

**Ontario Energy Board**

**EB-2011-0038**

**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.

**WRITTEN SUBMISSIONS OF THE CITY OF KITCHENER**

**Introduction**

*Union's Application and Summary of Kitchener's Submission*

1. By its Application to the Ontario Energy Board ("Board") dated April 18, 2011, Union Gas Limited ("Union") seeks the following approvals:
  - a) approval of final balances for all 2010 deferral accounts and an order for final disposition of those balances;
  - b) approval of the market transformation incentive for 2010 and an order for final disposition of the balance;
  - c) approval of the impact of federal and provincial tax changes in 2009 and 2010 and an order for final disposition of the balances;
  - d) approval of \$3.433 million as the customer portion of earnings sharing in 2010 and the proposed disposition of that amount to Union's customers; and,
  - e) approval of its regulated and unregulated cost allocation methodology.
2. The City of Kitchener ("Kitchener"), an active intervenor in this proceeding, makes no submissions regarding the approvals sought by Union under point a) in paragraph 1 above, with the exception of deferral account numbers 179-70 and 179-72. Kitchener's submissions in respect of those two deferral accounts follow below in paragraphs 7 to 22. In

summary, Kitchener respectfully submits that Union has erroneously applied deemed return calculations to storage margin sharing which were unintended by the Board and were specifically not approved. Kitchener also submits that the net benefits of resource optimization transactions, even under longer-term transactions, should continue to be shared in some equitable fashion with ratepayers, if the integration of storage pools truly provides the optimization mechanism.

3. Kitchener makes no submissions regarding the approvals sought by Union under points b) and c) in paragraph 1 above.
4. Kitchener has no objection to the approval sought by Union under point d) in paragraph 1 above.
5. Kitchener's submissions regarding the approval sought by Union under point e) in paragraph 1 above follow below in paragraphs 23 to 40. In summary, Kitchener respectfully submits that the Board should not approve Union's regulated and unregulated cost allocation methodology until a full review of its allocation methodology is completed in Union's pending rebasing application.

#### *Kitchener's Collaboration with Other Intervenors*

6. In its active intervention in this proceeding, Kitchener has collaborated with other intervenors, in particular, CME and FRPO. Kitchener was a joint sponsor of the evidence of John Rosenkranz, filed as Exhibit K2.4. Kitchener has also collaborated with CME and FRPO on the preparation of argument to minimize duplication. Kitchener supports the submissions of CME and FRPO<sup>1</sup> and hopes its submissions which follow will assist the Board from a slightly different focus and perspective.

#### **Deferral Accounts 179-70 and 179-72**

##### *Accounting Order / Accounting Principles – Deemed Returns*

7. Union's short-term and long-term storage deferral accounts were established by Accounting Order of the Board (Tr Volume 1, page 152, lines 18 to 21). Kitchener has tried to obtain a copy of the legacy Accounting Order that established storage deferral accounts 179-70 and 179-72 to append to its argument, but was unable to do so prior to the filing deadline. Nothing necessarily turns on the Accounting Order, other than to remind all parties what it specifically authorized Union to record in

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<sup>1</sup> Kitchener has also had an opportunity to review the storage deferral account submissions of Mr. Aiken on behalf of LPMA and supports them.

- each deferral account and what, if anything can be inferred about any accounting convention or standard of care expected of Union. However, Kitchener has included at Appendix A an extract from Appendix "F" (Accounting Order) to the EB-2010-0148 Rate Order for Union. It identifies and describes the accounting entries for storage deferral accounts 179-70 and 179-72.
8. Union makes a net entry to the storage deferral accounts on a monthly basis (Tr Volume 1, page 153, lines 9 to 13). The monthly entry reflects deemed cost calculations for interest, return and income taxes that are not accounting entries based on debits and credits (Technical Conference Tr page 77, lines 10 to 24).
  9. For deferral account 179-72, the net monthly entry includes an amount deemed by Union as a notional return on equity capital which is in addition to charges paid to third party storage providers under long term contracts (Exhibit B3.15). The notional return on equity capital deemed by Union on purchased storage is \$ 6.63 million for 2010 (Exhibit B3.15). Three of the five purchased storage contracts are with parties that are related to Union, while the other two contracts are with unrelated parties (Exhibit B3.15 and Tr Volume 1, pg 132, lines 15 to 18).
  10. The deemed inclusion by Union of a notional return on equity capital on a purchased storage service is not supported by provision in the CICA Handbook (Technical Conference Tr, page 77, lines 6 to 19), yet Union does not believe it violates any generally accepted accounting principles (Tr Volume 1, page 157, line 26 to page 158, line 14, inclusive).
  11. Union defends the inclusion in its deferral accounting of a deemed return on equity capital on storage services purchased under long term contracts as a commitment of shareholder resources that is equivalent to the actual building of incremental storage assets (Union Oral Argument Page 18, lines 18 to 28).
  12. This "buy or build" argument by Union is flatly absurd, particularly for the purchased storage contracts from unrelated parties. No shareholder or other capital (except presumably for working capital in the normal course of operations) has been committed by Union to fund these purchased storage services. In fact and as a wholly practical matter, one of the core benefits of buying an asset-based service under long-term contract from a third party that otherwise would require a considerable outlay of capital by the purchaser to build the same asset-based service is that the capital outlay is avoided.

13. Since no shareholder capital is deployed to access these asset-based services, there is no principled accounting basis to deem any equity capital return as a cost of the purchased storage services, let alone a deemed return with a risk premium attached to it as Union has done. As Mr. Aiken fairly and accurately put it to the Union witness panel, this treatment arises from “phantom assets” (Tr Volume 1, pg 129, lines 10 to 20).
14. Moreover, rather than “buy or build” storage to serve long-term markets, Union, in fact, wants it both ways in its accounting under deferral account 179-72. Union includes the cost of purchasing storage services from third parties (“buy”) and it adds a deemed return on equity capital (“build”) to record the margin on a net basis in the account. This treatment, in our view, is “double dipping” and grossly in error at a fundamental level.
15. For those storage services that are purchased from parties that are not fully at arms length, Union’s accounting of costs under deferral account 179-72 is clearly “double dipping” in our respectful submission from a ratepayer view on margin sharing. Once, for the equity return earned by related parties, including Union, that is surely embedded in the contract cost of the purchased storage service. And, twice, for the deemed return on equity capital that is notionally added as a cost of the purchased storage, but which is not actually incurred by Union.
16. Kitchener will not repeat the arguments of other parties who challenge the post-tax equity hurdle rate of 14.4% used by Union in its calculations for the sharing of margins in storage deferral accounts. Suffice it to say that, in its net entries to storage deferral accounts, Union has erroneously applied deemed return calculations to margin sharing which Kitchener respectfully submits were unintended by the Board and were specifically not approved.
17. The net effect of these erroneous storage deferral account calculations by Union is detrimental to ratepayers. As illustrated by LPMA in its argument, Kitchener supports the use of Exhibit J1.4 by the Board to adjust the margins to be shared with ratepayers and correct the errors arising from the returns deemed by Union.

#### *Resource Optimization*

18. As revealed in evidence in this proceeding, Union derives significant net revenues in the long-term ex-franchise storage market from resource optimization transactions (Exhibits B3.53 and K2.2). These net revenues arise from Union operating its storage pools on an integrated basis [Tr Volume 1, page 150, line 26 to page 151, line 4), by taking advantage of

- contract and load diversity across in-franchise and ex-franchise markets. Resource optimization is largely a post-NGEIR phenomenon (Exhibit B3.61).
19. Resource optimization is attributed by Union to the 179-72 deferral account where, under the NGEIR Decision, any sharing of net storage margins with ratepayers ceases after 2010.
  20. To the extent that resource optimization exists due to the integrated nature of Union's storage pools (in-franchise and ex-franchise), then the accounting separation of regulated and unregulated storage businesses under NGEIR should not be interpreted by Union to contractually (under longer-term arrangements) or otherwise sever in-franchise ratepayers from the operational benefits of integration for the sole financial benefit of Union in subsequent years.
  21. Kitchener respectfully submits that the net benefits of resource optimization transactions, even under longer-term transactions, should continue to be shared in some equitable fashion with ratepayers, if the integration of storage pools truly provides the optimization mechanism. In other words, the physical and operational integration of the storage pools should provide an enduring benefit for ratepayers (as it does for Union) rather than a transitory one under the NGEIR accounting separation model.
  22. Benefits from resource optimization could be equitably shared with ratepayers on a going forward basis in one or more ways. Prior to rebasing, perhaps a formulaic pro rata approach based on the underlying storage space available for optimization transactions could be used. At the time of rebasing, when a full examination can be made of regulated and unregulated storage operations and the allocation of costs (as further submitted below in paragraphs 38 to 40) then a more robust approach may be developed. Whether an interim or final approach is adopted, the key outcome is to achieve equity from a rate-making perspective, consistent with the underlying assumption that the integration of Union's storage pools provides the means to optimize.

### **Allocation Methodology**

23. As noted above in paragraph 1, Union has applied to the Board for approval of its regulated and unregulated cost allocation methodology. Kitchener's submissions on this aspect of Union's application follow below.

#### *Black & Veatch Study*

24. The Settlement Agreement in EB-2010-0039 provided for the commissioning by Union of an independent study of its cost allocation methodology for the allocation of costs between its regulated and unregulated storage operations. The study would 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 (Paragraph 20 of EB-2010-0039 Settlement Agreement).
25. Union retained Black & Veatch ("B & V") to conduct the study of its cost allocation methodology. The B & V Final Report was filed as Attachment A to Exhibit A, Tab 4 of Union's evidence and Mr. Feingold of B & V appeared in a panel alongside Union witnesses to speak to it.
26. The study was undertaken to address the concerns of some intervenors, including Kitchener, that the allocation of costs by Union for storage deferral accounts and margin sharing, i.e. for rate-making purposes, was not well understood and lacked transparency. Moreover, a significant level of controversy had arisen alongside an evolving level of understanding in the EB-2010-0039 proceedings for some cost components, in particular, the post-tax hurdle rate (as it has come to be defined in the instant proceeding).
27. Paragraph 20 of the Settlement Agreement in EB-2010-0039 also provided that "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." Based on this provision, Kitchener held the reasonable expectation that issues of controversy, including the post-tax hurdle rate, would be squarely within the realm of the study and addressed by B & V as independent study staff.
28. In some respects, Kitchener can commend the work done by B & V and the documentation of Union's allocation methodology that is embedded in its Final Report. However, a key concern of Kitchener and other parties which was communicated to B & V at the outset of its study at a meeting in December 2010 (Exhibit A, Tab 4, page 2, lines 5 to 9) was notably absent in its Final Report. This unaddressed concern was the post-tax hurdle rate. The Board will be aware that this particular matter has attracted significant attention and generated vibrant submissions from parties other than Kitchener.
29. The fact that B & V did not address the post-tax hurdle rate in its Final Report, despite its identification as an issue of concern to intervenors for

Union's cost allocation methodology, brought into question the degree of independence exercised in its study. The somewhat limited nature of the recommendations put forward by B & V (discussed further below) and its overall finding that was fully in support of Union's cost allocation methodology also gave Kitchener and others some pause as to the independence exercised by B & V. These questions contributed to the retention of Mr. Rosenkranz by Kitchener, alongside CME and FRPO, to assist with discovery and to examine the reasonableness of Union's cost allocation methodology and review Union's calculation of margins for the storage deferral accounts.

30. B & V recommend several "near-term enhancements to Union's computational process and evidentiary presentation" (Exhibit A, Tab 4, Attachment A, Section 1, pages 5 and 6). Union indicated its willing adoption of these recommendations (Exhibit A, Tab 4, page 4, lines 1 to 3) although Kitchener notes that Union's response to the first two B & V recommendations dealing with transparency ("more robust documentation" and "development of all supporting calculations on a step-by-step basis") is limited.
31. The qualification by B & V of these enhancements to Union's computational process and evidentiary presentation as "near-term" is suggestive to Kitchener that longer-term enhancements are also possible. Kitchener is supportive of that possibility and, indeed, will argue below that Union's current cost allocation methodology for the allocation of costs between its regulated and unregulated storage operations should emphatically not be static and approved "as is".
32. Kitchener respectfully submits that the recommendations of B & V in its Final Report are supportive of a finding by the Board that Union's cost allocation methodology continues to struggle with a lack of transparency. While Union's efforts to improve upon transparency are commendable, they don't yet go far enough. This statement is likely to be self-evident simply from the complex record in this proceeding.

#### *Rosenkranz Evidence and Recommendations*

33. As noted above in paragraph 28, Mr. Rosenkranz of North Side Energy, LLC was jointly retained by CME, FRPO and Kitchener in this proceeding to assist with discovery (Tr Volume 2, page 108, lines 13 to 16) and as set out in his intervenor evidence on our behalf (Exhibit K2.4, page 1).
34. During the oral hearing, counsel for Union tried unsuccessfully to block the admission of Mr. Rosenkranz's evidence on the grounds that it could

not be properly qualified as expert evidence on the subject matter. Curiously, this procedural effort came *after* Union had filed its Reply Evidence (Exhibit K1.9) in response to Mr. Rosenkranz's evidence. The Board accepted the admission of the intervenor evidence. Kitchener appreciates the discretion which the Board exercised to admit it and is heartened by the Board's view that it has found the evidence to be helpful (Tr Volume 2, page 111, lines 17 to 20).

35. Mr. Rosenkranz made several principal findings and recommendations as a result of his review of Union's cost allocation methodology and storage margin sharing calculations. Four of the findings relate to the allocation of costs to Union's non-utility storage operation and three of the findings relate to the margin calculations (summarized at Exhibit K2.4, page 1). Kitchener supports these recommendations, with some qualification around resource optimization and capital allocators, and respectfully submits that the Board adopts them in its findings in this proceeding.

#### *NGEIR Decision and Rebasing*

36. The NGEIR Decision was issued in December 2006 and, among other things, granted forbearance from the regulation of rates for storage in the ex-franchise market. The NGEIR Decision enabled Union to continue to operate its storage pools on a fully integrated basis while providing for an accounting separation of regulated and unregulated storage operations.
37. Three structural models were available to the Board in its deliberations of storage rate forbearance under NGEIR – accounting separation, functional separation and divestiture. Accounting separation was chosen by the Board. As with all of the available structural models, various trade-offs were involved.
38. While there are things to commend its use, in Kitchener's respectful but hopefully informed view, accounting separation is the least transparent of the three structural models with the greatest risk of inappropriate cross-subsidies. The risk of cross-subsidies arises and endures due to the integrated nature of the storage pools and the financial incentives to Union under NGEIR. This continues to be a threshold concern to Kitchener and, respectfully, is why it believes so strongly in complete and unambiguous transparency of the allocation of costs between Union's regulated and unregulated storage operations.
39. Kitchener submits that the NGEIR Decision contemplated a different allocation of costs by Union over time as storage assets were added and



the market for storage evolved. The following extract from NGEIR at page 102 is instructive:

"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" [emphasis added].

40. In our respectful view, this finding in NGEIR is persuasive in and of itself that a static cost allocation methodology should *not* be approved for all time. Kitchener submits that a full examination of the allocation methodology is required and that Union's pending rebasing application is the proper venue for such a review. The Board should not approve Union's regulated and unregulated cost allocation methodology until, at a minimum, that full review is completed.

All of which is respectfully submitted.

**The Corporation of the City of Kitchener**

James A. Gruenbauer, CMA

Manager, Regulatory Affairs and Supply

Per:

A handwritten signature in black ink, appearing to read 'J. Gruenbauer', is written over a faint, circular official stamp.

## Appendix A – Union Gas EB-2010-0148 Rate Order Appendix "F" Extract

**UNION GAS LIMITED****Accounting Entries for  
Short-term Storage and Other Balancing Services  
Deferral Account No. 179-70**

Account numbers are from the Uniform System of Accounts for Gas Utilities, Class A prescribed under the Ontario Energy Board Act.

Debit	-	Account No. 570 Storage and Transportation Revenue
Credit	-	Account No. 179-70 Other Deferred Charges - Short-term Storage and Other Balancing Services

To record, as a debit (credit) in Deferral Account No. 179-70 the difference between actual net revenues for Short-term Storage and Other Balancing Services including; C1 Off-Peak Storage, Gas Loans, Consumers' LBA, Supplemental Balancing Services, C1 Firm Peak Storage, C1 Firm Short-term deliverability and M12 Interruptible deliverability and the net revenue forecast for these services as approved by the Board for ratemaking purposes.

Debit	-	Account No. 179-70 Other Deferred Charges - Short-term Storage and Other Balancing Services
Credit	-	Account No. 323 Other Interest Expense

To record, as a debit (credit) in Deferral Account No. 179-70, interest on the balance in Deferral Account No. 179-70. Simple interest will be computed monthly upon finalization of the year end balance in the said account in accordance with the methodology approved by the Board in EB-2006-0117.

**UNION GAS LIMITED****Accounting Entries for  
Long-Term Peak Storage Services  
Deferral Account No. 179-72**

Account numbers are from the Uniform System of Accounts for Gas Utilities, Class A prescribed under the Ontario Energy Board Act.

Debit	-	Account No. 570 Storage and Transportation Revenue
Credit	-	Account No. 179-72 Other Deferred Charges - Long-Term Peak Storage Services

To record, as a credit (debit) in Deferral Account No. 179-72, the difference between actual net revenues for Long-Term Peak Storage Services including C1 Firm Peak Storage and the net revenues forecast for these services as approved by the Board for rate making purposes.

Debit	-	Account No. 179-72 Other Deferred Charges - Long-Term Peak Storage Services
Credit	-	Account No. 323 Other Interest Expense

To record, as a debit (credit) in Deferral Account No. 179-72 interest on the balance in Deferral Account No. 179-72. Simple interest will be computed monthly upon finalization of the year end balance in the said account in accordance with the methodology approved by the Board in EB-2006-0117.