



uniongas

A Duke Energy Company

March 25, 2004

Ontario Energy Board
2300 Yonge Street
Suite 2601
Toronto, Ontario
M4P 1E4

Attention: Mr. Peter O'Dell, Assistant Board Secretary

Dear Mr. O'Dell:

**Proposed Amendments to Affiliate Relationship Code for Gas Utilities ("ARC")
RP-2002-0140 – Union Gas Submission**

On March 15, 2004 the Board requested that the affected utilities provide comments on the Proposed Amendments to the Affiliate Relationship Code for Gas Utilities by March 25, 2004. Union Gas' ("Union's") comments (3 copies) are enclosed.

Please contact me if you require additional information, at (519) 436-4538.

Yours truly,

Mike Packer
Director, Regulatory Affairs

Michael Penny (Torys)

**UNION GAS LIMITED (“UNION”)
COMMENTS ON THE PROPOSED AMENDMENTS TO THE
OEB AFFILIATE RELATIONSHIPS CODE FOR GAS UTILITIES
RP-2004-0140**

This submission is in response to the Board’s initial request for comments on the proposed amendments to the Affiliate Relationships Code for Gas Utilities (“ARC”).

Union has reviewed the proposed amendments to the ARC and the accompanying draft of the Board’s Background Policy Paper (“BPP”). While Union agrees with the need to establish rules for affiliate relationships, Union is concerned with the overall direction that has been laid out by the Board and the potential impact on ratepayers. In particular, Union is concerned with the cost of the transfer pricing rules that are being proposed in Section 2.3 of the ARC. It is Union’s view that the proposed transfer pricing rules will result in higher costs to ratepayers without a corresponding benefit.

Section 1.2

The proposed amendments to the ARC treat corporate services and shared services the same as other services. That is, the definition of service has been expanded to include corporate services and Section 2.2 specifically refers to the sharing of services. However, the transfer pricing rules do not consider the uniqueness of this type of organizational structure. Instead, the transfer pricing rules imply that there is no difference between the complete outsourcing of an activity by the utility to an affiliate and the integration of certain parts of activities between affiliates that provide benefits to ratepayers. It is impossible to establish a competitive bidding process for an activity that is performed in

part by the utility in conjunction with one or more other affiliates. Furthermore, the nature of these activities does not lend themselves to service provision by anyone other than a corporate parent (e.g. activities such as general counsel or insurance risk management).

Union supports the inclusion of definitions that make the ARC easier to apply. In particular, definitions of corporate services and shared services would be beneficial. Union views these to be distinct variants of the term “service” and suggests that a definition of each should be included in Section 1.2 of the ARC.

Union submits that the following amendments to Section 2.3 of the proposed ARC would appropriately recognize the benefits provided by corporate services and shared services, while adhering to the purpose of the ARC.

Corporate Services and Shared Services

Section 2.3.Xi

Despite sections 2.3.4, 2.3.5, and 2.3.6 [note: it is proposed that section 2.3.7 be deleted], a utility may enter into agreements with affiliates for a corporate service or shared service if:

- (a) the details of the cost allocation methodology are documented and filed with the Board; and*
- (b) the details of the cost allocations for the agreements between the utility and affiliate are fully disclosed.*

Section 2.3.Xii

In the case of a corporate service or shared service, the utility shall pay no more than the affiliate’s fully-allocated cost to provide that service. The fully-allocated cost may include a return on the affiliate’s invested capital. The return on invested capital shall be no higher than the utility’s approved weighted average cost of capital.

Section 1.5

The proposed amendments to the ARC contemplate a much more complex affiliate transaction evaluation process (market existence determination, tendering and independent evaluation) than currently exists. Most of Union's service agreements expire at the end of 2004. In addition, the proposed amendments to the ARC may cause Union to reassess what services it will outsource to affiliates in the future. As a result, Union anticipates that it will take substantially longer than three months to comply with the ARC after the proposed amendments have been incorporated.

Section 2.3.1

Union assumes that it will be able to request an exemption under Section 1.6 of the ARC, and if circumstances justify it, the Board would approve a contract with an affiliate with a term in excess of five years. While it is anticipated that most contracts would not exceed a one or two year period, Union has had past experience where contracts have been equal to or have exceeded the proposed five year limit. An example would be gas transportation contracts. Based on forecasted requirements and available capacity, Union has entered into contracts in excess of 5 years and the Board approved these transactions for recovery in rates. As such, Union submits the following amendment [in **bold**] to this section.

Section 2.3.1

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

Section 2.3.2

While Union recognizes that the fully allocated cost prior to outsourcing may be one measure of the reasonableness of the affiliate's charge for services, it may not be the most appropriate measure. Other considerations include whether the underlying assets that were used to provide the service prior to outsourcing were nearing the end of their economic life (and as such the asset would be replaced in any event) and whether service quality levels are directly comparable. An example of this would be a fully depreciated computer system. Consequently, Union submits that Sections 2.3.2 and 2.3.3 of the proposed amendments to the ARC should be deleted.

Section 2.3.5

For a fair and open competitive bidding process to work effectively, the bids received must be kept confidential. Union assumes that this confidentiality would be preserved under the ARC.

The need to undertake a competitive bidding process for contracts that are expected to renew on an annual basis will be burdensome with little incremental benefit. Union suggests that the ARC requirements allow for a renewal or extension process without the need to have a competitive bidding process each year.

Section 2.3.6

In applying the threshold associated with competitive bidding, Section C.2.d. of the BPP notes that the proposed threshold tests are based on the total dollar value over the life of

the contract. Union feels that this creates incongruence between the threshold value, which is based on an annualized figure, and the total value of a multi-year contract. Union submits that a proper comparator would be to match the terms of both the threshold and the contract value. This approach will ensure that there is equal treatment of contracts, whether for one year or multiple years, and that costs are not unnecessarily incurred simply because a contract extended beyond one year.

Union submits that the portion of Section C.2.e. of the BPP that refers to “*How should utilities apply the threshold test*” should be amended as follows:

How should utilities apply the threshold tests?

Note that both the proposed threshold tests (in sections 2.3.6 and 2.3.7) are based on the average annual dollar value over the life of the contract. Some outsourcing contracts may not have a fixed dollar amount. In such cases, the utility should make a reasonable estimate of the likely average annual dollar value of the contract. An internal budget estimate may be useful for this purpose.

Section 2.3.7

Union submits that the requirement to undertake an independent evaluation will unnecessarily complicate the time and cost associated with the tendering process. The use of third party evaluations should be at the discretion of the utility, as it ultimately bears the responsibility for establishing the prudence of affiliate costs when applying for recovery in rates. In this regard, a competitive bidding process should be sufficient in the first instance.

In the specific case of gas supply contracts, it would be impractical to seek out an independent audit of the tendering process. In the spot gas market, delays can mean lost

opportunities and the potential for increased gas costs for ratepayers. As a result, Union anticipates having to apply for an exemption for these contracts.

Section 2.3.10

The BPP indicates that the Board will require evidence that a market does not exist before considering the application of the cost-based rule. The Board's expectations on this matter are unclear. The ARC would be easier to apply if it contained a description of the types of evidence the Board could rely on to demonstrate that a market did not exist.

Sections 2.3.12 to 2.3.16 – Transfer of an Asset

The BPP discusses the treatment of capital gains on the sale of assets to an affiliate. The disposition of gains and losses is not within the ambit of the ARC. The rate treatment of gains and losses on the sale of assets is an issue that must be decided by the Board, in the appropriate forum, at the time evidence can be provided and argument heard with respect to the specific transaction in question. In Union's view this would be a rates proceeding.

Union notes that the transfer pricing methodology and associated thresholds for the sale of assets to an affiliate are different than elsewhere within the rule. Union suggests that the proposed amendments for asset sales should be aligned with those for services, products, resources and use of asset. Union also submits that Sections 2.3.14 and 2.3.16 would only be applicable if the asset is not disposed of through a fair and open competitive bidding process.

Section 2.6.1.1

Union assumes that if the utility has complied with sections 2.3.4 through 2.3.6 of the ARC and acquired the services at a market price, the affiliated service provider's cost is irrelevant and there would be no necessity for the affiliate to produce the information identified in section 2.6.1.1(1)(i). As section 2.6 in general speaks to the confidentiality of the utility's information, not to the language of the service agreements, Union suggests that this section is better positioned following section 2.3.10, which discusses the transfer pricing when no market exists.

Union submits that section 2.6.1.1 should be removed from section 2.6 Confidential Information. In its place, a new section following section 2.3.10 should be added as follows:

2.3.10.1

Where the transfer price is based on Section 2.3.10, a utility shall not enter into or renew a contract with an affiliate unless it contains provisions which require the affiliate to:

- (a) Comply promptly with all requests by the Board for information with respect to:*
 - (i) The transactions provided under the contract; and*
 - (ii) The fully allocated cost to the affiliate of providing any service, resource, product or use of asset under the contract.*