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August 11, 2006

Ontario Energy Board
2300 Yonge Street,
Suite 2700
Toronto, ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Re: EB-2005-0551 – Argument – Issue II Storage Regulation

Dear Ms. Walli:

Per Procedural Order No. 9, attached please find in electronically searchable format Union's argument (Exhibit Y2) with respect to Issue II Storage Regulation. Also, fourteen (14) hard copies will be couriered today.

If you have any questions concerning this filing please call me at (519) 436-5382.

Yours truly,

Connie Burns, CMA, PMP
Manager, Regulatory Initiatives

cc: Glenn Leslie, Blakes
All EB-2005-0551 Intervenors

ARGUMENT (EXHIBIT Y2)

UNION GAS LIMITED

NATURAL GAS ELECTRICITY INTERFACE REVIEW

AND

STORAGE REGULATION

Introduction

These proceedings have involved primarily two issues for Union.

1. New services for gas-fired power generators.
2. Forbearance from regulation of the rates charged for the storage of gas pursuant to section 29 of the *Ontario Energy Board Act* (the "Act").

There are four other related issues transferred from Union's most recent rate case (Procedural Order No. 3) that will be addressed in these submissions.

In respect of new services for gas-fired power generators there is a comprehensive Settlement Agreement among the interested parties (Exhibit S.2). Several of the services contemplated by that Agreement (F24S, UPBS, DPBS and high deliverability storage services) are subject to a resolution of pricing and forbearance issues, i.e., Union's ability to develop and sell such services at market values. Union's submissions in support of its proposals are set out below. Union's submissions on the balance of the Settlement Agreement were made at the beginning of the oral hearings in these proceedings commencing June 19, 2006 (TR. Vol. 1, pp. 38-57 and 100-104). Union's proposal with respect to F24-T service allocation was also dealt with at the outset of the hearings (TR. Vol. 2, pp. 3-14 and 63-88). The Board issued its decision with respect to Union's proposal during the course of the hearings.

The Settlement also deals with one of the issues transferred from Union's rate case (Procedural Order No. 3, Appendix A, Issue No. 4 - M12 service upgrades for power generators) and with

the third issue identified in the Board's first Procedural Order (transportation capacity bidding process and allocation).

Apart from Union's proposal to eliminate certain deferral accounts, which is also dealt with below, these submissions will focus on the issue of forbearance from regulation of the sale of gas storage services.

Union's Proposal

Based on the record in these proceedings, there can be no reasonable doubt that Union's sales of storage services to ex-franchise customers at market rates occur in a competitive market for the sale of such services and that there are many direct and indirect substitutes available to participants in these markets, who are primarily LDCs and marketers (Union Technical Conference Undertakings Nos. 39 and 47, Exhibit B, Tab 1). Union has been participating in this market and selling storage services at market rates for 17 years and there is no suggestion that any element of the "public interest" within the meaning of section 29 of the Act requires regulation of Union's sales of storage services to ex-franchise customers.

Accordingly, Union submits the Board should, pursuant to section 29 of the Act, forbear from regulation of sales of storage services into ex-franchise markets. Conversely, it may be important to emphasize that Union is not proposing that the Board refrain from regulating the provision of bundled services including storage to in-franchise customers. Sales to in-franchise customers will, under Union's proposal, continue to be regulated at rates reflecting Union's cost of service. Moreover, the benefits of forbearance accruing to Ontario that have been identified in Union's evidence have not been challenged.

Much of the evidence and cross-examination in these proceedings and in particular, evidence and cross-examination on behalf of IGUA/AMPCO et al. has been directed at demonstrating there are currently no competitive alternatives to Union's storage services available to Union's in-franchise customers. This results from the fact that such customers receive bundled service at cost of service rates, which at present, in the case of storage, are well below market values (TR.

Vol. 5, p. 23; TR. Vol. 10, pp. 102-103). It is therefore not surprising that such customers may not have comparably priced storage services nor have actively sought out other alternatives to Union storage (TR. Vol. 13, p. 50).

In any event, Union is not proposing any fundamental change to the current regulatory framework as it relates to in-franchise services. The considerable time spent in these proceedings on in-franchise customers' options and the relationship between cost of service rates and market values for storage was therefore misdirected.

In fact, it was acknowledged by IGUA/AMPCO's witness, Mr. Stauft, during the hearings that Union's position actually meets IGUA/AMPCO's essential concerns about burner-tip sales and service (TR. Vol. 9, p. 184).

Insofar as there is forbearance from regulation of sales to Union's ex-franchise customers, there will be a continuation of existing practices as it relates to the sale and pricing of storage services at market, which are acceptable to all of the participants in this market who appeared during the proceedings (TR. Vol. 9, pp. 91-93). However, unlike present practice, forbearance from regulation pursuant to section 29 of the Act entails that all revenues and costs associated with the competitive services remain outside of regulation. Once a finding is made that there is sufficient competition to protect the public interest, ex-franchise customers will pay market price and the risks or rewards associated with market prices are assumed by those who provide the services. This treatment is consistent with FERC practice in the United States (TR. Vol. 2, p. 147) and with Canadian legal principles as determined in *City of Calgary v. ATCO Gas and Pipelines Ltd.* (TR. Vol. 4, pp. 1-5). The *ATCO* case confirmed that rate payers have no claim to utility assets, or to the revenues associated with those assets, once the assets are no longer required for the provision of regulated services.

Similarly, under forbearance the current requirements for Board approval of the party, term and volumes subject to storage contracts under subsection 39(2) of the Act are no longer necessary or required in respect of ex-franchise sales. Accordingly, the Board should forbear from exercising

its powers under subsection 39(2) in respect of such sales (Union evidence, Exhibit C, Tab 1, pp. 3-4).

In order to prospectively implement forbearance related to ex-franchise services and the separation of storage service between in-franchise and ex-franchise customers, Union proposes to fix the allocation of storage capacity allocated to in-franchise requirements effective January 1, 2007 (Union evidence, Exhibit C, Tab 1, p. 26). No one other than Kitchener has objected to the use of the approved aggregate excess methodology to determine the appropriate allocation of storage for these seasonal balancing purposes (Union evidence, Exhibit C, Tab 1, p. 26; Union reply evidence, Exhibit D, Tab 1, p. 22; Union Hearing Undertaking response K.12.10, Exhibit B, Tab 3). Any additional in-franchise requirements after this allocation has been made will be procured by Union in the market so that in the future, to the extent any more storage space is required, the cost of storage for all in-franchise customers will be a blend of cost of service and market prices leading, perhaps, to a more efficient use of storage by those customers (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, p. 9 and 33; TR. Vol. 4, p. 125). New storage capacity required for ex-franchise sales will be developed or acquired outside of regulation (Union evidence Exhibit C, Tab 1, p. 3).

Union is, in accordance with these proposals, seeking an order from the Board to adjust rates effective January 1, 2007 to exclude all storage costs and revenue associated with ex-franchise sales from the determination of 2007 rates. Further, Union is seeking to eliminate the existing S&T deferral accounts that currently capture market-based margins in excess of amounts incorporated into rates.

There is no need for another proceeding to determine the allocation of costs and revenues. The allocation can be based on the 2007 cost study filed in Union's most recent rate case and accepted by the Board for determining 2007 rates in EB-2005-0520.

The cost allocation necessary to determine the appropriate allocation of assets to ex-franchise sales has already been completed (Union Undertaking K.4.3, Exhibit B, Tab 3). Union has been

allocating storage costs between in-franchise and ex-franchise customers for some time (TR. Vol. 4, p. 110) and can provide whatever additional records the Board requires to document the allocations (TR. Vol. 2, p. 117).

History

As indicated above, Union began selling transactional storage services to ex-franchise customers at market prices in 1989. The impetus at the time was the existence of a functioning competitive market that valued storage higher than cost of service rates combined with a desire to allow Union to capture any difference between cost of service and market values (premiums).

In accordance with the Board's decision in RP-1999-0017 dated July 21, 2001, Union began to transition all long term ex-franchise customers to market rates (Union evidence, Exhibit C, Tab 1, p. 10).

Market values for ex-franchise storage services are typically established through "open season" offerings similar to an auction. The market value of storage is determined on an annual basis from the seasonal commodity differentials. Any storage which is not sold in the current year has no future value. Consequently, Union has no incentive to "inventory" or withhold capacity from these auctions (Union Reply evidence, Exhibit D, Tab 2, pp. 24-25; EEA/Schwindt Reply evidence, Exhibit D, Tab 3, p. 11). Accordingly, the prices obtained by Union through these auctions reflect market values, and not any exercise or attempted exercise of market power on the part of Union.

The normal measure of the market value of storage is the winter/summer price differential for natural gas. The value of storage is therefore impacted by North American gas inventories, weather and the overall availability of natural gas supplies. Generally, the values that Union has received in connection with its sales of storage, either through auctions or negotiation reflect these factors (EEA/Schwindt Report, Exhibit C, Appendix B, Table 5 at p. 38; Appendix J to Union's Reply evidence, Exhibit D, Tab 2).

Storage values have varied widely in the past and are expected to continue to vary in the future with no assurance that current values will persist. During the 2001/2002 storage season and again during the 2003/2004 storage season, values of storage declined below cost of service levels, and at times had a negative value (Union's Reply evidence, Exhibit D, Tab 2, pp. 24-25).

Onus

There has been, throughout the proceedings, discussion of the onus of establishing that forbearance pursuant to section 29 of the Act is justified. This reflects a misunderstanding of the issues. Clearly, the status quo is that sales of storage services to ex-franchise customers are being made at market values in a competitive market. No ex-franchise customer of Union has complained about the present practice or advocated change. Accordingly, the issue is not whether forbearance is justified, but rather whether the current practice should change. The onus of establishing that the current practice of sales at market values to ex-franchise customers should be changed should be borne by those who propose that change. This is consistent with FERC practice (TR. Vol. 5, pp. 20, 42 and 149). Having said this, Union is a proponent of forbearance in accordance with section 29 of the Act. Section 29 did not exist when the Board initially authorized sales at market values. However, that situation has now changed and absent any showing that there is a reason to change the current practice, Union submits that the only onus it bears is to propose an appropriate method for implementing forbearance consistent with the public interest requirements of section 29. Union submits that its proposals in this respect have not been seriously challenged except to the extent that the City of Kitchener has argued for greater allocation of storage at cost than would be provided on the currently approved aggregate excess methodology.

Economic Principles

In assessing the extent of competition in markets for storage, it is important to recognize that conditions characterized by a "perfectly" competitive market seldom exist and do not need to be satisfied in order to justify forbearance. The fact that all of the assumptions of a perfectly competitive market are not fulfilled does not mean that a market is uncompetitive or not

"workably competitive" (EEA/Schwindt reply evidence Exhibit D, Tab 3, pp. 2-3; TR. Vol. 8, pp. 132-136).

The central issue in relation to determining whether the market is competitive is market power. During the hearings, the suggestion was frequently made that because current market values for storage exceed cost of service rates by a considerable margin, Union must be exercising market power to achieve the higher values. These arguments are wrong for at least two reasons. First, market values for storage reflect seasonal commodity price differentials that bear no relationship to the cost of providing the service, and second, the difference between cost of service rates and market values may reflect both scarcity and differential "rents", and not the exercise of market power (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, pp. 5-7 and 33; TR. Vol. 5, p. 23).

Market power exists when a supplier has the ability to restrict output, raise price and thereby earn supernormal profits. Evidence that a firm such as Union realizes prices above a regulated rate is not evidence of market power. Many firms have the "power" to raise their prices significantly, but cannot do so profitably (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, p. 4). There is no evidence in these proceedings that the values realized by Union for the sale of storage services to ex-franchise customers reflects market power. To the contrary, the evidence indicates that the prices realized by Union through "open season" auctions and by negotiation are consistent with the value of storage as established by seasonal commodity price differentials in the competitive natural gas commodity market.

BP's evidence in this regard was that when its "open season" offers for Union's storage were lower than prices others were willing to pay, BP simply located acceptable alternatives from other suppliers (TR. Vol. 13, p. 61). Similarly, GMi testified that their negotiated prices for storage services from Union reflected a thorough assessment of competitive alternatives (TR. Vol. 10, pp. 79-82, 107 and 111). GMi acknowledged they relied on Union but rejected the suggestion they are dependant. In short, there is no evidence of market power in the prices Union realizes for ex-franchise sales.

In other respects, there was no real disagreement amongst the various experts who testified on the appropriate steps for determining market power which involve:

1. Identification of the relevant product market;
2. Identification of relevant geographic market;
3. Determination of market shares and concentration; and
4. Consideration of barriers to entry.

The conclusions reached by the witnesses called on behalf of the BHT and IGUA/AMPCO, Ms. McConihe and Mr. Stauft, on the first three of these factors were flawed principally because they limited their inquiry to an investigation of the availability of uncontracted pipeline capacity in and out of Ontario. Their conclusions in this respect ignored the various means through the secondary market and otherwise that pipeline capacity can be made available, and also ignored substitutes for storage that were discussed at length by witnesses who actually participate in these markets (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, pp. 19-29 provides a thorough rebuttal of the BHT and IGUA/AMPCO evidence on the subject of pipeline capacity, and is fully consistent with the evidence of participants in the market, GMi and BP, who testified).

With respect to barriers to entry, it is true that there has not been significant new greenfield storage development in Ontario for some time. However, there has been significant development of new storage projects in Michigan and other locations within the geographic market defined by EEA/Schwindt. The lack of development in Ontario does not reflect barriers to entry so much as the lack of proper incentives and a workable framework for storage development in Ontario (EEA/Schwindt evidence, Exhibit C, Appendix B, pp. 57-59). Forbearance provides the needed incentive for the development of economic storage. This mechanism is consistent with the direction of storage regulation in the U.S. (Exhibit J.4.3),.

Analysis of Competition for Union Storage Services

The Board received evidence from three highly qualified experts (EEA/Schwindt, Reed and Smead) who concluded that Union's storage services compete with other storage facilities and

with substitutes for storage in a market that includes at least Ontario, Michigan, Pennsylvania and New York. In this market, Union's share, measured by working capacity and deliverability, is relatively small. BHT's expert, Ms. McConihe, came to similar conclusions in her initial assessment of the market (BHT Undertaking K.8.1) and in the earlier work she did for Enbridge (Enbridge Storage Competition Studies, Exhibit I.8.1, Tab 7(b); TR. Vol. 8, pp. 119, 159-166). Ms. McConihe's ultimately more restrictive definition of the market in this case resulted from an analysis of the availability of uncontracted pipeline capacity (a consideration not addressed or even mentioned in her earlier work for Enbridge).

It is submitted that the analysis carried out by EEA/Schwindt; supported by experts called on behalf of MHP and Enbridge (Mr. Reed and Mr. Smead); and validated by the evidence of market participants (BP and GMi); should guide the Board in its consideration of the state of competition in the market defined in their evidence.

The EEA/Schwindt analysis used approaches fully vetted by both the Canadian Competition Bureau and the U.S. FERC to conclude that Union Gas storage operates within a competitive market. Their work, and in particular, their conclusions as to the availability of pipeline capacity, the extent of competition with other storage facilities, and the appropriate geographic market definition is supported by EEA's GMDF model which, apart from other qualifications, was used for 1999 and 2003 National Petroleum Council studies requested by the Secretary of Energy in the United States in connection with the formulation of energy policy in that country. The model has also been used by the Department of Energy in the United States in conjunction with Homeland Security to identify critical gas industry infrastructure (TR. Vol. 4, pp. 32-33). Their conclusions regarding the availability of pipeline capacity and the size of the geographic market is further demonstrated conclusively through the price correlation analysis included in the EEA/Schwindt report. As stated by Professor Schwindt, price correlation analysis is an accepted tool and is recognized by the Competition Bureau (TR. Vol. 2, p.161).

Mr. Smead, who gave evidence on behalf of Enbridge, has extensive working experience in the gas industry and was very aware from that experience of the vigorous competition between

Dawn storage and storage facilities in the United States (TR. Vol. 6, pp. 5-6). Mr. Smead endorsed EEA's work in defining the relevant market for Dawn storage and, insofar as pipeline capacity is concerned, concluded that, based on EEA's analysis, that:

> "... the weight that the Board should place on concerns over the ability to move gas back and forth among competitors should be very low; that should be a relatively unimportant consideration in this proceeding (TR. Vol. 7, pp. 161-162)."

Mr. Reed, the expert who testified on behalf of MHP, was one of four American economists appointed by FERC to the Task Force on Competition whose work led to the FERC's 1996 Guidelines For Market Based Rate Regulations. Mr. Reed also fully endorsed and accepted the results of the EEA/Schwindt analysis (TR. Vol. 5, p. 13).

As noted above, the BHT expert, Ms. McConihe, ultimately restricted the relevant geographic market to Ontario, based on the results of a survey carried out by another consultancy, Ben Schlessinger & Associates ("BSA") into the availability of uncontracted primary pipeline capacity. This survey concluded that most pipeline capacity is under contract. This result is not surprising, since pipelines generally are not built or expanded unless there are contracts to support the development.

The reasons the results of the BSA survey are not significant are dealt with at length in the EEA/Schwindt Reply evidence, (Exhibit D, Tab 3, pp. 21-29). Mr. Reed, who agreed with EEA/Schwindt, summarized the position as follows:

> "Their [EEA/Schwindt] primary evidence that they offer in terms of scope of the market, is their price correlation analysis. And from that, they concluded that the market is a broad market, in terms of Michigan, New York, Pennsylvania, Ontario, and so forth."
>
> The existence of pipeline capacity is important in terms of integrating that market, the availability of unsubscribed firm capacity is not, and I think we both agree on that position." (TR. Vol. 5, p. 108)

Moreover, the existence of a very "deep and liquid market" at Dawn means that there are no significant restrictions on the ability to obtain storage services or close substitutes at that location. BP's witness, Mr. Acker, testified on this subject as follows:

> "That being said, if you're asking me specifically about the Dawn hub, which I define as not only the Dawn storage field but areas around the Dawn storage field, including Michigan, my personal opinion is that the secondary market is deep and liquid. My personal evidence for this is that BP has been beaten on numerous occasions by other buyers of services. We've also been beaten by other sellers of services in a secondary market. We believe our offer to sell or our offer to buy services and assets was competitive. But other options were apparently available to buyers and sellers. That being said we have enjoyed some reasonable success in either buying or selling services and assets. And so, in my opinion, that is evidence of a competitive and relatively liquid secondary market." (TR. Vol. 13, p. 16)

In summary, there is a market for pipeline and storage capacity that is active and offers a reliable substitute for contracted firm service pipeline capacity. Natural gas marketers currently hold significant amounts of natural gas pipeline and storage capacity on most, if not all, of the major pipelines and storage fields in the geographic market defined by EEA/Schwindt. These companies profit by rebundling and reselling pipeline and storage capacity to meet the needs of their customers (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, p. 25).

The record in these proceedings demonstrates that market participants can and do find alternatives or substitutes for Dawn storage.

- BP gave evidence, also documented in Union's reply evidence (Exhibit D, Tab 2, pp. 5-6), regarding several LDCs in the north-eastern United States that choose storage fields in Michigan over Dawn to meet their requirements. All of these utilities have the option of purchasing storage from Union at Dawn (TR. Vol. 13, pp. 41-42).
- Both GMi and Enbridge were able to arrange for services that effectively used storage in Michigan and New York, respectively, as an alternative to Dawn (GMi, Vol. 10, pp. 67 and 117; Enbridge, 2002 Storage Competition Study, Exhibit I-8.1, Tab 7(b), p. 13; Enbridge, TR. Vol. 4, pp. 173-174).

- BP gave evidence of their ability to provide alternative service to a former Union storage customer through a delivery/redelivery service that replaced Union storage but did not depend on physical storage (TR. Vol. 13, pp. 20-22). Also, as noted above, BP was itself able to find substitutes for Union storage elsewhere in the market when its bids in response to Union RFPs did not succeed (TR. Vol. 13, p. 61).
- Mr. Reed gave evidence on the significance of backhaul services in linking storage to markets, and also the reasons why the BHT evidence on this subject was of limited assistance (TR. Vol. 4, pp. 172-174). A concrete example of the use of backhaul for these purposes relating to Centra Manitoba is found in the EEA/Schwindt Reply evidence, (Exhibit D, Tab 3, pp. 24-25).
- Mr. Smead testified as to the ability to link storage to markets or replace storage through displacement or exchanges (TR. Vol. 7, pp. 164-166).
- GMi testified that the ultimate ceiling on Dawn storage prices is the net cost of the transportation alternative (i.e., the net cost of transporting gas directly from Alberta to Quebec in the winter rather than shipping in the summer, storing at Dawn and withdrawing in the winter), which GMi actually uses as a partial alternative to Dawn storage (TR. Vol. 10, pp. 65-68, 93-96; and undertaking K10.1).
- Enbridge testified that it received a number of responses to its recent RFP relating to storage (20 Bcf) and that "there were alternatives that were very much in a comparable price to what Union bid" (TR. Vol. 7, p. 78 and Undertaking K7.11). In fact, there were better offers available had Enbridge's RFP not required regulatory approval of market pricing. Respondents to the RFP who themselves had other options were not willing to accept this restriction (TR. Vol. 7, p. 78).
- When counsel for IGUA/AMPCO suggested to GMi witnesses that several of the alternatives under discussion were not viable because they were bundled services which required the buyer to take the commodity as well as S&T services GMi responded: "Not necessarily. We talked about CoEnergy earlier. There was no commodity involved. It's just a service provider ... And you can do that every day for whatever period you want, and the volume you want. You can do it every day with marketers." (TR. Vol. 10, p. 87)

In its Reply evidence (Exhibit D, Tab 2), Union prepared detailed case studies to show, by way of example, how storage in Michigan can be and is linked to markets in Ontario and elsewhere. This very detailed analysis amply demonstrates why excess pipeline capacity is not necessary to link storage facilities or to provide substitutes for storage within the market as defined by EEA/Schwindt.

The only evidence contesting these conclusions was Ms. McConihe's which was based on a survey done by BSA which in turn looked only for uncontracted primary pipeline capacity and ignored entirely secondary markets, and also ignored substitutes for such capacity (TR. Vol. 8, p. 159). In the end, during cross-examination by Enbridge counsel, Ms. McConihe conceded that she did not know whether the market under consideration "is competitive or not" (TR. Vol. 8, p. 210). This is because Ms. McConihe made no serious attempt to examine the ways in which the market for storage and transportation services actually works.

The focus of much questioning during the proceedings was on the ability of Union's in-franchise customers to immediately replace their allocation of Union's storage under bundled service contracts. While this is possible, it is also not an issue, since Union does not propose to change the way in which storage is currently allocated to in-franchise customers at cost of service rates. Moreover, Union's ex-franchise customers who are accustomed to acquiring storage or alternative services in the market do not contract for storage services in the manner envisaged by these questions. Most of these customers plan for their storage requirements and are able to contract for storage and pipeline capacity or make other arrangements on a more orderly basis (EEA/Schwindt reply evidence Exhibit D, Tab 3, pp. 21-23; and GMi TR. Vol. 10, pp. 76-77).

In this regard, Union's Reply evidence, and in particular the appendices to that evidence deal in detail with recent storage and pipeline expansions in Michigan designed to meet the needs of participants in the market for storage and transportation. DTE Storage and Vector have been aggressively expanding capacity to meet customer requirements and have evidenced substantial ability to expand capacity further in future (Union reply evidence Exhibit D, Tab 2, pp. 3-11 and Appendices A – H; TR. Vol. 9, pp. 191-196).

Intervenor Evidence

The evidence provided by intervenors and, in particular the BHT and IGUA/AMPCO suffers from a lack of recognition of the integrated nature of natural gas markets in North America and the implications of this integration in identifying the relevant geographic market for Union storage services. Specifically:

- there is a failure to appreciate or recognize the relevance and importance of gas price analysis as an indicator of market connectivity;
- the availability of pipeline capacity in the market has been grossly understated;
- the role of commercial transactions collectively referred to as the "secondary market" and other sources of capacity that connect storage facilities and provide competitive alternatives for storage services in Ontario have been almost entirely ignored;
- market power has been defined using the wrong price comparisons (EEA/Schwindt Reply evidence, Exhibit D, Tab 3, pp. 5-7);
- Ms. McConihe and Mr. Stauft excluded consideration of any options that they could not observe through a cursory examination of posted information of the facility owner/operator. In doing so they ignored the real nature of the integrated North American market by inappropriately restricting their analysis to firm pipeline capacity in primary markets, which are only a small subset of available transactions (EEA/Schwindt reply evidence Exhibit D, Tab 3, p. 29).

Perhaps the most telling comment on the analysis of available pipeline and storage capacity carried out by Ms. McConihe and Mr. Stauft was GMi's witnesses' observation that "this evidence "is very troubling, because I don't find myself in there" (TR. Vol. 10, p. 83). That is to say, these analyses were by and large surrealistic. They ignored the manner in which natural gas markets in North America actually operate. Mr. Reed summarized the problem in response to questions from BHT counsel:

> "Let me give a real world answer, and then we can back up to a theoretical one, if you like. On a real world basis the way you ascertain the level of competition or the competitiveness of a competing product, be it supply purchases at the hub or exchanges,

> backhauls, virtual storage as it is called, is typically by issuing an RFP and seeing what bids you get back.
>
> And from the experience of our clients and others in the market place, when you issue an RFP for storage related services at Dawn, you get a competitive response ... " (TR. Vol. 4, pp. 177-178)

Mr. Stauft concluded that Union had market power based on the difference between Union's cost of service rates and the current market values of Dawn storage service sold to ex-franchise customers. This analysis is based on Mr. Stauft's interpretation of a FERC policy statement that provided that cost of service rates could be a proxy for the competitive price when no data on relevant market transactions were available. In this case, there is no need for such a proxy, because storage services have been sold to ex-franchise customers at market based rates for a number of years. Moreover, Mr. Stauft ignores the fact that FERC generally sets rates based on incremental, rather than average costs, with the result that cost of service rates under FERC jurisdiction can be much higher than would be the case if an average cost, or "rolled in" methodology is used (TR. Vol. 5, pp. 24/25). Mr. Stauft acknowledges in his own evidence that marketers will not pay more than the value of storage based on seasonal commodity price differentials (TR. Vol. 9, pp. 172-176). Market prices for ex-franchise storage services generally tracked such differentials and there is, accordingly, no basis whatever for Mr. Stauft's assertion that the difference between Union's rolled in cost of service rates and current prices for storage services are evidence of market power.

Apart from any other consideration, Ms. McConihe's evidence in this case on the correct approach to geographic and product market definition is remarkable, because it differs radically from her previous analyses of these issues when she adopted an approach which was consistent with the approach adopted here by EEA/Schwindt (Enbridge Storage Competition Studies at Exhibit I-8.1, Tab 7(b) and Ms. McConihe's Red Lake Affidavit, Exhibit J-8.5). Ms. McConihe explained the inconsistency between her earlier analysis and her approach to market analysis in this case on the basis that she believed there was unsubscribed pipeline capacity available when the Enbridge Storage Competition Study was completed in July, 2002. While this may be the case in July, 2002, it is not mentioned as a factor in that study, nor does it explain the fact that

Ms. McConihe accepted the same views in an earlier study for Enbridge completed in January, 2001, nor does it explain the discrepancy between her current evidence and the approach she adopted in her affidavit in support of market based rates in the Red Lake application. In addition, Ms. McConihe ignores the availability of unsubscribed pipeline capacity associated with the current Vector expansion, and ignores the potential for additional pipeline expansions that would be available to meet incremental demand if requested by shippers.

There was, during the proceedings, a good deal of discussion of Ms. McConihe's price screen test which attempted to compare prices at various locations in order to determine whether those locations were plausibly within the same geographic market. Ms. McConihe produced three different versions of her price screen data during the course of the hearing, and it is apparent that each of these analyses was flawed by a number of errors and omissions. Counsel for IGUA/AMPCO invited Ms. McConihe to rework her price screen data based on some of the errors and omissions that were brought to her attention during cross-examination. This request was misdirected, since the purpose of the cross-examination was not to correct all of the errors that Ms. McConihe had made in her calculations, but rather to point out that the calculations were, on the whole, unreliable because of the number of errors. More to the point, Ms. McConihe's price screen analysis is not relevant to a determination of the relevant geographic market, since it relies entirely on cost of service rates as opposed to prices that are actually being charged in the markets under examination (TR. Vol. 8, pp. 132-157; TR. Vol. 9, pp. 51, 138/139 and 146-156).

Ms. McConihe also seems to assign an undue importance to the limited number of Ontario customers holding storage capacity outside of Ontario. It is neither surprising, nor alarming that Ontario customers with access to storage priced at the cost of service have not availed themselves of storage options outside of Ontario. As Mr. Aker of BP Energy stated, "I have never been approached, nor have I found any, in-franchise end-use customer who is interested in purchasing storage services from the secondary market. They are adequately serviced by the bundled services that their utilities provide them today" (TR. Vol. 13, p. 75). If customers have access to cost of service based storage services, they are not likely to be interested in services

priced at market based rates. In fact, as noted in the EEA/Schwindt reply evidence, there is a significant incentive for customers with access to cost of service based storage to maximize their use of this storage beyond the economically optimum level.

In summary, it is submitted that the expert evidence submitted on behalf of the BHT and IGUA/AMPCO is not helpful in determining whether the Board can properly forbear from regulation of sales of storage services to ex-franchise customers. Apart from any other consideration, both Ms. McConihe and Mr. Stauft focused largely on the competitive alternatives available to in-franchise customers based on tariff rates available to those customers from Union in comparison to other jurisdictions (TR. Vol. 9, pp. 138-/139 and 187). As noted above, Union is not seeking market pricing or forbearance with respect to in-franchise sales.

Public Interest Considerations

It is submitted that the "public interest" considerations referred to in section 29 of the Act should include interests of the kind normally protected by competitive markets, and do not encompass general public policy interests that may transcend and, in fact, conflict with the public interest in competition.

Union submits that forbearance in accordance with Union's proposals will produce benefits of this kind.

Forbearance from regulation of storage sales will encourage the development of new storage within and connected to Ontario by offering Union and other storage providers the opportunity to manage the costs and revenues associated with operating in a competitive storage market. It will also continue to attract economic development of storage related infrastructure in Ontario. The evidence in these proceedings is that such development is unlikely to occur under the current regulatory regime (TR. Vol. 2, pp. 148-150; TR. Vol. 3, pp. 123-128 and 152-153). This point was summarized neatly at the end of GMi's evidence. When GMi was asked by the Presiding Member whether they would prefer more storage at higher prices than no storage at lower prices, GMi responded: "You bet, sir." (TR. Vol. 10, p. 119)

Such developments will also attract gas volumes moving into and through Ontario, which is critical to Ontario's security of supply and will have a positive impact on the liquidity of gas markets in Ontario, which in turn benefits all Ontario consumers, including new power generators.

A continuation of sales at market values will continue to enhance market efficiency as customers will only contract for what they require, and storage services will be directed to those who value them most.

Finally, this framework will support other third party storage providers and new market entrants who will in turn increase and enhance levels of competition within the market.

Degree of Separation of Storage from Transmission/Distribution

Union is not proposing a physical separation of assets. Union is proposing to leave the storage operation integrated as it is today and to use its Board approved cost allocation methodology to split rate base, costs and revenues (TR. Vol. 2, pg 118).

There has been some discussion about when and how this allocation would be reviewed by the Board (TR. Vol. 2, p. 117; Vol. 3, pg 130; p. 137; and p. 149; Vol.4, p. 110). In fact, this allocation already exists. Union has a cost allocation study that has been used for years during the rate setting process to split costs and revenues between the in-franchise and ex-franchise sales. This allocation was most recently completed in the EB-2005-0520 rate proceeding (TR. Vol. 1, p. 65). Union is proposing to rely on the 2007 cost allocation study filed in EB-2005-0520 as the basis for the allocation of costs and revenues effective January 1, 2007 (TR. Vol. 4, p. 110).

An issue raised in the proceedings is the extent, if any, of separation that should exist between storage service and transmission/distribution service. Ms. Worthy of BP Canada Energy Company summarized these concerns when she testified that "there could be issues that arise with respect to things like transfer of information or preferential treatment, any of those kinds of

things, certainly whenever transmission and storage are held by the same party there can be concerns". Ms. Worthy went on to say "those concerns, however, can be mitigated, and particularly through the appropriate codes of conduct, affiliate relationships, and to the extent necessary oversight and complaint mechanisms that would allow for any issues to be addressed on a timely basis"(TR. Vol. 13, page 15).

Member Chaplin raised similar concerns about whether Union could use its control over transportation to its own benefit in the storage market. Prof. Schwindt pointed out that after 17 years of experience there is no evidence of this happening to date. Mr. Henning testified that open access transmission made it unlikely Union could use operating control of transmission to benefit its storage business, even if it was so inclined (TR. Vol. 4, pp. 123-130).

Mr. Reed testified that "The key, from an economic and public policy perspective, is to not allow the utility to use the monopoly portion of bundled service, in this case distribution, to in any way gain a competitive advantage. So long as that monopoly component is available on open access basis to everyone who may seek to replicate bundled service, there is no competitive advantage" (TR. Vol. 5, p. 142). At Transcript Vol. 8, p. 30, Mr. Smead, in responding to a question from member Chaplin about the appropriate level of separation, testified he thought that "just affiliate rule type separation." would suffice.

Paragraph 98 of FERC Order No. 678 (Exhibit J4.3) indicates that FERC requires pipelines to separately account for all costs and revenues associated with facilities used to provide market-based services to ensure that market-based services are not subsidized by cost-based services. This provision makes clear that FERC contemplates service providers providing both cost and market based services.

When Union responded to the Board's lines of business reporting directive in RP-2002-0130, it estimated that it would cost approximately $19.3 million to realign the Company into two lines of business: storage & transportation/distribution (Union Undertaking K.3.4). Given the integrated nature of the Dawn storage facility, the costs of separating storage from transmission

are likely to be as great, if not greater and the cost of actually separating the company would be many multiples of that amount. Mr. Reed testified that there are firms like Union regulated by FERC that provide storage services at both cost and market-based prices without any necessity for separate business units or divestiture. The example he provided was Detroit Edison. (TR. Vol. 4, p. 210-211)

In summary:

1. There is no evidence that there have been any problems with respect to the integrated nature of Union's storage, transmission and distribution business to date. Union's proposals in this proceeding have no effect on the status quo (storage services will continue to be offered to and priced to ex-franchise customers in the same manner as today).
2. Union's proposal appears to be consistent with U.S. practice.
3. Because of the integrated nature of Union's storage, transmission and distribution system the costs associated with functionally separating storage from transmission and distribution are very significant and any benefits unknown.
4. There are other ways of addressing these concerns such as codes of conduct, oversight and complaint mechanisms.

Finally, it must be noted that Union has been selling storage at market rates for 17 years and there have been no issues or complaints related to Union offering market based storage services.

Elimination of Storage and Transportation Service Deferral Accounts

Union will eliminate the two existing S&T deferral accounts that would be unnecessary if the Board forbears from regulation of ex-franchise storage service sales: the Short Term Storage and Other Balancing Services deferral account (179-70) and the Long Term Peak Storage Services deferral account (179-72). Union is also proposing the elimination effective January 1, 2007 of the three other S&T deferral accounts that relate to transactional transportation related services:

the Transportation and Exchange Services deferral account (179-69), the Other S&T Services deferral account (179-73) and the Other Direct Purchase Services deferral account (179-74) (TR. Vol. 1, p. 67). These deferral accounts capture variances between actual and forecast margin primarily associated with ex-franchise transactional transportation related services.

Procedural Order No. 3 in this proceeding dated March 15th, 2006 transferred Union's proposal to eliminate S&T deferral accounts from Union's 2007 rates proceeding to these proceedings. The relevant evidence Union filed in its 2007 rates proceeding was refiled in this proceeding as Exhibit J3.3.

There are primarily two reasons that Union is proposing to eliminate the three transactional transportation related service deferral accounts:

i) There is no reason to treat these revenues (margins) any differently than any other revenue stream, for which all of the forecast revenue is included in the determination of Union's revenue deficiency/sufficiency without deferral accounts to capture variances relative to forecast; and

ii) Elimination of these deferral accounts is consistent with the Board's policy direction as outlined in its NGF report dated March 30, 2005 (TR. Vol. 2, p. 134-136)

Union has concluded that the revenue derived from these services can be forecast as accurately as any other revenue. There is no reason to treat the revenues derived from transactional transportation related services any differently than other forecast revenues.

The elimination of transactional transportation related deferral accounts is consistent with statements in the NGF Report regarding incentive regulation including:

1. "*[the Board] does not intend for earnings sharing mechanisms to form part of IR plans*" (p. 28)

2. “*an appropriate balance of risk and reward in an IR framework will result in reduced reliance on deferral or variance ac*counts” (p. 31)

Elimination of S&T transactional service deferral accounts is consistent with and supports these statements (Exhibit J3.3).

CCK Rebuttal

The City of Kitchener has advanced two substitutes for the approved aggregate excess storage space allocation methodology which has been in use for the past six years (TR. Vol. 12, p. 21):

1. March 1 Control Point: Based on a forecast of a customer’s winter demand and supply, storage space allocation is determined by “working backwards” from the March 1 control point. March 1 Control Point + November to February Demand less Supply = November storage space (Kitchener’s evidence p.15), and

2. A proportionate share of the system integrity space Union reserves to manage daily temperature risk. (Kitchener’s evidence p.18)

Kitchener is proposing that both elements of the methodology for all <u>wholesale</u> T-service or unbundled service customers and that the first element be available to all T-Service or unbundled service customers (TR. Vol. 12, pp.149-150).

The existing aggregate excess calculation determines a customer’s storage space allocation as the difference between a customer’s aggregate daily winter demand (November to March inclusive, or 151 days) and the customer’s average annual daily demand applied to the same period assuming normal weather conditions (TR. Vol. 12, p. 21).

Kitchener argues the aggregate excess methodology provides insufficient access to cost-based storage (TR. Vol. 12, p. 164) and that Union should provide a lower cost of service for all

Ontario customers, by allocating more storage to in-franchise customers and less to ex-franchise customers (TR. Vol. 12, pp. 185-186).

Kitchener acknowledges that over the last five years, there was only one occasion when the City's storage allocation was insufficient and in that instance Kitchener was able to avoid overrun charges. On April 7th, 2003 Kitchener overran their storage withdrawal requirements. On April 8th, 2003 the City brought in incremental gas supply to rectify the situation (TR. Vol. 12, p. 176).

Kitchener has engaged in continuing efforts to access more storage space at cost of service rates (TR. Vol. 4, p. 22) since switching from the bundled M9 rate to the semi-bundled T3 rate in 1999. This is understandable, but as Mr. Henning testified "from an economic efficiency perspective, it is a good thing to move as many customers as possible toward viewing the true marginal cost of the storage" (TR. Vol. 4, p. 125).

Enbridge and the City of Kingston have been paying market based prices for the storage services they receive from Union for some time. In principle Kitchener's position should be no different from these LDCs (TR. Vol. 12, pp. 162-163). Kitchener acknowledges that they have other options (TR. Vol. 12, p. 154; p. 155; and p. 175). However, as Kitchener themselves pointed out they "would be nuts to shop for storage that costs a dollar a GJ if they can get it at 35 cents" (TR. Vol. 12, p. 190). Kitchener also recognizes that their economic evaluation of storage would be different if they were to pay market prices (TR. Vol. 12, p. 155). In the circumstances Union submits that Kitchener's service should, at the very least, not include increased access to storage at cost.

March 1 Control Point

Union determines the amount of storage space it will have available on November 1 using the aggregate excess methodology. Union then considers winter supplies and demands on its system and determines a forecast March 1 inventory level and then compares that level to the inventory

needed to meet firm delivery obligations from storage on March 1. If there is a shortage in relation to the March 1 inventory requirements, Union buys additional gas in the winter.

The T3 rate schedule provides two deliverability options – customer and Union supplied deliverability inventory. Both are cost based services. Kitchener has chosen the customer supplied option. The alternative would provide full access to contracted storage deliverability when their inventory levels are low (TR. Vol. 12, p. 26; p. 139).

In advancing this methodology, Kitchener is inappropriately mixing storage space with deliverability. The aggregate excess methodology is designed to determine how much storage space is needed to seasonally balance supply and demand. Storage deliverability is the maximum amount of gas that can be withdrawn from storage on any one day (TR. Vol. 12, p. 21). Given the difference in attributes, i.e., seasonal versus daily, it would not be appropriate to determine storage space entitlements on the basis of deliverability requirements.

March 1 Control Point + System Integrity Space

There is no reason why Kitchener should claim a portion of the system integrity storage space that Union requires to operate its storage, transmission and distribution system because Kitchener already receives no-notice service from Union which provides for daily balancing (TR. Vol. 12, p. 33).

System integrity storage space is a reserve against the following risks:

a) 3.3 Bcf of storage to manage weather variances for the daily non-metered residential and small commercial customers. Union estimates how much heat sensitive load there will be on the next day based on the expected temperature. If temperatures vary from forecast, Union uses this inventory to react and meet demand on that day.
b) 1.7 Bcf to backstop supply failures. If there is an upstream supply failure or operating restrictions on another pipeline, Union uses this inventory to meet demand on that day.
c) 4.1 Bcf to manage operating contingencies on a daily basis.

System integrity space is, as indicated, used to manage daily variations in supply and demand. Union does not rely on system integrity space to meet simple variations in customer demand and segregates system integrity space from the gas supply planning process (TR. Vol. 12, p. 31). In contrast, Kitchener wants to access more storage space so that they can include that additional space in their gas supply planning process. This is not the purpose of Union's system integrity reserves.

If Union forecasts colder weather generally, Union will buy spot gas to meet the demand (TR. Vol. 12, p. 25; p. 36; p. 39; p. 41; p. 48; and p. 49). Union does not use system integrity space to balance customers seasonally (Union Undertaking 44).

The service Kitchener receives from Union is a no-notice service. Union provides the daily load balancing. As long as Kitchener delivers its contracted DCQ and has sufficient gas in inventory, the City's customers can use the gas they need. If on any day an industrial plant within Kitchener is using more gas than anticipated for that day, Kitchener does not have to react to that unanticipated demand. Union does have to react to Kitchener's unanticipated demand. Enbridge, Kingston and other LDCs must manage daily balancing and variances due to weather. They have to nominate and balance daily (TR. Vol. 12, pp. 26-27); Kitchener does not.

At Transcript Vol. 12, pp. 175-176, Kitchener acknowledges that if they find that weather has varied beyond reasonable expectations the City must pursue other options to balance supply and demand. Union is an option to the extent that services are available, but Kitchener often chooses to purchase spot gas, or cover the risk as they have done in the last several years, by selling gas in the fall and having equivalent volumes redelivered to them in March or April. Conversely, if Kitchener finds there is too much storage space there are also options. These include retaining the extra gas to mitigate price risk or selling inventory at market values.

Conclusion

Kitchener has accepted the burden of establishing their position that the current storage space methodology is longer appropriate (TR. Vol. 14, p. 1). Kitchener has failed to advance a better

methodology than aggregate excess for determining the amount of storage space needed for seasonal balancing. Kitchener's March 1 control point methodology in effect "backs into" the amount of storage space required to maintain full access to the storage deliverability Kitchener wants, without recognizing that there are other options such as winter supply or electing the Union supplied deliverability inventory option. Kitchener's system integrity space proposal would provide them with storage space to manage daily weather variances that the City is not actually exposed to. In Union's submission, Kitchener has failed to demonstrate why their alternative storage space allocation methodologies are appropriate. The aggregate excess methodology continues to be a fair, efficient and practical methodology to allocate cost based storage space to in-franchise customers.

Power Services

Union is proposing to price UPBS, DPBS, F24-S and high deliverability storage services at market values. Union will need to develop assets to provide these services and the ability to secure market values is necessary to attract the capital needed to develop the assets. Without forbearance, Union would go the market to purchase these services (TR. Vol. 2, pp. 143-145). Union plans to conduct an "open season" soon to determine the level of interest for high deliverability services and will identify minimum bid prices in the open season package to address the generators' requirement for more information about the cost of these services (TR. Vol. 3, pp. 103-104).

Generators have suggested that the high deliverability services otherwise available are poor substitutes for the services that can be provided by Enbridge and Union. The generators' position is that the alternatives would not allow them to withdraw gas from storage on an intra-day basis (TR. Vol. 10, p. 138; p. 140; pp. 179-182). Having said that, APPrO recognizes that one other available option is to buy additional space to get the deliverability they need. That would provide them more space than required (TR. Vol. 10, p. 228). However, as Mr. Henning testified, the extra space has value and could be resold (TR. Vol. 3, p. 46).

APPrO supports the development of additional storage and recognizes the importance of incentives to storage developers (TR. Vol. 10, p. 144). APPrO's concerns are entirely focussed on establishing a value for the services in question (TR. Vol. 10, p. 246). APPrO has testified that they are not trying to pay a lower price than market. They are simply trying to develop or identify a mechanism to ensure a competitive price (TR. Vol. 10, pp. 237-238).

The generators admittedly plan to resell the storage services they obtain from Enbridge and Union when they don't need them into the secondary market (TR. Vol. 10, p. 234; p. 239).

The generator's concerns about the cost of these services have been addressed by Union's commitment to identify minimum bids in the open season package. Another measure of the value of high deliverability service is the net cost of sufficient storage space to achieve the desired deliverability (TR. Vol. 10, p. 228).

Generators need to evaluate their alternatives by soliciting offers in the market and comparing the cost of products and services (TR. Vol. 2, p. 59; Vol. 3, p. 48). There are many options to obtain incremental deliverability (TR. Vol. 3, p. 27). Supply doesn't have to come from storage (TR. Vol. 3, pp. 44-45). There is more than one marketer. In a competitive market there will be a competitive price for intra-day supply (TR. Vol. 3, pp. 82-83).

Marketers can also develop services to meet a market need (TR. Vol. 3, p. 48). Interest in the marketplace underpins development and development requires the necessary commercial pricing and commitments as well as a proper commercial framework (TR. Vol. 3, pp. 42-43).

Mr. Aker of BP Canada Energy Company testified that BP could not currently provide a firm intra-day service (TR. Vol. 13, p. 25) but acknowledged that situation could change if such services were available in the market from Union or Enbridge. Mr. Aker stated that "I'm unaware of anyone who's been unable to satisfy their needs, whether it's in the primary, secondary, or ex-franchise market" (TR. Vol. 13, p. 70). Mr. Aker also stated that "My business will react to the way the market evolves. If customers of ours have access to storage services, we

will approach them and explore opportunities to help them optimize those services. Whether they paid cost or market-based in that scenario is irrelevant" (TR. Vol. 13, p. 76).

In summary, a market for high deliverability services must be allowed to develop in order to ensure the assets required are in place. Generators have options and the market will develop more options for them in the future. Further, as noted above, generators can themselves go to the market to seek out options and pricing as well.