ONTARIO ENERGY BOARD

BOARD STAFF SUBMISSION

Union Gas Limited

2013 Rates Application

Board File No. EB-2011-0210

August 17, 2012

Introduction

Union Gas Limited ("Union" or the "Applicant") filed an application on November 10, 2011 with the Ontario Energy Board (the "Board") under section 36 of the *Ontario Energy Board Act, 1998* for an order of the Board approving or fixing rates for the distribution, transmission and storage of natural gas, effective January 1, 2013 (the "Application"). The Board assigned file number EB-2011-0210 to the Application and issued a Notice of Application on December 1, 2011. The Application was filed on the basis of US General Accepted Accounting Principles ("USGAAP").

The Board issued its Procedural Order No. 1 on January 11, 2012, which established the approved list of Intervenors for this proceeding. In addition, Procedural Order No.1 recognized the need for the Board's determination on Union's request for the adoption of USGAAP for regulatory purposes (the "Preliminary Issue") in accordance with the Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment (the "Addendum Report").

In Procedural Order No. 1 the Board established a timeline for interrogatories, interrogatory responses, submissions, and reply submissions related to the Preliminary Issue in advance of further procedural steps. In addition, the Board adopted the evidence related to the USGAAP issue from Union's 2012 IRM Proceeding EB-2011- 0025 (the "Adopted Evidence").

Submissions were received from the London Property Management Association ("LPMA"), Consumers Council of Canada ("CCC"), School Energy Coalition ("SEC"), Canadian Manufacturers and Exporters ("CME"), Association of Power Producers of Ontario ("APPrO") and Board staff. LPMA, CCC, SEC and Board staff supported the request by Union for the adoption of USGAAP for regulatory purposes. CME and APPrO were also supportive of Union's request but provided some proposed conditions of approval.

The Board issued its Decision on the Preliminary Issue and Procedural Order No. 2 on March 1, 2012. The Board granted Union approval to use USGAAP for regulatory purposes.

In Procedural Order No. 4 dated March 26, 2012, the Board scheduled a Settlement Conference to commence June 6, 2012. The Settlement Conference was duly convened on June 6, 2012 and adjourned on June 18, 2012 with Mr. Chris Haussmann as facilitator.

In broad terms, the parties reached an agreement with respect to rate base and cost of service for the test year, being the issues under headings Exhibit B – Rate Base and Exhibit D – Cost of Service, respectively, with the exception of matters pertaining to Gas Supply Planning (Issue 3.14) and the capital expenditures relating to Parkway West (Issue 1.1). The parties also reached agreement on several other issues, each of which were separately identified as settled in the Settlement Agreement.

Issues that remain unresolved include issues under heading Exhibit C - Operating Revenues, the Common Equity issue under heading Exhibit E - Cost of Capital, Exhibit G - Cost Allocation, Exhibit H - Rate Design and Exhibit DV – Deferral & Variance Accounts. The updated revenue deficiency as a result of the Settlement Agreement is $54.524 million.

An Oral Hearing was held from July 10, 2012 to July 30, 2012. The submissions below reflect observations and concerns of Board staff on issues that remain unsettled and which require a decision by the Board. Board staff have addressed the following issues in the submission:

- Demand Forecast
- Operating
- Cost of Capital
- Gas Supply and Ex Franchise Revenue
- Cost Allocation and Rate Design
- Parkway West

The submission is intended to assist the Board in evaluating Union's application and in setting just and reasonable rates.

OPERATING REVENUE

Weather Methodology and Normalized Average Consumption

Union's demand forecasting methodology is based on a multiple regression analysis within the general service market. Union has proposed to use a 20-year declining trend to derive the total Heating Degree Days estimates for 2012 and 2013. The Heating Degree Days is a significant variable that is used to derive the Normalized Average Consumption ("NAC") forecast. Forecast estimates for NAC are prepared for the residential customers by individual rate class. The NAC consumption forecast for residential and commercial customers incorporates assumptions related to several demand variables: weather normal, energy efficiency, total bill amounts, fall season weather and structural trend variables.

At the oral hearing, Union submitted that its use of a 20-year declining trend was the most appropriate and superior to other methodologies[1], especially as compared to the 30-year declining trend and the current Board approved methodology which is a hybrid using a 55/45 weight of the 30-year and 20-year declining trend. However, Union confirmed that it did not investigate any other methodologies including those that have been examined by Enbridge[2]. Union has indicated that the root mean square error of the current regression model proves that it is an accurate model and the trend line shows that the 20-year trend intersects the middle of the data demonstrating better symmetry as compared to the 30-year trend or the hybrid approach. In its Argument-in-Chief Union indicated that on a weather normalized basis, it is forecasting an increase of about 0.7% in throughput volume relative to 2007 Board approved levels.[3]

<u>Normalized Average Consumption ("NAC")</u>

Board staff have used the Rate M2 NAC data presented in Exhibit J1.4 and compared it to the forecast for 2011 and 2012 that has been derived using the 20-year trend. Union itself did not produce a trend line for NAC; it produces its forecast with a regression model using the variables described above. The year over year percentage NAC changes have been presented graphically below:

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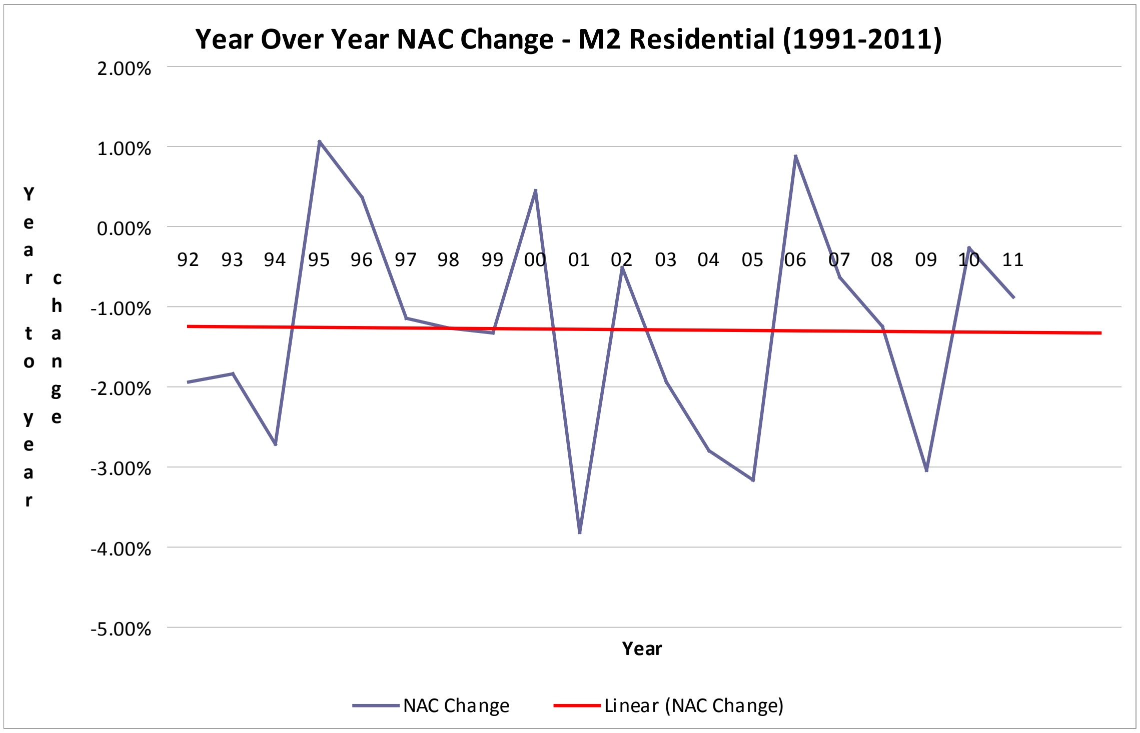
[1] Oral Hearing Transcript, EB-2011-0210, Vol. 1 at p.33.
[2] Oral Hearing Transcript, EB-2011-0210, Vol. 1 at p.32.
[3] Union Argument-in-Chief, EB-2011-0210, Vol. 13 at p.12.



As can be noted from the above graph, the trend line does not show a significant downward sloping curve. The trend line has been forecasted into 2012 and 2013 and does not show a pronounced decrease in 2012 and 2013 but is within the range of a 1.5% annual decline. However, Union has forecasted a 5.1% reduction from 2011 to 2013. In other words, the 20-year declining trend as proposed by Union may be yielding a pronounced downward sloping curve resulting in a much lower NAC even though it may be cutting through the middle of the data indicating better symmetry. On the other hand, Union has claimed that the 30 year trend has a bias towards over-forecasting HDD as it does not capture the general change in weather that has occurred in the recent past.

Board staff submit that Union's use of a 20-year declining trend may lead to under-forecasting HDD and consequently throughput. This is supported by the comparison of the total NACs from 2007 to 2011 and forecasts for 2012 and 2013 as presented in J.C-1-1-2. Union's total NAC as noted in J.C-1-1-2 has declined from 3,975 m^3 in 2007 to 3,830 m^3 in 2011, a drop of 145 m^3 or 3.7% over a four year period. At the same time, the forecasted NAC for 2013 is 3,610 m^3 or a decline of 5.7% over 2011 actuals.

The actual NAC for the total commercial market when compared to the forecast for 2011 shows a variance of 5.7% as noted in J.C-1-2-4. In other words, the commercial market was under-forecasted by 5.7%. In response to an interrogatory (J.C-1-1-2), Union has indicated that the residual error is 5.8% which refers to the error that cannot be explained by the regression model. Board staff submit that this is a large residual error for a regression model.

In the general service or old M2 residential rate, the difference between actual and forecasted NAC for 2011 is 37 cubic meters. At the oral hearing, Union submitted that the 1.7% error is within the two percent forecast accuracy and of this only 1% or 22 cubic meters is the unexplained error.[4] This 1% error in NAC translates to approximately $3.5 million in revenues for the M1 rate class.[5].So although the 1% error seems inconsequential and considered within an acceptable range by Union when discussing forecast accuracy or the NAC estimate, the revenues underpinning that error are significant. Indeed, if this residual error is removed, then the annual reduction in NAC is about 1.5%, which is very similar to the trend line produced in the graph showing year over year NAC changes..

In Union's 2004 rates case (RP-2003-0063), Union's weather evidence discussed seven methodologies. However, in the current rates case Union has presented only one methodology, the 20-year declining trend. In other words, Union has not discussed other methodologies such as the ARIMA[6], de Bever trend[7], moving averages, etc. Board staff submit that since Union has not discussed alternative methodologies, the Board does not have sufficient information or the confidence that the 20-year declining trend is the most accurate and appropriate methodology. In fact, Board staff would argue that based on arguments presented earlier, the 20-year declining trend has a bias towards under-forecasting as evident from the NAC comparison. In its Argument-in-Chief, Union has submitted that intervenors have not

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[4] Oral Hearing Transcript, EB-2011-0210, Vol. 2 at p.128.
[5] Oral Hearing Transcript, EB-2011-0210, Vol 2 at p.137.
[6] ARIMA (Auto Regressive Integrated Moving Average model) is a broad class of time-series models that, when stationarity has been achieved by differencing follows an ARIMA model. An ARIMA model is a type of time-series forecasting model that can be autoregressive, moving average, or a combination of the two. In an ARIMA model, the series to be forecast is expressed as a function of previous values of the series (autoregressive terms) and previous error terms (the moving average terms).
[7] The de Bever method is a regression model that features a long-term and short-term component. The former takes the form of a constant, while the latter is accomplished via a five-year weighted average of degree days. The model is estimated over a period equal to the estimated periodicity of the weather cycle.

presented any competing analysis or a better forecasting methodology. However, this does not lead to the automatic conclusion that a methodology that may have a bias towards under-forecasting, and has not been compared with a variety of other potential methodologies, should be adopted by the Board.

In addition, Union has not performed some of the tests that would further validate its regression model. This includes testing for heteroskedasticity.[8] The presence of heteroskedasticity can invalidate statistical tests of significance that assume that the modelling errors are uncorrelated and normally distributed and that their variances do not vary with the effects being modelled. In addition, the standard errors are biased when heteroskedasticity is present. When heteroskedasticity is present, the ordinary least squares estimation will underestimate the standard errors, making the t-statistics larger than they should be. So although the model may seem accurate with low errors, the reason could be the presence of heteroskedasticity. The Union Gas Forecast Analysis performed by R.J.Rudden in 2004 and submitted as Exhibit C1, Tab1, Appendix C did refer to the issue of heteroskedasticity. Although the report did not raise it as a major concern it did recommend testing for heteroskedasticity. The report also noted that the goal of statistical perfection must come second to accuracy projections in a short-term forecasting environment.[9]

Considering the lack of sufficient information on alternative methodologies and the fact that Union's proposed model is yielding far lower NACs for the forecasted years as compared to the average decline over the past 21 years,[10] Board staff submit that the Board should approve a weather methodology that gives equal weight (50/50) to the 20-year and 30-year declining trend. This is in line with what the Board contemplated in its Decision in RP-2003-0063. Board staff further submit that if Union prefers the 20-year declining trend then it should bring forward more than one methodology in the next cost of service proceeding to better inform the Board and provide a sufficient basis for selecting a particular forecasting methodology. Board staff note that Union should also consider adopting different methodologies for its different regions (for example: North and South) considering that the demand variables could show varying impacts within the different regions.

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[8] Heteroskedasticity occurs when the standard deviations of a variable monitored over a specific amount of time, are not constant.
[9] Union Gas Forecast Analysis, R.J. Rudden Associates, December 16, 2004 (Exh C1/T1/App C)

In the contract market where Union uses a "bottom-up" approach to forecast throughput, Board staff takes no position on the forecast presented by Union.

In-Franchise Revenue

<u>Red Lake Project</u>

Union has added gas distribution service to the community of Red Lake in Ontario. This is part of a larger project that is providing gas service to a goldmine in Red Lake. Union has included the capital costs associated with the Red Lake project in its rate base for 2013 and this includes system costs to provide service to the community of Red Lake. However, Union has confirmed in response to an interrogatory (J.B-1-1-5) that its conversion forecast does not include customer attachments in Red Lake. In other words, although the costs of the project are included, the revenues have not been accounted for in the current Application.

At the oral hearing, Union confirmed that it expects to add approximately 800 customers in the community of Red Lake by 2013. Union also confirmed that its conversion forecast has been understated by 800 for 2013 as it does not include Red Lake conversions.[11] Board staff submit that as a matter of principle Union should include conversions related to Red Lake in its Application including the distribution revenues that are attributed to these attachments.

<u>Authorized Overrun Revenue</u>

Union has not forecasted any overrun charges in the power market. In Union's other large industrial and commercial markets, the total overrun forecast in $600,000. This is despite the fact that total overrun charges for all sectors ranged from $1.5 million to $2.4 million from 2007 to 2011.[12] Customers usually incur overrun charges when the contracts' parameters are exceeded. In the case of the power market, if a customer runs more than the days that are already included in their fixed charges, the customer would start incurring overrun charges.

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[10] M2 Residential NAC comparison.
[11] Oral Hearing Transcript, EB-2011-0210, Vol. 2 at p.122.
[12] Exhibit JT1.17.

In Exhibit JT1.17, Union provided overrun charges in the power, industrial and commercial markets for the period 2007-2013. The forecast for the power market is zero for 2012 and 2013. This is despite the fact that the Halton Hills power plant has already incurred $300,000 in overrun charges up to the end of June 2012. Board staff have calculated the average overrun charges from 2007 to 2011 and presented Union's forecast for 2012 and 2013 in the table below. Board staff have also included its proposed 2013 overrun revenue forecast.

Market	2007 - 11 Average – Actual ($)	2012 Forecast ($)	2013 Forecast ($)	Board staff submission $
Power	180,000	0.0	0.0	300,000
Steel/Chem/ Refinery	400,000	0.0	0.0	400,000
LCI/Key	1,200,000	500,000	600,000	1,200,000
Greenhouse	100,000	0.0	0.0	100,000
Total	1,880,000	500,000	600,000	2,000,000

Source: Exhibit JT1.17

The only sector that Board staff propose to be above the average overrun revenues for 2007 to 2011 is the power sector. The reason is that Union has confirmed that it has recovered $300,000 from just one power plant in the first six months of 2012 when the forecast was zero. Board staff have used a conservative amount similar to the first six months of 2012. It is also not known whether other power plants have incurred any overrun charges in the first six months of 2012.

Board staff submit that the Board should require Union to increase revenues related to overrun charges by $1.4 million for 2013.

COST OF CAPITAL

Common Equity Ratio

Union has proposed a capital structure which includes a common equity ratio of 40% for 2013 as compared to the 36% currently included in rates. In support of its proposal, Union retained two experts: Mr. Steven M. Fetter and Dr. Vander Weide. In response, intervenors presented the expert evidence of Dr. Laurence D. Booth.

Mr. Fetter's opinion is that an equity thickness of 40%-42% would improve Union Gas' financial profile benefitting its customers through the Company's enhanced ability to attract capital from investors when needed and upon reasonable terms. Mr. Fetter, in his report, also indicated that equity ratios of utilities are rarely set below 40% in the United States. Further, Mr. Fetter noted that a review of other Canadian gas utilities shows the deemed equity ratios to be in the range of 39% to 43%. In its Argument-in-Chief, Union submitted that it has to compete for capital with other utilities across the United States and Canada and a 36% equity ratio puts Union at a disadvantage.[13]

However, Dr. Booth in his testimony submitted that the list of Canadian gas utilities included in Dr. Vander Weide's report did not represent a fair comparison to Union and Enbridge who were considered the two premier gas distribution utilities in Canada. Dr. Booth noted that some of the utilities included in Dr. Weide's list were fairly small as compared to Union and would probably require a higher common equity ratio in order to access the capital markets and further added that smaller utilities may need to access the capital markets on a more frequent basis as compared to larger utilities that can raise their long-term capital requirements in a single issue[14]. Further, Dr. Booth stated that larger companies can access parts of the capital market such as swaps and derivatives that small companies are unable to access due to their limited size. Union, in its Argument-in-Chief, refuted this claim and submitted that the list presents a fair comparison especially ATCO Gas and Terasen.[15] Union submitted that its equity ratio is demonstrably low to the comparator groups with ATCO Gas at a 40% common equity ratio and Terasen at 39%.

Union's view is that its current equity structure is not commensurate with its risk. However, it agreed that its business or financial risk has not changed materially since 2007. In fact, Union witnesses confirmed several times during the oral hearing that that there had been no material increase to its business or financial risk.[16] The Report of the Board on the Cost of Capital for Ontario's Regulated Utilities dated December 11, 2009 (EB-2009-0084) on page 50 states:

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[13] Oral Hearing Transcript. EB-2011-0210, Vol. 13 at p.53.
[14] Oral Hearing Transcript EB-2011-0210, Vol. 6 at p.11
[15] Oral Hearing Transcript. EB-2011-0210, Vol. 13 at p.55.
[16] Oral Hearing Transcript. EB-2011-0210, Vol. 4 at p.128 and Vol. 5 at p.15 and 31.

> For electricity transmitters, generators and gas utilities, the deemed capital structure is determined on a case-by-case basis. The Board's draft guidelines assume that the base capital structure will remain relatively constant over time and that a full reassessment of a gas utility's capital structure will only be undertaken in the event of significant changes in the company's business and/or financial risk.

Board staff notes that Union has provided no evidence that there has been a significant change or a noticeable increase in its business or financial risk. Dr. Booth in his testimony indicated that Union's business and financial risk has in fact declined over 2007 when it last came to the Board with a cost of service application. Union has maintained a strong credit rating from DBRS during the IRM period and has had an excellent access to the commercial paper market. Union's credit rating from Standard & Poor's ("S&P") is BBB+ and the weaker rating is mainly due to the fact that the rating for Spectra Energy, Union's parent is BBB+ and S&P will not give a higher rating to a subsidiary as compared to the parent.[17] In response to a Board staff interrogatory, Union confirmed that an equity component of 40% will not lead to a higher credit rating or a lower cost of debt.[18] In other words, ratepayers are not likely to receive any benefit from a higher common equity ratio. The entire benefit of a higher equity component would go to the shareholder.

In its Argument-in-Chief, Union submitted that the determination in the Board's Cost of Capital Report is merely a guideline. Union further submitted that the market now has a better appreciation of the risks of debt and the attractiveness of equity.[19] Union submitted that in the Board's Decision in the Hydro One Network Inc. proceeding (EB-2009-0096), the Board indicated that it would entertain a challenge to the applicability of a guideline provided that challenge was supported by evidence.[20] Union submitted that it has filed evidence in relation to its request for a 40% equity ratio and this should be the basis for the Board to vary from the Board's Report on Cost of Capital.[21]

[17] Oral Hearing Transcript EB-2011-0210, Vol. 6 at p.50.
[18] Exhibit J.E-1-1-2 (b).
[19] Oral Hearing Transcript, EB-2011-0210, Vol. 13 at p. 64.
[20] Decision with Reasons, Hydro One Networks Inc., EB-2009-0096 at p.48.
[21] Oral Hearing Transcript, EB-2011-0210, Vol. 13 at p.68.

Board staff notes that for Union's most recent issue of debt dated June 21, 2011, the issues were launched in the morning and fully subscribed by the afternoon[22]. This suggests that the current common equity ratio poses no concern for investors. Investors view Union as a strong investment and this is evident from the fact that its unsecured debt issue was fully subscribed in a couple of hours.

Board staff submit that Union has not provided any evidence to demonstrate a deterioration in its risk profile. The only reason that Union wants a higher common equity ratio is that, in its opinion, the current structure is not commensurate with its risk profile. However, Union has not shown any adverse impact as a result of this mismatch between its risk profile and capital structure. In fact, the evidence is the opposite. Union has been able to easily access the debt market and most investors view Union as a strong investment. Union has over-earned in all of the IRM years. The total over-earnings from 2007-2012 amounts to $278.7 million.[23] This is over and above the Board approved rate of return. Union over-earned even in 2008-09 during the peak of the financial crisis. During the peak of the financial crisis in 2008-09, Union over-earned by $82.3 million in 2008 and $51.6 million in 2009.[24] This clearly demonstrates that Union's business risk, that is, the risk of not being able to earn the approved rate of return is low or has actually declined since 2007.

The price of natural gas has been consistently low over the last couple of years. Considering the current supply outlook in North America, gas prices are expected to remain competitive in the medium to long-term. Natural gas remains the fuel of choice for many businesses and is extremely competitive as compared to other fuels. Consequently, Union's business risk remains relatively low. Union has indicated that there has been some de-contracting of transportation but this has been mitigated by new growth opportunities of moving US gas into Ontario and other markets.[25]

Board staff submit that Union has not provided sufficient evidence to support its request for a 40% common equity ratio. The financial ratings of Union remain strong, it has good access to capital markets, its business model is strong, its earnings have been consistently above the Board approved rate of return since 2000, and gas remains a competitive fuel with significant opportunities in the power market. In

[22] Oral Hearing Transcript EB-2011-0210, Vol. 5 at p.12
[23] Oral Hearing Transcript, EB-2011-0210, Vol. 4 at p.134.
[24] Exhibit J.O-4-14-1, Attachment 1.

addition, the Board's Report on Cost of Capital envisions a review of the capital structure only if there is a significant change in a utility's business or financial risk, and Union has confirmed no increase in risk. For all these reasons, Board staff submit that the status quo be maintained and Union's common equity ratio remain at 36%.

Gas Supply and Ex-Franchise Revenue

Board staff have combined the submission on gas supply and ex-franchise revenue. Union uses the gas supply plan in part to derive storage and transportation revenues and therefore it makes sense to combine the discussion of these issues.

Gas Supply

Union's forecast for long-term transportation revenue is $148.5 million in 2012 and $141.9 million in 2013. This forecast is comprised of three components: M12 Long-term Transportation, Other Long-term Transportation, and Other Storage & Transportation ("S&T"). The short-term transportation and exchanges revenue forecast is $32.2 million in 2012 and $20.2 million in 2013.

Union's gas supply planning process is guided by a set of principles that are intended to ensure that customers receive secure, diverse gas supply at a prudently incurred cost. The gas supply model provides a forecast of Union's costs required to serve in-franchise sales service and bundled direct purchase customers. The costs are reflected in the various gas cost accounts that are cleared through the quarterly rate adjustment mechanism ("QRAM") and the annual deferral account disposition mechanism.

Union holds a combination of firm upstream contracts, Dawn sourced supply and storage capacity to meet the full forecast annual demand. A key objective of the gas supply plan is to optimize the use of upstream contracted pipeline capacity. This is accomplished by managing upstream transportation capacity on an integrated basis and shifting the use of this capacity from one area to serve demand in another area when the opportunity and the need exist.

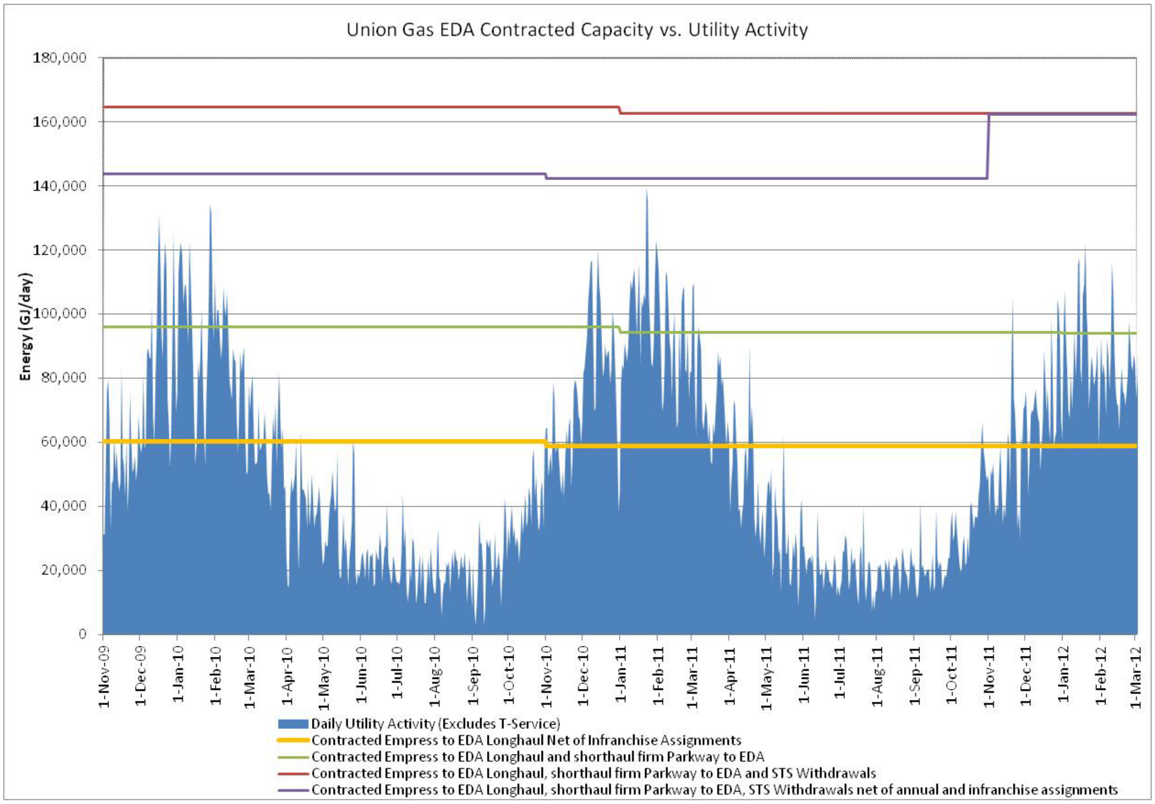
[25] Oral Hearing Transcript EB-2011-0210, Vol. 6, Pg.93

A synthesis of the firm contracts in the Eastern Delivery Area ("EDA") is graphically presented below. The uppermost line (red line) in the graph indicates Union's actual contracted capacity of approximately 160,000 GJ per day. This is based on a design day requirement or in other words a peak day requirement. Union has indicated that the design day[26] is based on the coldest day in the past 50 years. The last time that the temperature reached the design day was in 1981.[27]

At the oral hearing, Union indicated that they need to hold enough capacity to meet a design day within a given winter.[28] But as can be seen in the graph below, the actual requirement is far below contracted capacity even on the coldest days. In other words, Union's gas supply plan seems to provide for a far larger cushion than required and ratepayers have to pay for holding this capacity. At the same time, Union is benefiting from this additional capacity in several ways and has generated significant revenues through gas supply optimization.

Union has assigned some capacity on an annual basis. The capacity assignments are provided in Exhibit J3.6 and some of these assignments are represented below in the graph by the purple line (the second line from top of the graph).

[26] Oral Hearing Transcript, EB-2011-0210, Vol. 7 at p.161-162 (Design Day is a 47 degree day in the North and a 44 degree day in the South)
[27] Oral Hearing Transcript EB-2011-0210, Vol. 7, at P.161
[28] Oral Hearing Transcript EB-2011-0210, Vol. 4, Pg.77



A review of the assignments in Exhibit J3.6 reveals that the volumes are fairly consistent from month to month. In other words, they are pre-planned and Union is fully aware that the capacity will not be required. In fact, as per the graph above, Union assigned approximately 20,000 GJ per day on a long-term basis. At the oral hearing, Union indicated that in case it required additional capacity, the Storage & Transportation group ("S&T") would be able to purchase the required quantities. This clearly indicates that Union is planning for far more capacity than required. As a result, Union ratepayers have to incur Unabsorbed Demand Charges ("UDC") in the northern and eastern zone which is the demand charge cost for upstream transportation that is left empty or does not flow to full capacity to meet customer's annual firm demands.

Board staff submit that Union's current gas supply plan far exceeds the requirements of its in-franchise customers. It is prudent to have some level of excess capacity in order to meet peak day demand or to account for pipeline disruptions. However, it is also important that the assumptions underlying the gas supply plan be prudent and reasonable. The fact that Union has assigned capacity on a long-term basis and is able to easily determine significant capacity assignments well in advance as evident in Exhibit J3.6, indicates that the gas supply plan is contracting for capacity that far exceeds the needs of its ratepayers. However, ratepayers are being asked to bear a significant cost for meeting a design day requirement, which may occur once in a 20 or 30-year period. Even in such instances, Union has indicated that it can obtain additional supplies if needed. Additionally, Union has indicated that it has other alternatives to get gas if required and can also access gas from storage.[29]

Board staff submit that Union should be directed to develop a gas supply plan that reflects the realistic requirements of its customers and include a reasonable cushion to meet peak demand requirements that are likely to occur rather than planning for a rare event.

Ex-Franchise Revenues

Union has over the years used the excess capacity to generate a significant amount of revenue under its S&T operations. Union assigns various long-haul transportation assets on a monthly, seasonal and even annual basis. When Union assigns the transportation capacity to a third-party, Union derives revenue by selling this capacity. In such cases, Union releases unutilized capacity to the market due to excess supply to the plan and any value received for the pipe is credited to ratepayers to offset UDC costs. Union has provided the UDC costs incurred from 2007 onwards in Exhibit J4.1. Even after taking into account the credit received from assigning capacity to third parties, ratepayers have incurred significant charges over the years, to the tune of $5.7 million from 2007 to 2011 (as noted from Exhibit J4.1). A significant portion of the costs could be reduced if the assumptions underlying the plan were more closely aligned to demand. Board staff is not advocating that there should be no UDC charges. There would be some charges in case of warmer weather or a mild winter. However, the current UDC charges stem from contracting for capacity that far exceeds customer requirements even beyond a cold winter.

If the empty pipeline is TCPL capacity, then Union generates RAM credits through TCPL's FT-RAM program. FT-RAM or Firm Transportation Risk Alleviation Mechanism is a service to TransCanada's long-haul firm transportation ("FT") shippers. The FT-RAM program allows long-haul FT shippers to apply unutilized FT demand charges against their cost of interruptible transportation ("IT") service.

[29] Oral Hearing Transcript, EB-2011-0210, Vol. 3 at pp.16-17.

When the pipeline capacity is not required and is assigned along with the RAM credits, any revenues generated flow to ratepayers through the UDC account. However, when the utility needs the supply and it is being delivered through an alternate route, revenue generated as a result of such assignment flow to Union's utility earnings. In other words, Union is using a regulatory asset and selling it in the market and repurchasing the same service at a lower cost, and keeping the margins. It is important to note that the majority of the transactions are of the latter type where Union arranges for alternative transportation and keeps the proceeds. This is evident from Exhibit J3.3 where Union has indicated that from November 2009 to March 2012 there were no capacity assignments of Eastern Zone transportation for purposes of mitigating supply position (offsetting UDC). Union made alternative arrangements to deliver the purchased supply to Union's market and the demand charge for the firm transportation capacity was charged to ratepayers. The net proceeds to Union from November 2009 to March 2012 amounts to $26.5 million.

Similarly, in Exhibit J7.3, Union provided net revenues from capacity assignments in the Central Delivery Area (CDA) which essentially refers to activities on the Empress-Parkway system. As part of the transaction, Union enters into an exchange with the same counterparty to redeliver the gas to an alternate location in Union's franchise area. The net revenue reflects the value of the entire transaction, which is comprised of the capacity release less the cost of alternate transportation arrangement. The revenue attributable to the Empress to Parkway optimization amounts to $9.01 million for 2011.

As noted in Exhibit J7.3, the balance of the revenue of $11.3 million earned from Empress-Parkway optimization was as a result of using RAM credits to facilitate incremental exchange activity. In this scenario Union optimizes the system by leaving the FT pipe empty, and uses interruptible transport to move Union's gas supply from Empress to a delivery location. Union manages the incremental cost of the interruptible transportation through the use of RAM credits generated from the empty Empress to Parkway pipe.

All the above activities have been a fairly profitable venture for Union and have contributed significantly to its overall earnings during the IRM period. Most importantly, the genesis of facilitating all these optimization activities is the gas supply plan that contracts for far more capacity than required.

At the oral hearing, Union has indicated that the FT-RAM program may discontinue and that TCPL in its current proceeding before the National Energy Board has requested to end the program. However, Union confirmed that even if the RAM program were to be discontinued it could still earn revenues through other mechanisms such as facilitating base exchanges.

Union has forecasted $9.1 of exchange revenues in 2013 rates attributable entirely to non-FT RAM related exchanges.[30] In its Argument-in-Chief Union proposed to include $11.6 million related to the FT-RAM program in 2013 rates and set up a variance account to capture any additional revenues or adjust revenues that were below $11.6 million. Alternatively, Union suggested setting up a deferral account to track revenues related to the FT-RAM program. Under both scenarios Union proposed that revenues be shared 75-25 in favour of ratepayers.[31]

Board staff submit that almost all revenues generated as a result of using pipeline capacity that customers have paid for in gas supply costs should go back to offset gas costs. Board staff submit that customers have paid for this capacity and Union is using it to generate revenues for its own benefit. A portion of this has been shared through the earnings sharing mechanism; however it is Board staff's view that the entire revenue pool should flow to ratepayers since they are the ones who paid for this excess capacity that Union optimizes. These revenues cannot be classified as storage and transportation revenue for the simple reason that Union has not paid for this capacity and assumes no risk. Union is simply paying a much higher price for firm transportation up front, at the cost of ratepayers, and then transporting the gas for a much lower costs largely to its own benefit. Board staff does acknowledge that Union needs some incentive to optimize and proposes that 90% of the revenues generated through optimization activities related to transportation capacity that in-franchise customers have paid for should go to offset gas costs while the remaining amount should flow to utility earnings. This sharing proportion is similar to other transactional services where the ratepayer asset is used such as short-term storage transactions.

Board staff further submit that there may be other activities that may not qualify under the above description but generate revenues for Union. In cases where Union

[30] Union Argument-in-Chief, EB-2011-0210, Vol. 13, Pg.36

generates revenues that are not related to selling transportation capacity paid for by ratepayers to a third party and then transporting gas through cheaper alternate arrangements, the revenues generated should go to a newly established Storage and Transportation Margin Deferral Account which is discussed later in this submission.

Parkway West Project

Union has provided some information on a proposed Parkway West project that is projected to go into service in 2014. The project will provide added reliability for Enbridge to meet its gas supply needs and provide additional transportation opportunities to Union from Parkway to Maple, which would be a competing pipeline to the infrastructure proposed by TCPL. There was extensive cross-examination on the costs and need of the project at the oral hearing. The cost of the project is estimated to be around $200 million.

There was extensive discussion and discovery of the Parkway West project in the current proceeding. However, this project has no impact on 2013 rates and Board staff is not certain what determination the Board can make with respect to this project. The cost, need, prudency and impact on the environment will all be reviewed in the leave to construct application that Union is expected to file before the end of 2012.

Board staff submit that no decision is required on this project in this proceeding, and the only direction that the Board could issue would be that Union should file all the relevant information of not only the pipeline approval that it is seeking but all associated facilities that are required and that would support the project. This would include detailed information on possible alternatives and the opportunities that the project could provide for the non-utility portion of Union's operations.

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[31] Oral Hearing Transcripts, EB-2011-0210, Vol. 13 at pp.39-42.

Cost Allocation

Cost Allocation - Parkway Station Costs and Related Rate Design

Mr. Rosenkranz described the manner in which the costs of transporting gas on the Dawn-Parkway transmission system are divided and allocated. Mr. Rosenkranz noted that these costs are divided into two distinct categories: the cost of the compressors needed to move gas from the Dawn Hub into the Dawn-Parkway system (Dawn Station costs); and all remaining costs (Dawn-Trafalgar Easterly costs). Mr. Rosenkranz noted that the Dawn-Trafalgar Easterly costs include Union's transmission pipelines, the compressors at Lobo, Bright, and Parkway, and the metering facilities at Kirkwall and Parkway. Dawn-Trafalgar Easterly costs are allocated using a distance-based commodity-kilometre methodology while Dawn Station costs are allocated on the basis of design-day demand.[32]

Mr. Rosenkranz noted that Union delivers and receives gas at Parkway and that the predominant direction of physical flow at Parkway is from Union to TCPL and Enbridge.[33] [34] As such, Mr. Rosenkranz noted that the metering and compression facilities at Parkway Station are designed to meet Union's design day requirements to export gas from Union into TCPL and Enbridge.

Mr. Rosenkranz noted that metering costs are a function of design day demand and that compression horsepower at Parkway is determined by Union's peak day requirements to deliver gas into TCPL and Enbridge. In addition, Mr. Rosenkranz stated that Union's metering and compression assets at Parkway are not used to transport or deliver gas to any of Union's upstream in-franchise markets connected to the Dawn-Parkway transmission system. Therefore, Mr. Rosenkranz recommended that the Parkway station costs should be separated from the overall Dawn-Trafalgar Easterly Transmission costs[35] and allocated to rate classes on the basis of design day requirements.[36]

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[32] Exhibit K10.7 at p. 2
[33] Ibid at p. 3.
[34] Exhibit B1, Tab 9, Schedule 2 shows that the flows through Parkway is predominately export based.
[35] Dawn-Trafalgar Easterly costs are allocated using a distance-based "commodity-kilometres" methodology.
[36] Exhibit K10.7 at p. 3.

Mr. Rosenkranz noted that once the Parkway Station costs have been separated in the cost allocation, the costs should be recovered from those services that use the Parkway facilities. As well, Mr. Rosenkranz recommended the establishment of a non-export M12 service that can be used by in-franchise customers to meet an obligated delivery requirement at Parkway. The non-export M12 service would allow shippers to deliver gas to Union but would not give shippers rights to deliver gas to TCPL or Enbridge. Mr. Rosenkranz recommended that the costs for this service should be allocated on the same basis as the Dawn-Trafalgar Easterly costs (with the exclusion of the Parkway Station Costs).[37]

Board staff supports the recommendations of Mr. Rosenkranz as discussed above. Board staff notes that of Union's forecasted 2013 design day contracted quantities at Parkway (approx. 3.0 PJ/d) only approx. 0.4 PJ/d of those volumes are for in-franchise customers.[38] [39] Furthermore, the obligated deliveries of 0.7 PJ/d which offset the total contracted volumes requiring compression at Parkway may result in none of the 0.4 PJ/d of in-franchise volumes actually requiring compression or metering at Parkway.[40] Therefore, the metering and compression assets at Parkway are being used, for the most part, by Union's ex-franchise customers. Board staff submits that allocating Parkway Station costs on the basis of design day requirements more appropriately reflects cost causation principles when compared to Union's proposal which uses a distance-based commodity-kilometre approach. Board staff further submits that Union's proposal over allocates Parkway Station costs to Union's in-franchise customers.

In Board staff's view a necessary outcome of this recommendation is that Parkway Station costs be separated from the rest of Dawn-Trafalgar Easterly Costs and recovered from those services that utilize the Parkway facilities.

In addition, Board staff supports creating a non-export M12 service for those in-franchise customers that need to move gas to Parkway (in order to meet obligated delivery requirements) but do not use Parkway facilities. Those customers should not

[37] Ibid at pp. 3-4.
[38] Exhibit K8.3.
[39] Oral Hearing Transcripts, EB-2011-0210, Volume 8 at p.110.
[40] This may not be the case if the obligated deliveries at Parkway must be provided at the discharge side of the compressor station. In that situation, in-franchise customer obligated deliveries would require use of Parkway compression assets.

have to pay for Parkway Station costs when they do not use Parkway Station assets. Board staff notes that Union, in cross-examination, stated that customers who provide obligated deliveries at Parkway need to do so at the discharge side of the compressor station and as such compression assets are used by these customers.[41] Board staff requests that Union confirm that this is the case in its reply submission, so the Board can determine whether this service would be useful to in-franchise customers with obligated deliveries at Parkway.

Cost Allocation – Utility vs. Non-Utility Storage

Board staff notes that Union's methodology for separating its utility and non-utility storage businesses was originally approved by the Board in EB-2005-0551 and reconfirmed by the Board in EB-2011-0038. In the EB-2011-0038 Decision and Order, the Board stated:

> The Board finds that the intent of the NGEIR Decision was to effect the one-time separation of plant assets between Union's utility and non-utility businesses. Therefore, there is no need for a subsequent separation (or the filing of another cost study).[42]
>
> The Board finds that Union has appropriately applied its 2007 Cost Allocation Study for the one-time separation of plant.[43]

Board staff was not concerned about the one-time separation of plant assets in this proceeding as that was previously addressed by the Board. However, Board staff in the EB-2011-0038 proceeding was concerned about the manner in which the costs related to storage plant additions (and the related O&M) were being allocated by Union.

Union, in this proceeding, provided a description of its methodology for allocating costs related to storage additions. Union provided the following table:

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[41] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at p.142.
[42] Decision and Order, EB-2011-0038, January 20, 2012 at pp. 6-7.
[43] Decision and Order, EB-2011-0038, January 20, 2012 at p. 11.

Description	Allocation Methodology
New Storage Asset – increase in capacity or deliverability	100% Allocation to unregulated
New Storage Asset – no increase in capacity or deliverability	Allocated regulated versus unregulated based on the historic allocation of assets at that location
Replacement Asset – no increase in capacity or deliverability	Allocated regulated versus unregulated based on the historic allocation of assets being replaced.
Replacement Asset – increase in capacity or deliverability	Cost of replacing the existing asset like for like is allocated regulated versus unregulated based on the historic allocation of assets being replaced. The cost of providing the incremental capacity or deliverability is allocated 100% to the unregulated operation. This results in a new blended rate for this asset.

In regards to the allocation of O&M costs related to non-utility storage, Union stated the following:

a) Actual O&M related to the operation of the storage facilities was allocated to the non-utility storage operation using the same allocators applied to the assets for that facility.

b) Administrative and general expenses and benefits in support of non-utility storage operations were allocated in proportion to storage O&M.

c) O&M costs related to the development of new storage assets are assigned based on an estimate of time spent annually on the development of non-utility projects.

d) O&M costs related to the Regulatory department for development of new storage assets, are assigned based on an estimate of time spent annually on the development of non-utility projects.[44]

Board staff supports the methodologies for allocating capital and O&M costs to non-utility storage as described above. However, Board staff requests that Union provide the calculations which support the aggregate amounts included in the following table. The first four (4) rows in the following table correlate to the above noted classifications of O&M costs related to non-utility storage.

[44] Exhibit A2, Tab 2, p.8.

A2, Tab 2 Categories	$(M's)
Operation of Storage Facilities	6.2
Admin, General & Benefits	5.8
Development of New Storage Assets - Other	0.6
Development of New Storage Assets - Regulatory	0.3
Sub Total	12.9
Donations	0.7
Exhibit D1, SS2 Updated, Line 30 Non Utility Allocations	13.6

Board staff notes that the above table was first produced by Union in response to supplemental questions from FRPO.[45] No working papers were included in the response to give parties assurance that the above amounts were calculated correctly. As such, Union should provide the calculations to support the $12.9 million figure above.

In addition, Board staff notes that as a result of Union's review of its allocation factors in early 2012[46], which looked to confirm that the methodology set above was applied correctly, Union identified updates that were required to 10 of its storage pools. Union noted after the allocation factors were updated, Union compared the updates against its 2013 rate evidence. Union determined that the use of the revised allocation factors for storage capital additions would have decreased the utility storage assets by approximately $25,000 in 2013 (less than $10,000 in related revenue requirement). Union stated that this amount is immaterial and does not require an update to its evidence.[47] Union also noted that the allocation factor update results in a decrease to utility O&M of $100,000.[48] Board staff submits that although these amounts are indeed quite small, the Board should require Union to update its allocation factors as part of its evidence in this proceeding and reassign the noted amounts from utility to non-utility ($100,000 in O&M and the revenue requirement related to the $25,000 in decreased utility storage capital costs). Board staff is the view that the utility / non-utility storage allocation should be completely accurate before starting Union's next IRM term (if the Board determines that a new IRM regime is appropriate).

[45] Union - Supplemental Question Responses, FRPO Supplemental Question #1.
[46] This review occurred as a result of recommendations in the Black & Veatch report filed in EB-2011-0038.
[47] Union - Supplemental Question Responses, FRPO Supplemental Question #1.
[48] Union - Supplemental Question Responses, FRPO Supplemental Question #2.

Board staff submits that the above noted methodology for allocating costs between utility and non-utility storage related to storage additions should continue going forward. The allocation of utility / non-utility storage costs should be updated in every rebasing and be reflected in the pre-filed evidence.

Rate Design

General - Rate Design and Revenue-to-Cost Ratios

Union noted that when designing its 2013 proposed rates for Union North and Union South, the following factors have been taken into consideration:

- The revenue deficiency for the company as a whole;
- The relative rate changes of other rate classes;
- The allocated cost of service;
- The level of current rates and the magnitude of the proposed change;
- The potential impact on customers;
- The level of contribution to fixed cost recovery;
- Customer expectations with respect to rate stability and predictability; and
- Equivalency of comparable service options.

Union stated that the revenue-to-cost ratios reflect Union's application of accepted rate design principles and are underpinned by the cost allocation study. Union also noted that the 2013 proposed revenue-to-cost ratios are within an acceptable range and are generally consistent with those approved by the Board in EB-2005-0520.[49]

In an interrogatory response, Union noted that revenue-to-cost ratios are the outcome, not an input, of the application of Union's Rate Design Considerations described above. Union noted that acceptable revenue-to-cost ratios must:

- Satisfy rate design principles set forth in evidence, and
- Bear a reasonable relationship to previously approved revenue-to-cost ratios.

[49] Exhibit H1, Tab 1, p. 12 (Updated).

Union stated that acceptable revenue-to-cost ratios guidelines include:

1. Firm in-franchise general services (Rate 01, Rate 10, Rate M1 & Rate M2) close to unity.
2. Large firm in-franchise contract services (Rate T1, Rate T3 and Rate 100) close to unity.
3. Other in-franchise firm services between (1) and (2) above will vary due to firm rate continuum considerations. A revenue-to-cost ratio approximating 80% or more is generally realized.
4. Rate M12 firm transportation service close to unity.
5. Interruptible in-franchise service pricing is set in relative relationship to firm services, with the resulting revenue-to-cost ratios showing greater deviation from unity.[50]

Board staff believes that Union's rate design considerations (and revenue-to-cost ratio guidelines), discussed above, are appropriate. However, Board staff does have a few issues with the manner in which these considerations were followed and implemented that it would like to raise for the Board.

First, a general principle is that approved revenue-to-cost ratios, for in-franchise customers, should not move away from a unity position. In a number of in-franchise rate classes, the EB-2005-0520 Board-approved revenue-to-cost ratios were closer to unity than proposed in this case. These rate classes are: Rate 01 (from 0.976 to 0.975), Rate 25 (from 0.467 to 0.446), Rate M2 (from 0.972 to 0.940), Rate M5A (from 0.824 to 0.746), and Rate M10 (from 0.131 to 0.073).[51]

Union provided the following rationale for these changes. Union stated that the proposed rate is designed to manage the relationship between the firm and interruptible service, maintain the rate continuum across all of the firm rate classes and the interruptible rate class, and to manage the level of rate increases to the rate classes.[52] Board staff believes that these may be reasonable reasons to breach the general principle of not moving away from unity. However, Board staff submits that, for

[50] Ex. J.H-1-5-2.
[51] Ibid.
[52] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at p. 8.

each rate class where Union has moved away from unity, Union should provide more comprehensive rationale as part of its reply argument so that the Board has a stronger basis for approving Union's rate design proposal.

Secondly, in regards to Union's proposal to increase rates in Rate M1 to slightly beyond unity (1.003) and over-recover from that rate class by an amount of $1.14 million, Board staff submits that this over-recovery (which results in cross-subsidization) is not appropriate.[53] Rate M1 (Union's small volume general service class in the south) should not have to pay more costs then are allocated to that class (on the basis of the cost allocation study). Board staff notes that Rate M1 is Union's only in-franchise rate class with a revenue-to-cost ratio of higher then 1.0. Board staff understands that Union is attempting to balance the rate continuum and help offset larger rate increases in other rate classes by over-recovering in Rate M1 but in Board staff's view this proposal is unfair to Union's M1 customers. Board staff submits that Rate M1's rate design should not result in a revenue-to-cost ratio higher than 1.0.

Board staff notes that Union is materially under-recovering from Rate M7 ($1.2 million) and Rate M12 ($2.6 million) and these rate classes have delivery rate impacts of less than 2%.[54] Board staff understands that for rate continuum purposes further rate increases for Rate M7 are not feasible. However, Board staff is of the view that Rate M12 does not have the same rate continuum constraints as does M7. Board staff notes that Union stated the reason the revenue-to-cost ratios for Rate M12 have been maintained at 0.984 (and not increased to 1.0) is due to the fact that some C1 transportation credits are applied to the M12 class.[55] Board staff understands this to mean that Rate M12 is already recovering revenues at (or above) unity with costs (when C1 credits are included in the calculation). However, Board staff questions why Union would propose to over-recover from an in-franchise rate class (Rate M1) rather than an ex-franchise rate class being Rate M12 which has delivery impacts estimated at 1%. Board staff submits that Union should increase its rates in Rate M12 to result in a revenue-to-cost ratio of 1.0 (exclusive of the impact that C1 credits would have on the ratio).

Finally, Board staff has some comments in regards to Union's allocation of S&T

[53] Exhibit H3, Tab 1, Schedule 1.
[54] Ibid.
[55] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at p. 12.

margins to the rate classes. Board staff notes that the overall revenue deficiency (after the proposed rate increases have been applied) for Union's northern in-franchise rate classes is $13.125 million and the overall revenue deficiency (after the proposed rate increases have been applied) for Union's southern in-franchise rate classes is $10.778 million. The overall revenue deficiency for in-franchise rate classes (after the proposed rate increases have been applied) is $23.903 million.[56] These amounts are offset by the S&T margins of $23.903 million that are built into rates. Board staff notes that approx. 55% of S&T margins are being allocated to the north and approx. 45% are being allocated to the south. Union noted that the methodology for the split in the S&T margin allocation between operation areas is that the same proportion of the total revenue deficiency (before proposed revenue increases are applied) should be recovered by S&T margin allocations in both operation areas.[57] This methodology results in approx. 30% of the total revenue deficiency in each operation area being recovered through the allocation of S&T margins.[58]

Board staff submits that although the methodology used by Union as discussed above results in an equitable allocation of S&T margins between operation areas (from the perspective of revenue deficiency offsetting) it has no correlation to the manner in which the revenues are derived and is different from the allocation of S&T margins in 2007 (EB-2005-0520).

Board staff notes that in 2007, Union had approx. $36.6 million in S&T margins included in rates.[59] Board staff believes that Union allocated approx. $12.45 million to North in-franchise customers and $22.14 million to South in franchise customers in 2007.[60] [61] On a percentage basis, the S&T margin allocation in 2007 was approx. 36% to the North and 64% to the South. In addition, Board staff notes that the above allocation recovers different amounts of overall revenue deficiency in the North and

[56] Ibid.
[57] Oral Hearing Transcripts, EB-2011-0210, Volume 11 at pp.146-148.
[58] Exhibit H3, Tab 1, Schedule 1.
[59] Exhibit J12.6.
[60] Eb-2005-0520, Rate Order – Working Papers, Schedule 5.
[61] Board staff notes that the S&T margin allocation aggregates to $34.59 million. Board staff is unsure what happened to the remaining approx. $2 million in S&T margins. Union can perhaps comment on this in its reply submission.

the South.[62] As such, the methodology that Union has proposed for 2013 does not seem to have been applied for its 2007 rate design mechanism.

Board staff notes that Union has acknowledged that it is using the S&T margins as a rate design tool to manage rate impacts, rate continuity and revenue-to-cost ratios in 2013.[63] In its Argument-in-Chief, Union submitted that using these margins as a rate design tool has been done in the past and is appropriate.[64]

Board staff notes that the Board, in this proceeding, needs to determine whether the allocation of S&T margins should be properly considered a rate design tool. Board staff is of the view that the allocation of S&T margins should not be used as a rate design tool.

Board staff does see the attraction of using the allocation of S&T margins as a rate design tool in this particular case (i.e. helping to offset significant rate impacts in the North). However, Board staff submits that there are more appropriate ways to allocate these revenues between operation areas which have more direct linkages to the manner in which the S&T margins are generated. Board staff submits that Union, in its reply argument, should file a convincing rationale for the methodology currently proposed for allocating S&T margins and should also provide alternative methodologies (with rationale) for allocating S&T margins. The Board should have a number of potential options to review and consider before determining which methodology is the most appropriate.

Board staff is of the view that the Board should choose the methodology that it believes is most appropriate and require Union to maintain the same methodology for the allocation of S&T margins going forward. Board staff submits that Union should not be allowed to change the methodology from rebasing to rebasing unless the Board decides that the allocation of S&T margins should be treated purely as a rate design tool. Changing the methodology in each rebasing provides no assurance to the Board that there is rationale for or stability of the methodology used.

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[62] North in-franchise revenue deficiency (delivery and transport & storage) was $15.74 million in 2007 and South in-franchise revenue deficiency (delivery and storage) was $37.43 million in 2007. Union offset approx. 79% of its North in-franchise revenue deficiency with S&T margins and 59% of its South in-franchise revenue deficiency with S&T margins. Board staff notes that these are all derived numbers from the EB-2005-0520 Rate Order Working Papers at Schedule 5.

[63] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at pp.121-122.

If the Board determines that it is appropriate for S&T margins to be used as a pure rate design tool, Board staff submits that there is no need to maintain a single methodology. Union should have the ability to allocate the margins in any way it believes will best manage rate impacts, rate continuity and revenue-to-cost ratios.

<u>Supplemental Service Charge – Group Meters for Commercial / Industrial Customers in Rate M1 and Rate M2</u>

Union proposed to update the additional service charge applicable to “Supplemental Service to Commercial and Industrial Customers under Group Meters” in Rate M1 and Rate M2. Union noted that the supplemental service allows for the combination of readings from several meters, where the meters are located on contiguous pieces of property of the same owner and are not divided by a public right-of-way.

Union proposed to increase the additional service charge on the Rate M1 rate schedule from the current approved $15 per month to $21 per month. On the Rate M2 rate schedule, Union proposed to increase the additional service charge from the current approved $15 per month to $70 per month ($35 per month in 2014 – for consistency with its 2014 M1 / M2 rate design proposal). Union stated that it is proposing to increase the additional service charge to ensure that customers who combine readings from several meters do not receive an unintended benefit in comparison to customers who cannot combine meter readings. This change will result in all Rate M1 and Rate M2 customers paying the same monthly customer charge for all meter readings.[65]

Union noted, in cross-examination, that the benefit received by customers that have the ability to combine meter readings is that those customers have the opportunity to combine volumes. Combining volumes allows customers to have more of their volumes charged at lower rates (in the higher volume blocks of the delivery rates.[66]

Board staff supports this proposal and believes that that the same supplemental

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[64] Oral Hearing Transcripts, EB-2011-0210, Volume 13 at p.81.
[65] Exhibit H1, Tab 1 at p. 56.
[66] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at p. 13.

charge should be applied in the North. Board staff notes that Union offers an equivalent meter combination service in its Northern service area. However, there is no equivalent supplemental charge. When asked about this during cross-examination, Union noted that there is no supplemental service charge in the North as it has been a longstanding policy. Union stated that it believes it is not prudent to introduce this type of supplemental service charge in the North in the face of its longstanding policy, particularly in light of some of the rate increases that are proposed in 2013 for Union's Northern customers.

Board staff submits that Union's northern customers that have the ability to combine meters are receiving the same unintended benefit as those Southern customers that have the same ability. Accordingly, a supplemental charge equal to the monthly customer charge should be applied to Union's Northern customers (Rate 01 and Rate 10) that combine meter readings to ensure equitable treatment amongst the customers in those rate classes.

<u>Rate 01 / 10 and Rate M1 / M2 – Volume Breakpoint and Rate Block Harmonization Proposal for 2014</u>

Union proposed to lower the annual volume breakpoint between the Rate 01 and Rate 10 rate classes in Union North and the Rate M1 and Rate M2 rate classes in Union South from 50,000 m^3 to 5,000 m^3. Union also proposed to harmonize the rate block structures in the small volume General Service rate classes (Rate 01 and Rate M1) and in the large volume General Service rate classes (Rate 10 and Rate M2). Union proposed to utilize the current Board-approved rate block structures for Rate M1 and Rate M2 in Union South for Rate 01 and Rate 10 in Union North respectively. Union proposed to implement the annual volume breakpoint and rate block structure changes on a revenue neutral basis effective January 1, 2014.[67]

Union noted that its proposal to lower the annual volume breakpoint between small volume General Service rate classes (Rate 01 and Rate M1) and large volume General Service rate classes (Rate 10 and Rate M2) to 5,000 m^3 from 50,000 m^3 will improve the rate class composition of Rate 01 and M1 and achieve more

[67] Exhibit H1, Tab 1 at p. 14 (Updated).

homogeneous rate classes. Also, Union noted that the proposal will improve the rate class size in Rate 10 and Rate M2, which will ensure viable large volume General Service rate classes and improve rate stability.[68]

Board staff has some concerns in regards to Union's rate redesign proposal discussed above.

First, the methodology used by Union to allocate costs related to those customers that are moving classes (due to Union's volume breakpoint proposal) is not supported by a cost allocation study. In regards to the customer-related costs for the customers that are moving rate classes, Union used proxies (or weightings) to move those costs. Union noted that the weightings are the same as those used to split the M2 rate class as part of the 2007 rebasing proceeding.[69]

The evidence supporting the noted weighting was filed at Exhibit J12.2, which stated:

> The Average Weighted Customers factor is developed by applying weights to the actual customer counts to ensure a proper allocation of costs. The weights currently used by Union are 1.0 for residential, 1.5 for commercial, and 2.0 for industrial. NCI understands that Union is currently reviewing the appropriateness of these weights.[70]

Union is asking the Board to accept these weightings, which are the manner in which customer-related costs for those customers moving classes (under Union's volume breakpoint proposal) are being allocated, on the basis that the weightings were accepted previously. Board staff submits that having prior approval for a methodology does not prove that the weightings are accurate. There is no evidence, in this proceeding, supporting the accuracy of the weightings. In fact, the evidence filed in the previous proceeding notes that "… Union is currently reviewing the appropriateness of these weights,"[71] which Union has not done in any formal manner to help support its evidence in this case".

[68] Exhibit H1, Tab 1 at pp. 14 - 16 (Updated).
[69] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at p. 32.
[70] Exhibit J12.2.
[71] Ibid.

Board staff submits that without better evidence supporting the accuracy of the proxy approach, the Board cannot reasonably be expected to support Union's proposal.

Furthermore, both LPMA and SEC have filed exhibits which highlight possible problems with Union's proxy approach for allocating customer-related costs for those customers that are moving rate classes due to Union's volume breakpoint proposal. LPMA filed, at page 26 of its Part 3 Compendium, what Board staff will describe as an accuracy test of Union's proxy methodology. LPMA basically compared the customer-related cost allocation resulting from the proxy approach (using 2010 actual customer numbers) versus Union's actual cost allocation (which uses 2013 forecast numbers from the cost study) on the basis of a 50,000 m^3 customer breakpoint. Board staff notes that, in regards to Rates 10 and M2, Union's proxy approach results in customer-related cost allocations that vary by more than 70% from an allocation based on the actual cost study.[72] Board staff understands that LPMA's comparison is not entirely an apples-to-apples comparison, however, the magnitude of the difference between the two methodologies gives Board staff reason to be concerned that Union's proxy approach may result in allocations of customer-related costs that are not entirely accurate.

SEC filed, on page 18 of its Panel 7 Compendium, a schedule which highlights that the customer-related costs on a per-customer basis for the cohort of customers that are switching rate classes under Union's volume breakpoint proposal is lower than the both the customers who are remaining in Rates 01 and M1 and those customers that are already in Rate 10 and M2.[73] Board staff is of the view that there is a likely flaw in the allocation methodology for moving the customer-related costs (i.e. Union's weighting approach) that results in per-customer costs for the cohort of customers moving classes to be lower than the costs for customers remaining in Rates 01 / M1 and Rate 10 / M2.

Board staff is also concerned by the rate impacts caused by Union's Rate 01 / 10 and Rate M1 / M2 volume breakpoint and rate block harmonization proposal. Board staff has set out a chart, filed by Union, of the delivery bill impacts below[74]:

[72] Exhibit K12.1 at p. 26.
[73] Exhibit K10.5 at p. 18.
[74] Exhibit J12.1.

Annual Volume	2013 Proposed with Annual Volume Breakpoint of 50,000 m³ Rate M1	Rate M2	2014 Proposed with Annual Volume Breakpoint of 5,000 m³ Rate M1	Rate M2	Bill Impacts $	%
1,800	323.12		324.97		1.85	0.6%
2,200	337.57		339.58		2.01	0.6%
2,600	351.94		354.09		2.14	0.6%
3,000	366.20		368.47		2.27	0.6%
5,000	436.44		439.21		2.77	0.6%
5,001	436.47			585.59	149.12	34.2%
6,000	470.93			618.57	147.64	31.3%
7,000	505.38			651.36	145.98	28.9%
10,000	608.53			749.11	140.58	23.1%
20,000	948.89			1,073.28	124.39	13.1%
30,000	1,288.78			1,396.41	107.64	8.4%
50,000	1,968.54			2,038.38	69.85	3.5%
60,000		3,252.26		2,355.05	(897.21)	-27.6%
70,000		3,642.17		2,671.24	(970.93)	-26.7%
80,000		4,031.07		2,987.00	(1,044.07)	-25.9%
100,000		4,804.38		3,616.58	(1,187.80)	-24.7%
200,000		8,521.82		6,720.25	(1,801.58)	-21.1%
300,000		12,148.30		9,797.39	(2,350.91)	-19.4%
500,000		19,308.57		15,922.58	(3,385.98)	-17.5%

As can be seen from the above chart, customers consuming between 5,001 m^3 and 20,000 m^3 will experience significant rate shock in 2014 if Union's proposal is approved. Overall, the proposal leads to increased costs for customers consuming less than 50,000 m^3 annually. Board staff notes that the rate impacts in the above table do not include the rate increases caused by Union's 2014 rate application (whether that application is filed under an IRM regime or Cost of Service). Therefore, these rate impacts will likely be even larger at the time that the proposal is actually implemented. In addition, Board staff notes that Union's general service customers are seeing significant rate impacts in 2013 (as a result of this application)[75] [76] and the Board needs to be mindful of how year-after-year rate increases will impact customers.

Union noted that only approx. 4% of its customer base will be adversely impacted by the Rate M1 / M2 volume breakpoint and rate block harmonization proposal.[77] Board staff is of the view that although the proposal only impacts a small number of Union's customers, those customers are impacted materially. A perfect example is the customer that is currently consuming just over 5,000 m^3 of gas annually. That customer in 2013 will pay about $436.47. In 2014, that customer will be paying

[75] Exhibit H3, Tab 4, Schedule 1 (Updated).
[76] Typical General Service customers are seeing delivery bill impacts as follows in 2013 (assuming Union's other requests for 2013 are approved): Rate M1 – 4.5%, Rate M2 – 10.9%, Rate 01 – 13.6%, and Rate 10 – 12.5%.
[77] Oral Hearing Transcripts, EB-2011-0210, Volume 12 at p. 22.

$585.59 (plus the impact of Union's 2014 rate case). That is not a fair outcome for that customer. Board staff notes that Union discussed rate continuity at length throughout the proceeding. In Board staff's view, this proposal does not address rate continuity. Board staff submits that Union should have offered a proposal to somehow ease the customer into the new rate class (and related higher delivery charges). As the proposal is currently designed, Board staff cannot support it. The rationale for the proposal is to create more homogenous rate classes and to increase rate class size, which the proposal does. However, in Board staff's submission, the cost, being the rate impacts discussed above, are more deleterious then any benefit accruing from the proposal.

For the above reasons, Board staff submits that the Board should reject Union's 2014 Rate 01 / 10 and Rate M1 / M2 volume breakpoint and rate block harmonization proposal.

Board staff notes that it does support Union's goal to achieve more homogenous general service rate classes and to increase the size of its larger volume general service rate classes. However, Union should file better supporting evidence for the manner in which costs will be allocated between the revised rate classes, create a plan to ease customers into the new rate classes and propose to implement the rate design proposal in a year that does not follow a year with significant rate increases which impact the same group of customers.

Rate Mitigation

Board staff is of the view that rate mitigation should only be applied when rate impacts are greater than 10% on the total bill. Board staff notes that 10% rate impacts on the total bill has been used, in the past, by the Board as an informal benchmark for what magnitude of rate impacts should trigger rate mitigation. Board staff submits that the same 10% benchmark is appropriate in this case.

If the Board's findings in this proceeding, when taken as a whole, result in rate impacts greater than 10% on the total bill, Board staff submits that the Board should consider any and all rate mitigation measures it deems appropriate.

Deferral and Variance Accounts

Short-term Storage and Other Balancing Services Deferral Account (No. 179-70)

Union noted that following the NGEIR Decision (EB-2005-0551), Union's practice has been to sell its non-utility storage space on a long-term basis and to sell the excess utility space on a short-term basis. Union stated that, despite this practice, it is authorized by the Board to sell non-utility storage space under short-term contracts and retain 100% of the revenues.

Union noted that if it sells short-term peak storage services using non-utility storage space, the total margins received from the sale of all peak short-term storage should be allocated to ratepayers and shareholders based on the utility and non-utility share of the total quantity of peak short-term storage (less than 2 years) sold each calendar year. Union stated that this methodology is transparent to all participants and will yield the same proportionate return on all short-term transactions for the ratepayers and the shareholders.

Union stated that considering the seasonal volatility and variability of market-priced storage, it cannot predict what period of time will yield the highest or lowest prices for short-term peak storage services. Union noted that the use of a proportionate share of calendar year margins ensures that neither party is impacted by the timing of storage sale, or fluctuations to storage values throughout the year.

Union noted that it is able to give effect to its proposal due to its ability to track what storage assets are being used for each type of storage transaction.

Union stated that, going forward, it will continue to sell all excess annual utility storage as short-term peak storage and 90% of all margins from C1 Off-Peak Storage, Gas Loans, Enbridge LBA, Supplemental Balancing Services, and C1 Firm Short-Term Deliverability will accrue to ratepayers.[78]

[78] Exhibit C1, Tab 7.

Union noted that it proposes to change the description of the Short-term Storage and Other Balancing Services Deferral Account (the "Short-Term Storage Account") in the accounting order to update the list of revenues included in the account and the proposed short-term storage margin sharing methodology.[79]

Union proposed the following description for the Short-Term Storage Account:

> 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; Peak Short-Term Storage underpinned by excess utility storage assets, Off-Peak Short-Term Storage, Gas Loans and Supplemental Balancing Services and the net revenue forecast for these services as approved by the Board for ratemaking purposes.[80]

Board staff supports Union's proposal with a few qualifications. Board staff is of the view that Union should sell only short-term storage services using the excess utility space and that the revenues should be allocated between the utility and non-utility storage operations as proposed by Union. With regard to how Union goes about selling short-term services, Board staff submits that Union must prioritize the sale of short-term storage services that rely on the excess utility storage space. This will help to ensure that ratepayers are not being adversely harmed by Union's non-utility business selling the same services as its utility business.

In addition, Board staff submits that the Short-Term Storage Account should capture payments related to storage encroachment. In its January 20, 2012 Decision and Order in EB-2011-0038, the Board stated the following:

> However, the Board does note that, in the past, Union has encroached on its utility space. The Board is of the view that the existence of Union's utility assets creates a situation where those assets effectively become an "insurance policy" in relation to Union's resource optimization activities on the non-utility side of its storage operations. Union's utility assets can act as a backstop on the rare occasions when Union oversells its non-utility storage space. The evidence suggests that the occurrence of this has been rare and it would be difficult to

[79] Exhibit H1, Tab 4.
[80] Exhibit H1, Tab 4, Appendix C.

> determine retrospectively to what degree, if any, Union relied on the existence of the utility assets in the conduct of its non-utility storage business to set contract terms and pricing.
>
> The Board is of the view that there should be an ongoing monitoring of this potential encroachment so as to inform the Board as to the need to revisit this issue at a future date. The Board therefore finds that Union shall be required to monitor for and maintain records of all future encroachments and provide such information in its rebasing application.[81]

It is Board staff's position that the Board, in EB-2011-0038, was clearly concerned about the occurrence of storage encroachment. The Board decided not to address this issue at that time because the occurrence had been rare (only one instance recorded in evidence).

Board staff notes that, in this proceeding, Union provided a schedule highlighting that for a brief period in 2011, Union again encroached on its utility storage position.[82] Board staff is of the view that this second recorded encroachment requires the Board to address the situation now.

Board staff submits that Union should be required by the Board to pay fair market value for the use of its utility storage space in the rare situations that Union's non-utility storage operation encroaches on its utility storage space. Board staff notes that in cross-examination Union stated that the cost to rectify its encroachment issue in October 2011 was $1.1 million (and this cost was incurred to move 2 PJs off its system).[83] Board staff requests that Union file a rate that could be used as a proxy for fair market value which can be applied by the Board in situations where Union encroaches on its utility storage space. Board staff notes that Union's proposal should be supported by robust rationale.

Board staff submits that the 10% incentive payment to Union's shareholder (which applies to the other net revenues in the Short-Term Storage Account) should not apply to storage encroachment payment amounts. Union should not be granted a 10% incentive payment for encroaching on its utility storage space.

[81] Decision and Order, EB-2011-0038, January 20, 2012 at p. 16.
[82] Exhibit C1, Tab 6.
[83] Oral Hearing Transcripts, EB-2011-0210, Volume 7 at p. 173.

In regards to the description for the Short-Term Storage Account, Board staff proposes the following.

> 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; Peak Short-Term Storage underpinned by the excess utility storage assets (above utility requirements and below the 100 PJ fixed utility asset), Off-Peak Short-Term Storage, Gas Loans and Supplemental Balancing Services and the net revenue forecast for these services as approved by the Board for ratemaking purposes.
>
> To also record, as a credit in Deferral Account No. 179-70, the fair market value payment related to any encroachment on Union's utility storage space by Union's non-utility storage operation.

Board staff notes that Mr. Rosenkranz proposed that the account should be broadened to include short term storage revenues obtained from optimizing utility storage space that is not classified as excess utility storage space.[84] Board staff disagrees with that proposal on the basis that the Board addressed this issue in EB-2011-0210 and stated:

> In regards to the argument put forth by CME and supporting parties that the revenues from *all* resource optimization activities should be shared with ratepayers, the Board disagrees. The Board finds that although Union's system is integrated, Union does plan its resource optimization activities around non-utility storage assets only.[85]

Board staff agrees with Union that "it is only the net revenue earned on the excess utility storage assets that are subject to deferral and sharing."[86]

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[84] Exhibit K10.7 at p. 11.
[85] Decision and Order, EB-2011-0038, January 20, 2012 at p. 16.
[86] Exhibit J.DV-4-10-1.

Establishment of Storage and Transportation Margin Deferral Account

As noted previously, Board staff is of the view that almost all revenues generated from the use of pipeline capacity that Union's customers have paid for in gas supply related charges should be used to offset gas costs.

For the other transportation and storage activities, that prior to the past IRM period would have been captured in Accounts 179-69,179-73, and 179-74 and do not fall under the above gas supply related activity classification, the related revenues should be captured in a new Storage and Transportation Margin Deferral Account. Board staff notes that Union's 2013 S&T Margin forecast is $23.9 million (this amount has been built into in-franchise rates).[87] This amount is exclusive of any FT-RAM revenues that may be generated during 2013. Board staff notes that Union provided a schedule which highlighted the amounts of transmission-related transactional services that would have been covered by the above noted accounts for 2010 (actual) to 2013 (forecast).[88] The amount that Union presented for 2013 is approx. $15.3 million. [89] [90] Board staff requests that Union, in reply argument, advise whether that amount changes based on excluding that revenues generated from the gas supply related transportation activities that Board staff has referred to above.

Board staff submits that the sharing mechanism for this account should be the same as that used for Accounts 179-69, 179-73 and 179-74 when they were still in operation. Therefore, 90% of the forecast margin amount should be built into rates and any variance from that amount should be shared 75:25 in favour of ratepayers which is the same ratio when the accounts were active in 2007.

Board staff also requests that Union file a proposed description for the account which includes the type of service offerings that would be covered. Board staff notes that Accounts 179-69, 179-73, and 179-74 covered the following revenue generating

[87] Exhibit H1, Tab 10, Schedule 1.
[88] Exhibit J6.2
[89] Transportation and Exchange Service Account (179-69) - $13.73 million, Other S&T Services Account (179-73) - $0.99 million and Other Direct Purchase Services Deferral Account (179-74) - $0.64 million; Total = $15.3 million.
[90] Board staff notes that of the $23.9 million S&T margin forecast Union has shown that $20.53 million would be covered by accounts 179-70, 179-69, 179-73, and 179-74. Board staff requests that, in reply argument, Union explain why the $3.4 million remaining ($23.9 million - $20.53 million) would not be subject to deferral account treatment.

activities (when they were still in operation): C1 Interruptible Transportation, Energy Exchanges, M12 Transportation Overrun, M12 and C1 Non-Loss-of-Critical-Unit Protected Firm Transportation, M12 Limited Firm/Interruptible Transportation, C1 Firm Short Term Transportation, Hub2Hub service, Off-system capacity, Redirection / Name Changes, Ontario production, other S&T services, Supplemental Load Balancing (T1 and R1) and T1 Storage Inventory Demand Charge.[91] Union should include any of the above activities that are still undertaken by Union and also add any new activities that Union is involved in since these accounts were discontinued (with the exception of the activities that rely on assets paid for as part of gas supply related charges).

Board staff is of the view that the significant variance between its forecast of S&T margins and the Board approved margin amount in rates (which would have been captured in the above noted accounts) during the last IRM term requires that ratepayers have protection from these variances in the test year.

Accounting Issues

<u>Segmented Disclosure of Utility Business</u>

Union does not file separate Audited Financial Statements (AFSs) for the regulated portion of the business. In the interrogatory response J.D-15-1-1, Union indicated that it does not consider the unregulated business as a reportable segment as defined by CICA (Canadian Institute of Chartered Accountants) Handbook. Union stated that it evaluates the need for reportable segments on management approach and the information used by the chief operating decision maker.

Natural gas RRR 2.1.6 states:

Where **the financial statements of the corporate entity regulated by the Board contain material business not regulated by the Board**, the utility shall disclose the information separately according to the segment disclosure provision in the Canadian Institute of Chartered Accountants ("CICA") Handbook.

[91] Exhibit K6.4 at pp. 10-13.

CICA Handbook Section 1701 Segment Disclosures established the criteria for a reportable segment as follows:

> An enterprise should disclose separately information about each operating segment that:
> (a) has been identified as an operating segment or that results from aggregating two or more of those segments using aggregating criteria, and
> (b) exceeds any of three quantitative thresholds (namely 10% of the combined revenues; 10% of the combined profit or loss and 10% of the combined assets).

In the oral hearing, Union confirmed that 24% of the utility's Earnings before Interest and Tax ("EBIT") for 2012 comes from Union's unregulated business as per Union's evidence Exhibit F4, Tab 2, Schedule 1. Union also confirmed that the EBIT percentage from unregulated business is similar in 2011. Union stated that it does not have a distinct set of financials for Union's unregulated storage operation that include interest and taxes. However, Union also stated that the allocation of the interest and tax numbers would merely be a product of an allocation exercise.

Board staff note that in the EB-2010-0008 proceeding, the Board ordered Ontario Power Generation to file a separate set of AFSs for its prescribed facilities. Since the unregulated business comprises 24%[92] of Union's total corporate earnings before interest and taxes in 2012 and is considered "material" as per RRR 2.1.6 and the CICA Section 1701, Board staff submit that Union should be required to file AFSs for the regulated portion of the business. Board staff further submit that regardless of the requirements under the CICA Handbook, Union should file AFSs for the regulated business.

Filing AFSs for the regulated portion of the business will allow the Board to better assess revenue requirement and earnings sharing in rate applications and monitor performance during the IRM period. Further, providing information on a segmented basis will lead to greater transparency and improved efficiency in rate applications. Intervenors will have more confidence in the segmented information presented in rate applications and this may also lead to less contentious proceedings.

- All of which is respectfully submitted -

[92] Oral Hearing Transcript volume 8. P.63