducted its work in a manner so that it could determine:

- If Union's cost allocation methodology for the allocation of costs between its regulated and unregulated storage operations had a conceptual basis that was grounded in sound and acceptable utility costing principles and the operational realities of its gas utility system.
- If there were certain regulatory precedents established by the Board that Union recognized and incorporated into its cost allocation and accounting methods.
- If Union's cost allocation and accounting methods provided analytical and computational transparency (i.e., did it create a sufficient and verifiable audit trail - identification of input data sources, traceable information flows, identification of each computational step).

MR. FEINGOLD: The session that I lead and teach at that course is dealing with ratemaking and cost allocation issues for gas distribution utilities.

MR. SMITH: And you have been engaged as a course organizer and speaker since 1985; is that correct?

MR. FEINGOLD: That's correct.

MR. SMITH: Members of the Panel, I would ask that Mr. Feingold be qualified and admitted to provide expert testimony to this Board on the issues of cost allocation and rate design.

MR. QUESNELLE: Any objections from the...? No? Thank you. We will, thank you, Mr. Smith.

MR. SMITH: Members of the Panel, Mr. Feingold's report has been filed and adopted in evidence, so I don't propose to review it at any great length, but there are a couple of things that I would like to bring out, if I may be permitted.

Mr. Feingold, can I ask you to turn, please, to page 1-5 of your study?

MR. FEINGOLD: I have it.

MR. SMITH: Now, were you, as a result of your study, able to reach an overall assessment with respect to Union's cost allocation method and your examination of the attribution of revenues and costs to the two deferral accounts in issue?

MR. FEINGOLD: Yes, I was.

MR. SMITH: And what was your overall conclusion?

MR. FEINGOLD: As indicated on page 1.5, in my opinion, the conceptual underpinnings and resulting or associated methodologies upon which Union's cost allocation process is based are well-conceived, thorough, and reasonable in their treatment of storage-related plants and expenses. I did point out, however, on this page that, in my view, the presentation of the separation of costs between its regulated and unregulated storage operations fails to demonstrate those positive attributes by not providing a sufficient level of detail and explanation. In fact, that's why this report was included in Union's evidence in this proceeding, by virtue of the number of schedules that were included in the report that tries to provide a more detailed audit trail and explanation on how the cost allocation process is conducted by Union.

MR. SMITH: Can I ask you to turn to page 1 -- or 1-3 of your study, sir. And can you just summarize briefly for the Board the steps you took to arrive at your overall assessment?

MR. FEINGOLD: Yes. I believe there were three steps related to the work task that Black & Veatch chose to undertake in the study. The first was to review and evaluate Union's cost allocation and accounting processes for its unregulated and regulated underground storage operations and then make recommendations on any changes to those underlying assumptions and methodologies.

Secondly, we were tasked with reviewing and evaluating Union's revenue and cost allocations between its two deferral accounts used to track both short- and long-term storage contracts and make recommendations on any changes to the underlying assumptions and calculations.

One aspect of that was to reconcile the storage sold by Union to the physical storage space owned by Union, and then finally, we were tasked with developing a written report that this exhibit constitutes that presents our detailed findings and recommendations.

MR. SMITH: Now, just looking down at page 1-3, Mr. Feingold, under the heading "guiding considerations and areas of concentration", can you advise the Board what is referred to as guiding considerations and areas of concentration and why that's included in this study?

MR. FEINGOLD: It's included to provide a framework and a context for the primary focus that Black & Veatch chose to take in the review and the study. By definition, cost allocation is a process that requires a recognition of what I would characterize as cost causation principles. You are trying to establish a relationship between the requirements of customers and the costs that are incurred by the utility in satisfying those requirements.

And so these guiding considerations and areas of concentration were laid out as a backdrop so that parties could understand exactly why cost causation was an important consideration in evaluating a cost allocation process and study.

MR. SMITH: So just to expand on that, if you can, Mr. Feingold, looking at item number 3, a key consideration, what is being referred to there and why the particular example?

MR. FEINGOLD: Well, as I just alluded to in the previous answer, one of the key elements of conducting a reasonable cost allocation study is to establish operating relationships between the customer-service requirements, for example peak day, capacity needs of a customer, relative to the costs that are incurred by the utility in meeting those requirements.

And so, for example, in item 3, under Section 1.2, I have a parenthetical that provides an example of what I mean by that, and I show that a customer's peak demand requirements that are being satisfied are through the incurrence of capacity-related costs providing the required level of gas delivery service.

So in other words, if a utility is designing its capacity needs based on the worst-case design considerations, a peak day or a peak hour, and that is what's driving the incurrence of the costs of those facilities to meet customers' needs, that should be the basis for capturing cost causation within the context of a cost allocation study.

MR. SMITH: Thank you very much, Mr. Feingold, for that explanation.

I have just one final question or series of questions, and this is actually to you, Mr. Tetreault, in relation to Exhibit K1.3. Do you have that?

MR. TETREAULT: I do.

MR. SMITH: And this is a letter that, as the letter recall if they specifically identified system integrity space the way that Union has. So I would have to go back and refresh my memory from those utilities.

MR. QUINN: Okay. Well, I think again maybe it would be enhanced by hearing Mr. Isherwood's testimony, and then, Mr. Feingold, I can come back to you at that time.

More broadly then, I presume in your expansive experience you have looked at other utilities that perform transfers between internal departments or, potentially, affiliates?

MR. FEINGOLD: When you say "transfers", I assume you mean, for example, a utility shared service organization that has a certain type of transfer pricing method set up?

MR. QUINN: Yes.

MR. FEINGOLD: I have reviewed other utilities methods in that regard, yes. Not necessarily addressing storage, though.

MR. QUINN: Okay. Well, then just speaking more broadly then, not including storage, when there is an actual transfer that creates ratemaking implications to its customers, is it your experience -- well, let me speak of capital asset allocations first.

Have you had experience in reviewing allocations of capital between a utility and possibly an affiliate?

MR. FEINGOLD: Yes, I have. Primarily in the general plant area, for example.

MR. QUINN: And in those plant allocations, what is the process for ensuring the appropriate transfer price?

MR. FEINGOLD: It depends in large part on what the particular regulatory preferences are in that particular jurisdiction. But I would say that a starting point, and a very important starting point, is to ensure that cost causation is reasonably reflected in the costs that are transferred from one entity to another, on equity and fairness grounds.

MR. QUINN: So to the extent that you are determining if it is an appropriate, fair price, what numbers are used to -- let me speak specifically.

In asset allocations, is that generally based upon some form of either recent inventory or asset valuation?

MR. FEINGOLD: Well, I would say that there are two considerations that I have come across most often within the context of how a utility assigns shared costs or shared services to its utility affiliates.

One would be to look at the underlying costs of providing that service.

And in some jurisdictions they also look at the prevailing market prices for substitute services that could be provided to the utility by a third party.

I would say generally that's sort of the landscape for that type of review.

MR. QUINN: So in that more recent example you gave, you are talking about an example where they use the either higher of cost or market or lower of cost or market?

MR. FEINGOLD: Again, it depends on the particular regulatory jurisdiction. My recollection is that there is some jurisdictions where cost is the primary driver. And in other jurisdictions it may be, as you suggest, the higher of or the lower of, depending on which way the services are flowing between the entities.

MR. QUINN: And when that evaluation is done, what is used as the quantity of assets to be valued?

MR. FEINGOLD: I would say, generally speaking, there is a desire on the part of the utility to use a quantity that is consistent with the quantity that is used to allocate similarly situated costs among its regulated customer groups.

MR. QUINN: Maybe you could say that -- if you would say that again on a more simple level. Can you help me with what that means?

MR. FEINGOLD: Yes. For example, you could have a plant asset that is allocated to a utility's residential, commercial, industrial classes on a design-day basis, and that would dictate that those same costs that are allocated to another entity -- to an affiliate, for example -- should be allocated on that same basis to ensure that the cost causation that is reflected within the regulated utility is also captured in assigning costs to the other corporate entity.

MR. QUINN: So the cost causation principle in that example would say based upon the services provided?

MR. FEINGOLD: Based upon the services provided, but also recognizing the costs incurred by the utility whenever those services were first required to be satisfied by the utility; so in other words, what caused that plant investment to be incurred.

MR. QUINN: So in this application, we are talking about storage assets. How would you apply that thinking to the storage assets?

MR. FEINGOLD: Well, to the extent that within the context of Union's 2007 cost allocation study, certain allocation factors were utilized to allocate storage plant among rate classes or among rate schedules, those allocators would also be used to allocate cost to the unregulated operation.

MR. QUINN: And you are saying that this holds true independent of the physical count or quantification of those assets at the time of separation?

MR. FEINGOLD: Well, if by "physical quantification" you are talking about the booked cost, the allocation factor would be applied to the booked cost, or even before that, a direct assignment of the booked cost would be examined to see if there is a way to attribute to a particular business entity a particular asset, without having to rely upon a more generalized allocation factor.

MR. QUINN: So in this case, for December 31st, 2006, that is the period under which these assets were separated?

MR. FEINGOLD: That's my understanding.

MR. QUINN: So a physical count at December 31st, 2006, what information does that inform for you in this type of transfer pricing?

MR. FEINGOLD: Well, by "physical count," again, I am saying that that is synonymous with the original cost of that facility at the time that it was transferred. That original cost, though, does not require that an allocation factor be applied to it that is associated with that same time frame.

MR. QUINN: So at that point, you would believe that the forecast would provide a more fair count of those assets for the purposes of separation?

MR. FEINGOLD: In the case of storage capacity, which is a large component of the costs that we are talking about, the design-day forecasts are a stable determinant for purposes of creating a cost allocation factor. And in my view, and I believe in the Board's view, based on its acceptance of the 2007 cost allocation study as a reasonable basis for separation, that that was appropriate.

MR. QUINN: So once the forecast is in place and approved by the Board, there should be no further shifts to that number?

MR. FEINGOLD: Well, I think based on the NGEIR decision, as I read it, this was envisioned as a one-time transfer of assets, by virtue of the Board choosing to use an accounting separation process.

MR. QUINN: So it would not be appropriate, then, to shift different from what the NGEIR decision applied in this case?

MR. FEINGOLD: Not if it was defined as a one-time separation.

MR. QUINN: Okay. Thank you.

Now, further -- and I am conscious of logistics and time here, sir.

MR. QUESNELLE: Mr. Quinn, I have got just going on 11:00. If you have a natural break, and if you have quite a bit more, we could take a break now.

MR. QUINN: I do, sir. I have some more, and I was going to move on to another topic, so if that's helpful?

MR. QUESNELLE: Yes, it is. Why don't we take a break now for 15 minutes? And we will resume at 11:15.

--- Recess taken at 10:58 a.m.

--- On resuming at 11:18 a.m.

MR. QUESNELLE: Whenever you are ready, Mr. Quinn.

MR. QUINN: Thank you, sir.

I provided additional copies of the compendium that was filed last night, and I was going to ask Ms. Sebalj if this is the appropriate time to put an exhibit number on it.

MS. SEBALJ: Yes, we can mark it as Exhibit K1.7, and I did add an additional copy on the dais for you.

MR. QUESNELLE: Thank you.

EXHIBIT NO. K1.7: COMPENDIUM OF CROSS-EXAMINATION MATERIALS FOR FRPO

CROSS-EXAMINATION BY MR. QUINN:

MR. QUINN: Thank you. Thank you to Union and Board Staff for helping us out just to make sure if we made some progress, and maybe so that I understand what we may be prepared for, has Union reviewed K2.3 and K4.5 to determine their ability to complete the interrogatory response?

MR. THOMPSON: Okay. Well, I take your point about long-term/short term, but they are both on the non-utility side of the ledger for cost allocation purposes.

MR. FEINGOLD: You can characterize both in the same way, but in terms of how they get to the ledger, it's very different in how the Board recognized the treatment of the dollars that are associated with the ledger for short-term storage and the dollars that are associated with long-term storage.

MR. THOMPSON: All right. Thanks.

Now, one of Mr. Rosenkranz's criticisms is that we are going to use 2006 year-end amounts as the point of departure for this exercise on a permanent basis. We should be using the actual numbers. Do you agree with that, sir?

MR. FEINGOLD: No.

MR. THOMPSON: Well, that's a surprise. I thought all cost allocators would support the use of the most recent information.

MR. FEINGOLD: Well, there is a difference between what you would characterize as most recent information when you look at actual utilization of a system versus the design characteristics of a system, and they are very different.

As an example, if a certain plant asset is allocated to classes on the basis of design day demand or peak day demand, which is the case with regard to storage deliverability, if you use the actual peak day in any one particular 12-month period, that can vary significantly because of factors such as weather, economic impacts on customers' use of gas, versus a design-day characteristic, which is more closely aligned to the manner in which the plant asset was originally designed, installed, and the costs incurred, and it's a more stable allocator for purposes of assigning costs to groups of customers.

MR. THOMPSON: But here we are talking about plant balances, sir, and why would anyone, when they have the choice between actual plant balances at a particular point in time and forecast plant balances made before that point in time, opt to stick to the forecasts when the actuals are better?

MS. ELLIOTT: Sorry, Mr. Thompson, I think we are confused here. We did use actual values, dollar values, in the ledger. All the allocations are applied to actual values in the financial records. So we used the allocation factors derived from the cost study, but we applied them to the actual values on the books at the time of the separation.

MR. FEINGOLD: And that was my understanding in the conduct of the study as well.

MR. THOMPSON: Okay. Well, maybe I didn't state that question properly. But why wouldn't one use the actual information to derive the allocation factors? What's the problem with that?

MR. FEINGOLD: The problem goes to the heart of what most appropriately captures the concept of cost causation.

And as I tried to describe in my earlier response to you, Mr. Thompson, if an asset is being designed to accommodate a certain maximum capacity or a certain maximum daily requirement on the part of customers, that is really, in my mind and my opinion, the driver on how costs are incurred associated with that facility or that asset, and it's most closely aligned to the maximum requirements that customers have for using that, as opposed to a peak-day demand during a 12-month period that could be lower or somewhat higher, based on factors that are not associated with the cost causation characteristics of that fixed asset in the ground.

MR. THOMPSON: All right. Well, I will move on and we will hear from Mr. Rosenkranz on that.

I don't know what time you are planning to break for lunch, Mr. Chairman, but --

MR. QUESNELLE: If this is good for you, Mr. Thompson, we can do it right now.

MR. THOMPSON: That's fine.

MR. QUESNELLE: Okay. We will return at 1:30.

--- Luncheon recess taken at 12:29 p.m.

--- On resuming at 1:35 p.m.

MR. QUESNELLE: Mr. Thompson?

MR. THOMPSON: Thank you, sir.

Panel, I wanted to talk about optimization transactions. You had a little bit of discussion about this with Mr. Quinn, and it's a concern of Mr. Rosenkranz, as you know. Could someone on the panel just give me the

Union definition of an optimization transaction?

MS. ELLIOTT: I think that's a question that should probably be put to Mr. Isherwood on the next panel.

MR. THOMPSON: All right. Well, I will do that. But this is a cost allocation issue, as I understand it. It's not a deferral account balance issue. Does no one on this panel have any idea what the concept means?

Let me put my understanding is it -- is it's the use of integrated assets, the cost of which have been fully allocated to stakeholders, but you use those integrated assets to maximize revenue optimization. Is that an acceptable definition?

MS. ELLIOTT: I guess if we are talking about the cost allocation implications of the optimization transactions, we are dealing with Union's storage assets, the costs of which have been allocated based on how those costs have been incurred. The optimization of those assets is to get additional value out of the existing assets. But there are no specific costs or fixed costs associated with optimization activities.

MR. THOMPSON: Right. Well, that was one of the points I wanted to have you say -- tell me that optimization activities do not attract fixed costs. You would agree with that proposition.

MS. ELLIOTT: I would, yes.

MR. THOMPSON: Okay. And would you agree with me that in the NGEIR decision the optimization topic was addressed by the Board under the short-term storage transactions

DECISION WITH REASONS

E.B.R.O. 456

IN THE OF the Ontario Energy Board ACt R.S.O. 1980 Chapter 332 as amended; AND IN THE MATTER OF an application by Union Gas Limited to the Ontario Energy Board under Section 19 of the said Act for an Order of Orders approving or fixing just and reasonable rates and other charges for the sale distribution transmission and storage of gas; AND IN THE MATTER OF an Order by the Ontario Energy Board for a limited review of certain matters relating to Union Gas Limited pursuant to section 13(5) of the said Act.

BEFORE: S.J. Wychowanec Q.C. Chairman and Presiding Member

O.J. Cook Member

DECISION WITH REASONS

September 26 1989

ISBN 0-7729-5939-0

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Document Title

Decision with Reasons; Rates; 1990 Test Year; Phase I & II

Document Type	**DECISION.REPORT**
Erf ID	**U29458**
Applicant	**Union Gas Limited**
Proceeding	**EBRO 456**
Location	**Toronto**
Catalogue#	**U EBRO 456.4 Ref.1**
Document Date	**Tuesday, September 26, 1989**

9.148 The Board is of the opinion that the "new evidence" adduced by GMi in this case is not sufficiently persuasive to cause it to reverse its earlier findings. In general terms the Board regards the SNG premium costs as associated with a former Union management decision which as earlier decisions of this Board have found is a cost to be shared between customers and shareholders. The Board is of the view that the portion of the cost

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which is disallowed in rates is seen by the shareholders as a fixed cost which they must continue to bear until the Union/Petrosar agreement terminates. In the Board's view that portion of the total SNG premium which is to be borne by the customers should also be regarded as a fixed cost which cannot be identified with any particular class of customer but rather should be borne by all customers until the Union/Petrosar agreement expires on May 1 1993.

9.149 Accordingly the Board accepts Union's proposal to again include a portion of the SNG premium costs in rate M12 for the 1990 test year.

Revenue to Cost Ratios and Class Rates of Return

Introduction

9.150 In its past decisions the Board has consistently supported cost allocation methodologies which appropriately reflect cost causality. The costs allocated to each customer class when compared with the forecast revenue recovery from each of those rate classes produces revenue to cost ratios which indicate over or under contributions by the rate classes relative to allocated costs.

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9.151 In the Board's E.B.R.O. 412-III case Board Staff had raised the issue of rates of return by customer class and whether Union's cost allocation study which allocates the same system-wide rate of return to each customer class is appropriate. Board Staff through Dr. Carl Weaver had proposed that the allocated rate of return to each customer class should be risk adjusted.

9.152 Although the Board did not accept that proposal it invited Union

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Ontario

RP-2002-0130

IN THE MATTER OF AN APPLICATION BY

UNION GAS LIMITED

FOR

YEAR 2003 RATES

DECISION WITH REASONS

2003 MAY 08

minimized rate shock, considered customers' expectations, and addressed the comparability of equivalent service options. With respect to comparability of equivalent service options, Union stated that its DCC proposal was motivated partly by recognizing that future customers of unbundled services approved in RP-1999-0017 would provide the same avoided cost benefit as bundled direct purchasers by the 22-day Parkway call but would not be paid the DCC. In recognition of this circumstance, such customers would pay delivery rates net of the DCC. As such, Union submitted that its proposal treated equals equally.

Union agreed with the "small volume intervenors" that its proposal left "residual" DCC costs in rates, asserting that this feature recognized cost causation and rate design principles, reflecting differences among rate classes (i) in the provision of avoided cost benefits and (ii) in design day use of transmission capacity. 142

Union strongly urged the Board not to further defer the DCC issue, arguing: (i) the issue has been before the Board on three occasions, in the RP-1999-0017, RP-2001-0029, and the current proceedings; (ii) deferral of a decision on this issue will have only negative impacts, already being felt in customer negotiations, due to uncertainty with respect to the economics of new industrial loads; and (iii) the evidence is clear and complete on this issue. 143

3.2 Positions of the Parties 144

VECC submitted that the Board's three major findings with respect to the DCC issue in its RP-2001-0029 Decision with Reasons were: (i) the DCC was not required as an incentive for obligated deliveries, penalties may be a "significant encouragement"; (ii) Union's proposal was not acceptable without more compelling evidence; and (iii) if fuel switching in response to eliminating the DCC credit would be material, Union should bring a proposal that addressed phasing out of the credit program over time. VECC noted that Union's current proposal largely recapitulated the same position as in the RP-2001-0029 proceeding, in spite of the Board's "clear language" in the RP-2001-0029 Decision. Further, no phase out timetable had been proposed nor had Union provided evidence supporting the DCC as a load retention rate. Therefore, VECC submitted that it was open to the Board to find that since no new or compelling evidence had been presented by Union regarding the DCC, the DCC payments and costs be removed at once, or over time. Further, VECC charged that Union gave "short shrift" to Union's own ability to mitigate impacts through negotiated rates adding that "[b]ecause of the application of the PBR price cap, a direct rates subsidy from system sales customers in the form of embedded DCC costs is obviously more attractive to the Company, even if more flimsily supported." 145

VECC, LPMA, Schools, and CAC submitted that Union had not been responsive to the Board's RP-2001-0029 direction but merely refiled its original, RP-1999-0017 proposal. 146

VECC argued that the DCC should be eliminated completely from rates on the basis that existing contractual commitments and penalties should provide appropriate incentives to obligate deliveries. 147

VECC stated that since the new unbundled services did not require firm daily obligated deliveries, the DCC payment was now inconsistent with obligations requiring equal daily deliveries. 148

149

VECC was concerned that Union's proposal would result in rate reductions to large volume customers regardless of whether deliveries were obligated, or of migration to system sales service in the future. VECC noted that there was no contractual obligation for existing DP customers to remain DP customers beyond their existing one-year contract.

150

VECC submitted that DP customers' obligation to deliver be treated in the same manner as other system optimization practices which Union is responsible to undertake to achieve the lowest possible rates for all customers. Further, Union's proposal optimizes the system at a higher cost than pre-DP since the cost of the rate subsidy was not required prior to the innovation of Direct Purchase.

151

VECC criticized Union's proposal as not recognizing the system benefits provided by firm deliveries arranged to supply system sales customers. VECC remarked that Union's attribution of system benefits to some classes and not others for tasks performed by the utility pre-DP, was not consistent with the integrated system concept adopted by Union. VECC argued that Union's position selectively credited some classes of customers at the expense of others by considering system sales demands as day-to-day deliveries.

152

VECC noted Mr. Kitchen's testimony to the effect that if DP customers did not deliver as Union had, additional facilities would be required, the cost of which would be allocated to other customers based on Dawn-Trafalgar design day demand. Accordingly, VECC argued that costs caused by some customers would be allocated to other customers. This violation of cost causality principles would be exacerbated by the fact that the cost-causing DP customer would realize lower commodity prices while the system sales customer would paying for an avoided facilities cost embedded in rates plus a new, additional facilities cost.

153

VECC submitted that the design day methodology is used to allocate existing facilities, contending that Union's approach does not recognize or define which customers among all classes of customers cause additional facilities costs. Also, VECC noted that the Board in EBRO 470 held that it would ensure fair treatment of customers if DP migration increased costs.

154

VECC further criticized Union's proposal because the avoided costs built into rates would not change regardless of the quantum of avoided costs benefits provided.

155

VECC submitted that DP customers had voluntarily assumed the burden of making delivery arrangements in exchange for a lower gas supply cost and thus needed no additional subsidy. In addition, there was no evidence of an increased burden by obligating firm deliveries; rather, Union's witness stated that firm deliveries were more cost effective than interruptible deliveries.

156

VECC noted that existing direct purchasers have been able to turn back TCPL capacity allowing them to deliver gas at a lower cost than firm deliveries on the Alliance and Vector pipelines whose costs are the responsibility of system sales customers. Also, direct purchasers receive the DCC payment regardless of delivery point and enjoy some flexibility due to the ability to change delivery points from Parkway to Dawn while Union's deliveries on behalf of system sales customers are all at Dawn because Union has allocated all of its TCPL capacity to direct purchasers.

157

VECC suggested that if Parkway deliveries by DP customers were genuinely considered to be relatively onerous, the Board could find, as a least cost alternative to system optimization, that direct purchasers be able to change their delivery point to Dawn, provided that the DP customers choosing to do so assumed contractual commitments on the Alliance and Vector pipelines.

158

VECC disputed that Union's proposal was consistent with past practice, arguing that according to Union's witness, Mr. Kitchen, prior to EBRO 493-04/494-06 the DCC reflected the buy/sell methodology and was not embedded in rates. Mr. Kitchen also confirmed that the buy/sell mechanism arose due to Union's need to take title of a direct purchaser's gas; the buy/sell reference prices were in rates to facilitate the development of a competitive gas market.

159

VECC submitted that DCC payments recognizing avoided storage and transmission facilities costs started after the EBRO 499 Decision. Prior to EBRO 493-04//494-06, different commodity prices were paid by Union for obligated and non-obligated deliveries with the differential reflecting price, delivery point (Alberta or Ontario), and the transportation utilization underpinning delivery. Prior to the 1998 Act, when the utility had to hold title to the gas, buy/sell customers received a benefit due to the difference between the price they had negotiated with producers and the higher price in rates that Union paid to buy/sells.

160

VECC argued that in its EBRO 493/494 Decision with Reasons, the Board eliminated the price differential between obligated and non-obligated deliveries. The Board, in calling for changes to Union's buy/sell pricing methodology, noted that Union recorded deviations from the forecast cost of short-term supplies-- included in gas commodity charges for both buy/sell and system customers–to its PGVA "... which costs are usually charged only to system customers." In eliminating the differential, the Board commented that "... once this change is effected Union's own western Canadian firm supplies would not be excessively depleted due to an artificial economic incentive to elect direct purchase."

161

VECC submitted that the Board's findings in EBRO 493/494 more closely matched Union's actual firm supply costs with the costs paid to buy/sells by eliminating "... the higher cost of short-term supply embedded in the firm buy/sell reference price." VECC claimed that Union's prior practice under the Direct Purchase Displacement Policy increased commodity prices for system customers. VECC added that the Board also directed Union to bring a proposal to the Board for a commodity price for obligated deliveries that was closer to a true firm delivery price. VECC described Union's response to this directive (in EBRO 493-04/494-06) as "... the DCC with its current characteristics ... an artificial economic incentive to direct purchase customers based upon Union's unique view of system benefits." While the Board gave interim approval to the proposal -- pending a comprehensive review in the next proceeding -- there was no Board scrutiny of the DCC in the next proceeding because a comprehensive settlement agreement was filed with the Board.

162

VECC disputed Union's interpretation of the history of this issue, claiming: (i) no mention was made of either a reward for obligated deliveries or of the DCC as a premium for Parkway deliveries in EBRO 493/494; (ii) in EBRO 456-4, the Board required all deliveries (including DPs) to Ontario Local Distribution Companies (" LDCs") to be firm and obligated. The Board neither required Union to pay a premium for DP obligated deliveries nor recognized Parkway deliveries as qualifying for a premium; (iii) notwithstanding Union's claim that the Board's EBRO 412 decision precludes Union from mandating a delivery point, Union's contracts with DPs require obligated deliveries. Further, the EBRO 410-II, 411-II, and 412-II Decisions were issued prior to the existence of the current competitive gas market.; (iv) EGDI has included an obligated delivery requirement for its DP customers since EBRO 410-II and the following decisions, yet makes no payment similar to the DCC in recognition thereof; and (v) the EBRO 410-II and subsequent decisions considered the use of purchasers who had any latitude with respect to delivery point were the Ontario buy/sells or Ontario bundled-T customers who held upstream transportation capacity, most of whom would have held TCPL capacity and would therefore have had to comply with TCPL's delivery point rules : these were few in number since they would have to accept the risk of holding TCPL FT capacity. Schools noted that most, if not all, of TCPL's FT to the eastern zone was delivered to Parkway.

Schools joined VECC and LPMA in dismissing Union's load loss concerns with respect to the VECC proposal, noting the overall bill impacts, Union's ability to negotiate rates, and the possibility of using contract class deferral credits to mitigate any rate impacts. 189

Finally, Schools criticized Union's proposal as being unfair to M2 direct purchasers in that these customers, unlike M7 and T1 customers, would be worse off after the DCC elimination. Schools remarked on the heterogeneity of the M2 class, noting that it included institutional and commercial buildings, many of whom had been direct purchasers for years: the "misfortune" of school boards, building owners, and the like who direct purchase sizeable volumes, to be in the M2 class stemmed from Union's restrictions regarding the aggregation of buildings under common ownership for ratemaking purposes. As an example, Schools stated that under Union's proposal, the average school in Union's franchise area would lose a DCC payment of $582 and gain a delivery rate reduction of $127. 190

Schools supported VECC's proposal. Schools did not advocate separate compensation for M2 direct purchasers. However, if the Board accepts Union's proposal, Schools argued it must be modified to treat all direct purchasers equally. 191

CAC argued that the Board had to resolve four issues: (i) whether Union's "DCC-equivalent" rate proposal should be viewed as compensation for a system benefit provided by direct purchasers or as an incentive to retain direct purchasers' loads; (ii) whether Union has provided sufficient justification for its proposal; (iii) whether rejection of Union's proposal would be fair; and (iv) the appropriate mitigation should Union's proposal be rejected. 192

CAC disputed Union's interpretation of the DCC as reflecting a system benefit, noting that the Board had never reviewed the question of whether obligated deliveries provided a benefit that should be paid by system customers: the Board's acceptance of settlement agreements in which the system benefit rationale was made does not constitute a thorough review of the ratemaking principles embodied in the DCC proposal. 193

CAC disputed Union's characterization of the Board's EBRO 412-I Decision that Union could not unilaterally impose a delivery point for fear of inhibiting the development of a competitive Ontario commodity market. CAC argued that Union's position views the preservation of the historic rationale of the DCC as the fundamental issue, ignoring the facts that the competitive market is fully developed and that utilities and their direct purchase customers have far more contractual freedom today. 194

CAC stated that prior to DP, all customers were system customers, contributing to optimal system operation. The development of DP meant that Union could not control whether deliveries would be made as required. CAC interpeted the DCC as a payment to direct purchasers to control the risk of failure of DPs to honour their obligations to deliver and hence incent system optimization. CAC noted however that optimal system operation benefitted direct purchasers and that "[t]he anomalous result ... 195

was that Union's system customers had to pay DP customers to do not only what was in their interest, but what was a matter of contractual obligation."

CAC submitted that the DP customer's obligation to deliver is no different than obligation they had as system customers and that all customers benefit from delivery of required volumes at required locations. Therefore, no inter-class payment is required. 196

CAC argued that rate shock concerns are properly addressed by mitigation measures; they are not a proper rationale for Union's rates proposal. 197

CAC argued that Union had failed to justify the basic elements of its proposal, i.e., that DP customers provide a benefit for which they deserve to be compensated, that DP customers would not honour delivery obligations without a DCC-equivalent allocation, that the DCC calculation is reasonable, and that without the DCC-equivalent allocation there would be significant fuel switching. 198

CAC agreed with VECC and others that Union's proposal, through allocating costs that have not been incurred, violated cost causality principles. 199

CAC argued that parties' expectations of DCC or DCC-equivalent payments do not constitute a basis for ratemaking in the absence of a sound economic rationale. CAC acknowledged that while avoiding rate shock was an important regulatory principle, it did not provide a basis for accepting Union's proposal but, rather, argued for rate mitigation measures. In rejecting Union's proposal, CAC accepted the need to eliminate the DCC but proposed a five-year phase out of the plan to mitigate potential adverse effects. 200

Kitchener noted that Union has always depended on obligated Parkway deliveries and, prior to 1987, had no concerns in this respect because Union arranged all deliveries to its system. Kitchener acknowledged that in the early days of DP, an obligated delivery premium was necessary to increase the competitiveness of the gas supply market. However, Kitchener argued that the need for this incentive has disappeared due to the EBRO 456-4 Decision in which the Board allowed Union to mandate obligated deliveries. The maturity of DP makes cross-subsidization by system gas customers unnecessary, and undesirable. 201

Kitchener noted that the avoided cost rationale for the DCC, which gave rise to cross-subsidization, was proposed by Union on an interim basis in EBRO 494-06, with the Board accepting it as such while contemplating a full review in the next main rates case. Kitchener submitted that there has never been a full Board inquiry into the cost implications of the DCC methodology; in fact, "... the cross-subsidization ... was never revealed until RP-2001-0029." 202

Kitchener claimed that Union's proposal was not in compliance with the Act's requirement that rates be just and reasonable (s.36(2)) insofar as the proposal violated cost causality principles by requiring system customers to bear the cost of the reliability concerns caused by DP's actions. Also, the proposal results in revenue to cost ratios significantly at variance with the ratios last approved by the Board in EBRO 499. In this latter regard, Kitchener argued that "... the Board's approval of a utility's rate design in any case is essentially an approval of the resulting revenue to cost ratios. ... Having approved in EBRO 499 the rate design ... the Board should not depart from that approval during the PBR term, absent extraordinary circumstances." 203

Kitchener maintained that Union's approach of allocating avoided, not actual, costs was both dangerous, due to the introduction of cross-subsidization, and unprecedented, since the approach is not applied to any other avoided costs or system benefits, such as Union's Alliance and Vector arrangements. Kitchener stated that "... in an integrated system like Union's, each customer class benefits from the presence of the other customer classes and these interrelated benefits are not accounted for by cross-subsidization." Further, Kitchener argued that the need for the DCC is obviated by the existence of contractual obligations and penalties. 204

Kitchener noted that firm deliveries for system customers do not receive a DCC credit while firm Dawn deliveries -- which entail no avoided cost benefits -- receive the DCC credit. Kitchener added that "the customer classes which bear the burden of Union's proposal in this case (M2, M9 and M10) are the same classes who were targeted by Union's flexibility and service basket design proposals in RP-1999-0017 which was rejected by the Board." 205

Kitchener echoed other intervenors in noting that the rate impacts in Union's evidence are delivery rate impacts only and do not account for the commodity and transportation costs of energy supply. Kitchener concluded that the absence of any phasing out proposal from Union indicated that Union was "not unduly concerned about the impact of the intervenor's proposal on its industrial customers." 206

Kitchener urged the Board to eliminate the DCC as per VECC's proposal and consistent with the EBRO 499 approved rate design and with the RP-1999-0017 settlement agreement. 207

IGUA supported Union's DCC proposal on the basis that the avoided cost benefit was an appropriate compensation to direct purchasers for the contractual risks and commitments they have assumed in firm obligated deliveries to a specific delivery point. IGUA urged that if the Board rejects Union's proposal, the DCC not be eliminated. 208

IGUA submitted that prior to direct purchase, Union arranged supply for all its distribution customers by holding a portfolio of gas supply contracts which required delivery at specific points. A "substantial component" of the portfolio comprised firm service contracts requiring TCPL to deliver gas to Parkway east end at a 100% load factor. IGUA added that the Board and intervenors accepted "at all material times" that these deliveries benefitted the system through reduced Dawn-Trafalgar facility requirements, the avoided cost of which was a reasonable measure of benefits and reflected in distribution rates. Further, there would be no cost consequences of a delivery failure for system gas customers if Union did not suffer a loss or if Union did suffer the loss but the Board did not approve cost recovery. 209

IGUA argued that this was in contrast to the predetermined cost consequences including DCC clawback and automatic penalties, spelled out in the contract, for a direct purchaser's failure to deliver. IGUA added that direct purchasers, unlike system gas customers, derive no benefit from Union's "diversity as system supplier." 210

IGUA submitted that the introduction of direct purchase resulted in the replacement of suppliers' contractual commitments to Union with direct purchasers' contractual commitments to Union, enabling continued system benefits in the form of avoided facilities' costs. IGUA admitted that while the calculation of this benefit had changed, "... the entitlement of direct purchasers to receive that 211

OAPPA submitted that system customers cannot contractually obligate deliveries since these customers do not handle the gas. OAPPA contrasted this with the daily, firm obligation to deliver, regardless of consumption, of direct purchasers.

OAPPA submitted that the delivery rate impacts of VECC's proposal on direct purchasers are shown 221
by the evidence to be significant; further, they are unjustified, given the continued obligation to deliver. With respect to the argument that delivery rate impacts are dwarfed by commodity price fluctuations, OAPPA stated that this view was misguided since direct purchasers have made supply arrangements based on their own risk tolerances "... that simply do not allow a conclusion such as VECC's to be made with confidence." OAPPA stressed that "... delivery arrangements and the attendant costs are key elements of a customer's natural gas supply portfolio and therefore, a major consideration on their own."

OAPPA noted that the customer letters received by the Board supported Union's proposal. OAPPA 222
urged the Board to adopt Union's proposal but, failing that, urged the Board to mitigate the impact of adopting VECC's proposal by phasing out the DCC over a period of no less than five years.

Tractebel supported Union's proposal arguing that: (i) direct purchasers bear a unique delivery 223
obligation; (ii) direct purchasers provide a system benefit; (iii) the system benefit provided is appropriately reflected in rates; (iv) the system benefits are appropriately measured by avoided costs; (v) there is no rationale for changing the status quo; and (vi) changing the status quo will result in rate shock.

Tractebel argued that the DP delivery obligations were different and more onerous than either the 224
obligations of system gas customers or the obligations of Union. Tractebel noted that system gas customers are under no obligation to deliver on an even daily basis or to a specific delivery point; nor are system customers liable for failure to deliver. Tractebel submitted that Union "meets the supply demands of its system as it wishes," citing Union's use of its northern TCPL capacity to serve the southern area during non-peak conditions. Further, Union does not have to deliver gas that system customers do not consume, nor does Union suffer penalties for failure to deliver.

Tractebel noted that all parties accepted that obligated deliveries provided a system benefit. Tractebel 225
stated that this benefit is appropriately reflected in rates because, in EBRO 412-III, the Board approved a premium payment for obligated deliveries to a fixed delivery point in recognition of the system benefit provided. Again, in EBRO 493-04/494-06, the Board accepted the avoided facilities' cost as an appropriate measure of system benefits. Tractebel argued that the NEB's treatment of TCPL's FST rate also recognized avoided costs.

Tractebel described Union's proposal as a necessary modification of the DCC to accommodate 226
unbundling that maintains the underlying DCC principle while VECC's proposal would "... completely eliminate the principle of paying a premium to customers who obligate their deliveries. ... VECC is saying that the cost allocation associated with the DCC is incorrect, and always has been."

Tractebel criticized VECC's proposal as ignoring all of the Board's case law on DCC, remarking that 227
the Board approved different rates for obligated and unobligated deliveries back in EBRO 412-III in 1988. Tractebel argued that although the DCC had undergone modifications as the gas market evolved, the principle and practise of recognizing the system benefits of obligated deliveries had been maintained.

Tractebel disputed VECC's interpretation of the issue as a cost allocation issue, submitting that "...[Union's DCC proposal] is best characterized as a rate design issue." Tractebel distinguished between "costs" incorporated in a revenue requirement and "costs" relevant to rate design stating that the former were payment obligations related to operating expenses and capital costs, "direct costs" defined by Tractebel, while the latter, as per Bonbright, was a broader concept incorporating considerations such as cost causality, avoided costs, and cost shifting. 228

Tractebel dismissed the commodity price volatility argument as bordering on the absurd and urged the Board to approve Union's proposal in view of the delivery rate shock attributes of the competing proposals. 229

Energy Probe ("EP") described the DCC as "a muddle of contradictions" containing both favourable and unfavourable characteristics. 230

EP credited the DCC as providing system planning and control benefits and argued that Union's proposal would strengthen the enforcement of delivery obligations through increased penalties for non-compliance. EP asked the Board to urge all parties to try to increase the liquidity at Parkway to obviate the need for failure-to-deliver penalties in the future. 231

EP argued that historically, the DCC had not been consistently associated with system benefits stating that "[a]t one time, the DCC only represented a difference between the buy/sell reference price and WACOG. Only later was DCC used as a system planning tool." As such, EP urged that the Board "... not feel bound to maintain the status quo, but ... take a more principled review of the issue." 232

EP noted that the DCC was unique and suggested that it was so due to its unfavourable characteristics which included violating basic ratemaking principles, overpaying for DCC benefits, violating the Board's RP-2001-0029 directive, and creating customer confusion. 233

EP submitted that the DCC was based on "what-if" phantom costs as opposed to actual costs incurred. EP acknowledged that while avoided costs are useful in determining whether a particular expense is justified, they are not appropriately included in rates as they do not represent real costs incurred. EP noted that Bonbright's first attribute of a sound rate structure is "effectiveness in yielding total revenue requirements.": as the DCC is not included in Union's revenue requirement, it doesn't belong in rates. EP suggested that "nowhere does Bonbright endorse rate recovery of costs a utility does not bear." 234

Noting that it is obligated Parkway deliveries that avoid costs, EP questioned why Union paid 24% of the DCC between January 1 and October 31, 2002, for deliveries at Dawn and Ojibway when these west end deliveries increase the need for facilities. Further, EP claimed that some DP shippers were "double dipping" at the expense of high coincident peak users since the shippers are paid the DCC for Dawn deliveries -- including capacity associated with the delivery point flexibility which also flows benefits to shippers. 235

EP recommended that DCC payments for west end deliveries be eliminated immediately with the other DCC payments eliminated over a five-year period "unless a cost-based alternative capable of ensuring deliveries arrangements that meet Union's system planning needs can be implemented 236 sooner." Until this time, EP agreed with VECC that "the Board has the authority to ensure that Direct Purchase deliveries at 100% load factor are obligated."

237

EP envisioned such a cost-based alternative as ensuring that "... the deliveries of, or on behalf of, all customers, including DP and system customers, are economically optimal for the overall system." Such a system would require customers who demand service at the coincident peak to bear costs of meeting that demand and would provide compensation for relieving congestion only if the utility bears a real cost. EP suggested that the compensation be the minimum payment required to ensure the needed supply and that this amount of compensation might be determined through an auction process.

238

In Union's reply argument, Union responded to the charge made by some intervenors that Union had not complied with the Board's directive in RP-2001-0029, Union stated that the Board did not review the merits of its DCC proposal, nor reject its proposal in the RP-2001-0029 Decision with Reasons. Union's position is that its DCC proposal had been accepted, by all parties and the Board, in settlement agreements in the preceding EBRO 499 and RP-1999-0017 proceedings. When disagreement arose over the interpretation of "revenue neutrality" in the RP-2001-0029 proceeding, the Board accepted Union's alternative submission: that the DCC not be eliminated. Union submitted that in bringing forward a detailed justification for its original proposal was consistent with the Board's directive.

239

Union added that it had not provided a schedule for phasing out the DCC since its proposal did not involve any phasing out.

240

Union argued that the Board had always maintained that fixed delivery point obligations should be negotiated, not unilaterally imposed. Noting that DP contracts are typically twelve months in duration, Union submitted that "[t]here is no basis in the evidence for the conclusion that direct purchase customers will continue to make these commitments in the absence of consideration."

241

With respect to the payments made to DP customers, Union asserted that DCC costs are in rates and have been from the start. Further, intervenors have agreed with, and the Board has approved of, this arrangement.

242

Union disputed the contention by some intervenors that issues agreed upon in settlement agreements, such as the DCC issue in EBRO 499 and RP-1999-0017, had not been reviewed, arguing that although they had not been litigated, they had been reviewed by the parties prior to the settlement, and by the Board in accepting the settlement. Union argued that settled issues "... are more reliable [than litigated issues] precisely because experienced parties with experienced legal counsel following a thorough discovery process and extensive negotiations, all in a process financed through intervenor cost awards, have all agreed to a resolution of the issue."

243

Union disputed LPMA's argument that M2 customers would pay twice for facilities, once when they are avoided and then again when they are built. Union argued that obligated deliveries provide a $27M benefit regardless since, in the absence of obligated deliveries, new facilities would be required earlier than otherwise: actual facilities constructed would be incremental to the $27M cushion in avoided costs.

244

6 OTHER ISSUES 342

6.1 Standard Storage Service and Standard Peaking Service Rate Derivation 343

Union's Argument in Chief 344

Union questioned this subject appearing on the Issues List, noting that the Standard Storage Service ("SSS") and Standard Peaking Service ("SPS") rates are applicable to unbundled services, beginning April 1, 2003, for which there are not yet any customers. Further, Union submitted that the rationale underpinning the services and rates were provided in pre-filed evidence in the RP-1999-0017 proceeding and were settled in the subsequent settlement agreement that was accepted by the Board in that case. 345

Union added that, pursuant to the RP-2001-0029 proceeding, SSS and SPS rates were included in the 2001 and 2002 rate orders. The calculation of the rates was provided once in the working papers attached to the 2001 and 2002 draft rate orders and again in this proceeding. Because there were not any customers for these services, Union used the existing, cost-based T1 storage rates to derive SSS and SPS rates rather than using a cost allocation to the U2 class. 346

Union added that it was not seeking any change in rate design or terms of service for the SSS or SPS services and, since Kitchener had not sought any specific relief in respect of this issue, advised that "... it would appear that no decision or comment is required of the Board." 347

Intervenors' Positions 348

Kitchener was the only intervenor to make a submission on this issue. It submitted that although a separate rate for these services was provided in a post-ADR document in the RP-2001-0029 proceeding, the derivation of the rates was first provided in this proceeding. Kitchener accepted that Union could not use a cost study to develop these rates because it was impossible to forecast demand for the services. 349

Kitchener stated that the appropriateness of the SSS and SPS rates could be deferred to the 2004 rates case but argued that "... the Board should be concerned about the determination and the assumptions that underlie both the SSS and SPS rates" and that "... Union needs to consider developing the rate from the ground up, based on costs posited on assumed demand parameters." 350

Union's Reply Argument 351

Union made no further submissions on this issue. 352

Board Findings 353

The Board notes that under the Act, one of its objectives and responsibilities is to maintain just and reasonable rates for the transmission, distribution, and storage of gas. As such, the Board expects Union to base all of the rates it seeks to impose on customers in 2004 on an appropriate allocation of costs. 354

6.2 Lines of Business 355

Background 356

In the RP-1999-0017 decision, the Board directed Union to file financial information segregated by line of business and a cost allocation study as a guide for evaluation of the cost responsibility by line of business and by rate class. 357

Union stated that its processes, systems, tracking and reporting systems are designed to provide information by rate class, and not by line of business. Union suggested that if it generated financial statements using subjective allocation factors, the result may not be sufficient for sound decision making and could lead to misinterpretations. Union stated that this method of generating financial statements is also contrary to the objectives and basic principles of segmented disclosure as described in Section 1701 of the Canadian Institute of Chartered Accountants ("CICA") Handbook. 358

Union has dedicated resources to investigate splitting the company into two lines of business, namely (i) distribution and (ii) storage and transportation. 359

Union indicated that it would be difficult to split the Dawn Operations Centre into discrete storage and transportation elements because of the presence of common plant assets and Operations and Maintenance costs. 360

Union also noted that gas commodity cost is strictly a pass-through item and there is no reason or justification to require reporting gas supply as a distinct line of business. 361

The parties agreed to deal with the matter in argument . 362

Union's Argument in Chief 363

364 Union filed a status report on December 20, 2002 stating that it had decided not to reorganize along lines of business because the cost will outweigh the benefits. Union indicated that it will conduct a notional line of business study as part of the 2004 rate case and attempt to report actual performance broken down by notional lines of business.

365 Union requested a withdrawal of the line of business directive or clarification from the Board as to what the line of business information is to be used for.

Positions of the Parties 366

367 CEED submitted that Section 36 of the Act recognizes four distinct lines of business for which the Board sets rates. CEED asked for clarification as to how anyone would be misled if Union reported as directed by the Board. CEED also rejected Union's suggestion that the use of allocation to generate financial statements would be contrary to the Board's objectives. CEED stated that a regulator must understand the operations of the regulated entity, and the Board's directive would lead to a better appreciation of Union's activities.

368 CEED was particularly concerned that in the absence of financial information on a line of business basis, revenues from the regulated transportation and distribution operations of the Utility could be used to subsidize its unregulated storage and gas sales business.

369 CEED indicated that delivery service is the only service which customers must purchase from the regulated business. Other services such as storage, billing and metering are, or will be, open to competition. As a result, the cost for each component should be segregated in order for the customers to make well informed decisions in choosing service providers.

370 CEED rejected Union's contention that reporting on lines of business is a management decision. It contended that the Board's unbundling decision necessarily leads to a situation wherein the utility is obliged to discretely report costs on gas sales, storage, transportation and distribution respectively. It also rejected Union's argument that financial statements by lines of business would be prone to misuse and misinterpretation. It contended that Union could prepare notes to financial statements by lines of business to explain that the statements had been prepared for filing with the regulator and not for accounting purposes.

371 CEED rejected Union's argument that such a methodology would run counter to the objective s and basic principles of segmented disclosure in Section 1701 of the CICA Handbook. CEED noted that this Section explicitly states that "Nothing in this section is intended to discourage an enterprise from disclosing additional information specific to that enterprise or to a particular line of business that may contribute to an understanding of the enterprise."

372 CEED also indicated that since the Board's original direction was issued in its RP-1999-0017 Decision dated July 21, 2001, Union has had numerous opportunities to request that the Board reverse its decision, but has not done so.

The Board is not persuaded by the Utility's assertion that the provision of the information requested in the form requested is futile and wasteful of ratepayers' resources. The Board has indicated its flexibility in structuring the directive so as to minimize costs and complication. But the requirement remains, and subject to constructive suggestions from the Utility as to how to fulfill it, it is the Board's expectation that the information required, in the form in which it is required, will be provided in conjunction with the 2004 re-basing application. Union's undertaking to provide a notional reporting by line of business for the 2004 rates case may form the basis for the fulfilment of the Board's directive. The Utility is encouraged to consult with Board Staff as that undertaking is developed in preparation for the 2004 rates case. 384

6.3 Revenue to Cost Ratios 385

Union's Argument in Chief 386

Union submitted that revenue to cost ("R/C") ratios arise as an issue only due to the reduction in R/C ratios below 1.0 of the contract classes when the DCC payments are replaced by equivalent rate reductions. 387

Union argued that there was no material difference between the "net effective R/C ratios" resulting from the rates which included DCC and which were approved as just and reasonable in EBRO 499 on the one hand, and the R/C ratios under its proposal on the other. Union submitted that column (f) of Exhibit B, Tab 9, Schedule 3, showing current net-of-DCC R/C ratios, and column (i) of Exhibit B, Tab 10, Schedule 5, showing R/C ratios after implementation of its proposal, supported this claim: "... in all instances except rate M6A, to the extent the R/C ratio changed, it moves marginally closer to 1.0." 388

Intervenors' Positions 389

VECC stated that revenue to cost ratios should be close to equilibrium as a general principle, with any divergences to be carefully scrutinized and justified. 390

VECC noted that under Union's proposal, the range of revenue to cost ratios would change, from 1.022 to 0.511 in EBRO 499 (see accompanying table), to 1.06 to 0.295. Under VECC's proposal, the range would mirror the existing EBRO 499 range. VECC questioned the validity of Union's proposal primarily on the grounds that no other jurisdiction had incorporated a similar methodology that transferred system benefits from one class to another in its rate design to recognize avoided facilities costs. 391

Describing the process of analyzing an integrated system to find inter-class cost and benefit consequences as "laborious and unrewarding," VECC argued that "[i]f direct purchase customers get a credit for gas deliveries formerly made by Union before Direct Purchase came to be, then it is important that other types of benefits are recognized and similarly rewarded." Referring to the increased benefits to direct purchase customers arising from Union's Alliance and Vector contracts that allowed direct purchasers the benefits of turning back TCPL capacity and purchasing gas in the secondary market-- while not assuming the cost of the Alliance and Vector capacity, VECC asserted that consistency in rate design would require lower system customer rates in recognition. 392

VECC warned that accepting Union's "unique rate design ideas" could encourage "endless creative and theoretical wrangles about who really benefits from different aspects of Union's integrated system design ... divorced from the well-established principles of cost causality ... ." 393

VECC urged the Board not to accept Union's proposal, citing the Board's "historical and continued need to rely on revenue-to-cost ratios to ensure the just and reasonableness of rates", quoting excerpts from the Board's RP-1999-0017 Decision with Reasons, (paras 2.457 - 2.459): 394

> "The Board is also not prepared to accept the argument that there is no need to provide revenue and cost information on a rate class basis. The Board has generally relied on the revenue-to-cost ratio in determining that there is no unfair assignment of cost responsibility among rate classes. Evidence in this proceeding established no other basis upon which to check for cross-subsidization other than to use cost information." 395
>
> "The Board does not accept Union's arguments that "using a cost based measure, such as cross-subsidy is not meaningful in PBR because rates are judged just and reasonable by not being escalated beyond the restrictions approved by the Board" nor that "the approval by the Board of a level of pricing flexibility means that if Union makes rate changes anywhere within the boundaries of the flexibility constraints approved by the Board, then the result will be just and reasonable rates". The Board can not automatically assume that the resulting rates will remain just and reasonable among classes".
>
> "In the Board's view there will be a continuing need to monitor changes in rate relationships to ensure that rates continue to be just and reasonable. The Board therefore directs Union to file with the Board and provide in the customer review process appropriate cost information, including rate class revenue-to-cost impacts."

LPMA submitted that "... the key question related to the revenue-to-cost ratios resulting from Union's proposal to embed the DCC into delivery rates is whether or not those revenue-to-cost ratios are staying at a level that is reasonable." 396

LPMA provided a table summarizing the R/C ratios (for delivery services) for in-franchise customers as approved for 1999, under Union's proposal, and under the intervenors' proposal. This table is reproduced below. 397

398

Description	Rate Class	1999 Approved	Union Proposal	Intervenor Proposal
General Service	M2	1.021	1.067	1.022
Firm comm/ind contract	M4	1.019	0.936	1.021
Interruptible comm/ind contract	M5A	0.818	0.613	0.816
Seasonal comm/ind contract	M6A	0.583	0.365	0.583
Special large volume contract	M7			

Firm		0.886	0.655	0.873
Interruptible and seasonal		0.511	0.270	0.511
Large wholesale service	M9	1.003	1.033	1.004
Small wholesale service	M10	0.614	0.579	0.558
Contract Carriage	T1	0.792	0.499	0.771

399

In comparing the 1999 approved R/C ratios to the R/C ratios under Union's proposal, LPMA noted the "significant increases" to the M2 and the M9 classes and described the increases as "unacceptable and not reasonable." Further, under Union's proposal, the other rate classes "... see significant drops in their revenue-to-cost ratios."

400

LPMA argued that while the approved 1999 revenue-cost-ratios were found to be reasonable by the Board, the significant changes under Union's proposal demonstrate that the ratios would not remain reasonable. In contrast, the table shows that under the intervenors' proposal, revenue-to-cost ratios are maintained close to their existing levels, thereby better attaining Union's stated objective of ensuring that the R/C ratios stay at a reasonable level.

401

LPMA urged the Board to reject Union's proposal because, in incorporating rates adjustments not based on costs which have been actually incurred, moves away from cost-based rates. "Such a change would be a fundamental change in the way rates are set in this province and would result in rates that are neither just nor reasonable."

402

Kitchener argued that R/C ratios illustrate rate design and provide a measure of whether rates are just and reasonable. It submitted that the last rate design and rates based on a full cost allocation study and approved by the Board were those in EBRO 499. Further, Kitchener asserted that mid-term PBR rate design changes are inconsistent with the PBR principle of tying rate changes to the price cap formula.

403

Kitchener noted that the DCC was the only issue in this proceeding that could alter the EBRO 499 approved rate design and, based on a comparison between the EBRO R/C ratios and the R/C ratios under VECC's proposal, urged the Board to accept VECC's DCC proposal.

404

IGUA stated that the R/C issue arises "... because the rate changes Union proposes produce revenue-to-cost ratios below 1.0 for some contract rate classes with a delivery commitment differential credit and revenue-to-cost ratios greater than 1.0 for those rate classes with a delivery commitment differential debit."

405

IGUA urged that if the concern about R/C ratios was a matter of "optics,"a separate line item in the cost study to reflect the "delivery commitment differential" for each rate class would address this concern. IGUA proposed that for each rate class, this differential would reflect the mix of system sales and direct purchase customers in the class and would quantify the net benefits provided or enjoyed by the class due to the 100% load factor delivery commitments made by direct purchasers. IGUA suggested that the differential for each rate class be derived from the avoided carrying costs of incremental Dawn-Trafalgar facilities.

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IGUA added that its "line item in the cost study" approach would provide a better alignment of R/C ratios and "... will better reflect the realities of the redistribution of risks and obligations associated with the provision of 100% load factor deliveries at specific points within Union's system which have ensued with the widespread shift to direct purchase and the consequential transfer of delivery commitments from Union's suppliers to direct purchasers." 406

Regardless of whether such a delivery commitment differential line item is added to the cost study, IGUA submitted that direct purchasers remain entitled to consideration for the system benefits that they provide. 407

Board Findings 408

The Board considers that an appropriate cost allocation study respects generally accepted principles of cost causation. In view of the principle that each rate classes should generally be responsible for costs it has caused to be incurred, the Board believes that revenue-to-cost ratios provide information that is useful in the consideration of the justness and reasonableness of proposed rates. In the absence of conflicting considerations, this approach would yield expected revenue-to-cost ratios of 1.0 for each rate class. 409

The Board acknowledges that, in practice, rates may be approved which do not result in revenue-to-cost ratios of 1.0 for each rate class. This may arise due to conflicting criteria considered in the rate design stage of developing a sound rate structure. 410

Notwithstanding the preceding, the Board believes that any proposal which results in the revenue-to-cost ratio for any class moving further away from 1.0 should be carefully scrutinized and justified before being given regulatory approval. The Board does not agree that any such further deviations from a revenue-to-cost ratio of 1.0 present merely a problem with "optics." 411

The Board notes that there is no evidence before it that any other jurisdiction has approved the inclusion of avoided costs of facilities in rates. As a matter of principle, the Board finds that no rate class should be assigned a cost that has not actually been incurred by the utility. Therefore, as the payment of the DCC is phased out by Union, it is appropriate that the cost embedded in rates be phased out, for the purposes of calculating the revenue requirement and the revenue-to-cost ratio. 412

The Board finds that both the revenues and costs used in deriving the revenue-to-cost ratios should reflect expected actual revenues collected and actual costs incurred. To derive these ratios otherwise, increases the opacity of the proposal and decreases the usefulness of the ratio itself. 413

Therefore, the Board accepts the position of some intervenors that, under Union's proposal, some rate classes that already enjoy a revenue-to-cost ratio of significantly less than 1.0, would see a further reduction in revenue-to-cost ratios. Under VECC's proposal, the class revenue-to-cost ratios would remain closer to those approved by the Board in EBRO 499. 414

Since the Board has found elsewhere in this Decision that the DCC be phased out over five years, it is also appropriate that the revenue requirement component corresponding to the DCC cost responsibility also be phased out over the five-year period. Union is therefore directed to amend its 415 rates to reflect the phasing out of the DCC and to provide the corresponding R/C ratios in its fiscal 2004 rates application.

6.4 Deferral Account Disposition 416

There are three categories of deferral accounts, namely, the Gas Supply Accounts, the Storage and Transportation Accounts and Others. 417

As of December 31, 2002, the Gas Supply Accounts balances consists of; 418

i) Firm Supply Purchase Gas Variance Account (179-80) debit balance of $6.885 million; 419

ii) Other Purchased Gas Costs Account (179-68) credit balance of $35.923 million after adjusting for the Unabsorbed Demand Charge of $3.1 million agreed upon by all parties at the Alternate Dispute Resolution ("ADR") Settlement; and 420

iii) the Southern Operations Area TCPL Tolls and Fuel Account (179-67) and the Northern Operations Area Heating Value Account (179-89) and the TCPL Tolls and Fuel Account (179-100) totalling a net credit balance of $2.259 million. 421

iv) the total for the Gas Supply Accounts amounts to a net credit of $31.297 million. The Storage and Transportation accounts and Other Deferral accounts amounts to a credit of $981,000. The total to be disposed amounts to a credit of $32.278 million. 422

Union proposed the following disposition of the Gas Supply Account balances: 423

a) **Firm Supply Purchase Gas Variance Deferral Account** 424

$6.885 million will be allocated to firm rate classes in the Northern and Eastern Operations Area, and all rate classes in the Southern Operations Area in proportion to system sales volume in 2002. 425

b) **Other Purchased Gas Costs Deferral Account (Credit of $35.923 million)** 426

i) Flexibility - South - Credit of $1.941 million to be assigned directly to the M2 general service rate class. 427

Flexibility - North - Credit of $0.123 million to be assigned directly to the M2 general service rate class. 428

ii) Unabsorbed Demand Charge 429

430

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

LPMA recommended that the Board accept Union's overall gas supply plan as appropriate and reasonable.

Board Findings

Union noted that it was seeking approval to use the 20-year trend methodology for rate-making purposes to underpin Union's revenue forecasts (Chapter 2.2). If it did not receive approval for use of the 20-year trend methodology for rate-making purposes, Union would likely not continue to operate under two methodologies. Union concluded that if the Board did not approve the 20-year trend methodology in this cost of service application, but maintained the 30-year trend, Union was likely to return to the 30-year average for planning purposes and would seek recovery in any future case of all costs associated with that change.

The Board notes that there were relatively few intervenor concerns expressed about Union's Gas Supply Plan.

The concerns raised by CME related to Union's use of the 20-year weather trend for gas supply planning purposes are dealt with in Chapter 2.2 of this Decision.

Regarding the concerns of Energy Objective related to both Union's spot purchases of Ontario gas and the policy of a Parkway delivery commitment for Ontario gas producers, the Board is of the view that Energy Objective has not provided sufficient support for the positions it is advancing. The Board considers the production and marketing of Ontario natural gas to be an important policy issue in the province's energy supply plan. The Board invites Energy Objective to participate in the Natural Gas Forum to have its concerns considered in a broader policy context. Alternatively, the Board would welcome further evidence touching on this subject in subsequent proceedings. In the interim, the Board accepts Union's position on these matters.

The Board notes VECC's concern that spot gas costs are not allocated to direct purchase customers. The Board does not accept the proposition that costs should be allocated to a rate class without regard to cost causality. The Board expects that the load balancing proposal discussed subsequently will have the effect of significantly reducing, if not eliminating, the need for spot gas for balancing direct purchase gas accounts. VECC has not proposed any specific alternatives to Union's proposals. The Board accepts Union's position on this matter.

The Board accepts the principles underlying Union's proposed Gas Supply Plan for 2004. However, Union is directed to revise its Gas Supply Plan for 2004 so that the Plan reflects the Board's findings with regard to the approved weather nomalization methodology for 2004 as prescribed in Chapter 2.2.

3.2 UPSTREAM TRANSPORTATION ALLOCATION METHODOLOGY (VERTICAL SLICE)

Union stated that it currently allocates upstream transportation to Southern region customers migrating from sales service to direct purchase using the vertical slice allocation methodology approved by the Board in RP-1999-0017. The vertical slice is determined based on Union's projected upstream transportation portfolio to serve Southern sales customers commencing each November 1st and remaining in effect for one year. The portfolio is restructured each successive November 1st. Union proposed to continue with the vertical slice, using its projected upstream transportation portfolio as of November 1, 2003.

Union described, in its August 2003 update, the two new transportation components to be included in this portfolio beginning November 1, 2003.

The first such new contract is a firm transportation contract with Trunkline Gas Company from the Gulf Coast of Mexico to Bourbon, and Panhandle Eastern Pipeline from Bourbon to Ojibway. This contract is effective November 1, 2003 and has a principal term of two years with a firm capacity of 60,138 GJ/day during the first year and 42,202 GJ/day during the second year. The volumes are obligated at Parkway, which is facilitated by a firm Ojibway to Parkway service. The contract also contains a provision such that the volume for the second year can be reduced by up to 5,275 GJ/day.

The second contract is for firm transportation on Vector Pipelines, transporting gas from Chicago to Dawn. Union stated that there should be no controversy associated

8. LOAD BALANCING AND MARCH PARK

8.1 LOAD BALANCING

Background

The current method of Load Balancing has been in place since the inception of the Bundled-T service some 15 years ago.

Load Balancing service, that is the timely matching of system supply and demand, is required when the amount of gas delivered by customers varies from the amount they physically consume on a given day or throughout the season. Union's Board approved methodology for recovering load balancing costs, and its proposal in this proceeding, arise from Board directives in previous decisions.

In its EBRO 494 Decision, the Board directed Union "... to conduct a cost allocation study and propose a rate structure similar to that of Centra where the forecast cost of short-term supplies are included in the delivery charge. In that way all customers, such as ABC customers who cause load balancing costs to be incurred will pay those costs."

In the EBRO 493-04/494-06 proceedings, Union proposed to classify all costs in the Other Purchased Gas Cost Account in excess of the Ontario landed WACOG as either load balancing or flexibility costs. Both of these costs would be recovered in delivery rates by rate class. Regardless of whether customers in a rate class were sales service, buy-sell service, or bundled-T service customers, all would pay the same charge, under the rationale that incremental supplies purchased in the winter to meet actual winter demand benefitted both direct purchase and sales service customers.

In its EBRO 493-04/494-06 Decision, the Board accepted Union's proposal but went on to suggest that a possible alternative might be to incorporate these features:

1. a monthly supply/demand inventory forecast for each type of service;
2. calculation of monthly differences between supply and demand;
3. comparison of monthly actuals to forecasted amounts; and
4. a true-up mechanism.

In its EBRO 499 Decision, the Board found that the existing load balancing cost methodology should be continued for the 1999 test year but that as soon as Union completed its unbundling exercise, the Board expected Union to bring forward a new load balancing proposal.

Union uses storage space and deliverability, balancing gas inventory, and spot gas to provide load balancing services. The recovery of the load balancing costs associated with each asset type is accomplished according to the type of asset used. Storage space and deliverability costs are recovered in delivery rates based on the forecast use of these assets by each rate class. Costs of the balancing gas inventory, which comprises 29.5 PJ, are allocated to all rate classes, which is similar to the treatment of Union's working inventory. Costs of incremental or unplanned spot gas supplies, which are used to balance sales service and Bundled-T customers when actual winter demands exceed forecast demands, are recovered from these customers. The costs of load balancing using spot gas are calculated by multiplying the volumes of spot gas purchased in winter to meet unplanned demand by the summer/winter price differential.

Union's Position

At present, Bundled-T customers must supply their daily contract quantity ("DCQ"), a quantity based on each customer's normalized consumption over the most recent 12 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 argument. Let me turn to the issue of optimization. I take it this is another area in which you complain about Union's methodology, correct?

MR. ROSENKRANZ: I have some disagreements, I guess would be a way to say it, yes.

MR. SMITH: And as I understand it, in effect, what you are saying is that the total storage capacity should be increased by the amount of Union's optimization activities; is that correct?

MR. ROSENKRANZ: Again, I have a hard time agreeing with the way you put it, so I would like to try to explain it a little differently. I mean, the approach we took, as I explained, was -- at the outset was to look at the allocation of the costs based on who is getting what benefits.

And with respect to the in-franchise or utility customers, it's pretty clear, in terms of getting a handle on what the value of that storage is. It's providing specific services up to a certain quantity, and the value is -- for rate-making purposes is cost-based.

With respect to -- and again, here is the -- NGEIR, in my mind, clearly said that there is a certain amount that is being used for -- as a utility asset for utility customers. All of the rest is for the -- is the cost responsibility of the non-utility business.

So in terms of what you do with optimization revenue, optimization revenue should be -- I think the Board was pretty clear that the short-term margins or the net revenue

July 30, 2010

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4B 1E4

Dear Ms. Walli:

Re: EB-2010-0039 Union's 2009 Deferral Account and Earnings Sharing Disposition Settlement Agreement

Please find enclosed the comprehensive Settlement Agreement, agreed to by all parties to the Settlement Conference, for the above-noted proceeding.

Should you have any questions, please contact me at 519-436-5476.

Yours truly,

[Original signed by]

Chris Ripley
Manager, Regulatory Applications

c.c.: C. Smith, Torys
EB-2010-0039 Intervenors

Encl.

CR/la

EB-2010-0039

ONTARIO ENERGY BOARD

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 amending or varying the rate or rates charged to customers as of October 1, 2010.

SETTLEMENT AGREEMENT

July 30, 2010

This Settlement Agreement ("Agreement") is for the consideration of the Ontario Energy Board ("the Board") in its determination, under Docket No. EB-2010-0039, for an order of the Board amending or varying the rate or rates charged to customers as of October 1, 2010 in connection with the sharing of 2009 earnings under the incentive regulation mechanism approved by the Board as well as final disposition of 2009 year-end deferral account and other balances (the "Application"). Union is also seeking approval of a cost allocation methodology used to allocate costs between Union's regulated and unregulated storage operations. By Procedural Order No.1 dated June 1, 2010, the Board scheduled a Settlement Conference to commence July 26, 2010. The Settlement Conference was duly convened, in accordance with Procedural Order No. 1, with Mr. Kenneth Rosenberg as facilitator. The Settlement Conference proceeded until July 27, 2010.

The settlement presented in this Agreement is comprehensive in that the agreement that has been reached settles all issues in this proceeding.

The Agreement is supported by the evidence filed in the EB-2010-0039 proceeding.

The purpose of this proceeding was for:

(a) approval of final balances for all 2009 deferral accounts and an order for final disposition of those balances;

(b) approval of the market transformation incentive for 2009 and an order for final disposition of the balance;

(c) approval of the impact of federal and provincial tax changes in 2009 and an order for final disposition of the balance;

(d) approval of the customer portion of earnings sharing in 2009 and the proposed disposition of that amount; and,

(e) approval of Union's regulated and unregulated storage operations cost allocation methodology.

It is acknowledged and agreed that none of the provisions of this Agreement is severable. If the Board does not, prior to the commencement of the hearing of the evidence in EB-2010-0039, accept the Agreement in its entirety, there is no Agreement (unless the parties to the Agreement agree that any portion of the Agreement the Board does accept may continue as a valid agreement).

It is further acknowledged and agreed that parties to the Agreement will not withdraw from this Agreement under any circumstances except as provided under Rule 32.05 of the Board's Rules of Practice and Procedure.

The participants in the Settlement Conference agree that all positions, negotiations and discussion of any kind whatsoever which took place during the Settlement Conference and all documents exchanged during the conference which were prepared to facilitate settlement discussions are strictly confidential and without prejudice, and inadmissible unless relevant to the resolution of any ambiguity that subsequently arises with respect to the interpretation of any provision of this Agreement.

The role adopted by Board Staff in Settlement Conferences is set out on page 5 of the Board's Settlement Conference Guidelines. Although Board Staff is not a party to this Agreement, as noted in the Guidelines, "Board Staff who participate in the settlement conference are bound by the same confidentiality standards that apply to parties to the proceeding".

The evidence supporting the Agreement is set out in the Agreement. Abbreviations will be used when identifying exhibit references. For example, Exhibit B1, Tab 4, Schedule 1, Page 1 will be referred to as B1/T4/S1/p1. Attached as an Appendix is A/T1/Schedule 1 "Per Settlement" which is a schedule showing the final agreed upon deferral account balances and earnings sharing amount. The structure and presentation of the settled issues is consistent with settlement agreements which have been accepted by the Board in prior cases. The parties agree that this Agreement and any Appendices form part of the record in the proceeding.

In Procedural Order No. 1 in this proceeding, the Board granted intervenor status to all intervenors of record in EB-2010-0039. The following entities participated in the Settlement Conference:

Canadian Manufacturers & Exporters ("CME")

Consumers Council of Canada ("CCC")

City of Kitchener ("Kitchener")

Energy Probe Research Foundation ("Energy Probe")

Federation of Rental-housing Providers of Ontario ("FRPO")

Industrial Gas Users Association ("IGUA")

London Property Management Association ("LPMA")

Union Gas Limited ("Union")

Vulnerable Energy Consumers Coalition ("VECC")

The parties to this Agreement include all of the above noted entities (the "parties"). The parties to this Agreement represent major stakeholders and constituencies with an interest in Union's rates.

The parties to this settlement encourage the Board to accept this Agreement in its entirety. The parties to this Agreement also support finalization of the rate order in these proceedings to enable implementation of this Agreement in Union's October 1, 2010 QRAM.

1. Unabsorbed Demand Cost Variance Account (179-108)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B.01
3. JT1.10

2. Short-Term Storage and Other Balancing Services (179-70)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B1.01, B2.02, B5.02, B8.01, B9.02

3. Long-Term Peak Storage Services (179-72)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B1.02, B2.02, B4.02, B6.01, B7.02, B8.01, B9.02

4. Deferred Customer Rebates/Charges (179-26)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B4.03

5. Lost Revenue Adjustment Mechanism (179-75)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B3.03, B3.04, B8.01, B9.06, B9.11

6. Intra-Period Weighted Average Cost of Gas ("WACOG") Costs (179-102)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B4.04

7. Unbundled Services Unauthorized Storage Overrun (179-103)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1

8. Demand Side Management Variance Account (179-111)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B2.03, B5.03, B8.01, B8.02, B9.09, B9.10, B9.11
3. JT1.2

9. Gas Distribution Access Rule ("GDAR") Costs (179-112)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1

10. Late Payment Penalty ("LPP") Litigation (179-113)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B1.03, B1.04, B4.06, B5.07, B7.03, B8.01

11. Shared Savings Mechanism ("SSM") Variance Account (179-115)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B1.05, B3.05, B8.01, B9.06, B9.11

12. Carbon Dioxide Offset Credits (179-117)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1

13. Average Use Per Customer (179-118)

(Complete Settlement) Parties agree to Union's proposed disposition of this account.

Evidence References:

1. A/T1
2. B8.03

14. International Financial Reporting Standards ("IFRS") Conversion Costs (179-120)

The parties agree that, upon approval of this Agreement by the Board, Union will remove from the deferral account the capital costs associated with upgrading Union's accounting system in order to report results under IFRS. These capital costs will be replaced by the annual revenue requirement related to those capital costs, increasing the amount recovered between 2010 and 2014 to $1.747 million as illustrated in the table provided at JT1.11 (attached). For clarity, Union's 2009 deferral account balance will include $2.577 million of O&M. Union will include the revenue requirements noted on JT1.11 for years 2010 through to 2014 inclusive in the respective future deferral account disposition proceedings.

Further, the parties agree that, upon approval of this Agreement by the Board, Union will make an adjustment of $0.386 million to the deferral account to the credit of ratepayers. The adjustment is being made to reflect the difference between the inclusion of 2008 IFRS related costs of $0.965 million in Union's 2008 earnings sharing calculation (with the result that, at the margin, ratepayers absorbed 90% of this cost) and the credit for reversal of these costs included in the 2009 earnings sharing calculation (with the result that, without the agreed adjustment, ratepayers would have been credited with only 50% of this cost). The parties agree that the adjustment to Union's 2008 IFRS expenses is without prejudice to the method for calculating utility earnings for the purposes of earnings sharing as approved by the Board in the EB-2009-0101 settlement agreement.

Evidence References:

1. A/T1
2. B1.06, B8.01, B9.08
3. JT1.11

15. Cumulative Under-recovery – St. Clair Transmission Line (179-121) and Impact of Removing St. Clair Transmission Line from Rates (179-122)

The parties agree to defer determination of disposal of balances in deferral Account No. 179-121 and Account No. 179-122 until after November 1, 2010. November 1, 2010 is the deadline by which Dawn Gateway Limited Partnership ("Dawn Gateway") and its shippers will determine whether the Dawn Gateway Pipeline will proceed for in-service in November 2011.

The parties request that this matter come back on for hearing before the Board on a date or dates agreeable to the Board between November 29, 2010 and December 31, 2010. The parties further agree that in advance of that hearing Union shall be entitled to file further written evidence to address any changes in circumstances subsequent to the date of the Settlement Agreement and that parties have an opportunity to ask interrogatories in respect of that evidence and file responding evidence.

The agreement by the parties to defer any determination relating to the balances in Account No. 179-121 and Account No. 179-122 is without prejudice to the parties' positions with respect to the proper determinations concerning the accounts or the appropriateness of any relief requested in the proposed application.

In accordance with the terms of the settlement of this issue, Union has produced, in confidence and without prejudice to, its position pertaining to relevance and admissibility, the following documents:

(a) the Precedent Agreements between DGLP and its shippers filed confidentially in the EB-2008-0411 proceedings;

(b) communications including emails between DGLP and its shippers pertaining to amendments to the precedent agreements aforesaid;

(c) the Amended Precedent Agreements between DGLP and each of its shippers; and

(d) the Agreement of Purchase and Sale pertaining to the St. Clair Line between DGLP and Union.

Until a determination by the Board with respect to the balances in Accounts No. 179-121 and 179-122, Union will continue to track the ratepayer credit in deferral account 179-122 based on a sale date of March 1, 2010 as outlined by Union in response to CME interrogatories B3.14 and B3.31. Union will use the Board's methodology as outlined in its EB-2008-0411 Decision to calculate the ratepayer credit.

Evidence References:

1. A/T1
2. B1.07, B3.12, B3.13, B3.14, B3.15, B3.16, B3.17, B3.18, B3.19, B3.20, B3.21, B3.26, 3.28, B3.29, B3.30, B3.31, B3.33, B4.05
3. JT1.1, JT1.4

16. Market Transformation Incentive

(Complete Settlement)

Evidence References:

1. A/T1
2. B8.01, B9.03, B9.04, B9.05, B9.06, B9.07

17. Federal and Provincial Tax Changes

(Complete Settlement)

Evidence References:

1. A/T1
2. B8.01

18. 2009 Earnings Sharing

The parties agree that, upon approval of this Agreement by the Board, Union will credit ratepayers in the amount of $0.334 million, in addition to the $7.063 million credit reflected at A/T2/Appendix B/S1 (Corrected), which additional credit represents the adjustment to 2008 utility earnings sharing that would have resulted if Union had calculated the future income tax expense in respect of its OEB approved deferral accounts for 2008. The $0.334 million arises as a result of differences between 2008 and 2009 tax rates applicable to deferral accounts. This adjustment is consistent with Union's tax treatment of its deferral accounts in 2009, as outlined at A/T2/p9.

Evidence References:

1. A/T2
2. B1.08, B1.09, B1.10, B1.11, B5.05, B5.06, B6.02, B6.03, B6.04, B7.04, B7.05, B7.06, B7.07 B7.12, B8.04, B8.06
3. JT1.9

19. Allocation and Disposition of 2009 Deferral Account Balances, Market Transformation Incentive, and 2009 Federal & Provincial Tax Changes

(Complete Settlement) Parties agree to Union's proposed allocations.

Evidence References:

1. A/T3
2. B2.01, B7.01, B7.08, B8.07, B8.08, 9.12
3. JT1.3

20. Allocation of Costs Between Union's Regulated and Unregulated Storage Operations

The parties agree that, upon approval of this Agreement by the Board, Union will commission an independent study ("the Study") of its cost allocation methodology for allocation of costs between its regulated and unregulated storage operations. The Study will also examine the attribution of revenues to deferral accounts 179-70 and 179-72 and provide a volumetric reconciliation between physical space and space sold "short term" and "long term". Union will solicit a person, group or organization to conduct the study ("Study Staff") by way of a request for proposals ("RFP"). Union will provide an opportunity to the other parties to comment on a draft version of the RFP and to suggest changes. Final drafting of the RFP and selection of Study Staff will be at the sole discretion of Union.

Union will take steps to ensure that, at or near the outset of the Study, the other parties will be provided an opportunity to present Study Staff with their concerns, questions, and/or opinions on the subject matters of the Study.

The Study will be filed by Union in connection with its application to dispose of 2010 deferral account balances with sufficient time to permit full discovery and review of the Study as part of the application.

Any changes that Study Staff may recommend to Union's cost allocation methodology will not be implemented until after receiving approval from the Board. Any findings or recommendations made by Study Staff will be adopted, if at all, on a prospective basis, and will have no impact on balances disposed of prior to 2010.

This Agreement is without prejudice to any party's right to disagree with, or challenge any of the findings of Study Staff.

Evidence References:

1. A/T4
2. B1.13, B1.14, B1.15, B1.16, B1.17, B1.18, B1.19, B2.05, B2.06, B3.34, B3.35, B3.37, B3.38, B3.39, B3.40, B3.41, B3.42, B4.07, B4.08, B4.09, B4.10, B4.11, B4.12, B4.13, B4.14, B4.15, B4.16, B4.17, B4.18, B5.08, B5.09, B5.10, B6.05, B6.06, B6.07, B6.08, B7.09, B7.10, B7.11, B7.13, B7.14, B8.09, B9.14
3. JT1.5, JT1.6, JT1.7, JT1.8, JT1.12

Filed: 2010-06-25
EB-2010-0039
Exhibit A
Tab 1
Schedule 1
Per Settlement

UNION GAS LIMITED

Deferral Account Balances, Market Transformation Incentive and Federal and Provincial Tax Changes

Year Ending December 31, 2009

Line No.	Account Number	Account Name	Balance ($000's)	(1)
	Gas Supply Accounts:			
1	179-108	Unabsorbed Demand Costs Variance Account	(1,285)	(2)
	Storage Accounts:			
2	179-70	Short-Term Storage and Other Balancing Services	(4,949)	
3	179-72	Long-Term Peak Storage Services	(14,787)	
4	Total Storage Accounts (Lines 2 + 3)		(19,736)	
	Other:			
5	179-26	Deferred Customer Rebates/Charges	-	
6	179-75	Lost Revenue Adjustment Mechanism	2,394	
7	179-102	Intra-period WACOG Changes	(7,615)	
8	179-103	Unbundled Services Unauthorized Storage Overrun	-	
9	179-111	Demand Side Management Variance Account	1,468	
10	179-112	Gas Distribution Access Rule (GDAR) Costs	-	
11	179-113	Late Payment Penalty Litigation	5,651	
	179-115	Shared Savings Mechanism	8,922	
.	179-117	Carbon Dioxide Offset Credits	-	
14	179-118	Average Use Per Customer	(2,144)	
15	179-120	IFRS Conversion Cost	2,191	
16	179-121	Cumulative Under-recovery – St. Clair Transmission Line	-	
17	Total Other Accounts (Lines 5 through 16)		10,866	
18	Total Deferral Account Balances (Lines 1 + 4 + 17)		(10,155)	
19		Market Transformation Incentive	500	
20		Federal and Provincial Tax Changes	(1,500)	
21	**Total Deferral Account Balances, Market Transformation Incentive and Federal and Provincial Tax Changes (Lines 18 + 19 + 20)**		(11,154)	
22	**Earnings Sharing per Settlement Agreement**		(7,397)	

Notes:
(1) Account balances include interest to December 31, 2009.

(2) With the exception of UDC (No. 179-108), all gas supply-related deferral account balances are disposed through the QRAM process.

UNION GAS LIMITED

Undertaking of Union Gas
To Board Staff

Please provide a table that excludes capital expenditures, but includes any other expenditures, like depreciation.

Union has proposed recovery of $1.412 million of the capital costs related to upgrading Union's accounting system in order to report results under IFRS.

Removing the capital costs from the deferral account as proposed and replacing them with the annual revenue requirement related to the capital cost will increase the amount to be recovered over time to $1.747 million as illustrated in the table below. The increase in costs to be recovered relates to the interest, return and income taxes.

Impact of the Removal of Capital Costs

	2008	2009	2010	2011	2012	2013	2014	Total
Proposed by Union	1.918	2.071						3.989
Less capital expenditures	0.953	0.459						1.412
O&M	0.965	1.612						2.577
Revenue requirement	-	-	0.124	0.335	0.538	0.505	0.244	1.747
	0.965	1.612	0.124	0.335	0.538	0.505	0.244	4.324

Tab 8

Information related to unregulated storage that will be filed in 2013 rate case filing

Operating revenues

Long-term storage revenue	No	100% non-utility	
Short-term storage revenue	Yes	Allocated	Revenues on space in excess of 100 PJ's over in-franchise requirements
Other balancing services	Yes	Allocated	

Operating costs

Cost of gas			
Unaccounted for gas	Yes	Allocated	Volumetric allocation
Compressor fuel	Yes	Allocated	Volumetric allocation
Customer supplied fuel	Yes		Based on short term storage activity
O&M	Yes	Allocated	Allocations based on plant, level of effort
Depreciation	No		Relates directly to non-utility plant
Property taxes	Yes		Allocated based on plant

Capital & Plant

Capital expenditure- replacement	Yes	Allocated	In proportion to base assets
Capital expenditure- new storage	No		Relates directly to non-utility investment
Plant continuity	No		Relates directly to non-utility plant

Interest	No		Filing will be utility rate base only
Return	No		
Income taxes	No		