



uniongas

A Spectra Energy Company

January 7, 2009

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

Dear Ms. Walli:

Re: EB-2008-0220 – Reply Argument

Please find attached Union's Reply Argument in the above noted proceeding.

Yours truly,

[Original signed by]

Chris Ripley
Manager, Regulatory Applications

cc: EB-2008-0220 Intervenors
Michael Penny, Torys

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, pursuant to section 36(1) of the *Ontario
Energy Board Act*, 1998, for an order or orders approving
or fixing just and reasonable rates and other charges for
the sale, distribution, transmission and storage of gas as of
January 1, 2009

**REPLY ARGUMENT OF
UNION GAS LIMITED**

1. This is Union's Reply argument. It follows the headings used in Union's Argument in Chief. As the Reply endeavors not to repeat arguments already made, it should be read in conjunction with Union's Argument in Chief.

2009 Inflation Factor and Productivity Factor

2. Intervenors universally accepted Union's application with respect to the inflation and productivity factors as filed. Accordingly Union's proposals for the 2009 inflation and productivity factors should be accepted.

Z Factor Adjustments

3. Union is proposing Z factor adjustments for two matters in 2009: 1) the cost consequences associated with changes in taxation levels, as determined by the Board in EB-2008-0292; and 2) the cost consequences of adopting International Financial Reporting Standards ("IFRS").
4. Intervenors universally accepted Union's proposed Z factor treatment of the taxation levels. Accordingly, Union's proposals for the pass through of tax savings should be accepted.

5. Intervenor's opposed Union's proposed Z factor treatment of the costs related to IFRS. For the reasons set out below, Union submits that the intervenor arguments are without merit and that IFRS costs should be treated as a Z factor.

International Financial Reporting Standards

6. Union is proposing a Z factor adjustment, effective January 1, 2009, to cover costs associated with converting from Canadian generally accepted accounting principles to IFRS.

(a) IFRS Timing

7. Some intervenors have argued, as a so-called "threshold" issue, that because Union was aware of the IFRS issue in 2007, it should have been raised as part of the incentive regulation ("IR") proceeding (EB-2007-0606) and cannot now qualify for Z factor treatment. In support of this argument, CME and SEC claim that Z factors are only meant to provide for "unforeseen" or "unexpected" events. However, the criteria for Z factor treatment, to which they agreed in the settlement agreement in EB-2007-0606 and which were approved by the OEB, do not include the words or the concept of requiring a Z factor event to be "unforeseen" or "unexpected."
8. The Z factor adjustment is meant to provide for significant events which are beyond management's control. The Z factor adjustment is not restricted just to "unforeseen" or "unexpected" events.
9. Clear illustrations of this are explicitly mentioned in the approved settlement agreement: the cost of any judgment in Union's late payment penalty litigation and municipal permit fees. That there might be a judgment in Union's late payment penalty litigation was not unforeseen - indeed the possibility was explicitly *foreseen* in that the settlement agreement specifically mentions settlement or damages in the late payment penalty litigation as an example of a potential Z factor adjustment. The same can be said of municipal permit fees – they were not unforeseen either, and are also specifically mentioned as the source of a potential Z factor adjustment. They were potentially

significant events beyond management's control, the cost of which was, at the time unknown - just like the potential IFRS event.

10. In making the argument that a Z factor event must be "unforeseen" or "unexpected," therefore, SEC and CME are seeking to add additional criteria which were never agreed to or approved by the OEB and which are inconsistent with the Board-approved settlement agreement itself. There is no merit, therefore, to the suggestion that because the potential for IFRS costs was known in 2007, they can not qualify for Z factor adjustment now.
11. In any event, as noted at Exhibit B3.2, the CICA did not confirm the requirement of IFRS until February 2008, so conversion to IFRS was not confirmed by the time the settlement agreement was reached.
12. Further, as noted at Exhibit B6.2, Union did not complete a detailed cost analysis of IFRS impacts until mid-2008. Accordingly, even if Union had raised the potential for IFRS related costs during the IR plan in December 2007, there was no detailed review of the impacts and costs or even a CICA confirmation that IFRS would be implemented in Canada. There would have been nothing to talk about.

(c) Materiality

13. The principal objection of intervenors to Z factor treatment for IFRS costs is around the materiality threshold of \$1.5 M annually per Z factor event. The two principal arguments are: 1) the amount for 2009 (and 2010) is "close" to the threshold and is therefore suspect; and, 2) years 2011 and 2012 do not meet the materiality threshold. Both issues are dealt with below.
14. In Union's submission, whether the costs are "close" to the threshold or not is completely irrelevant. The narrow issue is whether the evidence, on a balance of probabilities, (not, as CME would argue, "convincingly") establishes a cost resulting from a Z factor "event" which exceeds \$1.5 M. In Union's submission, the evidence does establish a forecast cost in 2009 (and 2010) of \$1.5M which otherwise meets the criteria for a Z factor adjustment. As acknowledged at Exhibit B7.3 b), if the Board or

intervenors are concerned about variance between forecasted and actual IFRS costs, Union has no concern with the Board approving a deferral account to capture the IFRS costs.

15. The main intervenor arguments on materiality focus on: 1) “auditors’ fees;” 2) cost sharing with Westcoast; and, 3) so called 2008 costs being somehow “brought in” to 2009.

(d) IFRS Auditor’s Fees

16. A number of intervenors have questioned the \$299,000 attributable to “audit fees” in 2009. Union submits, first of all, that the evidence is that \$299,000 of costs related to Union’s auditors will be incurred in 2009 (Exhibit B 5.1(d), p. 4). There is no contrary evidence.
17. In any event, the amount is valid and is expected to be incurred in 2009. This cost relates to the initial up front work Union’s auditors will complete to review Union’s work and provide comments in advance of the implementation of any system and process changes required to comply with IFRS effective January 1, 2010 to produce comparative financial results for reporting in 2011.
18. The auditors fees included in 2009 (Exhibit 5.1(d) p.4) are related to the auditor’s preliminary work to review and approve the work Union must do to effect the transition from GAAP to IFRS, not the audit review of Union’s 2010 or 2011 financials which will occur in later years.
19. These fees paid to Union’s auditors to ensure the smooth and proper transition from Canadian GAAP to IFRS in Union’s financial reporting are transition costs related to IFRS that must be done *before* 2010, a year in respect of which Union will be required to file IFRS compliant financial statements. As noted several times in the evidence, because Union must file IFRS compliant 2010 financial information as well as 2011, Union’s transition to IFRS must be completed *before* 2010. Comments from Union’s auditors on Union’s transitional systems after 2009 will be too late.

(d) Union and Westcoast Energy Cost Sharing

20. In connection with the sharing of costs with Westcoast, intervenors have cynically turned a process that generated benefits for rate payers by reducing costs into another ground of complaint. Intervenors arguments on this issue are long on rhetoric but seriously short on facts.
21. The *evidence* is that Union worked with Westcoast to share resources and avoid duplicating effort and cost. The 50/50 allocation is not arbitrary. As Exhibit B6.1 c) indicates, Union worked with Ernst & Young to develop the cost impact of the transition to IFRS on Union from the ground up. The 50% figure is also, as a reality check, entirely consistent with the relationship of Union to other Westcoast subsidiaries, the relative balance of Union's assets (approximately \$4.8 B) to those of the consolidated Westcoast (including Union) of about \$9.6 B.¹

(e) Alleged 2008 Costs in 2009

22. Several intervenors argue that because 2008 costs are not recoverable, as having been incurred in a prior period for which a final rate order has already been made, somehow costs in 2009 *resulting from* investments made in 2008 should also be excluded from recovery. There is no logic or principle that supports this approach. Indeed, it is totally inconsistent with how rate regulation works. The only question is whether it is a cost incurred in 2009. If it is, it is not a "prior period" cost, even though the investment that caused this cost may have been made in a prior period. If this were not so, no ratebase additions would ever qualify for cost recovery.
23. CME's convoluted and ultimately irrelevant argument, that because capital additions are generally not added to rate base for cost recovery purposes during IR, misses the point. Z factors are an *exception* to the general rule. Z factor adjustments may involve the revenue requirement impact of capital investments just as much as they do OM&A expenditures. The question is not whether the costs result from a capital investment. The question is whether the cost meets the criteria for Z factor treatment and was incurred in

¹ Westcoast's 2007 audited financial statements are publicly available through SEDAR. See, for example, p. 38, footnote 5.

2009. The unchallenged and uncontradicted evidence in Exhibits A Tab 1, p. 6 Table 1 and B 5.1 p. 4(c) make it clear that the relevant cost is a cost incurred *in 2009*. The argument of CME and the other intervenors that the 2009 cost consequences of investments made in the prior 2008 period is confused, illogical and inconsistent with accepted regulatory practice. It lacks merit and should be rejected.

(f) IFRS Annual Costs

24. A number of intervenor submissions note that the IFRS costs included in Union's evidence for 2011 and 2012 are lower than the \$1.5 million threshold as contemplated in the Z factor criteria.
25. Union views the IFRS costs as a one time event and proposes to adjust rates annually over the IR term, given that the costs associated with the IFRS conversion are largely incurred in 2009 and 2010. Because a large proportion of those costs are capital costs associated with changes to Union's accounting system, there will be revenue requirement impacts beyond those years (depreciation, return, tax). Accordingly, the costs in 2011 and 2012 are directly relating to capital costs incurred in 2009 and 2010. They are part of the same Z factor "event" and cannot be viewed on a standalone basis (Exhibit A, T1, p. 6, Table 1; Exhibit B2.1(c)).

\$1.3 Million Ratepayer Credit per EB-2008-0304 Decision

26. A number of intervenor submissions note that Union's 2009 rate application does not include the \$1.3 million rate payer "credit" imposed as a condition of approval to transfer Union's voting shares to a wholly owned Westcoast limited partnership in EB-2008-0304. It is important to note, first of all, that this was a condition of leave to transfer shares. No share transfer has yet taken place.
27. Further, on December 1, 2008 Union filed a letter with the Board and intervenors informing parties that Spectra Energy would not be redeeming the preferred shares as part of an organizational restructuring. As noted at Exhibit B5.5, if the preferred shares are not redeemed, there is no revenue requirement reduction of \$1.3 million realized.

28. By letter dated December 19, 2008, the Board indicated that Union should file a motion to vary if it wished to change the third condition of approval established in EB-2008-0304. Union filed a motion to vary the EB-2008-0304 Decision in this respect on January 7, 2008. Accordingly, while that issue is outstanding, it would be inappropriate and premature to implement any rate change based on this condition.

Y Factor Adjustments

29. Intervenors either accepted Union's evidence or did not provide comment with respect to the proposed Y factor adjustments.
30. In addition, CME and IGUA invited Union to comment on the treatment of the revenues from the DOS-MN service offered by TCPL.
31. The DOS-MN service is part of Union's transportation portfolio that is available for optimization through S&T transactional activity. Benefits resulting from transactions to optimize transportation capacity have historically been and will, in the future, continue to be recognized as part of Union's regulated S&T transactional activity. The forecast margin from this type of transactional activity has long been recognized in the determination of rates.
32. The forecast margin from all S&T transactional activity included in rates was increased significantly in the 2007 rates settlement agreement. This margin was further increased in the incentive regulation settlement agreement when certain deferral accounts were eliminated (IR settlement agreement, p.33). The entire updated forecast was included in the determination of rates in 2008 for the benefit of ratepayers. The net result of these changes was to provide ratepayers with a fixed level of benefits from S&T transactional activity through the incentive regulation period, and to provide Union with a strong incentive to exceed that level of fixed benefit. Union is at risk for achieving the forecast results and is only rewarded if the net benefits exceed the threshold incorporated in rates.
33. Actual results for the year will be included in Union's determination of utility earnings, and will be subject to any earnings sharing, thereby providing the potential for further ratepayer benefit.

Long-Term Peak Storage Margin

34. Union confirms that rate payer credit related to 2008 long-term peak storage margins will be disposed of as part the 2008 deferral disposition proceeding.

Average Use Factor

35. Intervenors either accepted Union's proposal or did not provide comment with respect to the average use factor. Accordingly, Union's proposals for the AU factor should be accepted.

Annual Adjustment to General Service Monthly Charges

36. Intervenors either accepted Union's proposal or did not provide comment with respect to the general service monthly charge adjustments. Accordingly, Union's proposals for these adjustments should be approved.

Other Rate Schedule Changes

37. Intervenors either accepted Union's proposal or did not provide comment with respect to the other rate schedule changes. Accordingly, Union's proposals should be accepted.

Recovery of Rate Changes from January 1, 2009

38. Intervenors either accepted Union's proposal or did not provide comments with respect to the approval of rates effective January 1, 2009 and the recovery of rate changes from between the implementation date and January 1, 2009. Accordingly, these rate changes should be approved.

Conclusion

39. In conclusion, Union asks the Board to issue a rate order effective January 1, 2009 to reflect the proposed changes in rates as submitted by Union in this proceeding.

January 7, 2009

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AND TO: All Intervenors