UNION GAS LIMITED ("UNION")
SUPPLEMENTARY COMMENTS ON THE PROPOSED AMENDMENTS TO THE OEB AFFILIATE RELATIONSHIP CODE FOR GAS UTILITIES
RP-2004-0140

This submission is in response to the Board's public notice of Proposed Amendments to the Affiliate Relationships Code for Gas Utilities ("ARC"). On March 25, 2004, Union provided comments on the proposed amendments. These additional comments are in response to the Board's invitation to provide further comment on the proposed amendments with specific reference to matters identified in the public notice.

Union has reviewed the Results of Consultation with Gas Utilities section of the public notice. While no changes were made to the proposed amendments following the gas utilities' submissions, it is recognized that the Board has provided further commentary on the ARC. This included re-emphasizing the Board's intent that there be a balance between the cost of implementing the proposed amendments and the associated benefits. In addition, the Board identified specific matters requiring further discussion as part of the public notice.

Union's supplementary comments build on its initial submission and will focus on the specific matters for which the Board has invited further comment.

Shared Corporate Services

Union submits that there is merit in dealing with the acquisition and pricing of shared corporate services in a separate section of the ARC, including the addition of definitions that make the ARC easier to understand and apply. Union views shared corporate services as a distinct activity, worthy of its own definition and treatment within the ARC.

Shared corporate services have some of the same attributes as other general services provided by affiliates. However, it is important to identify the key characteristics of shared corporate services that differentiate them from other services provided by or in conjunction with an affiliate. These specific characteristics include:

> Shared corporate services relate to the responsibility that resides with the directors, officers and senior management of the business entity. They encompass the areas of corporate governance, fiduciary accountability, legal obligation, policy development and strategic planning of a corporation. The management oversight of these corporate services cannot be outsourced to an unrelated party as it would, in effect, relinquish those specific responsibilities of corporate leadership.
>
> The sharing of corporate services is a business model based on an integrated approach to the provision of common services to related business entities. It's a cooperative approach designed to provide core administrative, financial, human resource and legal services in a coordinated, efficient and effective manner that serve both ratepayers and shareholders.
>
> Shared corporate services is an overall corporate philosophy and its success is dependent on the contribution and participation of the related business entities. As such, to limit or prevent involvement of any party has a negative impact on the benefits received by all of the participants, benefits which can also accrue to ratepayers.

> The sharing of corporate services may take the form of the centralization of services within one business entity, resulting in it being the single provider of services to the related business entities. In other instances, it may involve the performance of activities in a number of related business entities, which when aggregated, represent the full provision of services to all of the related entities. In both situations, shared corporate services are performed and provided irrespective of business entity boundaries.

Based on the above characteristics, Union proposes the following definition of Shared Corporate Services for the Board's consideration:

> ***Section 1.2***
> *Shared Corporate Services relate to such administrative activities as corporate governance, fiduciary accountability, legal duty, policy development and strategic planning of the utility. These are responsibilities that reside with the senior leadership of the utility and are performed by or in conjunction with affiliated entities.*

It would be helpful if the Background Policy Paper (BPP) contained further definition and description of shared corporate services. This would be similar to Section 39.157.i(2) of the Public Utility Commission of Texas' Public Utility Regulatory Act which provides specific examples of corporate services. Specifically, it would be advantageous if the BPP clarified what activities would be considered corporate services and the situations under which these may be provided by or in conjunction with an affiliate.

Union submits that such a list of corporate services would include: accounting; environment, health & safety; finance; human resources; internal audit; legal; public

affairs; and strategic planning. Further to this, the BPP could also discuss the Board's expectations with regard to the type and detail of evidence that would be expected in support of the utility's decision to undertake shared corporate services.

Union recognizes that the decision to outsource services, whether to an affiliate or unrelated third party, will be subject to scrutiny by the Board. Clarification and comment within the BPP on what the Board expects the utility to file in support of their decision to outsource a service would be helpful, including an indication of when it would be appropriate to complete some type of business case analysis. However, Union is concerned that any attempt to codify such rules would result in provisions that are costly to implement, cumbersome to comply with, and may limit management's ability to make sound business decisions.

The three part test presented in Union's E.B.R.O. 493/494 rates proceeding has been both accepted and advanced by the Board as an appropriate measure of benefit, reasonableness and prudence. Including the concepts of cost incurrence, cost allocation and cost/benefit in the BPP has merit, as it will provide guidance to the utility in terms of what the Board expects when determining that the outsourcing of services is in the public interest.

As noted in Union's initial submission, the proposed codification of specific transfer pricing rules, including the tendering and contract evaluation requirements, will result in increased administrative effort and costs, without any evidence of a corresponding benefit to the ratepayer. Union believes that the utility should be given the latitude to determine how it will justify the cost and benefit of such arrangements during its rates proceedings, so that it can establish an appropriate balance between cost, effort and benefits achieved.

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

> ***Shared Corporate Services***
> *Section 2.3.Xi*
> *Despite sections 2.3.4, 2.3.5, and 2.3.6 [note: it has been previously proposed that section 2.3.7 be deleted], a utility may enter into agreements with affiliates for a shared corporate service when:*
> *(a) the details of the cost allocation methodology are documented and available to 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 shared corporate 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.*

With reference to the proposition *"that ratepayers must be shown to positively benefit "up front" from such outsourcing"*, this may infer that the utility cannot enter into a shared corporate services arrangement without prior Board approval or that there is an expectation of a financial benefit in the first year of the agreement. If included in the ARC or BPP, clarification on the term *"up front"* would be helpful. Union interprets this phrase to mean that the benefit is determined by the utility before it enters into a service agreement, rather than the Board having to grant approval to the utility before the agreement can be executed.

<u>Coming into Effect (Section 1.5)</u>

As previously submitted, Union anticipates that it will take substantially longer than three months to comply with the ARC; even after the proposed amendments have been

incorporated. Union recommends that a period of at least six months be available, after which time, any new affiliate agreement would need to be compliant with the amended ARC.

Union believes that, even if Union lawfully could (which is in doubt) restructure its existing agreements, it would not be appropriate for the Board to so require. These agreements were made in good-faith on the basis of the rules that were in place at the time of their execution. For Union, many of these agreements have a limited term and it would be inefficient to change them when there would only be a short period of time left before they expire.

Term of Contract (Section 2.3.1)

It is Union's position that, regardless of the contract term, the same rules and guidelines should be applicable to all contracts. For Union, the need to enter into contracts with affiliates for terms greater than five years in length would be infrequent. It is Union's understanding that it will be able to request an exemption under Section 1.6 of the ARC and that the Board would not unreasonably withhold approval of a contract with an affiliate with a term in excess of five years. 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****.*

Bundling versus Unbundling of Services (Section 2.3.8)

Union takes no issue with the proposed language of Section 2.3.8 of the ARC, as it states the Board's expectations and authority in applying the ARC. The BPP should, however,

address how the Board intends to apply such a test. Union submits that any bundling restriction should only apply to similar services from the same provider. Specifically, if the utility receives multiple services from one affiliate, these should not be aggregated to determine the threshold test. Likewise, if the utility is receiving similar services from multiple affiliates, then these agreements should not be aggregated.

Confidentiality of Competitive Bidding

In the past, utilities have sought to have commercially sensitive information kept in confidence with the Board. This is necessary to protect both the utility and the counter-parties with which it transacts business. Union has no doubt that the protection of each bidder's terms and information will improve the quality of the tendering process. Specifically, if a bidder cannot feel confident that their proposal will not become public information (especially if they are not the winning bidder), there will be a general reluctance to provide enough detail in their proposal to allow proper assessment of it or they may select to not bid at all.

Transfer of an Asset (Sections 2.3.12 to 2.3.16)

The BPP discusses the treatment of capital gains on the sale of assets to an affiliate. The BPP should not take the form of interpretive guidelines, especially in those situations where it appears to pre-determine the Board's position on matters that are not within the ambit of the ARC. Specifically, the treatment of gains and losses is not within the domain of the ARC as the parties to the asset transfer have no bearing on how the gain or loss should be handled.

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 the specific transaction in question. The question of the treatment of gains and losses can only be answered in the context of a particular sale of a particular asset. The answer turns, not on who purchases the asset, but on issues such as whether or not the asset is used to serve the public, whether it is depreciable or non-depreciable, and whether, even if depreciable, it was sold above or below net book value and/or original cost. In Union's view the appropriate forum for this determination is a rates proceeding.

Finally, Union is concerned that there is no mention in the BPP of the leading Canadian Case on the rate treatment of gains on the sale of assets – that is, *Atco Gas and Pipelines Ltd. v. Alberta Energy Utilities Board*, a decision of the Alberta Court of Appeal released on January 27, 2004.

Exemptions to the Code (Section 1.6)

The BPP should acknowledge that there may be special circumstances where the Board is prepared to grant exemption from any or all sections of the ARC. In Union's view, the BPP need not identify all possible special circumstances but there may be value in identifying examples. Such situations could include:

- Contract length in excess of five years, where the norm within the industry is beyond five years (e.g. upstream gas transportation contracts);

- Contract value in excess of the threshold, where the contracting process is under a separate process accepted by the Board (e.g. gas acquisition policy including spot gas); and
- Any contract entered into for a project or initiative whose cost consequences have been included in Board approved rates (e.g. information technology systems).

In this regard, the BPP would provide more clarity if the Board stated that an exemption would not be unreasonably withheld. In addition, it would be beneficial if it was clarified that once an exemption has been granted that it would be applicable to the term of the contract. This clarification would help avoid the potential of revisiting an existing exemption each time the utility has a proceeding before the Board.