uniongas
A Duke Energy Company

February 14, 2005

Mr. John Zych,
Board Secretary
Ontario Energy Board
2300 Yonge Street, 26th Floor
Toronto, ON M4P 1E4

Dear Mr. Zych

Re: Draft 2006 Electricity Distribution Rate Handbook (RP-2004-0188)

Union Gas ("Union") has reviewed the second draft of the 2006 Electricity Distribution Rate Handbook ("EDR Handbook") issued on January 10, 2005 and respectfully submits its comments on Chapters 3, 4, 5, 6, 7, 12, 13 and 14 which address matters of concern to Union

Chapter 3 – Test Year and Adjustments

The draft 2006 EDR Handbook proposes that 2006 rate applications be based on actual 2004 results with mandatory and optional adjustments to move actual 2004 results closer to a typical year of capital investments, operations and revenues. As an alternative, electricity distributors can file a forward test year application.

Union notes that distribution rates in the natural gas sector have been set on a forecast test year basis for approximately 30 years. In Union's view a forecast test year is superior to a historic test year approach. However, Union recognizes that it may not always be practical and cost effective to do so. In its E.B.R.O. 302-II Reasons for Decision (September 1975 Phase II Decision on Consumers Gas Company rates), the Board stated:

> *"This Board sees no objection in principle to using a current year as a test year when making a determination of rate base and return thereon pursuant to section 19(2) of The Ontario Energy Board Act. It is the future effect of rates that is being tested and, especially in the time of rapid change, up-to-date evidence, even if it is based partly on forecasts, is preferable to stale evidence provided it is reliable."*

The draft 2006 EDR Handbook and the filing requirements therein assume that rate applications are filed on the basis of an adjusted, historic test year. Union understands this approach was chosen primarily to reduce the time and effort required to set electricity distribution rates for 2006. The simplified approach appears to be appropriate as a transition measure. However, electricity distributors should consider moving toward using a forward test year as soon as it is practical for them to do so.

Chapter 4 – Rate Base

4.7 Treatment of Capital Gains and Losses

Union agrees that the Board should determine the treatment of capital gains and losses, on a case-by-case basis. While the use of thresholds may appear to be an efficient means of dealing with lower dollar value transactions, they preclude parties from looking at the circumstances that gave rise to the gain or loss, which may be required to properly determine the appropriate treatment.

In Union's view, there is no reason why ratepayers would be entitled to any share of the gain on the sale of a non-depreciable asset. In a recent decision by the Alberta Energy Utilities Board ("AEUB")[1], the AEUB directed ATCO to share capital gain resulting from the sale of a non-depreciable asset between shareholders and ratepayers. Upon appeal, the court found that the AEUB, in purporting to allocate proceeds of property not necessary to serve ratepayers had "acted beyond its jurisdiction by misapprehending its statutory and common law authority". Among other things, the court noted, "consumers of utilities pay for a service, but by such payment, do not receive proprietary right in the assets of the utility company. Where the calculated rates represent a fee for the service provided in the relevant period of time, rate payers do not gain equitable or legal rights to the non-depreciable assets when they have paid only for the use of those assets".[2]

4.7.3 Assets Sold to an Affiliate

Union agrees that the sharing of gains and losses on the sale of an asset sold to an affiliate should be the same as the sale of an asset to a non-affiliate. The treatment of gains and losses arising from the sale of an asset should be determined on the basis of such issues as whether or not the asset is needed to serve the public, whether it is depreciable or non-depreciable, and whether it was sold above or below net book value and/or original cost rather than who purchases the asset.

However, the proposed materiality threshold in the draft 2006 EDR Handbook for gains and losses on the sale of assets to affiliates is based on the value of the asset being sold rather than the amount of the gain or loss, as is the case for non-affiliate sales. Union sees no reason why the thresholds would be different.

Chapter 5 – Cost of Capital

5.1 Maximum Return on Equity

The draft 2006 EDR Handbook makes reference to a "maximum" return on common equity. It is not clear what the term "maximum" means in this context.

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[1] AEUB Decision 2002-037 dated March 21, 2002.

[2] Atco Gas and Pipelines Ltd. v. Alberta Energy and Utilities Board; Docket No.: 0201-0116-AC Alberta Court of Appeal, Calgary, Alberta. Judgement Date: January 27, 2004.

The Board's approach to setting rate of return on equity for natural gas utilities is set out in its *Draft Guidelines on a Formula-Based Return on Common Equity ("ROE Guidelines")*. In a December 1998 discussion paper "The Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario", the Board's consultant (Dr. Cannon) concludes that there is no serious impediment standing in the way of applying the Board's current formula-based approach for setting allowed returns for natural gas LDCs to electricity LDCs. This would ensure consistency of regulatory treatment between firms in these two, frequently-competing industries.

The allowed rate of return for gas utilities is the rate of return included in the utility's revenue requirement used to set rates. The Board's ROE Guidelines make no reference to the allowed rate of return being a maximum in specific circumstances. The same treatment that applies to gas distributors should also apply to electricity distributors.

Chapter 6 – Distribution Expenses

6.2.4 Employee Total Compensation

Incentive Plans

Union submits that incentive payments should be considered a legitimate element of the total compensation package offered by a utility to attract and retain qualified managers and staff in a competitive market for human resources. Incentive programs are a common element of business management in all sectors of the economy, and have come to be regarded by employees, and prospective employees, as an essential element of compensation.

6.2.7 Distribution Expenses Paid to Affiliates

Affiliate Transactions

With respect to the proposed additional filing guidelines identified in the draft 2006 EDR Handbook, Union's view is that, depending on the structure and terms of the agreement between the parties, the actual costs of the affiliate may have limited bearing on the pre-established price for the period. In reference to Schedule 6-3(a), Union submits that Question 3, which would require the filing of the affiliate's historical costs, would create a significant administrative burden that is unlikely to provide meaningful input into the process.

Shared Services

Schedule 6-3(b) of the draft 2006 EDR Handbook proposes that the utility must provide a general explanation of how they followed the transfer pricing and shared services rules in the Affiliate Relationship Code (ARC). Union submits that rate recovery of affiliate charges should be related to whether the cost of the service obtained from an affiliate is compliant with the transfer pricing provisions of the ARC rather than other aspects of the ARC (e.g., confidentiality and reporting requirements).

While Union can appreciate the desire for full disclosure of the utility's compliance with the ARC, only information relating to the utility's transfer pricing and cost is relevant to the rate setting process. Other compliance requirements of the ARC do not have a bearing on the costs that have been incurred.

Chapter 7 – Taxes / PILs

Union submits that explanatory detail provided in the draft 2006 EDR Handbook in Chapter 7 provides valuable clarity and explanations to the basic mechanics in the tax model and should be left within the final 2006 EDR Handbook.

7.1.1 General Principles Underlying the 2006 Tax Calculation

True-up of 2006 actual taxes paid to taxes recovered in rates

Once a utility's revenue requirement has been established and rates have been implemented, in Union's view, it would be inappropriate to pick one cost item and subject it to a true-up mechanism. In the natural gas sector, the Board has been reluctant to approve deferral accounts. They are only permitted when it is not possible to forecast a cost or revenue item accurately, and when variances between forecast and actual are material and outside of management's control.

The draft 2006 EDR Handbook indicates that no amount of tax relating to any prior year shall be included in rates for 2006. Union submits that this should be the case for any rate year. As is suggested in the draft 2006 EDR Handbook, any extraordinary difference between forecast and actual taxes can be dealt with pursuant to a separate, generic proceeding.

7.1.2.2 Non-Recoverable and disallowed expenses

Regulatory treatment of associated reduction in actual taxes payable in respect of non-recoverable or disallowed expenses

Union's view of what should happen with respect to taxes follows the arguments and positions put forth by Ms. McShane in her "Report on the Disposition Of Tax Savings On Disallowed Expenses" submitted on behalf of the Coalition of Issue Three Distributors. Ms. McShane identifies the four regulatory principles that have been followed for more than 25 years. Those core or basic principles are:

1. Benefits follow costs.
2. The stand-alone utility.
3. Level playing field.
4. No harm to ratepayer.

Union agrees with Ms. McShane's evidence that the above principles should be followed in rate setting. Union believes that the natural and proper outcome of this is that the person bearing the economic cost of the disallowed cost should recognize any tax savings associated with costs disallowed by the regulator. In Union's view, that is clearly the distributor / shareholder (Alternative 3).

It should be noted that decisions made by the distributor and its shareholders are based on after-tax dollars. To ignore this fundamental principle ignores a very real component of any utility's decision-making process. In his evidence on behalf of the School Energy Coalition, Mr. Mintz tries to recognize that there is a difference between corporations that are taxable and those that are tax exempt. His evidence applies economic theory to only half of a transaction (i.e., looking at economic theory to discuss how the tax associated with a cost disallowed by the regulator should be handled without also looking at how the disallowed cost is or should be handled). This approach does not give anyone the true economic consequence of a disallowed cost. Mr. Mintz' economic theory does not exist in a regulated environment.

Eligible Capital Expenses with respect to any adjustment to fair market value at October 1, 2001

Based on the four principles of regulation as identified in Ms. McShane's evidence, Union's view is that Alternative 3 (100% of tax savings to distributor) is the correct alternative.

Eligible Capital Expenses with respect to disallowed expense

Based on the four principles of regulation as identified in Ms. McShane's evidence, Union's view is that Alternative 3 (100% of tax savings to distributor) is the correct alternative.

Charitable Donations

Based on the four principles of regulation as identified in Ms. McShane's evidence, Union's view is that Alternative 3 (100% of tax savings to distributor) is the correct alternative.

7.1.2.4 Sharing of tax exemptions

Union agrees with the direction outlined in the draft 2006 EDR Handbook for the overall sharing of tax exemptions within a corporate group of which the distributor is a member but does not agree with the alternative provision that the federal Large Corporation Tax (LCT) exemption should not be pro-rata between distribution and other activities. Clearly the LCT applies to all business (regulated or non-regulated) within a corporate group. It follows that the exemption should benefit all businesses as well. To arbitrarily seize the LCT exemption for the benefit of ratepayers and to the detriment of shareholders who also pay the LCT tax is not consistent with the principles as set out by Ms. McShane in her evidence. In Union's view, exemptions including the LCT should be allocated to all businesses within a related group on a basis that is fair to all.

7.1.2.7 Amortization of tangible assets and capital cost allowance (CCA)

Based on the four principles of regulation as identified in Ms. McShane's evidence, Union's view is that Alternative 2 (the undepreciated capital cost at the beginning of 2005 excludes 2001 fair market value (FMV) bump) is the correct alternative.

7.1.2.8 Interest deduction

Based on the four principles of regulation as identified in Ms. McShane's evidence, Union's view is that Alternative 1 (interest deducted in computing the 2006 tax calculation should be the same as that allowed for recovery in 2006 rates) is the correct alternative.

7.1.2.11 Ontario Corporate Minimum Tax

Union agrees that the 2006 regulatory tax calculation should not include the Ontario Corporate Minimum tax but the balance paid should be allowed in rate base until the amount is recovered as the distributors become taxable.

Chapter 12 – Other Regulated Charges

The draft 2006 EDR Handbook contains charges related to the administration of the SSS (renamed to RPP), retail service charges and non-competitive electricity charges. These charges appear to have been set without detailed costing support, which may be appropriate during a period of transition. These charges should be supported by an appropriate level of costing support as soon as it is practical to do so.

Chapter 13 – Mitigation

The draft 2006 EDR Handbook identifies that bill impact analyses must be included as part of a distributor's rate application.

Union submits that the most relevant bill comparison for an electricity distributor is a comparison of distribution-related charges, which is the only component of the bill that electricity distributors can influence. In other words, electricity distributors should not be exposed to electricity commodity rate mitigation efforts in the electricity distribution rate setting process.

Mitigation efforts designed to minimize the potential rate shock that a distribution rate change will have on specific customer groups should be addressed through cost allocation and rate design, not the determination of a utility's revenue requirement. The utility's revenue requirement should properly reflect the prudently incurred costs required to operate the utility and provide reliable service to customers.

Chapter 14 - Comparators and Cohorts

Comparators and cohorts may be used as a tool to screen distribution rate applications. Utilities that exhibit unusual cost levels may be required to provide additional information in support of their rate applications.

The draft 2006 EDR Handbook invites the Board to make a ruling on who should receive the results of the analysis if the comparators and cohorts mechanism is pursued. As was suggested during the oral hearing, there is a danger that individuals who lack specialized knowledge may misinterpret the results of a comparators and cohorts analysis. In addition, there may be valid reasons why a utility's costs in a particular area may appear to be out of line with other utilities. As a result, the data used in and the results of a comparators and cohorts mechanism should be provided to Board staff for their exclusive use as a screening tool and not to others.

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

Yours truly,

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