Re: Proposed Amendments to the Affiliate Relationships Code for Gas Utilities ("ARC") RP-2002-0140 – Supplementary Submissions

On March 15, 2004, the Ontario Energy Board (the "Board") asked the natural gas utilities in Ontario to provide comments on proposed amendments to the Affiliate Relationships Code for Gas Utilities. In response, Enbridge Gas Distribution Inc. ("Enbridge") and Union Gas Limited filed submissions to the Board on March 25, 2004.

After considering the utility comments, the Board issued a Notice of Proposal to Amend a Code on June 03, 2004 and invited interested stakeholders to comment on the proposed amendments. The Notice also sought stakeholder comment on the utility comments and on specific matters identified by the Board.

Enbridge's supplemental comments on the proposed amendments and its response to the specific matters are attached to assist the Board.

ENBRIDGE GAS DISTRIBUTION INC. ("ENBRIDGE")
SUPPLEMENTARY COMMENTS ON THE PROPOSED AMENDMENTS TO THE ONTARIO ENERGY BOARD (THE "BOARD")
AFFILIATE RELATIONSHIPS CODE FOR GAS UTILITIES
RP-2004-0140

This submission is filed in response to the Board's public notice of Proposed Amendments to the Affiliate Relationships Code for Gas Utilities ("ARC") issued on June 3, 2004 and supplements the comments made by Enbridge in its written submissions to the Board on March 25, 2004 as part of the initial utility consultation. Comments are also provided on the specific questions and matters identified in the public notice.

Summary Points

In its March 25, 2004 submission, Enbridge identified four main areas of concern:

1. Competitive bidding and independent valuations should be used to ensure that transactions are fair to all parties. Where it is cost effective to do so, however, other options should be considered.

2. Corporate services should be treated differently than other affiliate services, particularly where it is not appropriate or possible to outsource or tender these services for public bid. Enbridge recommends that the Board grant an exemption from competitive bidding for corporate services.

3. A six-month implementation period would be more practical than the proposed three-month period. Existing contracts should not be reopened but Board approval would be required to renew contracts with terms exceeding 5 years.

4. Transfer prices associated with asset sales and transfers are best determined by tax rules and the treatment of the resulting capital gains should be considered as part of the utility's rates case.

Fair and Accurate Transfer Pricing

Competitive bidding and independent valuations should be used to ensure that transactions are fair to all parties. Where it is cost effective to do so, however, other options or exemptions should be considered with the onus being on the utility to justify cost and benefits of the alternate method to the Board. The recommended optional procedure is the same as the standard approach approved by the Alberta Energy and Utilities Board (the "AEUB"). In its 2004-010 Decision, the AEUB approved amendments to the Inter-Affiliate Code of Conduct for the EPCOR Group of companies. Section 4.5 of the amended code states that "the Utility, subject to any prior or contrary direction by the EUB, may utilize any method to determine Fair Market Value that it believes appropriate in the circumstances." The Utility must however "bear the onus of demonstrating that the methodology or methodologies utilized in determining the Fair Market Value of the subject goods or services was appropriate in the circumstances".

Allowing an optional approach in Ontario would provide the benefits of a standard approach through competitive bidding without prohibiting a more cost-effective method from being proposed when appropriate. For example, once the Board is satisfied that a utility's competitive bidding process is appropriate, the need for subsequent independent evaluations may not be required as frequently. For similar reasons, competitive bidding may not be the best option in cases where it may reduce net benefits, such as in the provision of corporate services (as discussed in more detail below).

Transfer pricing should not be based on historic costs, since they may not include all of the costs required to provide the service such as future capital upgrades. When the transfer price will be set through competitive bidding, confidential tenders should be used to ensure active competitive bids. Protection of each bidder's offer will improve the quality of the tendering process and encourage suppliers to bid. If their bid information is made public, they may not bid as competitively or at all.

With respect to the bundling of contracts for the purposes of determining when competitive bidding or independent evaluations are required, Enbridge submits that bundling should apply only to similar services from the same provider to avoid adding unnecessary expense to the cost of compliance.

Exemption for Corporate Services

Corporate services should be treated differently than other affiliate services with appropriate definitions to highlight the differences between non-competitive or shared services and services that can be outsourced to others.

Corporate services such as governance, treasury, policy and strategy are not transferable to external service providers. They are within the oversight responsibility of the directors, officers and senior management of the company and as a result of their strategic significance they cannot be outsourced. Other shared services, such as administration, finance and human resource and legal services can be provided by others, but not in a co-ordinated and effective manner that retains efficiencies internally.

As pointed out in the Deloitte Consulting ("Deloitte") Report (Section 6.3.5.3 of Exhibit A6 Tab 17 in RP-2003-0203), "the nature of shared services is different than that of other outsourcing arrangements" since "all recipients share in the

costs and cost savings", rather than the efficiencies flowing solely to the service provider in the case of outsourcing. As such, a cost-based approach, if done appropriately, would be more closely aligned with the regulatory principles of cost causality and transparency than a market-based approach with undisclosed margins. The Deloitte Report also points out that "market [pricing] is not typically used as a basis for establishing charges" since in most cases affiliate charges are based on costs (3.2.7).

Citing these reasons, the Deloitte Report concludes that "competitive tendering should not be required where services are provided by an affiliate on a shared service basis, provided the cost incurrence and cost allocation tests have been adequately addressed" (6.3.5.3). Enbridge agrees with this conclusion and submits that the appropriateness of corporate charges is best tested as part of a utility's rate case. Enbridge therefore recommends that the Board exempt corporate services from competitive bidding and individual evaluations.

When differentiating between services, Enbridge recommends that corporate services be defined as:

> *Strategic or administrative activities such as corporate governance, fiduciary accountability, legal services, policy development and strategic planning that are provided by the parent company to the utility and its affiliates on a shared service basis. Shared corporate services could include accounting; environment, health & safety; finance; human resources; internal audit; and, public and government affairs.*

Furthermore, Enbridge supports Union's proposed amendments to Section 2.3 of the proposed ARC as a means of recognizing the benefits provided by shared corporate services, while adhering to regulatory principles of cost causality and transparency. Adding a requirement that ratepayers must be shown to positively

benefit is unnecessary, as this is an issue that should form part of the Board's prudence review in any rate case.

Enbridge is not sure what the term "up front" means when used in conjunction with the ratepayer benefit test. If the intent is to require prior Board approval before a utility enters into any service agreement, management discretion may be hampered and ratepayer benefits may be diminished. Since the utility must justify its corporate charges as part of its rate case, there is no need for prior approval for normal business transactions, although the utility may decide that a preliminary review of a major initiative is prudent.

Implementation Timing

As previously submitted, Enbridge recommends that the Board allow six-months for utilities to comply with the ARC once the proposed amendments have been approved by the Board. Any new affiliate agreements signed after the amendments come into effect would need to be compliant with the new ARC.

Enbridge does not support the reopening of existing contracts or any retroactive application of the ARC that would abrogate its current agreements. These agreements were signed in good faith on the basis of rules that were in place at the time of their execution. The Board should be reluctant to require changes to specific terms in previously negotiated and executed contracts since it would undermine the contracting process.

Term of Contract

Enbridge concurs with Union that there may be situations where a term in excess of five years would be beneficial and that in such cases the Board would consider approving a longer-term contract. This could be accomplished through a

request for an exemption under Section 1.6 of the ARC, but it would be preferable to note this possibility by amending Section 2.3.1 as follows.

> *The term of a contract between a utility and an affiliate shall not exceed five years,* ***unless otherwise approved by the Board****.*

Asset Transfers

Enbridge agrees with Union that the treatment of capital gains on the sale of assets to an affiliate is "not within the ambit of the ARC". While the background policy paper was very helpful in explaining the intent and origin of the proposed amendments, the comments on asset transfers do not appear to be relevant to the ARC. The treatment of capital gains in connection with an asset transfer or sale would be determined by tax law and the resulting disposition of any capital gains or loses would be a rate issue. In Section 4.4 of the previously referenced EPCOR code, the AEUB requires asset transfers to be at Fair Market Value.

Comments on Specific Matters

a) As discussed in paragraph two of the Corporate Services section, Enbridge recommends that the Board exempt corporate services from competitive bidding and allow cost-based pricing of these shared services. Enbridge would support a separate rule along these lines to clarify the special nature of corporate services.

b) Enbridge recommends that the three-pronged test not be codified as all three prongs refer to cost allocation and cost-benefit issues that are more appropriately reviewed in the utility's rate case. Rather than making the specific tests part of the ARC, Enbridge recommends that the Corporate Services section of the ARC put utilities on notice that the Board expects utilities to address the three-pronged test when seeking rate approval for corporate charges.

c) Enbridge supports the dropping of market based pricing for corporate services. As stated in the Corporate Services section, these services are not conducive to competitive bidding and are best priced using a cost-based approach as recommended by Deloitte Consulting. Enbridge submits that ratepayer benefits should be assessed as part of a utility's rate case and that the onus should be on the utility to demonstrate any ratepayer benefits with the minimum threshold being that ratepayers are not harmed.

i. As discussed above, the three-month transitional period should be extended to six months.

ii. Further to our comments regarding implementation timing, Enbridge does not recommend reopening existing contracts to ensure compliance with new ARC amendments. Any subsequent changes to the ARC should be applied prospectively. Existing contracts were signed in good faith and reflect negotiations and commitments of parties based on the rules and regulations in place at that time. It would be inappropriate and costly to revisit settled agreements, but more importantly any abrogation of existing terms would undermine normal commercial relations, increase regulatory risk and bring the utility's contacting process into question. Enbridge recommends that existing contracts be made compliant when they are renewed.

iii. As discussed in the Contract Term section, Enbridge recommends that the Board consider the possibility of longer-term contracts as an exception to the general rule of a five-year maximum term. Since competitive bidding would not be a practical means of confirming that charges are fair at year five of a longer-term contract, the Board may wish to consider other means of assessing market pricing, such as those listed in the AEUB 2004-010 Decision in Section 4.5 of Appendix A. According to the AEUB, "[t]hese methods may include, without limitation, competitive tendering, competitive quotes, benchmarking studies, catalogue pricing, replacement cost comparisons or recent market transactions." As the utility must justify the

appropriateness of any charge for an outsourced service, this would be best done in its rate case. Putting additional restrictions and costs on affiliate services will make them less competitive with third-party supplied services and add costs unnecessarily for ratepayers.

iv. As mentioned briefly in the section of transfer pricing, the bundling of different services will increase compliance costs unnecessarily and decrease the likelihood of obtaining competitive bids of the service bundle. Enbridge recommends that the Board consider other means such as benchmarking to determine if existing charges are reasonable. Benchmarking has been recognized as an efficient and reasonable method of assessing market pricing for services. The Pacific Economics Group report (filed as Exhibit A6, Tab 1, Schedule 3 in RP 2003-0203) and the American Gas Association/Edison Electric Institute annual operating cost study (cited in Exhibit A6, Tab 4, Schedule 2 in RP 2003-0203) provide good examples of the empirical value of benchmarking.

v. As previously discussed, the quality of competitive bidding will be greatly improved by allowing bids to be submitted on a confidential basis. To do otherwise would significantly reduce the number and quantity of the bids, resulting in less accurate, potentially misleading and, in the worst case, no estimates of market pricing.

vi. Independent evaluations of a tendering process should not be allowed to impair normal business operations and they should not be required if a previously approved competitive bidding process is used. In the case of spot gas markets, the procurement process can be approved once and applied to future transactions without the need for further review.