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2006-05-01

VIA EMAIL and COURIER

Mr. Peter O'Dell
Assistant Board Secretary
Ontario Energy Board
2300 Yonge Street, Suite 2700
Toronto, ON M4P 1E4

Dear Mr. O'Dell:

**Re: Board File No.: EB-2005-0551
Natural Gas Electricity Interface Review Issues and Storage Regulation
Evidence of Enbridge Gas Distribution Inc.**

Please find attached ten copies of the evidence of Enbridge Gas Distribution in response to Appendix C (II) to Procedural Order No. 2.

Specifically, the evidence being filed by Enbridge Gas Distribution includes the following:

E-1-1	Storage Regulation
E-2-1	Regulatory Forbearance in Canadian Telecommunication Markets
E-3-1	Competitiveness of Natural Gas Storage Market

Also included is an updated index of the evidence of Enbridge Gas Distribution filed to date.

Yours truly,

A handwritten signature in blue ink, appearing to read 'David Stevens'.

David Stevens
Acting Senior Counsel, Regulatory

2006-05-01
Mr. Peter O'Dell
Page 2

Attachment

cc: Mr. F. D. Cass, Aird & Berlis (via email and courier)
EB-2005-0551 Interested Parties (via email)

Table of ContentsA – OVERVIEW AND BACKGROUND

<u>Exhibit</u>	<u>Tab</u>	<u>Schedule</u>	<u>Contents</u>	<u>Witness(es)</u>
A	1	1	Overview and Background	M. Giridhar

B – CONTEXT FOR DEVELOPING NEW RATES

<u>Exhibit</u>	<u>Tab</u>	<u>Schedule</u>	<u>Contents</u>	<u>Witness(es)</u>
B	1	1	Current Experience	D. Charleson J. Grant
	2	1	Operational Characteristics and Needs of Power Generation Customers	E. Chin E. Overcast
	3	1	Operational Characteristics and Issues: Load Balancing	D. Charleson
		2	Operational Characteristics, Issues, and Proposed Solutions: Storage	J. Grant
		3	Operational Characteristics, Issues and Proposed Solutions: Rate Implementation	J. Sarnovsky
	4	1	Rate Design Principles and Pricing Approaches	M. Giridhar

Table of ContentsC – PROPOSED TARIFFS FOR POWER GENERATION CUSTOMERS

<u>Exhibit</u>	<u>Tab</u>	<u>Schedule</u>	<u>Contents</u>	<u>Witness(es)</u>	
C	1	1	Overview	M. Giridhar	
		2	1	Rate 125	E. Overcast M. Giridhar
			2	Proposed Tariff for Rate 125	E. Overcast M. Giridhar
			3	Rate 125 – Draft Rate Schedule	M. Giridhar E. Overcast
	3	4	4	Rate 125 – Derivation of Charges	M. Giridhar E. Overcast
			1	Rate 316	E. Overcast M. Giridhar
			2	Proposed Tariff for Rate 316	E. Overcast M. Giridhar
			3	Rate 316 – Draft Rate Schedule	M. Giridhar E. Overcast
		4	4	Rate 316 – Derivation of Charges	M. Giridhar E. Overcast
			1	Additional Service Offerings	D. Charleson
			2	Additional Service Offerings – Derivation of Charges	D. Charleson
	3	Additional Service Offerings – Draft Rate Riders	D. Charleson		

Table of Contents

D – PROPOSED TARIFFS FOR RATE 300 CUSTOMERS

<u>Exhibit</u>	<u>Tab</u>	<u>Schedule</u>	<u>Contents</u>	<u>Witness(es)</u>
D	1	1	Overview	M. Giridhar
	2	1	Rate 300 – Overview, Description and Derivation of Charges	E. Overcast M. Giridhar
		1	Rate 300 – Draft Rate Schedule	E. Overcast M. Giridhar
	3	1	Rate 315 – Overview, Description and Derivation of Charges	E. Overcast M. Giridhar
		2	Rate 315 – Draft Rate Schedule	M. Giridhar E. Overcast

E – STORAGE REGULATION

<u>Exhibit</u>	<u>Tab</u>	<u>Schedule</u>	<u>Contents</u>	<u>Witness(es)</u>
E	1	1	Storage Regulation	J. Grant
	2	1	Regulatory Forbearance in Canadian Telecommunication Markets	View Communications
	3	1	Competitiveness of Natural Gas Storage Market	Navigant Consulting

STORAGE REGULATION

Introduction and Executive Summary

1. The purpose of this evidence is to respond to the Board's storage regulation questions that are posed in Appendix C (II) of the Board's Procedural Order No. 2 and to highlight relevant conclusions and observations from two independent studies that will be filed concurrently with this evidence.
2. The following pages analyze the over-arching forbearance question posed by the Board in this proceeding, as well as the Board's detailed questions, by making reference to independent studies. One study reviews established regulatory practice in the telecommunications industry and the second study analyzes the methodology and the results of the 2004 Energy Environment Analysis ("EEA") filed with the Board in the Natural Gas Forum. Enbridge Gas Distribution draws two conclusions from the analysis.
3. The first conclusion is that there is sufficient competition for the Board to refrain from regulating Enbridge Gas Distribution's storage rates and associated costs and rates of return, however, the Board should approve an exemption from this determination for all existing in-franchise customers.
4. The second conclusion is that the Board should refrain from economic regulation of new storage development as well as Transactional Storage Services because these activities take place in the competitive market, Enbridge Gas Distribution does not hold market power, and the participation of Enbridge Gas Distribution in the storage development marketplace is necessary to advance the Board's objective to promote the rational development of storage in the Province.

Witness: J. Grant

Studies Sponsored By Enbridge Gas Distribution

5. Enbridge Gas Distribution has commissioned two independent studies which provide useful background and analysis of rate forbearance experience, and the market power that Enbridge Gas Distribution has in the gas storage market.
6. The first study, by View Communications Inc., is filed at Exhibit E, Tab 2, Schedule 1. This study analyzes the forbearance experience in the Canadian telecommunications industry. It provides useful information concerning the forbearance history of the Canadian Radio-television and Telecommunication Commission ("CRTC") and the various standards, criteria, and policies that the CRTC has developed over the years. These approaches are to some extent unique to the telecommunications market, however, there are also parallels that can be drawn on the forbearance topic between the telecommunications industry experience and the question before the Board in this proceeding.
7. The second study, by Navigant Consulting Inc., is filed at Exhibit E, Tab 3, Schedule 1. This study comments on the methodology and results of the October 2004 EEA/Simon Fraser University study concerning competition in Natural Gas storage markets (filed in the Board's Natural Gas Forum materials) as they relate to Enbridge Gas Distribution.

The Board's Over-Arching Question

8. In its Procedural Order No. 2 at Appendix C (II), the Board poses an over-arching question concerning rate deregulation of gas storage, as follows:

"Should the Board refrain, *in whole or part*, from exercising its power to regulate the rates charged for the storage of gas in Ontario? (*Emphasis Added*)

9. This is an important question that has implications for ratepayers, utilities, and utility shareholders. In the view of Enbridge Gas Distribution, refraining from rate regulation *in whole* (complete forbearance) means that, subject to a Board finding that there is sufficient competition to protect the public interest, all ratepayer's gas storage rates would no longer be set and approved, by way of Rate Order, by the Board. These rates would be replaced by market prices and commercial arrangements between customers and their retail agents/marketers or various other parties which, taken together and operating in a competitive marketplace, would govern the final bill for storage services that each of a distribution utility's customers pay.
10. The public interest is served in a complete forbearance model by a sufficiently competitive marketplace where market power is not held by incumbent utilities and where informed customer choice, at the burner tip, allows customers or their agents to make prudent choices about how to utilize storage to balance their load requirements.
11. Complete forbearance from rate regulation also means that a utility's entire storage operations are subjected to competitive market pressures where its prices will fluctuate, depending on market conditions. As a result, the prices, revenues, expenses, net income and the rate of return of utility storage operations are subject to market conditions, not regulatory oversight and determination.
12. In the view of Enbridge Gas Distribution, refraining from rate regulation *in part* involves complete forbearance of a defined set of services, customers, or ratepayer groups (ie. a sub-set of the full suite of rates and services and/or markets). Such partial forbearance would need to meet the Board's same

Witness: J. Grant

forbearance test, but once this was met the same implications would apply as for full forbearance; those being that the utility's prices, revenues, expenses, net income and the rate of return associated with the defined set of services, customers, and ratepayers are subject to market conditions, not regulatory oversight and determination.

13. To answer the overarching question, there are a number of things that the Company suggests the Board consider. They include a proper definition of the market, consideration of competitive substitutes for storage within the defined market area, and a recognized quantitative test.
14. Reasoned and thorough consideration of these factors has been the hallmark of good analysis and regulation, and in Canada the roots of this analysis are found in the Competition Bureau's Merger Enforcement Guidelines. The EEA study discusses and applies these guidelines in its methodology. As the View Communications Study notes on page 7, the CRTC also applies this approach:

As with the Competition Bureau's Merger Enforcement Guidelines, the first step in the market power test is the definition of the relevant market. The relevant market is defined by the CRTC as follows:

The relevant market is essentially the smallest group of products and geographic area in which a firm with market power can profitably impose a sustainable price increase. Thus, in determining whether to refrain, and the extent to which it should refrain, the Commission considers it necessary to first identify a well-defined product market that takes into account the substitutes and other market features of the service in question.¹ (Emphasis added)

The relevant market should take into account the characteristics of the product or service in question and the geographic dimension of the product or service. The product market definition should include both the product offered by the company under review as well as any close substitutes for it. Buyers' ability and willingness to switch from one product to another, in response to a change in price is an important consideration for determining the products that should be included in

¹ CRTC, Telecom Decision 94-19, *Review of regulatory framework*, section III.B.

Witness: J. Grant

the relevant market. Similarly, the geographic market definition should consider the buyers' ability and willingness to obtain the product from a different location, in response to price changes.²

In situations where buyers can obtain a substitute for a supplier's product or can obtain the substitute from another location, in response to a price increase, the supplier is not considered to have market power.

15. Once a market has been properly defined and competitive substitutes have been taken into account, another important step in the process is to measure the concentration of ownership or market power in the defined marketplace. The analytic test recognized by gas industry regulators in the United States, Federal Energy Regulatory Commission ("FERC") involves the calculation of a Herfindahl-Hirshman Index ("HHI") value. The EEA report utilizes this measure in its analysis.
16. Only after considering these matters should the Board make a determination of the level of market power that Enbridge Gas Distribution has in the storage market place.
17. As indicated earlier, Navigant was engaged to review the October 2004 EEA/Simon Fraser University study concerning competition in Natural Gas storage markets (filed in the Board's Natural Gas Forum materials), and to comment on its analysis and the implications of that analysis for the regulation of Enbridge Gas Distribution's storage rates.
18. The Navigant Report makes the following observations and conclusions (at page 13):

The question raised by the EEA Study was whether Union Gas has market power in the provision of natural gas storage in Ontario. In accordance with FERC and general competition law procedure, the EEA Study answered this question in three steps:

² Competition Bureau, *Merger Enforcement Guidelines*, Part 3, September, 2004.

- Definition of the relevant market,
- Measurement of the market share and market concentration of the relevant firm, and
- Evaluation of other relevant factors.

In the first step, the EEA Study used good practice methodology to conclude that natural gas storage in Ontario is part of a much larger gas storage market, reaching from northern Illinois to the Niagara frontier. The second step showed that this market is highly competitive according to the quantitative structural tests, passing both US and Canadian screening tests for lack of seller concentration. Finally, the analysis confirmed competitiveness of the market by finding that other factors which could hinder competition, such as lack of regulatory barriers to trade or very high barriers to entry, do not exist.

The EEA Study therefore concluded that Union Gas does not have market power in the market for natural gas storage.

Navigant Consulting agrees with this conclusion. Navigant Consulting agrees with the methodology and conclusions of the quantitative analysis and the consideration of other relevant factors to define the relevant market. Navigant Consulting agrees with the structural assessment of that market. Navigant Consulting has computed the HHI index for the market, using the data presented in the EEA Study, and agrees that the HHI for working storage, using data by ownership group, is 1290, as found by EEA Study, well below the FERC screening value of 1800, confirming that the market is competitive.

From the same data, Navigant Consulting confirms that the four-firm concentration ratio is under 62%, meeting the Canadian Competition Bureau's criterion for a competitive market structure of a ratio under 65%. No one seller has more than a 21% market share, well under the 35% post-merger share criterion. Finally, Navigant Consulting agrees with the analysis of barriers to entry and regulatory barriers. Navigant Consulting also notes additional evidence with respect to the lack of barriers to entry, as detailed above.

Therefore, based on the evidence compiled and presented in the EEA Study, Navigant Consulting agrees with the conclusion of the EEA Study that Union Gas does not have market power in the market for natural gas storage.

Following this conclusion, Navigant Consulting concludes that Enbridge Gas Distribution does not have market power in natural gas storage. Enbridge Gas Distribution has a smaller physical storage capacity than does Union and only an 8% market share, so it would be even less capable of exercising market power by artificially raising and sustaining price. Enbridge Gas Distribution meets the historic and evolving FERC criteria for demonstrating that it does not have market power and that it should be granted market-based rates for its gas storage.

Accordingly, in Navigant Consulting's opinion, Enbridge Gas Distribution's storage could be relieved of price regulation with no negative impact on competition.

Further, Navigant Consulting believes that there is competition among jurisdictions for the location of new storage facilities. As established in the EEA Study and in the FERC decision, Ontario is part of a natural gas storage market that includes Michigan, the state with the most such facilities. Further, especially in the United States, storage regulation is rapidly evolving in the direction of more permissive pricing under many circumstances. In that context, it is important for Ontario's competitive position that as much pricing flexibility as feasible be accorded to Enbridge Gas Distribution in pricing natural gas storage.

19. As a result of the above, and given that Enbridge Gas Distribution does not hold market power, it is the Company's position that the Board should forbear from regulating all of Enbridge Gas Distribution's gas storage services, subject to the following exemption concerning the Company's in-franchise customer base.

In-Franchise Customer Base

20. A complete or whole forbearance would involve all storage services associated with all Enbridge Gas Distribution's in-franchise customers and markets, regardless of whether they are rate bundled or rate unbundled, and regardless of their end use.
21. Enbridge Gas Distribution takes the position that such a complete forbearance would only work for end use customers if they could be assured that they had real choice and sufficient competition for storage services at their burner tips.
22. These market conditions, in turn, can only exist for these customers if they first choose to be unbundled from distribution aspects of the system, after having weighed the advantages and disadvantages of bundled versus unbundled storage service, and then make an informed choice about what to do next.

Witness: J. Grant

23. In other words, for the true value of the highly competitive storage marketplace to reach all end use customers, they must first make an informed choice to unbundle the storage component from their bundled rate, and then they must review all the competitive storage offerings so that they make an informed and prudent choice of storage provider/service.

24. Because these conditions do not currently exist for these bundled customers, at their burner tips, Enbridge Gas Distribution recommends that the Board exempt Enbridge Gas Distribution's all in-franchise customers from rate forbearance at this time. The implications of this are that the Board would continue to regulate the storage rate component of distribution rates, at current levels of service, on the basis of the cost of service to Enbridge Gas Distribution of its current storage system, plus the cost to Enbridge Gas Distribution of its market priced storage contract (currently with Union Gas). Enbridge Gas Distribution estimates that this exemption would apply to its entire existing distribution customer base because there is only one customer who currently has chosen an Enbridge Gas Distribution unbundled storage service.

25. One final point to be made is that there are two built - in mechanisms that will allow for an increase in Enbridge Gas Distribution's rolled - in storage costs, over time, to a level that approaches a competitive market price for storage. The first mechanism relates to the fact that not all of the storage load balancing services required by Enbridge Gas Distribution's current distribution customers can be sourced from Enbridge Gas Distribution's own storage system, and as a result Enbridge Gas Distribution must procure storage services, at market, from a third party. Whether that third party is Union Gas or someone else the relevant test for the Board is whether the contracting process undertaken by Enbridge Gas Distribution has resulted in fair and reasonable prices from the market. If so, then

Witness: J. Grant

the rolling-in of the contract's pricing to Enbridge Gas Distribution's storage rates, for purposes of the calculation of the storage costs that qualify for the exemption, can be seen to be just and reasonable. The second mechanism relates to the fact that the Company's distribution system expands every year and from time to time it requires incremental storage space and deliverability that must be procured in the open and competitive storage market. Taken together, these mechanisms will increase the rolled-in storage costs over time, thereby gradually increasing the exempted (regulated) rates toward prices in the marketplace.

26. In summary, the need for this exemption is rooted in the fact that virtually all Enbridge Gas Distribution customers today have chosen to have storage (both company owned and the Union Gas contract) bundled into their rates. This leads to the conclusion that the existing capacity and deliverability of the Enbridge Gas Distribution's storage system, which is used or useful for balancing loads for existing end use distribution customers, should remain cost of service regulated.

Remaining Services and Activities Subject To Forbearance

27. It is the position of Enbridge Gas Distribution that, given the outcome of the market test discussed earlier, and excluding the exempted in - franchise customer services, there are two activities that should be the subject of a Board rate and regulation forbearance Order in this proceeding.
28. The first activity involves Transactional Storage Services. Given that these services are conducted in the competitive marketplace on a conventional basis by many buyers and sellers, that Enbridge Gas Distribution does not have market power in the storage marketplace, and that transactional storage services (ie., storage parking, loans, and other off-peak services) constitute uses of the storage system that are not necessary to balance loads for existing (ie.,

Witness: J. Grant

exempted) end use distribution customers, the Board should forbear from regulating Transactional Storage Services, effective in the 2007 Test Year. The consequential outcome of this is that all revenues, relevant costs, net income, and risks associated with this activity should be excluded from the Board's rate making process.

29. The second activity is prospective in nature and relates to the development of new storage capacity and deliverability. Given that these activities will be conducted in the competitive marketplace, that Enbridge Gas Distribution does not have market power in the storage marketplace, and that they are consistent with the Board's objective of rational system expansion of the storage system, the Board should forbear from economic regulation of the development of all new storage capacity and deliverability, effective in the 2007 Test Year. The first such example of new storage capacity and deliverability to be brought to the marketplace is the storage build that is proposed for the power generation market elsewhere in the Company's evidence in this NGEIR proceeding. The consequential outcome of this is that all revenues, incremental costs, assets, liabilities, net income and risks associated with the development of new storage capacity and deliverability should be excluded from the Board's rate making process.

The Board's Detailed Questions

30. In Appendix C (II) of the Board's Procedural Order No. 2, the Board posed four detailed questions that are related to the over-arching question. They are as follows:

1. *Do gas utilities (and/or their affiliates) either collectively or individually have market power in the provision of storage services for all or some categories of customers in Ontario?*

Witness: J. Grant

2. *If gas utilities (and/or their affiliates) do have market power in storage, is it appropriate for them to charge “market rates” for transactional and long-term storage services?*
 3. *If gas utilities (and/or their affiliates) do not have market power, is it in the public interest that all or some customers continue to pay storage rates at cost as opposed to market rates? How should the extra revenue from storage services at market rates be allocated?*
 4. *If the Board determines, based on considerations of market power and the public interest more generally, that some customers should pay for storage services at cost and others should pay for storage services at market prices, how should the line be drawn between the two types of customers and, specifically, should there be a constraining allocation of physical storage facilities to some types of customers based on measures such as aggregate excess or whether customers are considered “in-franchise” or “ex-franchise”? How should the extra revenue from storage services at market rates be allocated?*
31. With respect to the first three questions, the answers are contained earlier in this evidence.
32. Enbridge Gas Distribution notes that it has an affiliate who is interested in developing storage in Ontario if appropriate market conditions are apparent, however this affiliate is not currently a gas storage operator in Ontario or anywhere else in the market area. The HHI results discussed above, therefore, apply on an individual basis to Enbridge Gas Distribution and on a collective basis to both Enbridge Gas Distribution and its affiliate.
33. This affiliate (Enbridge Inc.) has intervened in this proceeding and will make submissions of its own.
34. It seems to Enbridge Gas Distribution that the Board’s fourth question contemplates a situation where the Board has determined that there is to be no forbearance of rates and services, or of a group of rates and services, as a result

Witness: J. Grant

of its deliberations in this proceeding. Instead, the Board would have determined in this proceeding that a blend of regulated cost based storage rates, and regulated market based storage rates, is the appropriate policy path.

35. In such a circumstance, question 4 raises issues relating to where the Board should draw the line between those paying cost based rates and those paying market based rates. In Enbridge Gas Distribution's system, this question can be answered by blending both market rates (for contracted storage) and cost rates (for Enbridge Gas Distribution owned storage) into one overall rate which would apply to existing customers, pursuant to existing cost allocation and rate design, as well as for new customers who have typical storage needs. For new customers who have unique requirements, Enbridge Gas Distribution proposes that they pay market based rates for that component of their requirements that exceed typical storage needs. One group of customers who have unique storage requirements are Gas Fired Generators. This group could pay market rates for storage above a line drawn at the typical level of deliverability (1.2%) afforded all other customers. In the absence of the Board's deliberations on the forbearance question, the Company has proposed this treatment elsewhere in this NGEIR filing. Any revenues generated above a floor price are proposed to be deferred and disposed of between interested stakeholders (including utility shareholders) in a subsequent proceeding.
36. The above noted approach allows for a methodical disposition of the matter in a non-forbearance scenario where the Board finds, as a matter of fact, that the market is not sufficiently competitive to protect the public interest for either all, or a group of, storage services.

37. There is, however, a broader and more serious implication to a non-forbearance outcome in this proceeding, and this is discussed below.

The Board's Objectives and Storage Development

38. In the Board's Report titled "Natural Gas Regulation In Ontario: A Renewed Policy Framework", issued in March, 2005, the Board noted that one of the five legislated objectives of particular relevance to the storage issue involves the facilitation of rational development and safe operation of gas storage (p. 45).
39. Enbridge Gas Distribution interprets this legislated objective as applying to all storage operators, and potential storage operators, in the Province.
40. The rational development and safe operation of gas storage in the Province requires that qualified storage operators, both existing and potential, be provided with an economic framework that encourages prudent risk taking and rates of return to shareholders that are commensurate with those risks.
41. Exploring for, finding, assessing, developing, marketing, and operating gas storage reservoirs is a business that is fundamentally different from a gas utility and the Board allowed rates of return that are related to gas distribution utilities. The risks of storage development are varied and substantial (eg. geological, geophysical, technical, financial, environmental, locational, landowner-related, commercial, and operational) and are therefore greater than those associated with utility distribution system expansion and development. Storage exploration and development is more akin to oil and gas exploration and development than to rate regulated utilities.
42. The Board found as much in a Consumers' Gas decision some years ago. In deciding how to treat the Consumers' Gas Exploration and Development ("E&D")

Witness: J. Grant

activities of the day the Board, in E.B.R.O 403, considered the benefits, the costs, and the risks of continuing to regulate the Company's E&D activities. After considering these factors the Board concluded, at paras. 5.11 and 5.12,

...should Consumers' elect to explore for new gas reserves, the customers may benefit from any success. Conversely, the customers will be at risk for capital investment, changes in government tax policies and gas pricing policies.

There is now no shortage of gas in Canada and since E and D involves considerable risk, it is the Board's opinion that all E and D activities should be removed from Consumers' utility operations effective September 30, 1986

43. The Board's Decision with Reason on this matter in the mid 1980's is instructive in the current context. In 2006, Ontario faces a situation where there will be no significant new storage developed unless economic deregulation occurs for all newly developed gas storage, regardless of the corporate entity that develops it. No prudent company, utility or otherwise, will take on the risks of new storage development without the commensurate rates of return. Failure to recognize this economic relationship would be an unfortunate outcome of a non-forgiveness scenario such as that contemplated in Question 4.
44. Given all of the above, in the view of Enbridge Gas Distribution, a decision in this case that does not refrain from regulating a utility's (or their affiliates) rates and returns for new storage development will serve to constrain, or perhaps even frustrate, the legislated objective of rational development of gas storage in Ontario.

Summary and Conclusions

45. There are a number of conclusions which the Board can draw from this evidence, and they are as follows:
- a. The gas storage market is sufficiently competitive to protect the public interest.

Witness: J. Grant

- b. Enbridge Gas Distribution does not have market power, as confirmed by Navigant, and as a result it will be subject to sufficient competition to protect the public interest.
- c. Given the above two conclusions, the Board should refrain from regulating the gas storage rates of Enbridge Gas Distribution, pursuant to Section 29 (1) of the *Ontario Energy Board Act, 1998*, subject to the exemption for in-franchise customers discussed in this evidence.
- d. The consequential effect of the Section 29 (1) ruling will be that all rates, revenues, incremental costs, assets, liabilities, net income and risks associated with the development of all new storage capacity and deliverability, as well as Enbridge Gas Distribution's Transactional Storage Services, should be excluded from the Board's rate making process, effective in 2007.

Regulatory Forbearance In Canadian Telecommunications Markets

Prepared for

Enbridge Gas Distribution Inc.

by

View Communications Inc.

May 1, 2006

View Communications Inc.

TABLE OF CONTENTS

1.	INTRODUCTION	1
2.	BACKGROUND	2
2.1	Telecommunications Competition	2
2.2	Relevance of the CRTC's competition and forbearance experience	3
3.	FORBEARANCE CRITERIA AND CONSIDERATIONS USED BY THE CRTC	5
3.1	Background and Overview	5
3.2	Market Definition.....	7
3.2.1	Product or Service Substitutes	7
3.2.2	Geographic Area	9
3.3	Market Share.....	11
3.4	Other Factors.....	12
3.4.1	Demand Conditions	12
3.4.2	Supply Conditions.....	13
3.4.3	Rivalrous Behaviour	15
4.	APPLICATION OF THE FORBEARANCE FRAMEWORK	16
4.1	Background.....	16
4.2	Market Definition.....	17
4.3	Market Share.....	17
4.4	Demand Conditions	18
4.5	Supply Expansion Capabilities	18
4.6	Rivalrous Behaviour	18
4.7	Forbearance Decision.....	19

5.	RECENT DEVELOPMENTS AND POST FORBEARANCE EXPERIENCE	20
6.	SUMMARY AND CONCLUSIONS	24

The CRTC's authority to forbear	Attachment 1
Summary of Canadian Telecommunications Markets Subject to CRTC Forbearance Rulings	Attachment 2
Excerpt from Telecommunications Decision CRTC 2006-15, <i>Forbearance from the regulation of retail local exchange services</i>	Attachment 3

1. INTRODUCTION

1. The Ontario Energy Board has initiated a proceeding to consider, among other things, whether the Board should refrain, in whole or part, from exercising its power to regulate the rates charged for the storage of gas in Ontario.
2. The Canadian Radio-television and Telecommunications Commission (CRTC) has forborne from regulating many telecommunications services since 1994 to the present. Most recently, the CRTC completed a proceeding to establish a framework for local forbearance, including criteria for use to determine when it is appropriate to forbear from regulating local telephone services. A Decision was issued on April 6, 2006.
3. There is no doubt that the natural gas and telecommunications industries are different. However, the factors driving the Board and the CRTC to consider forbearance, and their respective regulatory and policy objectives are strikingly similar.
4. The purpose of this report is to summarize the forbearance framework in use by the CRTC and offer it as a model which may assist the Board in its deliberations concerning forbearing from rates charged by Enbridge for gas storage in Ontario.

2. BACKGROUND

2.1 Telecommunications Competition

5. Since 1992, the CRTC has permitted the introduction of competition in virtually all telecommunications markets in Canada. Today, competitors exist for the supply of long distance services, telephone equipment, customer inside wiring, business and residential local telephone services, high-speed Internet services, wireless telephone services and data services.
6. The CRTC's authority to forbear from regulation derives from the Telecommunications Act (the relevant sections are provided in Attachment 1). The Telecommunications Act was proclaimed into law on October 25, 1993 and since then the CRTC has issued many Decisions and Orders concerning forbearance of telecommunications carriers' activities. A summary telecommunications markets subject to the CRTC forbearance rulings is provided in Attachment 2.
7. Most services offered by non-dominant telecommunications companies are not rate regulated and an increasing number of incumbent telephone companies' services are no longer subject to rate regulation. Services that remain rate regulated include residential basic local services, business single and multi-line local services, local calling features and options, pay telephone, digital network access, local channels and competitor services offered by the incumbent telephone companies.
8. In exercising its authority, pursuant to section 34 of the Telecommunications Act, the CRTC has used the analytical framework it developed in Telecom Decision CRTC 94-19¹. During proceeding leading to Decision 94-19, the CRTC examined alternative forms of regulation and the changes necessary to the regulatory framework to reflect an increasingly competitive telecommunications market. Among other things, the Commission developed an analytical framework to assess competitiveness for the purpose of determining whether or not the level of competition is sufficient to protect the interests of users. If the analytical framework indicates that there is sufficient competition in the market under review, the CRTC generally forbears from regulation of the market.
9. Section 3 provides a description of the criteria and considerations used by the CRTC in the exercise of its forbearance power.

¹ CRTC, Telecom Decision CRTC 94-19, *Review of Regulatory Framework*.

2.2 Relevance of the CRTC's competition and forbearance experience

10. In 1992, the CRTC commenced a detailed review of the regulatory framework for the incumbent telephone companies.² The purpose for the review and the incentives behind it were similar to those identified by the Board in its March 30, 2005 Natural Gas Forum Report.³ In fact, the CRTC's 1992 Review of Regulatory Framework shares many similarities with the Board's A Renewed Policy Framework initiative.
11. Both tribunals noted the significant changes occurring in their respective industries. The opening sentence of the Board's Report states "[t]he natural gas market is changing"⁴ and the Introduction to the Report states "[i]n view of the changing environment for the natural gas market, the Ontario Energy Board initiated the Natural Gas Forum in late 2003 to review the policy underlying key structural components of the natural gas regulatory system"⁵. Similarly, the CRTC introduced its review of the regulatory framework by noting that "the telecommunications industry has been characterized by significant technological changes".⁶
12. The Board confirmed that changes to the regulatory framework "are needed to address the emerging trends in the industry and to fulfil the Board's legislated objectives".⁷
13. The CRTC expressed a similar concern, stating:

The changing telecommunications environment raises questions as to whether the current regulatory framework is the most appropriate or effective to serve the public interest.⁸
14. In the context of this report, it is important to note that, notwithstanding the differences between the natural gas and telecommunications industries, both the Board and the CRTC identified comparable criteria for a new regulatory framework.⁹ In the March 2005 Report, the Board specified that the gas rate regulation framework must meet the following criteria:

² CRTC, Telecom Public Notice CRTC 92-78, *Review of Regulatory Framework*.

³ OEB, *Natural Gas Regulation In Ontario: A Renewed Policy Framework, Report on the Ontario Energy Board Natural Gas Forum*, March 30, 2005

⁴ OEB, *Natural Gas Regulation In Ontario: A Renewed Policy Framework, Report on the Ontario Energy Board Natural Gas Forum*, March 30, 2005, page 2.

⁵ OEB, *Natural Gas Regulation In Ontario: A Renewed Policy Framework, Report on the Ontario Energy Board Natural Gas Forum*, March 30, 2005, page 7.

⁶ CRTC, Telecom Public Notice CRTC 92-78, *Review of Regulatory Framework*.

⁷ OEB, *Natural Gas Regulation In Ontario: A Renewed Policy Framework, Report on the Ontario Energy Board Natural Gas Forum*, March 30, 2005, page 2.

⁸ CRTC, Telecom Public Notice CRTC 92-78, *Review of Regulatory Framework*.

⁹ Differences between the natural gas and telecommunications industries are discussed in Section 7.

- establish incentives for sustainable efficiency improvements that benefit customers and shareholders;
 - ensure appropriate quality of service for customers; and,
 - create an environment that is conducive to investment, to the benefit of customers and shareholders¹⁰
15. In a follow up proceeding to the review of the telecommunications regulatory framework proceeding, the CRTC stated that its regulatory framework was:
- ... designed to achieve the objectives and principles described below:
- (1) to render reliable and affordable services of high quality, accessible to both urban and rural area customers;
 - (2) to foster competition in the Canadian telecommunications markets;
 - (3) to provide incumbents with incentives to increase efficiencies and to be more innovative, and with a reasonable opportunity to earn a fair return for their Utility segments.¹¹
16. There are other significant parallels between the Board and the CRTC. The legislative authority, providing the tribunals with the power to refrain from rate regulation, are almost identical and each tribunal has indicated a willingness to consider forbearance as a means to achieve regulatory and policy objectives.
17. Technologies employed in the natural gas and telecommunications industries are different but the underlying objectives for regulation of the two industries are remarkably similar. In particular, the criteria used by the CRTC when determining whether or not forbearance is appropriate could be used, with appropriate modifications, as a regulatory tool for use by the Board to determine whether it should refrain from regulating the rates charged for natural gas storage in Ontario.

¹⁰ OEB, *Natural Gas Regulation In Ontario: A Renewed Policy Framework, Report on the Ontario Energy Board Natural Gas Forum*, March 30, 2005, pages 2-3.

¹¹ Telecom Decision CRTC 97-9, *Price cap regulation and related issues*, paragraph 10. A fourth objective was "to implement a price cap plan that is simple, straightforward, easy to understand and reduces the regulatory burden to the greatest extent possible".

3. FORBEARANCE CRITERIA AND CONSIDERATIONS USED BY THE CRTC

3.1 Background and Overview

18. In initiating its Review of Regulatory Framework proceeding, the CRTC issued a Public Notice requesting comments on how the regulatory framework should be modified.

19. Among other questions, parties were asked whether there should be more regulatory flexibility for the telephone companies in competitive markets.¹² As a result of the proceeding, the CRTC initiated a process to replace rate-of-return regulation with price cap regulation. In its Decision, which it subsequently characterized as a regulatory "blueprint"¹³, the CRTC also established a framework for determining if a market is subject to competition sufficient to protect the interests of users. If competition is sufficient, the Telecommunications Act stipulates that the CRTC "shall make a determination to refrain, to the extent it considers appropriate, conditionally or unconditionally, ... in relation to the service or class of services".¹⁴

20. The forbearance framework developed by the CRTC was consistent with competition policy literature and jurisprudence. The criteria was summarized in Decision 94-19 as follows:

- (1) the Commission should forbear when a market becomes workably competitive;
- (2) a market cannot be workably competitive if the dominant firm possesses substantial market power;
- (3) market power is a function of three factors: (a) market share held by the dominant firm; (b) demand conditions affecting responses of customers to a change in price of the product or service in question; and (c) supply conditions affecting the ability of other firms in the market to respond to a change in the price of the product or service;
- (4) high market share is a necessary but not sufficient condition for market power; other factors must be present to enable a dominant firm to act anti-competitively.

21. In the Decision, the CRTC relied on the Competition Bureau's Merger Enforcement Guidelines for assistance in identifying a "workably competitive

¹² CRTC, Telecom Public Notice CRTC 92-78, *Review of Regulatory Framework*, page 3.

¹³ CRTC, *Discussion Paper prepared for the Telecommunications Policy Review Panel*, paragraph 57.

¹⁴ See Attachment 1 for relevant sections.

market" and "market power".¹⁵ The presence of market power means the ability to profitably maintain prices about the competitive level for a significant period of time.¹⁶

22. The CRTC developed a series of "steps" or tests which, when applied, would assist in determining whether or not competition is sufficient to protect the interests of users and to forbear from regulating. The following steps were identified by the CRTC for assessing market and competitiveness:

Step 1, Defining the relevant market:

This first step is important because "once defined, the relevant market forms the basis for the entire forbearance exercise".¹⁷ Defining the relevant market entails identifying substitutes acceptable to customers and identifying the geographic area from which customers can feasibly obtain the product or service from other suppliers.

Step 2, Market shares:

The market share held by the largest firm, as well as the market shares of other firms, is determined. The CRTC also made it clear that market share alone should not be the determining factor. On this point, the CRTC said "[c]onsistent with the criteria contained in the Merger Enforcement Guidelines, the Commission considers that a number of factors in addition to market share should be considered in assessing market power".¹⁸

Step 3, Other factors to consider:

The CRTC identified the following three types of factors that should be considered in determining whether the market is workably competitive and to identify the presence of market power:

Demand conditions: Are customers able to switch to other suppliers in response to a price increase by the dominant firm?

Supply conditions: What are the expansion capabilities of companies in response to a price increase by the dominant firm?

Rivalrous behaviour: Is there evidence of rivalrous behaviour between suppliers in the market?

¹⁵ CRTC, Telecom Decision CRTC 94-19, *Review of regulatory framework*, section III.B.

¹⁶ Competition Bureau, *Merger Enforcement Guidelines*, paragraph 2.4, September, 2004.

¹⁷ CRTC, Telecom Decision CRTC 94-19, *Review of regulatory framework*, section III.B.

¹⁸ CRTC, Telecom Decision CRTC 94-19, *Review of regulatory framework*, section III.B.

23. After completing these steps, the CRTC would have sufficient information to determine if the dominant supplier has market power and the market is competitive sufficient to protect the interests of customers.
24. The next section explains each of the steps in more detail.

3.2 Market Definition

25. As with the Competition Bureau's Merger Enforcement Guidelines, the first step in the market power test is the definition of the relevant market. The relevant market is defined by the CRTC as follows:

The relevant market is essentially the smallest group of products and geographic area in which a firm with market power can profitably impose a sustainable price increase. Thus, in determining whether to refrain, and the extent to which it should refrain, the Commission considers it necessary to first identify a well-defined product market that takes into account the substitutes and other market features of the service in question.¹⁹ (Emphasis added)

26. The relevant market should take into account the characteristics of the product or service in question and the geographic dimension of the product or service. The product market definition should include both the product offered by the company under review as well as any close substitutes for it. Buyers' ability and willingness to switch from one product to another, in response to a change in price is an important consideration for determining the products that should be included in the relevant market. Similarly, the geographic market definition should consider the buyers' ability and willingness to obtain the product from a different location, in response to price changes.²⁰
27. In situations where buyers can obtain a substitute for a supplier's product or can obtain the substitute from another location, in response to a price increase, the supplier is not considered to have market power.

3.2.1 Product or Service Substitutes

28. In a recent Decision, the CRTC said that in determining if two products are sufficiently close substitutes to be in the same economic market, the underlying issue is whether or not the price of one product or service is affected by the price of the other product or service. Statistical evidence could assist in determining the

¹⁹ CRTC, Telecom Decision 94-19, *Review of regulatory framework*, section III.B.

²⁰ Competition Bureau, *Merger Enforcement Guidelines*, Part 3, September, 2004.

extent to which customers are willing to replace one service with the other in response to changes in prices.²¹

29. In the absence of statistical evidence, the CRTC determined that the substitutability assessment should be based on whether the services meet the same general user requirements. This does not mean that the services must be identical, but only that the services are sufficiently similar so as to satisfy the same general need of customers.²²
30. In the proceeding leading to the Decision, the CRTC considered whether or not voice over Internet protocol (VoIP) services were substitutes for the incumbent telephone companies' traditional local telephone services. The CRTC identified four factors to assist in making this determination; 1) the fundamental purpose of the services; 2) the manner in which local VoIP services are marketed and offered; 3) whether or not consumers perceive, or can be expected to perceive, local VoIP services as close substitutes for circuit-switched local exchange services; and, 4) whether or not local VoIP services and circuit-switched local exchange services are, or will be, purchased as replacements for one another.
31. Significantly, the CRTC determined that the technology used to provide the service is not a significant consideration; "[f]rom a consumer's perspective, the key question is not what technology is used to provide a service, but rather what use the service is to the consumer".²³ Although VoIP and traditional local telephone services are not identical, the CRTC concluded that they are substitutes for one another and therefore in the same relevant market, stating:

Based on the record of this proceeding, the Commission concludes that local VoIP services satisfy, or will satisfy, the same general user requirements of consumers of circuit-switched local exchange services. The Commission therefore finds that local VoIP services are close substitutes for circuit-switched local exchange services, and therefore are part of the same relevant market as these circuit-switched services.²⁴

32. From a buyer's perspective, the key question is the use of the service, not the technology or the means to provide the service.²⁵

²¹ CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraphs 106-107.

²² CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraphs 109

²³ CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraphs 110-111.

²⁴ CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraphs 126.

²⁵ CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraph 111.

33. Applying these considerations, the CRTC concluded that the fundamental purpose of VoIP local voice service is the same as circuit-switched local telephone service (i.e., traditional telephone service). Both types of services, even though they use different technologies and have certain service attributes that are different, provide real-time voice communications to/from anyone on the public switched telephone network.²⁶ In its Decision in the CRTC noted:

The Commission considers that neither the additional features nor the limitations of local VoIP services define or modify the fundamental purpose of the service nor will they prevent consumers from perceiving local VoIP service a replacement for circuit-switched local exchange service.²⁷

3.2.2 Geographic Area

34. The second aspect of the market definition is the geographic size of the market. If buyers are willing to substitute existing services with services acquired from other locations then services from those other locations should be included in the relevant market.
35. In 1997, the CRTC issued a Decision related to an application filed by the incumbent telephone companies for forbearance from regulation of interexchange private line services.²⁸ The nature of these services is such that the dedicated connection between two specific locations within Canada is available to a customer for transmitting voice, data and/or video between its two locations. Given the route specific nature of the service, the CRTC concluded that each route (or city-pairs) should be considered as a separate market for the purposes of forbearance analysis.²⁹ In other words, a buyer that requires an interexchange private line between cities A and B is not likely to substitute the service with one between cities X and Y.
36. Telecommunications services that are not route specific, such as local telephone services are somewhat more difficult to assess for determining the relevant geographic market. In the CRTC's recent Decision on forbearance from the regulation of retail local exchange services, the CRTC noted that strict application of the smallest geographical area test would require each and every location, where local telephone service is provided, as a market because "buyers would not

²⁶ CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraph 113.

²⁷ CRTC, Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol*, paragraph 124.

²⁸ The CRTC's decision to forbear from the regulation of interexchange private line services is discussed in more detail in Section 4, as an example of the application of the forbearance framework to a telecommunications market.

²⁹ CRTC, Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - forbearance from regulation of interexchange private line services*, paragraph 66.

be willing to substitute calling from their location for calling from another location".³⁰

37. The CRTC wisely decided that it would be impractical to define each location-specific service as a geographic market. In any case, the CRTC determined that there are economic, social and practical factors which should be considered when determining the geographic market. The criteria adopted for assessing the geographic market should include:

- an area with a social and economic community of interest, that has substantially similar local telecommunications market conditions, including common pricing and marketing strategies, local service providers and local service offerings; and
- an area that is administratively practical, competitively neutral, and which has well-defined, stable boundaries.³¹

38. The CRTC considered the following geographic areas³², listed in approximate size from smallest to largest:

Local Exchange³³,
Serving area of a full facilities-based provider of local telephone services,
Local Calling Area³⁴,
Local Interconnection Region³⁵,
Census Metropolitan Area (CMA), and
Province or incumbent-operating territory.

39. The CRTC concluded that the best approach for defining a relevant geographic market for local exchange services is the CMA. The reasons in support for this choice included:

³⁰ CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 141.

³¹ CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 141.

³² CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 142.

³³ The CRTC defines local exchanges as the basic unit for the administration and provision of telephone service by an ILEC, which normally encompasses a city, town or village and adjacent areas. Within an exchange and to other exchanges that have extended area service (EAS) or similar services with that exchange, all subscribers may place an unlimited number of calls of any duration to all other subscribers without incurring long distance toll charges.

³⁴ The CRTC defines local calling area as the sum of all destinations to which a dialled connection may be established over the public switched telephone network without incurring a long-distance charge above and beyond the local rate.

³⁵ A local interconnection region is an area including multiple incumbent local telephone company exchanges, used for defining the coverage areas for two local exchange carriers interconnecting with each other.

- customers within a CMA will generally have common social and economic interests,
- the CMA is more stable and well-defined than a local calling area or competitor serving area,
- the use of a CMA will result in increased efficiency in regulation, and
- the CMA is large enough to limit concerns about anti-competitive action but not so large to unduly delay forbearance.

3.3 Market Share

40. The CRTC's next step in assessing market competitiveness involves determining the market share held by the largest firm, as well as the market shares of other firms. A large market share is a necessary condition for market power, but may not indicate market power if there is easy entry into the market, rivalry among suppliers, and if buyers are knowledgeable and have the ability to switch suppliers.

41. In its Public Notice initiating a review of the forbearance framework for local telephone services, the CRTC summarized this point as follows:

High market share is a necessary but not sufficient condition for market power; other factors must be present to enable a firm with market power to act anti-competitively.³⁶

42. The CRTC's practice to not rely solely on market share measurements when assessing market power is consistent with the Competition Bureau's Merger Enforcement Guidelines. The Guidelines state:

Information that demonstrates that market share or concentration is likely to be high does not, in and of itself, provide a sufficient basis to justify any conclusion that a merger is likely to prevent or lessen competition substantially.³⁷

43. Since market share alone is not definitive of market power, the CRTC determined that it would be inappropriate to adhere to a particular market share as a basis for determining whether to forbear.³⁸ In fact, the CRTC has determined that even with market shares of 70% and 75%, it was appropriate to forbear from regulating

³⁶ CRTC, Telecom Public Notice 2005-2, *Forbearance from regulation of local exchange services*, paragraph 14.

³⁷ Competition Bureau, *Merger Enforcement Guidelines*, paragraph 4.11, September, 2004.

³⁸ CRTC, Telecom Decision CRTC 97-19, *Forbearance - regulation of toll services provided by incumbent telephone companies* section III.B.

- the incumbent telephone companies in the long distance and local telephone markets, respectively, if other conditions are satisfied.
44. In 1997, the CRTC decided to refrain from regulating the incumbent telephone companies' long distance telephone services.³⁹ In the Decision, the CRTC noted that the incumbent telephone companies had approximately 70 percent of the long distance market. In spite of the dominant market share, the CRTC concluded that the competitors' growing traffic volumes and steadily increasing market share was evidence that subscribers were able and willing to change suppliers. These factors led the CRTC to conclude that, even though the incumbent telephone companies had approximately 70 percent of the market, they did not have market power. In the absence of evidence of market power, the CRTC concluded that it should refrain from regulating long distance rates.
45. In its April 6, 2006 Decision concerning forbearance from the regulation of local telephone services, the CRTC determined that an incumbent telephone company with 75 percent market share or less should be forborne from the requirement to file local telephone service rates with the CRTC, if other conditions are satisfied.⁴⁰ The CRTC said it recognized that setting appropriate market share levels for forbearance is "not a precise scientific exercise" but any market share level, chosen as a forbearance condition in conjunction with other criteria, should demonstrate that competition in the relevant market is sustainable.⁴¹
46. The Competition Bureau has also established thresholds to identify mergers that are unlikely to have anti-competitive consequences from those that require a more detailed analysis. A market share less than 35 percent will generally not raise concerns about market power or be challenged by the Competition Bureau. A merger leading to a market share greater than 65 percent will generally cause the Competition Bureau to examine various factors to determine whether the merger will create, maintain or enhance market power.⁴²

3.4 Other Factors

3.4.1 Demand Conditions

47. In Decision 94-19, the CRTC described the process for assessing demand conditions as follows:

³⁹ CRTC, Telecom Decision CRTC 97-19, *Forbearance - regulation of toll services provided by incumbent telephone companies*.

⁴⁰ Telecom Decision CRTC 2006-15 and the list of pre-conditions for regulatory forbearance of local telephone service is discussed in Section 5.

⁴¹ CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 247.

⁴² Competition Bureau, *Merger Enforcement Guidelines*, paragraphs 4.12-4.13, September, 2004.

...demand conditions will affect the ability of the dominant firm to exercise market power. In assessing demand conditions, the basic focus is on the ability of customers to switch to another supplier or reduce consumption of the good or service in question in response to a price increase. Important market demand conditions identified by parties included: (1) the availability of economically feasible and practical substitutes; (2) the costs to customers of switching suppliers (the higher these costs, the greater the market power of the dominant firm); and (3) whether the product is an essential input, for example, a bottleneck service, into the customer's production process.⁴³

48. In circumstances where buyers have economically feasible and practical substitutes and costs of switching do not impede substitution, the dominant firm is not considered to have market power.
49. Factors that have led the CRTC to conclude that demand conditions are sufficient to prevent the dominant supplier from exercising market power include:
- customers are knowledgeable about the nature and pricing of the service⁴⁴,
 - customers can easily switch service providers⁴⁵,
 - customers do not need to incur significant additional capital costs to switch between service providers⁴⁶, and
 - long term contracts between suppliers and customers are not a sufficient reason to withhold forbearance⁴⁷.

3.4.2 Supply Conditions

50. The CRTC identified the following supply factors for assessing market power:

The Commission also considers it important to obtain information on the supply expansion responses of firms to price increases or other developments affecting the relevant market. *The easier it is for rivals to expand output in response to a non-transitory price increase, the lower is the dominant firm's market power.* For example, it is important to assess

⁴³ CRTC, Telecom Decision CRTC 94-19, *Review of regulatory framework*, section III.B.

⁴⁴ CRTC, Order CRTC 2000-553, *Forbearance granted for telcos' wide area network service*, paragraph 17.

⁴⁵ CRTC, Order CRTC 2000-553, *Forbearance granted for telcos' wide area network services*, paragraph 17, and Telecom Order CRTC 96-130.

⁴⁶ CRTC, Telecom Order CRTC 96-130.

⁴⁷ CRTC, Telecom Decision CRTC 98-8, *Local pay telephone competition*, paragraphs 98 and 99; Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 90.

whether competitors have enough capacity, or could easily add new capacity, to accommodate a substantial number of new customers in a reasonable period of time, if dominant firms were to raise prices significantly.

*The likelihood of entry is an important and related supply factor that the Commission must take into account in assessing the competitiveness of the market for a service or class of services. In this context, the Commission will consider whether entry occurred in the past, whether current attempts are being made to enter, and whether firms from related product or geographic markets have considered expanding into the relevant market. The Commission will also consider the nature of barriers to entry affecting the market, such as the presence of essential bottleneck facilities that competitors cannot duplicate and whether there are regulations or policies in place that prevent or limit entry, such as restrictions on foreign ownership, regulatory or licensing approvals or approvals for rights of way.*⁴⁸ (Emphasis added)

51. The Competition Bureau's Merger Enforcement Guidelines use the following factors to assess whether suppliers are able to profitably utilize excess capacity to begin supplying products in the relevant market, in response to a price increase:
- switching costs, such as the cost of adapting facilities (including distribution) in order to substitute production and/or sales in the relevant market for current production;
 - whether the firm is able to reposition its products or extend its product line;
 - whether and to what extent the firm is committed to producing other products;
 - to what extent the firm has excess capacity;
 - applicable intellectual property rights; and
 - applicable regulations that impose product quality or labelling standards and specifications, or that impose licence/permit requirements.⁴⁹
52. In 1997, the CRTC decided to refrain from the regulation of the incumbent telephone companies' interexchange private line services. In making its decision, the CRTC noted that there was a supply of alternative telecommunications facilities needed to provide the interexchange private line services. In addition, the CRTC decided to approve the forbearance applications because "competitors

⁴⁸ CRTC, Telecom Decision 94-19, *Review of regulatory framework*, section III.B.

⁴⁹ Competition Bureau, *Merger Enforcement Guidelines*, paragraph 4.2, September, 2004.

have the ability to expand capacity in response to any pricing increase by the dominant supplier".⁵⁰

53. The CRTC determined that the incumbent telephone companies' high speed interexchange private line facilities should be granted forbearance when there is evidence that a competitor is providing interexchange private line service on the same route, to at least one customer.⁵¹

3.4.3 Rivalrous Behaviour

54. In its Review of Regulatory Framework Decision, the CRTC said:

In assessing the degree to which a market may be workably competitive, evidence of rivalrous behaviour is also important. Such evidence may include falling prices, vigorous and aggressive marketing activities, or an expanding scope of activities by competitors in terms of products, services and geographic boundaries.

55. During the forbearance from regulation of local telephone service proceeding, the CRTC had the opportunity to consider rivalrous behaviour between local telephone service providers, particularly in Atlantic Canada. In the Decision, the CRTC determined that rivalrous behaviour exists, as explained below:

The Commission notes that the record provides clear evidence of rivalrous behaviour in the Halifax LFR [local forbearance region]. Both Aliant Telecom and EastLink are vigorously competing for residential local exchange customers through the use of bundles, promotions and extensive advertising campaigns. The Commission considers, therefore, that Aliant Telecom has provided sufficient evidence of rivalrous behaviour in the Halifax LFR.⁵²

⁵⁰ CRTC, Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 77.

⁵¹ CRTC, Telecom Order CRTC 99-434. The ruling applied to high capacity interexchange private lines. The forbearance test was specified as: "The Companies' domestic High Capacity/DDS services on a particular route will be granted forbearance upon the Commission being satisfied that one or more competitors of a Company are offering or providing, on that route, the equivalent of DS-3 bandwidth (or greater) on a private line basis to at least one customer, using terrestrial facilities from other than the Company in question or an affiliate of that Company". A DS-3 capacity is capable of supporting approximately 672 simultaneous voice conversations.

⁵² CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 506.

4. APPLICATION OF THE FORBEARANCE FRAMEWORK

56. This section summarizes how the CRTC applied its forbearance framework in the context of a typical forbearance application received from the incumbent telephone companies.

4.1 Background

57. In Decision 1997, the CRTC approved an application from the incumbent telephone companies to refrain from the regulation of their interexchange private line (IXPL) services.⁵³ An IXPL service is one that provides a clear communications path between two specific locations, determined by the customer, for the purpose of transmitting voice, data and/or video. An IXPL service is typically used by large business customers, such as banks, to transmit data files between data centres.

58. In 1994, the CRTC denied an application for the forbearance from regulation of IXPL certain competitive data services. The reasons provided for denying the earlier application were:

In the opinion of the Commission, the key issue to address with respect to forbearance is the supply of transmission facilities. In the case of private lines, there are essentially only two significant national facilities-based providers, Unitel and the Stentor members. Other entrants in these markets are small regional providers.⁵⁴

59. According to the incumbents, their market share was 67 percent of the market that included a range of competitive business services, including IXPL. Although the CRTC had denied the incumbent telephone companies' application, by September 1995 the CRTC decided to forbear from regulating all of Unitel's IXPL services.⁵⁵

60. In September 1996, the incumbent telephone companies filed a new application requesting forbearance from the regulation of IXPL services and the CRTC initiated a public proceeding to consider the application.⁵⁶ The CRTC used the

⁵³ Stentor Resource Centre Inc. was an organization that acted on behalf of the large incumbent telephone companies in Canada.

⁵⁴ CRTC, Telecom Decision 94-19, *Review of regulatory framework*, section III.C.2.b.

⁵⁵ CRTC, Telecom Decision 95-19, *Forbearance-services provided by non-dominant Canadian carriers*. In fact, the CRTC decided in favour of forbearing from the regulation of almost all services offered by Unitel, including IXPL services, even before it had the legislative authority to do so. However, in 1989, the Federal Court of Appeal reversed the CRTC's Decision in Telecommunications Workers' Union v. Canadian Radio-television and Telecommunications Commission and CNCP Telecommunications [1989], 2 F.C. 280, determining that the CRTC lacked the power to forbear from regulating services over which it had jurisdiction. It was not until the passage of the Telecommunications Act in 1993 that the CRTC was empowered to forbear from rate regulation.

⁵⁶ Telecom Public Notice CRTC 96-35, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*.

forbearance framework, described in the previous section, to assess whether the IXPL market was competitive sufficient to protect the interests of customers.

4.2 Market Definition

61. In considering whether to forbear from regulating IXPL services, the first step was the definition of the relevant market. The incumbent telephone companies defined the IXPL market as all interexchange private line services offered by them throughout their operating territories.⁵⁷ The CRTC, noting that the relevant market is the smallest group of products and geographic area in which a firm with market power can profitably impose a sustainable price increase, defined the market differently. It decided that IXPL was composed of two types of services and each of them in different markets. The first was older, lower capacity analogue services usually provided over copper technology, while the second type were high capacity and higher-quality, typically used for high-speed data (high-capacity services).
62. The CRTC also determined that the relevant geographic market was not the entire operating territories of the incumbent telephone companies. Noting that IXPL services are offered and provided on a route-specific basis, the CRTC concluded that each route should be considered a separate market. As a result, the CRTC decided that decisions regarding the forbearance of incumbent telephone companies IXPL services also should be made on a route-specific basis.

4.3 Market Share

63. With regards to the analogue IXPL services, the CRTC concluded that the incumbent telephone companies maintained a market share of 80 percent, and as high as 90 percent in Atlantic Canada. The CRTC also noted that the market share had remained virtually unchanged over the last three years and that there was little or no new entry by competitors. Based on this assessment, the CRTC concluded that, "absent regulation, the interests of customers of services would not be sufficiently protected" and denied forbearance from regulation of analogue IXPL services.⁵⁸
64. During the course of the proceeding, the CRTC was provided with market share estimates for high-capacity IXPL services but the estimates were not considered reliable enough for the purpose of the proceeding. However, the CRTC believed that it had sufficient information about the market to conclude that the incumbent telephone companies were losing market share to new entrants.

⁵⁷ Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 52.

⁵⁸ Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 69.

4.4 Demand Conditions

65. In considering demand conditions for high-capacity IXPL services, the CRTC considered whether or not customers' long-term contracts and associated contract termination penalties with the incumbent were a significant impediment for customers to switch service providers. The CRTC concluded that, although contract termination penalties were an impediment, long-term contracts also provided customers with lower rates. The CRTC concluded that technical standards for high-capacity IXPL equipment enabled customers to readily configure their networks and make use of alternate suppliers.⁵⁹
66. On this basis, the CRTC concluded that demand conditions did not provide the incumbent telephone companies with market power that would be detrimental to customers' interests.

4.5 Supply Expansion Capabilities

67. A number of factors were considered by the CRTC. It was noted that there were multiple facilities providers in the geographic areas which represented in excess of 80 percent of the total Canadian telecommunications market and that new fibre facilities builds were expected along many of the routes served by the incumbents.
68. The CRTC also considered concerns raised by some parties that there were barriers to entry for new competitors, such as difficulties in obtaining financing and access to rights-of-ways. Noting that new competitors were in the process of entering the market by building fibre facilities, the CRTC concluded that the barriers had not proven insurmountable.
69. Based on these considerations, the CRTC concluded that there were not "undue barriers to entry" particularly along the high demand corridors and that "on the most contested routes, competitors have the ability to expand capacity in response to any pricing increase by the dominant supplier".⁶⁰

4.6 Rivalrous Behaviour

70. Entry by new competitors and the resulting price competition and frequency of price changes, particularly by the incumbent telephone companies, was

⁵⁹ Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 90.

⁶⁰ Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 77.

considered a "measure of the degree of rivalrous competition".⁶¹ The CRTC also concluded that routes for which the incumbents introduced route-specific pricing provided an indication of the geographic areas where the greatest degree of competition could be expected for high capacity IXPL services.

4.7 Forbearance Decision

71. Employing the forbearance framework developed in Decision 94-19, the CRTC concluded the following with respect to the incumbents' ability to exercise market power to the detriment of customers:

With regard to the most important factor, namely, the supply of competitive facilities, the Commission considers that alternative facilities-based supply currently exists and can be expected to exist such that, while recognizing the impediment identified regarding contract termination penalties, in the near future rivalrous competition can be expected on all the routes covered by the Stentor companies' High Capacity 45 service at the time of the forbearance application. The Commission is of the view that for these routes, the Stentor companies will not have a degree of market power that would be detrimental to the interests of users.⁶²

72. As a result, the CRTC determined it appropriate to forbear from regulation of 20 routes where the incumbent telephone companies provided high-capacity IXPL services and where there was a competitive supply of services. CRTC subsequently decided that it would forbear from the regulation of additional high-capacity IXPL routes if at least one competitor, other than the incumbent, provides high-capacity IXPL services, to at least one customer.⁶³ Since the time Decision 97-20 was issued, the CRTC has refrained from regulating approximately 2000 high-capacity IXPL routes.

⁶¹ Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 89.

⁶² Telecom Decision CRTC 97-20, *Stentor Resource Centre Inc. - Forbearance from regulation of interexchange private line services*, paragraph 92.

⁶³ CRTC, Telecom Order CRTC 99-434. The ruling applied to high capacity interexchange private lines. The forbearance test was specified as: "The Companies' domestic High Capacity/DDS services on a particular route will be granted forbearance upon the Commission being satisfied that one or more competitors of a Company are offering or providing, on that route, the equivalent of DS-3 bandwidth (or greater) on a private line basis to at least one customer, using terrestrial facilities from other than the Company in question or an affiliate of that Company". A DS-3 capacity is capable of supporting approximately 672 simultaneous voice conversations.

5. RECENT DEVELOPMENTS AND POST FORBEARANCE EXPERIENCE

73. In a recent discussion paper, the combination of competitive market forces and forbearance from regulation was described by the CRTC as providing the means to reduce regulation, promote innovation, encourage the use of new technologies, and help ensure that economic resources are put to their most productive use. The benefits of forbearance, when used in conjunction with other regulatory incentives, were described by the CRTC as follows:

With the advent of competition and forbearance from regulation of many telecommunications services, there has been much less of a role for the Commission to play in ruling on the reasonableness of the ILECs' investments in new technology outside of rural and remote areas. With the introduction of a price cap regime on local exchange services in the late 1990's, this role was further diminished. The price cap regime left investment decisions up to the ILECs. The economic incentive for increased productivity improvements now drives the ILECs to pursue new technologies in the local market, while competitive market forces drives them in other more competitive sectors.

In light of these changes in industry structure and regulation, the Commission has viewed its role in competitive markets as one of allowing competitive market forces to drive innovation and technology and to ensure, to the greatest degree possible, that Commission policies do not distort investment decisions.

In markets where competition has not developed, the Commission has sought to ensure high quality service availability through service improvement plans.

In this new environment, the Commission has pursued a policy of technological neutrality that is designed to ensure that regulatory interventions in the market do not inadvertently incent or disincent the choice of a particular technology. The local competition regime is a prime example of the application of this principle of technology neutrality. It permits both the ILECs and new entrants to utilize whatever technologies they wish to compete with each other in the provision of local telephone services. The result of this policy is that we now see competitors using various types of wireless access, fibre, coaxial cable, digital subscriber line (DSL) over copper pair, as well as traditional copper pairs to provide analogue, digital and IP-based telephone services. Market trials of broadband over power line (BPL) are also underway in Canada and Industry Canada has recently initiated a public consultation on the use of BPL systems.⁶¹ The theory behind this approach is found in the objectives of the telecommunications policy in section 7 of the *Act*, as well as in the

economic literature, that competition is the best mechanism to allocate economic resources, and that market forces will spur innovation and the use of new technologies, more efficiently than regulation.⁶⁴

74. In 2005, the CRTC initiated a proceeding to consider a framework for forbearance from the regulation of residential and business local telephone services.⁶⁵ Consideration of a forbearance framework for local telephone services is a significant new development and one which the CRTC said would have been difficult to imagine five years ago. In its 2005 Report to the Governor in Council, the CRTC stated:

Over the past five years, there have been extensive changes in the telecommunications industry encompassing the regulatory framework, technological developments, industry consolidation and service and/or market developments. It would have been difficult to imagine five years ago that in 2005 the Commission would be holding a proceeding to, among other things, establish a framework for forbearance from regulation of residential and business local exchange telephone services.⁶⁶

75. The purpose of the proceeding was to establish a framework for local forbearance, including clear criteria that the CRTC can use to determine when it is appropriate to forbear from regulating local exchange services. In the proceeding, the CRTC also considered whether there should be a transitional regime to provide incumbent telephone companies with more regulatory flexibility prior to forbearance. Additional regulatory flexibility could come in the form of removing or lessening some of the existing regulatory obligations.
76. In anticipation of its Local Forbearance Decision, the CRTC described the objectives for the new criteria as follows:

In its current forbearance proceeding, the Commission is trying to establish benchmarks, based on competition law principles, to determine when competitive forces are sufficient to justify forbearance. If this proceeding is successful in developing such benchmarks, telephone companies will be able to apply for forbearance when they believe the benchmarks are satisfied. This would appear to be a more efficient procedure to follow than reviewing all local markets in Canada, before any pre-conditions are satisfied, to see whether significant market power exists.⁶⁷

⁶⁴ CRTC, *Discussion Paper prepared for the Telecommunications Policy Review Panel*, paragraphs 127-130.

⁶⁵ Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services*.

⁶⁶ CRTC, *Report to the Governor in Council, Status of Competition in Canadian Telecommunications Markets, Deployment/Accessibility of Advanced Telecommunications Infrastructure and Services*, October 2005, Executive Summary.

⁶⁷ CRTC, *Discussion Paper prepared for the Telecommunications Policy Review Panel*, paragraph 123.

77. The proceeding, including a public consultation, concluded in October 2005 and the CRTC issued its local forbearance Decision on April 6, 2006. The forbearance criteria developed for local telephone services relied heavily on the regime that the CRTC adopted in its 1994 Decision.⁶⁸ However, new specific criteria were developed for the purpose of clarifying and possibly expediting the forbearance process. For the purposes of forbearance from regulation of local telephone services, the CRTC specified that five preconditions must be satisfied. The two most relevant conditions, for the purposes of this report are:

- the incumbent telephone company has a market share 75 percent or less in the relevant market, and
- the incumbent telephone company demonstrates, to the CRTC's satisfaction, that rivalrous behaviour exists in the relevant market.⁶⁹

78. In arriving at the 25 percent market share loss criteria, the CRTC observed that it had received proposals from parties ranging from a low of 5 percent to a high of 35 percent but that determining the appropriate market share lost threshold was not a "precise scientific exercise". The CRTC indicated that company market share loss should be sufficiently high to provide confidence that enough customers have decided to take service from one or more competitors to indicate that there is a market acceptance of local telephone service competition and an openness to try competitive alternatives.⁷⁰

79. The market share loss should strike the right balance between the incumbent telephone company interests in consumers' interests. The CRTC stated:

The Commission considers that below 25 percent market share loss competition in a relevant market would be unlikely to be sustainable in a forbore environment, while above this level, provided that the other forbearance criteria set out in this Decision have been met, competition with the accompanying benefits to consumers would be delayed too long. The Commission finds that a 25 percent applicant ILEC market share loss level strikes the right balance between these competing interests. In light of these factors, the Commission considers that the applicant ILEC market share loss number should be set at 25 percent.⁷¹

⁶⁸ Telecom Decision CRTC 94-19, *Review of Regulatory Framework*.

⁶⁹ CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 242. A full description of the five criteria identified in the decision are provided in Attachment 4.

⁷⁰ CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraphs 247-248.

⁷¹ CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 248.

80. Some parties in the Local Forbearance proceeding recommended that the CRTC not forbear from the regulation of the incumbent telephone companies' rates unless there were three or more competitors in the market. However, in its Decision, the CRTC determined that even in markets where there are two competing service providers, the operation of market forces will generally be sufficient to protect the interests of customers.⁷²
81. Subsequent to the release of the Decision, the CRTC Chair provided additional information concerning implementation of the new local forbearance regime. In an interview, he said that he expects that "most business markets - in major cities at least - will be forborne in the next 18 months" and that the residential markets in Halifax, Montréal and Toronto "will soon qualify as well".⁷³ Regarding the criteria, the CRTC Chair also indicated that the incumbent telephone companies
- ... can apply at any time. They can even apply before they have entirely met the thresholds, so forbearance could be approved conditional on meeting the criteria.
- We expect to turn around forbearance applications in four months - and after the initial few applications even faster.⁷⁴
82. Even with these conditions for forbearance, Bell Canada expressed "profound disappointment" with the Decision and concluded that the CRTC will "continue to play a far too significant role in the marketplace".⁷⁵ In its news release, Bell indicated that an appeal of the CRTC's Local Forbearance Decision to the federal cabinet remains a "strong possibility".

⁷² CRTC, Telecommunications Decision CRTC 2006-15, *Forbearance from the regulation of retail local exchange services*, paragraph 354.

⁷³ Charles Dalfen, CRTC Chair, *CRTC Chair Responds to Forbearance Critics*, Angus Telemanagement, Telecom Update, April 18, 2006, www.angustel.ca/update/up.html.

⁷⁴ Charles Dalfen, CRTC Chair, *CRTC Chair Responds to Forbearance Critics*, Angus Telemanagement, Telecom Update, April 18, 2006, www.angustel.ca/update/up525b.html.

⁷⁵ Bell Canada Enterprises, *Canadians Denied Benefits of Open Competition*, April 6, 2006.

6. SUMMARY AND CONCLUSIONS

83. In 1992, the CRTC initiated a proceeding to consider changes to the regulatory framework. The proceeding culminated in a Decision in which the CRTC developed a new regulatory framework, including a series of tests for market power for use when considering whether to forbear from regulation. The forbearance framework has been used successfully by the CRTC since 1994.
84. Today, most of the services offered by non-dominant telecommunications companies and an increasing number of incumbent telephone companies services are no longer subject to rate regulation. Incumbent telephone company services that remain rate regulated include residential basic local services, business single and multi-line local services, local calling features and options, pay telephone, digital network access, local channels and competitor services offered by the incumbent telephone companies.
85. The natural gas and telecommunications industries share many similarities. Although the technologies differ, the regulatory and policy objectives are strikingly similar. Indeed, the CRTC's forbearance framework is a useful model for the Board to consider in its deliberations concerning forbearing from rates charged for natural gas storage in Ontario.

Attachment 1

The CRTC's authority to forbear derives from section 34 of the Telecommunications Act:

34. (1) The Commission may make a determination to refrain, in whole or in part and conditionally or unconditionally, from the exercise of any power or the performance of any duty under sections 24, 25, 27, 29 and 31 in relation to a telecommunications service or class of services provided by a Canadian carrier, where the Commission finds as a question of fact that to refrain would be consistent with the Canadian telecommunications policy objectives.

(2) Where the Commission finds as a question of fact that a telecommunications service or class of services provided by a Canadian carrier is or will be subject to competition sufficient to protect the interests of users, the Commission shall make a determination to refrain, to the extent that it considers appropriate, conditionally or unconditionally, from the exercise of any power or the performance of any duty under sections 24, 25, 27, 29 and 31 in relation to the service or class of services.

(3) The Commission shall not make a determination to refrain under this section in relation to a telecommunications service or class of services if the Commission finds as a question of fact that to refrain would be likely to impair unduly the establishment or continuance of a competitive market for that service or class of services.

(4) The Commission shall declare that sections 24, 25, 27, 29 and 31 do not apply to a Canadian carrier to the extent that those sections are inconsistent with a determination of the Commission under this section.

The powers which the CRTC may refrain from exercising are sections 24, 25, 27, 29 and 31 of the Telecommunications Act:

24. The offering and provision of any telecommunications service by a Canadian carrier are subject to any conditions imposed by the Commission or included in a tariff approved by the Commission.

25. (1) No Canadian carrier shall provide a telecommunications service except in accordance with a tariff filed with and approved by the Commission that specifies the rate or the maximum or minimum rate, or both, to be charged for the service.

(2) A joint tariff agreed on by two or more Canadian carriers may be filed by any of the carriers with an attestation of the agreement of the other carriers.

(3) A tariff shall be filed and published or otherwise made available for public inspection by a Canadian carrier in the form and manner specified by the

Commission and shall include any information required by the Commission to be included.

(4) Notwithstanding subsection (1), the Commission may ratify the charging of a rate by a Canadian carrier otherwise than in accordance with a tariff approved by the Commission if the Commission is satisfied that the rate

(a) was charged because of an error or other circumstance that warrants the ratification; or

(b) was imposed in conformity with the laws of a province before the operations of the carrier were regulated under any Act of Parliament.

27. (1) Every rate charged by a Canadian carrier for a telecommunications service shall be just and reasonable.

(2) No Canadian carrier shall, in relation to the provision of a telecommunications service or the charging of a rate for it, unjustly discriminate or give an undue or unreasonable preference toward any person, including itself, or subject any person to an undue or unreasonable disadvantage.

(3) The Commission may determine in any case, as a question of fact, whether a Canadian carrier has complied with section 25, this section or section 29, or with any decision made under section 24, 25, 29, 34 or 40.

(4) The burden of establishing before the Commission that any discrimination is not unjust or that any preference or disadvantage is not undue or unreasonable is on the Canadian carrier that discriminates, gives the preference or subjects the person to the disadvantage.

(5) In determining whether a rate is just and reasonable, the Commission may adopt any method or technique that it considers appropriate, whether based on a carrier's return on its rate base or otherwise.

(6) Notwithstanding subsections (1) and (2), a Canadian carrier may provide telecommunications services at no charge or at a reduced rate

(a) to the carrier's directors, officers, employees or former employees; or

(b) with the approval of the Commission, to any charitable organization or disadvantaged person or other person.

29. No Canadian carrier shall, without the prior approval of the Commission, give effect to any agreement or arrangement, whether oral or written, with another telecommunications common carrier respecting

(a) the interchange of telecommunications by means of their telecommunications facilities;

(b) the management or operation of either or both of their facilities or any other facilities with which either or both are connected; or

(c) the apportionment of rates or revenues between the carriers.

31. No limitation of a Canadian carrier's liability in respect of a telecommunications service is effective unless it has been authorized or prescribed by the Commission.

Attachment 2

**Summary of Canadian Telecommunications
 Markets Subject to CRTC Forbearance Rulings⁷⁶**

Market	Year	Details
Terminal Equipment	1994	Sale and rental of terminal equipment.
Wireless	1994	Cellular, personal communications services, mobile radio and paging, except in the case of incumbent in-house mobile service providers. Forbearance extended to incumbent mobile operations, starting in 1998, once competitive safeguards had been implemented.
Satellite Services	1994	Telesat's digital video compression services initially; further services offered by Telesat, such as sale/lease of earth stations and RF channels, in subsequent years.
Services Provided by Non-dominant Carriers	1995	Services, such as long distance, data, Internet and private line, provided by non-dominant competitive carriers.
Data and Private Line	1997	High-speed/DDS interexchange private line services provided by the incumbent telephone companies on a route-specific basis.
Internet Services	1997	Incumbent telephone companies' retail Internet services in 1997 and those of cable providers in 1998.
Long Distance	1998	Toll and toll-free services.
International Services	1998	Initially excluded Teleglobe; however, certain international services provided by Teleglobe later forborne as well.
Data and Private Line	2004	With some conditions, additional high capacity digital data interexchange private line services forborne from regulation on routes for which competitors of several incumbent local exchange carriers now offer, or provide, services at DS-3 or greater bandwidth.

⁷⁶ CRTC, *Report to the Governor in Council, Status of Competition in Canadian Telecommunications Markets, Deployment/Accessibility of Advanced Telecommunications Infrastructure and Services*, October 2005, Appendix 2.

Attachment 3

Excerpt from
Telecommunications Decision CRTC 2006-15,
Forbearance from the regulation of retail local exchange services

The Commission considers that an applicant ILEC can demonstrate to the Commission's satisfaction that it no longer can exercise market power in a particular relevant market when that applicant ILEC can demonstrate that it has met all of the following criteria:

- a) The ILEC has suffered a 25 percent market share loss in the relevant market for which forbearance is sought (market share loss);
- b) The ILEC has, for the six months prior to the application, met individual standards for each of the 14 specified competitor Q of S indicators of the rate rebate plan (RRP) for competitors, when the results are averaged across the six-month period (competitor Q of S);
- c) The ILEC has put in place the necessary Competitor Services tariffs. In the case of an application for forbearance from regulation of residential local exchange services, the ILEC has an approved Competitor Services tariff for bundled ADSL available over loops not used for primary exchange service (dry loops) as well as in conjunction with PES, and in the case of an application for forbearance from regulation of business local exchange services, the ILEC has an approved Competitor Service tariff for bundled ADSL available both over dry loops and in conjunction with PES as well as approved competitor Ethernet access service and transport service tariffs (Competitor Services tariffs);
- d) Where the Commission has required it, the ILEC has implemented competitor access to its OSS in accordance with *Competitive local exchange carrier access to incumbent local exchange carrier operational support systems*, Telecom Decision CRTC 2005-14, 16 March 2005 (Decision 2005-14) (Access to OSS); and
- e) The ILEC has demonstrated to the Commission's satisfaction that rivalrous behaviour exists within the relevant market (rivalrous behaviour).



Competitiveness of Natural Gas Storage Market:
Analysis Based on a Report for Union Gas

Evidence of Navigant Consulting

Prepared on Behalf of Enbridge Gas Distribution

May 1, 2006

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TABLE OF CONTENTS

1	INTRODUCTION	1
2	CRITERIA TO DETERMINE THE PRESENCE OF MARKET POWER.....	2
3	DEFINING THE RELEVANT NATURAL GAS STORAGE MARKET FOR ONTARIO PROVIDERS.....	4
3.1	EVALUATION OF THE PHYSICAL INFRASTRUCTURE	4
3.2	DETERMINATION OF THE RELEVANT MARKET.....	5
3.2.1	<i>The EEA Study: Quantitative Analysis.....</i>	<i>6</i>
3.2.2	<i>The EEA Study: Qualitative Analysis</i>	<i>8</i>
3.2.3	<i>FERC Decision</i>	<i>9</i>
4	TESTING FOR MARKET CONCENTRATION AND MARKET POWER	11
5	CONCLUSIONS WITH RESPECT TO ENBRIDGE GAS DISTRIBUTION	12
6	CONCLUSIONS WITH RESPECT TO PRICE FORBEARANCE.....	13

1 INTRODUCTION

At the request of Enbridge Gas Distribution, Navigant Consulting reviewed a paper by analysts from Energy and Environmental Analysis (EEA) and Simon Fraser University¹ analyzing the conditions of competition for natural gas storage in Ontario. The paper was produced for Union Gas.

This report contains Navigant Consulting's evaluation of that paper and its conclusions with respect to gas storage markets and market power in Ontario, drawing on the results of the EEA study. The conclusions also relate to the implications of that analysis for regulation of Enbridge Gas Distribution storage rates. This report also contains additional information from a recent FERC decision which we believe reinforces the findings of the EEA Study.

The EEA Study investigated the question of whether Union Gas has "sufficient market power to significantly influence the price of natural gas storage within its geographic market."² The EEA Study concludes that Union Gas does not have such market power. This Report will also address the question of whether the evidence from the EEA Study can be used to draw conclusions as to whether Enbridge Gas Distribution has market power in its geographic market.

¹ Henning, Bruce, Michael Sloan (Energy and Environmental Analysis) and Richard Schwindt (Simon Fraser University), "Analysis of Competition in Natural Gas Storage Markets for Union Gas Limited", October 28, 2004 (referenced as EEA Study).

² Ibid., pg. 1.

2 CRITERIA TO DETERMINE THE PRESENCE OF MARKET POWER

Market power is defined as the ability to raise prices above their competitive level and sustain them profitably over some time. For market power to be present in a market, several conditions must exist, including having relatively few sellers of the product or service, having few or no readily available substitutes for the product or service, and having barriers making it relatively difficult for new sellers to enter the market. Government agencies which have responsibility for competition policy, especially policy relating to mergers, are concerned about the actuality of or potential for market power in the markets which could be affected by mergers. Such agencies, in both the United States and Canada, have developed both structural and behavioural tests for the possible presence of market power.

Regulatory agencies charged with setting prices are interested in the presence of market power with respect to applications to them to forbear from price regulation, based on the argument that a competitive market will set prices that can be considered to be just and reasonable. In the United States, such a regulatory agency is the Federal Energy Regulatory Commission (FERC); in Canada, such an agency is the Canadian Radio and Telecommunications Commission (CRTC). Both of these agencies have looked to their respective competition bureaus for definitions of market power and for the tests and criteria to apply.

The EEA Study reviews these considerations and criteria with respect to Canadian competition policy as delineated in the Canadian Competition Bureau's Merger Enforcement Guidelines³ and the US considerations and criteria as applied by FERC, following the practice of the US Justice Department and Federal Trade Commission.

The tests applied in both countries are similar. They begin by defining the market. Once the market is defined, they calculate a quantitative measure of the degree of seller concentration in that market.⁴ This quantitative measure is then used as a screen. Markets with seller concentration below the screening value are usually not scrutinized further; the quantitative measure indicates that there are enough sellers of equal enough size that no seller is likely to be able to exercise market power. Markets with seller concentration above the screening value

³ Competition Bureau, *Merger Enforcement Guidelines*, Ministry of Supply and Services, Ottawa, 2004.

⁴ Canada and the United States use different measures of concentration. Canada uses the 4-firm concentration ratio, which is the cumulative market share of the four largest firms in the defined market. The screening criterion for the 4-firm concentration ratio is 65%. The United States uses the Herfindahl-Hirschman index (HHI), which is the sum of the squares of the market shares of all market participants. The screening criterion for the HHI is 1800.

are subject to further tests to determine whether some firms, or whether the particular firm which has applied for market-based rates, has market power within the market.

The EEA study then describes some of the cases in which FERC has applied these criteria to determine whether or not to forbear from price regulation of gas storage. The EEA Study finds that FERC has been willing to forbear from regulating prices for gas storage in some circumstances.

Navigant Consulting agrees with this description of the process of determining whether market power exists in a market in general and with the description of FERC's actions with respect to forbearance on rate regulation for natural gas storage.

FERC has stated quite simply the steps to the analysis of whether there is market power:

The analysis of whether the applicant has the ability to exercise market power includes three major steps: define the relevant market; measure the market share and market concentration; and evaluate other relevant factors.⁵

The EEA Study follows these steps.

⁵ WPS-ESI Gas Storage, LLC, Docket No. CP04-80-000, 108 FERC 61,061 at pg. 12. (Issued July 13, 2004)

3 DEFINING THE RELEVANT NATURAL GAS STORAGE MARKET FOR ONTARIO PROVIDERS

The EEA Study considers the end uses to which natural gas storage can be put and notes that the end uses of storage have changed with the restructuring of the natural gas market itself and with the advent of large amounts of gas-fired electricity generation. These two events have made the need for gas storage more dynamic and have led to the creation of various kinds of gas storage products. Some of the end uses served by physical storage of natural gas can also, as the EEA Study points out, be served in other ways. Depending on the nature of the end use, alternatives to physical storage can include open market purchase of natural gas in the region and pipeline capacity into the region. Nonetheless, to make the analysis more conservative, the EEA Study chose to focus only on physical natural gas storage in the geographic region as the relevant market. As the EEA Study observes, this choice will overestimate the degree of market power, if any, because it deliberately overlooks some potential substitutes.⁶

The EEA Study outlines a three-step analysis to define the relevant market area:

- Evaluation of the physical infrastructure to determine if it allows competition in connected geographical markets;
- Analysis of market pricing behaviour to confirm the boundaries of the regional gas market;
- Qualitative analysis of buyer behaviour to determine how market participants view the market.

Navigant Consulting agrees that these are appropriate steps to define the relevant market area. We will discuss each of them in turn.

3.1 Evaluation of the Physical Infrastructure

Navigant Consulting, and the EEA Study, note that Ontario has an accepted natural gas transportation and trading hub at Dawn. We also note that gas storage in Ontario is strongly connected to Dawn.

⁶ EEA Study, pg. 22.

The EEA Study analyzes the major pipeline connections to Dawn, both from the west in Michigan and from the east into New York and the TransCanada Pipeline. As the EEA Study notes, there are strong connections from Dawn to an extensive network of pipelines in Michigan.

Michigan also has extensive storage facilities. According to MichCon, a major Michigan gas distributor, Michigan has more gas storage than any other state.⁷ These storage facilities are connected to Dawn by paths that go through no more than two pipeline connections, as displayed in Table 4 on pg. 27 of the EEA Study. Finally, the EEA Study observes that Ontario has pipeline connections into New York.

These physical connections may not be useful to allow Ontario users to access gas storage facilities in Michigan or New York, in competition to physical gas storage facilities located in Ontario, if the pipelines regularly operate at capacity and cannot reliably provide transportation for Ontario gas to and from the storage facilities located outside the province. The EEA Study analyses this question and concludes that, while some of the pipelines do often operate at or near full capacity, gas can still be transmitted between storage fields located outside Ontario and Dawn through alternative pipeline routes.

Navigant Consulting has not made its own study of these conditions on the pipelines, but does not have information to indicate that the EEA Study conclusions are incorrect.

3.2 Determination of the Relevant Market

There are two steps in market definition for purposes of assessing market power. First, the product at issue must be identified (“product market”). Then the population of potential competitive sellers of that product must be identified (“geographic market”).

There should be no issue as to the product definition used in both EEA’s analysis and Navigant Consulting’s review. As noted earlier, the product definition is extremely conservative, focusing only on storage-vs.-storage, rather than introducing the many non-storage alternatives that may compete with storage. It is worth noting that this conservatism is at variance with rules recently proposed by the FERC, wherein all potential alternatives, be

⁷ MichCon website, <http://www.cis.state.mi.us/mpsc/gas/about3.htm>

they transportation, production variation, liquefied natural gas, etc., may be considered as a part of the product market.⁸

The primary issue in Ontario is the definition of the appropriate geographic market. EEA took both a quantitative and a qualitative approach to this question, and Navigant Consulting has reviewed EEA's analysis in detail. Our conclusion is that the EEA analysis appears to be valid and thorough, and that the definition of the geographic market set forth in EEA's analysis is both appropriate for the present enquiry and supportive of the conclusion that storage in Ontario is highly competitive.

3.2.1 The EEA Study: Quantitative Analysis

The EEA Study begins this analysis with a strongly quantitative approach to the determination of the relevant geographic market. It observes that two separate pricing points can be considered to be closely related markets if their price changes are highly correlated. They can also be considered to be closely related if the price differentials remain constant, reflecting the cost (physical or transaction) of moving products between them.

Navigant Consulting considers this to be an appropriate approach. A high level of price correlation between two markets is a strong indication that they are closely related, and that customers can freely choose between them; products in the two markets are close substitutes for each other. A lack of price correlation indicates a less strong relationship between the two markets.

No direct information exists on the price or value of storage, but natural gas is a highly traded commodity and the price for natural gas at various hubs, representing various geographical markets, is widely known and regularly published. Available pricing hubs include Dawn, locations in Michigan, a location in New York, and standard hubs in the producing areas like Henry Hub in Louisiana and NOVA/AECO in Alberta. Daily prices are available for these hubs.

The EEA Study analysed the relationship between prices at Dawn and those at nine other hubs, with varying degrees of geographical propinquity to Dawn. The most remote were Henry Hub and NOVA/AECO; the closest the Consumers Energy and MichCon city gates, both located in Michigan.

⁸ FERC, Notice of Proposed Rulemaking, "Rate Regulation of Certain Underground Storage Facilities", 113 FERC 61,306, Dockets RM05-23-000 and AD04-11-000, December 22, 2005. This NOPR will be discussed in more detail later in this report.

The first step of this analysis was to compute simple correlations, both annually and over periods of several (three and five) years, between natural gas prices at Dawn and each of these hubs. This analysis shows that the prices are highly correlated. However, as the EEA Study points out, such high correlations can be expected to occur, given the common time trend and the highly fungible nature of the commodity. While the correlations are all high, it is worthwhile to note that the correlations between Dawn and the Michigan and Illinois hubs are consistently very high. These correlations suggest that these hubs can be considered to be part of an integrated market.

However, very high correlations among variables is common in econometric analysis of time series, due to the common time trend. For example, the correlation between Dawn and Henry Hub over the period from 1999 to 2002 ranges from .990 to .998, while for the same time period the correlation between Dawn and both the MichCon and Consumers city gates ranges from .992 to .999. While these suggest a closer relation between Dawn and the Michigan points than between Dawn and Henry Hub, they are not conclusive because, as the EEA Study notes, “the correlation analysis tends to be dominated by the underlying trends in natural gas prices.”⁹

A common way to address problems of a dominant time trend is to take first differences; that is, to see if the relationship is as strong when the time trend is removed by looking for a relationship between the day to day changes rather than their levels. For these data, an analogous procedure, as used by the EEA Study, is to study the basis differentials between these hubs. The basis differentials are the differences between the prices at the respective hubs, rather than their levels. The basis differentials can be interpreted as the value of transmission between the two hubs.¹⁰ If these differentials were to be constant and always at the level of exactly the transportation cost, then the markets could be seen to be truly integrated. Then the only difference in price would relate to the cost of transferring gas from one geographic location within the market to another.

Looking at actual basis differentials, it can be expected that the closer the market integration, the smaller the basis differentials and the smaller their own variance. That is, if the two markets are close, transmission costs between them cannot be excessively high and the difference in prices between them will be stable.

The EEA Study performed this quantitative analysis. On the basis of these results, the EEA Study concluded that the results “indicate a very close relationship in daily price movements

⁹ EEA Study, pg. 30.

¹⁰ This discussion of basis differentials ignores transactions costs for simplicity; the actual basis differential can have a transaction cost component which would not affect this argument about the degree of market integration..

between Dawn and MichCon, Consumers Energy, Chicago and Alliance for the time period after Alliance and Vector are completed.”¹¹ The EEA Study also found a less strong, but still significant, relationship between prices at Dawn and those at Niagara. The relationships with the other hubs analysed was weaker.

The EEA Study acknowledged that there is no bright line test for the level of integration needed to define a market, but these quantitative results do indicate that the relevant gas market, and by extension the relevant market for gas storage, extends from Niagara through to Illinois, along the relevant pipeline routes. Navigant Consulting agrees with this conclusion.

Navigant Consulting also considers the quantitative analysis undertaken in this case to be more thorough than the usual such analyses in cases brought before FERC to request authority for market-based rates. In most such cases, the geographical market has not been an issue in contention, so the level of quantitative analysis shown here is not undertaken. Even when there is quantitative analysis, it is likely to be limited to the kind of initial correlation analysis undertaken by the EEA Study, and does not go beyond that to look at the size and stability of the price differentials, as did EEA. Navigant Consulting considers the EEA Study to represent a good practice with respect to quantitative geographical definition of markets, and considers that the quantitative analysis of the EEA Study establishes a strong case for this definition of the market.

3.2.2 The EEA Study: Qualitative Analysis

The EEA Study continues with consideration of the qualitative factors which can indicate how well integrated markets are. These include information on the transactions costs to storage customers of switching from storage suppliers located in Ontario to those located elsewhere in the integrated market, on behavioural indications of whether storage customers in Ontario consider storage in these other markets to be close substitutes, and whether there is evidence from the trade that these markets are considered substitutes for each other.

While the evidence, being qualitative, is necessarily less precise, the EEA Study shows that these indicators of market integration also point to a definition of a broad natural gas storage market for Ontario customers.

The EEA Study concludes that “the core competitive geographical market for Union Gas storage includes a total of 1,153 Bcf of storage working gas capacity, including”¹² capacity in

¹¹ EEA Study, pg. 35.

¹² EEA Study, pg. 41.

Michigan, Ontario, Illinois and Indiana, and Niagara. Navigant Consulting agrees with this conclusion of the relevant market.

3.2.3 FERC Decision

A recent FERC decision reinforces this conclusion. In the WPS-ESI FERC case cited earlier¹³, WPS-ESI applied to FERC for market-based rates. WPS-ESI operates a 3 Bcf storage facility in Michigan which is under the jurisdiction of the Michigan Public Service Commission (MPSC). The facility came into service in 2001.

In accordance with law and FERC practice, WPS-ESI filed with FERC a request for it to set rates for customers who were not within the jurisdiction of the MPSC; that is, a rate for interstate transactions or interstate customers. As part of this application, WPS-ESI filed a report from its consultant, IGC, which

determined that the relevant geographic market includes the geographic area traversed by the northern zone pipeline operated by ANR Pipeline Company (ANR) in Michigan, northern Indiana, northern Illinois, and eastern Iowa. IGC's study concludes that the relevant geographic market also includes western Ontario, a region adjacent to ANR's interstate system, because the Canada/United States gas market is now highly integrated, such that analysis can properly incorporate Canadian storage fields.¹⁴

The "Commission finds that IGC's findings are reasonable and appropriate."¹⁵

The FERC, therefore, has agreed with a market analysis saying that the relevant gas storage market for Ontario includes gas storage in Michigan and beyond to northern Illinois and northern Indiana. This FERC finding clearly indicates that the relevant natural gas storage market for customers in Ontario reaches well beyond the Ontario borders to include storage facilities in Michigan, Illinois and Indiana. This finding is consistent with the conclusions of the EEA Study, which also found that the Ontario core geographic market includes those states.

Following this definition, and recognizing that WPS-ESI does not have market power in this market area, the FERC approved market-based rates for it for all FERC-jurisdictional

¹³ WPS-ESI Gas Storage, LLC, Docket No. CP04-80-000, 108 FERC 61,061

¹⁴ Ibid., at pg. 3.

¹⁵ Ibid., at pg. 3.

transactions. Importantly, the FERC accepted a showing that the HHI was below 1,400 in a market inclusive of Ontario, a conclusion consistent with the EEA review as discussed below. Under the FERC's market-power criteria, it is only when the HHI exceeds 1,800 that additional scrutiny of market share, etc., becomes important in screening for market power. Thus, based upon the FERC's perception of the relevant market in the WPS-ESI order and upon EEA's consistent, analytically supported characterization here, natural gas storage in Ontario exists in an extremely competitive market.

4 TESTING FOR MARKET CONCENTRATION AND MARKET POWER

The second step in the process outlined by FERC is to measure the market share and market concentration. This step requires the market definition from the first step, so that the shares of the market can be determined.

The EEA Study, using various sources, compiled a list of all the storage facilities in the geographic market region. It finds a large amount of storage, controlled by thirteen separate companies. Some of this storage is under MPSC jurisdiction, but most is under FERC jurisdiction.

Taking the most restrictive of the definitions by aggregating all the storage owned by one party, the EEA Study finds that the HHI is 1290 and the four-firm concentration ratio is 62%. Both of these levels fall below the criterion value in the concentration screening test, meaning that these markets would not receive further scrutiny to determine whether some market participants have market power. Markets passing the screening criterion are assumed not to have market participants with market power.

In addition, the EEA Study considered several qualitative factors such as ease of entry into the storage market, regulatory barriers which might prevent storage customers in one jurisdiction from looking to purchase storage services in another jurisdiction, and physical system interconnection barriers. The EEA Study concluded that, given the size of this market, its overall competitiveness, and the small size of the Union Gas market share, Union Gas did not possess market power in this gas market.

To reinforce this conclusion with respect to barriers to entry, Navigant Consulting notes that the IGC study performed for the WPS-ESI application mentioned earlier listed potential new projects in the relevant market area with 64 Bcf of working gas capacity.¹⁶ One of these, Sempra's Bluewater Gas storage with 27 Bcf of working gas capacity, came into service in 2004. Although the IGC report did not show any of the other projects as under active development, it does indicate the presence of both physical resources and active interest in development of new storage. Continuing entry and the potential for new entry is evidence that access to appropriate physical resources does not constitute a barrier to entry.

¹⁶ WPS-ESI Gas Storage, LLC, FERC Docket No. CP04-90-000. Exhibit Z-5, WPS-ESI Market Power Analysis, Pg. 5.

5 CONCLUSIONS WITH RESPECT TO ENBRIDGE GAS DISTRIBUTION

Under the market definition used by the EEA Study, Union Gas had just under a 13% share of the market in the core geographical area. The EEA Study concluded that, given the size and openness of the competitive market, Union gas could not be said to have market power.

Having reviewed and tested the validity of the EEA analysis with respect to Union Gas, Navigant Consulting must conclude that the case for Enbridge Gas Distribution's lack of market power is even more compelling. Storage owned by Enbridge Gas Distribution has about 60% of the capacity of that owned by Union Gas. The Enbridge Gas Distribution has about 8% of the total working storage capacity in the defined market area. In Navigant Consulting's opinion, this small a market share, along with the competitive nature of the market itself, indicates that Enbridge Gas Distribution does not have market power in the provision of storage in Ontario. If Enbridge Gas Distribution were to attempt to raise its prices for storage artificially (beyond price increases dictated by cost pressures), it would suffer a serious enough erosion of its market share that the price increase would become unprofitable. This is the definition of the lack of market power.

6 CONCLUSIONS WITH RESPECT TO PRICE FORBEARANCE

The question raised by the EEA Study was whether Union Gas has market power in the provision of natural gas storage in Ontario. In accordance with FERC and general competition law procedure, the EEA Study answered this question in three steps:

- Definition of the relevant market,
- Measurement of the market share and market concentration of the relevant firm, and
- Evaluation of other relevant factors.

In the first step, the EEA Study used good practice methodology to conclude that natural gas storage in Ontario is part of a much larger gas storage market, reaching from northern Illinois to the Niagara frontier. The second step showed that this market is highly competitive according to the quantitative structural tests, passing both US and Canadian screening tests for lack of seller concentration. Finally, the analysis confirmed competitiveness of the market by finding that other factors which could hinder competition, such as lack of regulatory barriers to trade or high barriers to entry, do not exist.

The EEA Study therefore concluded that Union Gas does not have market power in the market for natural gas storage.

Navigant Consulting agrees with this conclusion. Navigant Consulting agrees with the methodology and conclusions of the quantitative analysis and the consideration of other relevant factors to define the relevant market. Navigant Consulting agrees with the structural assessment of that market. Navigant Consulting has computed the HHI index for the market, using the data presented in the EEA Study, and agrees that the HHI for working storage, using data by ownership group, is 1290, as found by EEA Study, well below the FERC screening value of 1800, confirming that the market is competitive. From the same data, Navigant Consulting confirms that the four-firm concentration ratio is under 62%, meeting the Canadian Competition Bureau's criterion for a competitive market structure of a ratio under 65%. No one seller has more than a 21% market share, well under the 35% post-merger share criterion. Finally, Navigant Consulting agrees with the analysis of barriers to entry and regulatory barriers. Navigant Consulting also notes additional evidence with respect to the lack of barriers to entry, as detailed above.

Therefore, based on the evidence compiled and presented in the EEA Study, Navigant Consulting agrees with the conclusion of the EEA Study that Union Gas does not have market power in the market for natural gas storage.

Following this conclusion, Navigant Consulting concludes that Enbridge Gas Distribution does not have market power in natural gas storage. Enbridge has a smaller physical storage capacity than does Union and only an 8% market share, so it would be even less capable of exercising market power by artificially raising and sustaining price. Enbridge meets the historic and evolving FERC criteria for demonstrating that it does not have market power and that it should be granted market-based rates for its gas storage.

Accordingly, in Navigant Consulting's opinion, Enbridge Gas Distribution's storage could be relieved of price regulation with no negative impact on competition.

Further, Navigant Consulting believes that there is competition among jurisdictions for the location of new storage facilities. As established in the EEA Study and in the FERC decision, Ontario is part of a natural gas storage market that includes Michigan, the state with the most such facilities. Further, especially in the United States, storage regulation is rapidly evolving in the direction of more permissive pricing under many circumstances. In that context, it is important for Ontario's competitive position that as much pricing flexibility as feasible be accorded to Enbridge Gas Distribution in pricing natural gas storage.