

June 11, 2007

BY FAX

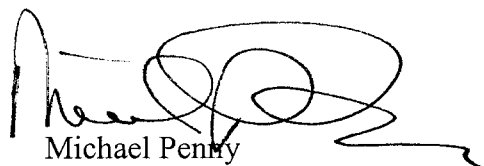
Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: EB-2007-0598

I am enclosing the Argument of Union Gas in this matter. The Confidential portion of this Argument has been redacted and will be filed under separate Private and Confidential cover.

Yours very truly,



Michael Penny

MAP/jeb
Enclosure

ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an Application by Union Gas Limited for an order or orders amending or varying the rate or rates charged to customers as of July 1, 2007;

**UNION GAS LIMITED
ARGUMENT**

1. By Application dated April 27, 2007, Union applied to the Board for final disposition of Union's 2006 deferral account balances and for final disposition of the 2006 earnings sharing amount.
2. The Board issued Procedural Order No. 1 on May 16, 2007 providing for a written hearing, including written evidence, written interrogatories and written argument. Union's written pre-filed evidence was delivered, with its application, to the Board on April 27, 2007. Union's written responses to interrogatories were delivered to the Board on June 5, 2007.
3. This is Union's Argument-in-Chief.

Overview

4. With respect to deferral account balances, as at the end of December 2006, Union's Board approved deferral accounts contained a net credit of \$179.570 million. This amount is comprised of \$197.803 million in credits in the gas-supply related deferral accounts (the majority of which has been managed through the QRAM process), \$16.990 million in credits in the storage and transportation-related deferral accounts and \$35.224

million in debits in the “other” deferral accounts. The individual deferral account balances are shown at Exhibit A, Tab 1, Schedules 1, 2 and 3 of Union’s pre-filed evidence and are described in detail at pp. 1-24 of Union’s pre-filed evidence. Each account balance shown in the evidence includes interest up to December 31, 2006. Interest is computed monthly on the opening balance of each account. Of the net balance of Union’s deferral accounts, Union is proposing to recover \$16.016 million from customers. The customer portion of Union’s pre-tax earnings sharing is \$12.879 million. Union is proposing to credit interest on this amount commencing January 1, 2007. The applicable interest rate used for the deferral account balances for the period January 1, 2006 to December 31, 2006 is the short-term debt rate of 4.15% approved by the Board in the RP-2003-0063 proceeding. Union is, therefore, proposing to dispose of a total debit balance in this proceeding of \$3.137 million (the difference between a \$16.016 million debit and a \$12.879 million credit).

5. It is now evident that it will not be possible to implement Union’s proposed disposition of deferral account balances and earnings sharing amount as part of the July 1, 2007 QRAM. Union, therefore, is proposing to implement the disposition of the deferral account balances and earnings sharing amount as part of the October 1, 2007 QRAM proceeding (Exhibit B1.5).
6. Union is proposing that interest accrue starting January 1, 2007 on the deferral account balances and the earnings sharing amount as approved by the Board in EB-2006-0117.

Gas Supply Deferral Accounts

7. Union’s Board approved QRAM process establishes reference prices for select gas supply deferral accounts and provides for the prospective refund/recovery of the

projected balances in these accounts, including interest, over the following 12 month period. Variances between the forecast and actual prospective refund/recovery amounts are tracked and included in the amounts prospectively recovered in future QRAM proceedings. Union made four QRAM applications in 2006. The Board approved all of them.

8. Under the QRAM process, the actual year end deferral account balances are subject to final Board approval.
9. As shown at Exhibit A, Tab 1, Schedule 1, p. 1 (and described at pp. 1-7 of Union's pre-filed evidence) the final 2006 gas supply related deferral accounts contain a credit of \$197.803 million, all but \$3.113 million of which (UDC and heating value) is recovered through the QRAM process.

Storage and Transportation and Other Deferral Accounts

10. Actual net revenues from storage and transportation services have been deferred against the net revenues included in rates as approved by the Board in the RB-2005-0520 Rate Order. Balances in the S&T deferral accounts are currently shared on a 75/25 basis between customers and Union. The credit balance of \$16.990 million represents the customer portion of the S&T deferral accounts. These accounts are discussed in detail at pp. 7-16 and in Exhibit A, Tab 1, Schedule 1 of Union's pre-filed evidence.

Normalized and Flow-Through Accounting for Taxes

11. The deregulation of a portion of Union's storage services business required a change to the timing of the recognition of certain deferred tax liabilities associated with the deregulated business.

12. Effective January 1, 1997, the OEB ordered a change in the accounting treatment of income taxes for Union from a normalized or deferred basis to a flow-through basis. Under both methodologies, approved rates were set to recover all of the taxes associated with Union's current and past economic activity. The difference between the two methodologies is only one of timing - when those liabilities must be recognized as a current cost of providing service.
13. The normalized method of accounting for income tax is, for most businesses, the required approach under Canadian Generally Accepted Accounting Principles ("GAAP"). Under the normalized method of accounting for taxes, the taxes recorded in a year must reflect both the current taxes payable and any future income taxes which relate primarily to the difference between tax and accounting depreciation in the relevant period.
14. Under the flow-through method of accounting, only those taxes actually payable in the current year need to be recorded as current liabilities. Under the flow-through method, therefore, those future tax liabilities arising from current economic activity which relate to the difference between tax and accounting depreciation need not be recorded in the current year but are only recorded in the year in which they actually become payable.
15. The flow-through method of accounting for taxes is, however, only available to rate regulated entities which meet three specified criteria:
 1. rates for service must be subject to approval by a regulator;
 2. rates must be designed to recover the cost of providing service; and

3. it must be reasonable to assume that rates set to recover costs in future can be charged to and collected from customers.
16. Under the flow-through method, the future deferred tax expense resulting from the difference between tax and accounting depreciation does not need to be reflected as a current expense because the entity is rate regulated and, therefore, there is a high level of comfort that the deferred future taxes associated with current or past economic activity will nevertheless be recoverable at a later date from customers.
17. However, when a business or portion of a business ceases to fulfill the preconditions for the flow-through method of accounting, the entity must immediately cease using the flow-through method, revert to the normalized method of accounting and reflect the deferred portion of the firm's tax liabilities in the current financial statements.
18. The OEB's NGEIR Decision effected a change in Union's eligibility to employ the flow-through method of accounting for a portion of Union's operations. The OEB released the NGEIR decision on November 7, 2006. In that decision, the OEB decided, among other things, to refrain from regulating rates for existing storage services to customers outside Union's franchise area and from regulating rates for new storage services to all customers, including those within the franchise.
19. Following this decision, Union no longer met the conditions precedent for flow-through accounting for income taxes with respect to revenues generated by these storage services. This is dealt with in Note 19 to Union's financial statements, which were audited and approved, without reservation, by Deloitte & Touche LLP on March 23, 2007.

20. Union also retained a second, independent audit firm, Ernst & Young, to opine on whether as a matter of accounting practice, Union was required to record immediately the formerly deferred tax liability associated with the portion of storage services that became deregulated as a result of the NGEIR Decision. Ernst & Young's opinion is that Union was required to record that deferred tax liability immediately.
21. The difference, in this case, between the current taxes paid under the flow-through method and the actual, all in, tax liabilities associated with Union's economic activity between 1997 and 2007 for long-term peak storage services is \$10.524 million. Put another way, the accounting rules for rate regulated entities allowed Union to defer certain current tax costs which benefited customers. Once the rate regulated exception for the flow-through method of accounting for the unregulated storage service business was lost, however, Union was no longer able to defer recording that portion of existing tax liabilities. This had the result that, rather than recognizing the cost of those tax liabilities in the future, those formerly deferred liabilities had to be recognized as a cost of providing long term peak storage services now.
22. The issue, therefore, is not whether rates should be set to recover this deferred tax cost. It was always been known and expected that rates would be set to recover that cost. The question is only one of timing – when would those tax liabilities have to be booked as a cost of providing long term peak storage services? The result of deregulation of this part of Union's business is that the formerly deferred portion of Union's tax liabilities can no longer be deferred. It must be recorded now.
23. Union will be responsible for all current and future tax liabilities associated with the unregulated storage business going forward. However, the issue here is the requirement

to recognize the liabilities associated with past revenues before deregulation - tax liabilities that, but for rate regulation, would already have been recognized and recovered in past years.

24. The only logical consequence, consistent with regulatory principle and historical treatment of income tax liabilities, is that since rates would have reflected and recovered the deferred tax liabilities under the flow-through method of tax accounting, they must also reflect and recover the same tax liabilities under the normalized method of tax accounting. Accordingly, Union debited this 2006 tax cost against 2006 income from the provision of the underlying storage services.
25. The “other” deferral accounts represent such things as deferred customer rebates/charges, direct purchase revenue, and several DSM variance accounts. These accounts are detailed at Exhibit A, Tab 1, pp. 16-24 and Schedules 1, 2, and 3 of Union’s pre-filed evidence. The total balance from the “other” deferral accounts is a debit of \$35.224 million.

2006 Earnings Sharing

26. The other issue in respect of which Union seeks final Board approval is the disposition of 2006 earnings sharing. Union has calculated the customer portion of Union’s pre-tax earnings to be \$12.879 million.
27. Union’s earnings for 2006 continue to be subject to the earnings sharing mechanism implemented by the Board for 2005. The mechanism is asymmetric with no dead band. Excess earnings are shared 50/50 between customers and Union, with any under earnings being for the company’s account. The Board indicated that any excess earnings should

be normalized for weather. Union is not requesting nor proposing that the Board conduct a rehearing on the appropriateness of weather normalizing earning for the purposes of earning sharing. However, Union continues to believe that the risk associated with the Board approved weather normalization methodology is not balanced and the practice of weather normalizing earnings for purpose of sharing with the ratepayers produces unacceptable results. While earnings are weather normalized for purposes of sharing, there is no off-setting methodology available to normalize the earnings impact weather has on operating costs or on S&T revenues.

28. Under the current earnings sharing mechanism implemented by the Board in 2005, earnings above the benchmark rate of ROE, normalized for weather, are shared equally between ratepayers and the Company. In particular for 2006, weather normalizing earnings for the purposes of earnings sharing requires Union to pay earnings to ratepayers that the Company in fact never earned. Before normalizing 2006 earnings for weather, there is no excess earnings to be shared with ratepayers, as the achieved return was below the benchmark ROE.
29. Union recognizes the Board's commitment to eliminating earnings sharing mechanisms as part of an incentive regulation framework and its plans to review weather normalization methods. The circumstances presented above illustrate the difficulties with earnings sharing mechanisms and support the need to address the method of weather normalization.
30. Exhibit A, Tab 1, Schedule 4 of Union's pre-filed evidence shows that Union's earnings subject to the sharing mechanism for 2006 were \$98.023 million prior to normalizing for weather. For 2006, the bench mark return on equity ("ROE"), as determined by the

Board approved formula, was 8.89%. The ROE calculated on actual 2006 earnings is 8.59%. Therefore, prior to normalizing for weather there would be no earnings sharing

31. In accordance with the Board's direction in the EB-2004-0480 and EB-2005-0189 proceedings, Union then weather normalized its earnings for purposes of the 2006 sharing mechanism. This involved two adjustments. These adjustments are detailed at Exhibit A, Tab 1, p. 29 and Schedule 4, Note 3.
32. First, Union adjusted its general service market volume and revenues in accordance with the weather normalization method for the general service rate classes approved by the Board in the RP-2003-0063 proceeding.
33. The second normalization adjustment related to the weather-related costs associated with unaccounted for gas ("UFG") and compressor fuel. On a weather normalized basis, consumption would have been higher and Union would have experienced higher compressor fuel and UFG costs. Accordingly, Union proportionally adjusted the UFG and compressor fuel costs as part of its earnings sharing weather normalization for 2006.
34. Exhibit A, Tab 1, Schedule 4 of Union's pre-filed evidence shows that Union's earnings subject to the sharing mechanism for 2006 were \$117.936 million after normalizing for weather. The associated ROE is 8.89%. Therefore, the 2006 variance to be shared between customers and Union is 10.33%. This produces the customer share of Union's pre-tax earnings of \$12.879 million.

[CONFIDENTIAL PORTION REDACTED AND FILED SEPARATELY]

Allocation and Disposition of 2006 Deferral Account Balances And 2006 Earnings Sharing Amount

35. Union's pre-filed evidence at Exhibit A, Tab 2, pages 1-8 and Schedules 1 and 2 proposes the methodology for allocation and disposition of Union's 2006 deferral account balances and 2006 earnings sharing amount. Exhibit A, Tab 2, Schedule 3 provides the impact of the proposed dispositions per residential customer in the Southern and Northern and Eastern Operations areas.
36. Union proposes to allocate the deferral account balances and earnings sharing amount in accordance with the methods approved by the Board in the past.
37. Because 2006 earnings sharing amount represents a variance relative to the benchmark ROE, Union is proposing to allocate this variance to rate classes using the same ROE allocation that was approved by the Board in 2004.
38. For the gas supply deferral accounts not recovered prospectively through the QRAM process, Union is proposing to allocate the balances using the approach Union has followed and the Board has approved in the past.
39. Similarly, the allocation factors proposed for the S&T deferral accounts and the "other" deferral accounts are all the same as the allocation factors approved by the Board in the RP-2003-0063, EB-2005-0211 and EB-2005-0520 proceedings.
40. Union is proposing to dispose of the deferral account balances and earnings sharing amount to infranchise general service (Rates M2, 01 and 10) customers prospectively over a three-month period, commencing October 1, 2007. The prospective refund or

recovery of variances is consistent with how Union refunds or recovers deferral account balances through the QRAM process.

41. Union is proposing to dispose of the deferral account balances and earnings sharing amount to distribution contract and exfranchise customers as a one time credit/charge with October 2007 bills.

Order Requested

42. Accordingly, Union requests an order of the Board approving the disposition of final deferral account balances and earnings sharing amount for 2006 as outlined in Exhibit A, Tab 1, Schedules 1, 2, 3 and 4. Union also seeks an order of the Board approving the method of allocation of these amounts proposed in Union's evidence at Tab 2, Schedule 1.

All of which is respectfully submitted

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

Michael A. Penny
Counsel to the Applicant,
Union Gas Limited