October 27, 2006

Ontario Energy Board
2300 Yonge Street,
27th Floor
Toronto, ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Re: Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089)

Dear Ms. Walli:

Please find below Union Gas Limited's ("Union's") submission in relation to the Board's questions dated September 5, 2006. Union's comments will focus on cost of capital related matters as Union feels that setting the appropriate cost of capital and capital structure for ratemaking purposes is extremely important to ensuring the financial integrity of utilities (gas and electricity) in the province and to providing an incentive for the investment in energy infrastructure needed to strengthen Ontario's economic future. In light of recent communication from the Board related to the timing of the process the Board plans to follow to establish a multi-year incentive regulation ("IR") framework for gas utilities (EB-2006-0209) and Union's understanding that the 2nd generation IR mechanism currently being discussed for electricity distributors is transitionary in nature, Union will not comment on this particular topic in this submission. Union plans to advance its views on IR in the EB-2006-0209 proceeding.

Ontario has one of the lowest Return on Equity ("ROE") rates in North America. Utilities in this province must compete globally for investment dollars as there are significant requirements to build energy infrastructure throughout the world. A more localized example of this competition can be seen in the development of natural gas storage assets. Michigan utilities have developed substantial storage assets over the last 5 years, supported by an 11% ROE and a 50/50 debt/equity capital structure. Ontario has not developed any substantial storage assets over that same period. In order for Ontario to remain competitive, attract future energy supply and continue to build and maintain energy infrastructure, utilities in the province require a competitive cost of capital and capital structure.

A sound and viable energy delivery system in the province fuelled by vibrant investment provides benefits to customers including security of supply and reduced natural gas price volatility.

Two of the questions asked in the Board's September 5, 2006 communication were of particular concern to Union. They were as follows:

> "Should the Board provide incentives for new infrastructure investment within the cost of capital methodology? If so, how might the Board do this?"
>
> "Should the Board impose dividend restrictions if higher ROEs are argued to be needed to attract capital financing? If there is a higher ROE, should the increased revenues be used to finance capital projects from internally generated funds and not be given to pay management bonuses and higher dividends?"

Both questions imply a fundamental lack of understanding of capital related matters and appear to be options under consideration to address returns on the existing infrastructure being too low to provide an incentive for investment in new infrastructure. To state the obvious, the ROE is a return to the shareholders on their equity investment. It is solely within the purview of the shareholders to determine how those funds should be used, including disbursement and reinvestment. In Union's view, the appropriate way to address low returns is to increase them. If the cost of capital and capital structure of a utility was set properly, investors would have the incentive required to make additional investments.

Providing an incentive (i.e. higher return) on new infrastructure over old infrastructure would notionally create different classes of investors. However, from a practical perspective when investors invest, they invest in an entity comprised of both new and old facilities. This is also true for debt holders as well as equity investors. Investors look at financial measures such as a firm's earnings per share ("EPS"), which is comprised of the earnings derived from all facilities (new and old). As a result, the combined return on new and old facilities has to be high enough to satisfy investors.

Dividends are a means that equity investors are provided to earn a return on their investment. Depriving equity investors of dividends (i.e. a return on their investment) will provide a disincentive, not an incentive for future investment.

The requisite seven (7) copies of this document have been provided and electronic versions have been sent to you in searchable Adobe Acobat (PDF).

Union has been monitoring the above noted proceeding and does not intend to become an active participant. Please direct any questions to me at (519) 436-4538.

Sincerely,

[Original signed by]

Mike Packer, CMA, CIM
Director, Regulatory Affairs
Union Gas Limited