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By Email

April 25, 2007

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Dear Ms Walli

Multi-Year Incentive Rate Regulation

Board File No.: EB-2006-0209

Our File No.: 302701-000411

We are the solicitors for the Industrial Gas Users Association (“IGUA”) and are writing in response to the Board’s invitation for comments contained in its letter to “All Participants” in these proceedings dated March 30, 2007. The letter invited comments on the following:

- the Incentive Regulation (“IR”) framework set out in Board Staff’s Discussion Paper dated January 5, 2007,
- the Total Factor Productivity (“TFP”) Study prepared by Pacific Economics Group (“PEG”), Board Staff’s technical expert, and
- the scoping of the generic hearing to be convened by the Board on its own motion.

Preliminary Observations

We submit that a determination by the Board of the elements of an IR framework for gas utilities is a matter which falls squarely within the provisions of Section 36(3) of the Board’s rate-making jurisdiction under the provisions of the *Ontario Energy Board Act* (the “*OEB Act*”). An IR framework is a “method or technique” which the Board “may adopt in approving or fixing just and reasonable rates”. Accordingly, the proceeding in which the Board determines issues pertaining to the elements of an IR framework must be a rate proceeding which engages Section 36 of the *OEB Act*.

We submit that, when exercising its rate-setting powers under Section 36, the Board’s jurisdiction and authority, under Section 19(1) of the *OEB Act*, is to “hear and determine all questions of law and fact” (emphasis added). We submit that this adjudicative mandate must be exercised in accordance with the rules of natural justice. These jurisdictional parameters and the legal obligations which they impose on the Board are matters which influence IGUA’s comments which follow.



IR Framework Described in Board Staff's Discussion Paper

According to the Discussion Paper, the concepts set out therein were informed by the OEB's March 30, 2005 Report entitled "Natural Gas Regulation in Ontario: A Renewed Policy Framework" (the "NGF Report"); views of stakeholders expressed in consultations with Board Staff; research conducted by Board Staff regarding IR mechanisms adopted and considered in other jurisdictions; and advice provided to Board Staff by PEG, its technical expert.

While these sources of information no doubt influenced the views which Board Staff have formed with respect to an appropriate IR framework, the views of Board Staff and the sources of information on which they are based cannot, as a matter of law, constrain the scope of matters of fact and law to be determined in the Section 36 proceeding.

For the purposes of determining the scope of the Section 36 proceeding, it needs to be recognized that there are IR models which the Board Staff's Discussion Paper does not address. An example is the simple proportion of inflation adjustment factor model, coupled with a 50/50 Earnings Sharing Mechanism ("ESM") ratepayer protection feature which EGD proposed and the Board approved when determining EGD's rates for 2004. This and other simplified approaches fall within the ambit of the Section 36 process which the Board needs to initiate to engage its jurisdiction under Section 36(3) of the *OEB Act*.

We submit that all relevant matters of fact and law pertaining to what can reasonably be characterized as an IR regime fall within the ambit of the proceeding.

To satisfy the requirements of Section 36(3) of the *OEB Act*, an IR mechanism needs to be designed to produce just and reasonable rates, i.e. a reasonable surrogate for rates that would be established under the traditional cost of service methodology. Stated another way, rates approved or fixed, by applying an IR mechanism, should provide the utilities with an opportunity to earn a reasonable but not an excessive rate of return. In this context, known changes during the IR period which will materially impact revenue and spending trends are relevant to a determination of any utility-specific adjustment factors which will apply for the duration of an IR plan.

We submit that this conceptual perspective is germane to a determination of the scope of the Section 36 proceeding which the Board initiates. Topics falling within the ambit of the proceeding include all of the topic headings in Board Staff's Discussion Paper and others. The test to be applied to determine whether or not a topic falls within the scope of the Section 36 proceeding is whether the topic is arguably relevant to a component part of what can reasonably be characterized as an IR regime.

PEG's TFP Study

The PEG study is relevant to a particular price cap IR regime. It does not address other IR approaches which some parties may ask the Board to consider.

Price cap theory is premised on the notion that a pricing standard can be extracted from economic data pertaining to the economy as a whole and to the gas industry in particular. In this context, it needs to be ascertained whether it is theoretically appropriate for there

to be one price cap adjustment factor for EGD and another for Union. The PEG Study not only presents different caps for EGD and Union, it goes much further and postulates the notion that price cap analyses and theory can be refined to a point where different price caps for different rate classes for separate utilities can be established by analyzing available data. IGUA questions whether price cap theory can be refined to such an extent and finds the data used in the PEG Study to support conclusions with respect to this approach to be of questionable reliability.

PEG's TFP Study reveals that any analysis of TFP is complicated and that the data can support a broad range of conclusions. Some particular matters of concern to IGUA include the following:

- (a) whether the available data (largely U.S. data) is sufficiently relevant to Ontario gas utilities to justify the conclusions which PEG presents for EGD and Union and particular customer classes served by those utilities;
- (b) whether the samples and time periods used in the PEG analysis are appropriate and consistent;
- (c) the sensitivity of results to the use of different assumptions;
- (d) all of the areas in the PEG Study where judgment has been relied upon to exclude certain data from consideration and the rationale for these judgments; and
- (e) the sensitivity of results to the application of different judgments.

At this time, PEG's TFP Study is still a work in progress and the untested opinion of advisors to Board Staff. Suffice it to say that when the PEG TFP Report is finalized and filed in evidence in these proceedings, it will need to be carefully tested. Its conclusions may prove to be too volatile and unreliable to support any precise price cap findings for application to the Ontario gas utilities and/or their particular customer classes.

Process

IGUA supports the process analysis prepared by Mr. Warren. We submit that the "Utility Applicant" model, which Mr. Warren describes in his letter to the Board dated April 20, 2007, is the best way to structure the process so as to minimize the risk of breaching the rules of natural justice.

It appears to be common ground that the List of Issues should be developed at an early stage of the process. As already noted, we submit that all topics arguably relevant to a component part of what can reasonably be characterized as an IR regime fall within the scope of the proceeding and should be included on the Issues List. The topics on the Issues List should include both generic and utility-specific issues, if utility-specific price cap relief is being requested by each Utility Applicant.

The process directions should include a clear description of the information the utilities will need to provide in the context of the Section 36 process. The nature of the information which the utilities will need to file will be informed by the Issues List and the conceptual rationale for an IR mechanism, i.e. a method or technique to enable the Board to approve or fix just and reasonable rates for the period in which the IR mechanism will



operate. For example, known changes in the IR period which will materially impact revenue and spending trends are relevant to a determination of any utility-specific adjustment factor which will apply for the duration of an IR plan.

We are attaching to this letter a very preliminary List of Issues which reflects the topics raised in the Board Staff's Discussion Paper and other relevant matters. The purpose of providing this preliminary Issues List at this time is simply to emphasize that the scope of the Section 36 process is to be determined by considerations of relevance and not constrained by the Board Staff's Discussion Paper or any of its inputs such as the views expressed by the Board in the NGF Report. These views may provide background but are not determinative for the purposes of scoping the Section 36 proceeding.

IGUA recognizes that there will be further exchanges between Board Staff and interested parties with respect to the Issues List and that our preliminary List of Issues includes a number of sub-topics; each of which will need to be refined as the dialogue with respect to issues progresses. We are providing our preliminary comments on the matter, at this time, in order that all stakeholders will be aware of the principles which we contend are to be applied to establish the scope of the proceeding.

The Settlement Conference is another stage of the process which IGUA regards as important. It is preferable that incentive regimes be negotiated rather than imposed.

We hope that these comments will be of some assistance to the Board and its Staff in initiating the Section 36 proceedings that are necessary to determine the appropriate elements of an IR framework to be applied when approving and fixing just and reasonable rates for the Ontario gas distributors.

Please contact us if there are any questions arising out of the contents of this letter of comment.

Yours very truly

Peter C.P. Thompson, Q.C.

PCT\slc
enclosure

c. List of Interested Parties
Murray Newton (Industrial Gas Users Association)

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Preliminary List of Issues

Incentive Regulation (“IR”) Plan Design components:

- Price & revenue caps/Rate freeze/inflation only
- Inflation factor(s)
- Productivity factor(s)
- Single or multiple price caps
- Rate Design
- Routine and non-routine adjustments
- Discretionary services
- Term of the Plan
- Off-ramps and other protective features
- DSM
- Reporting requirements
- Re-basing requirements
- Filing requirements
- Impacts of NGEIR decision
- Deferral and variance accounts
- Exogenous factors affecting revenue requirement during IR, including:
 - Changes in normalized average uses
 - Merchant generation
 - Changes to cost of capital
 - Technological and market changes
 - Tax changes
 - Major known additions and retirements
 - Replacement mains and system expansion projects
- Other issues:
 - Return on common equity
 - Weather normalization and degree day assumptions
 - Depreciation rates