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September 8, 2009

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
27th floor
Toronto ON M4P 1E4

Dear Ms Walli,

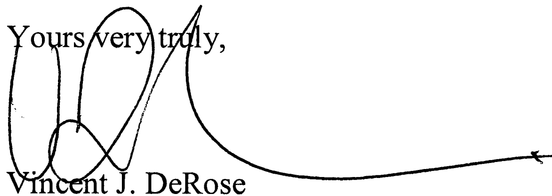
Cost of Capital in Current Economic and Financial Market Conditions
Board File No.: EB-2009-0084
Our File No.: 339583-000037

I am writing on behalf of Canadian Manufacturers & Exporters ("CME"). CME is one of the intervenors that co-sponsored the comments of Dr. Laurence Booth, which were filed with the Board this afternoon.

In addition to relying upon the evidence of Dr. Booth at the Stakeholder Conference scheduled to commence on September 21, 2009, CME may also refer to the submissions of the Province of Ontario made before National Energy Board during TransQuébec & Maritimes Pipeline Inc.'s 2007 and 2008 Cost of Capital Application. I attach a copy of those submissions to this correspondence.

If you have any questions or concerns, please feel free to contact me at your convenience.

Yours very truly,



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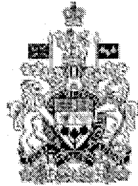

Hearing RH-1-2008
Audience RH-1-2008

Trans Québec & Maritimes Pipeline Inc. (TQM)
2007 and 2008 Cost of Capital Application

Gazoduc Trans Québec & Maritimes Inc. (TQM)
Demande concernant le coût du capital pour 2007 et 2008

VOLUME 14

Hearing held at
L'audience tenue à

National Energy Board
444 - 7th Avenue SW
Calgary, Alberta

October 21, 2008
le 21 octobre 2008

International Reporting Inc.
Ottawa, Ontario
(613) 748-6043

Canada

HEARING /AUDIENCE
RH-1-2008

IN THE MATTER of Trans Québec & Maritimes Pipeline Inc.
2007 and 2008 Cost of Capital Application

HEARING LOCATION/LIEU DE L'AUDIENCE

Hearing held at Calgary (Alberta), Tuesday, October 21, 2008
Audience tenue à Calgary (Alberta), Mardi, le 21 octobre 2008

BOARD PANEL/COMITÉ D'AUDIENCE DE L'OFFICE

G. Caron Chairman/Président

R. George Member/Membre

G. Habib Member/Membre

APPEARANCES/COMPARUTIONS

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- Mr. C.K. Yates, Q.C.
- Me L.-A. Leclerc
- Mr. D.P. Langen

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Canadian Association of Petroleum Producers
- Mr. N.J. Schultz

Canadian Gas Association
- Mr. L. Smith, Q.C.

Industrial Gas Users Association
- Mr. P. Jeffrey

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ATCO Utilities
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Gaz Métro
- Me V. Regnault

TransCanada PipeLines Limited
- Mr. P. Keys

Union Gas Limited
- Mr. L. Smith, Q.C.

Governments/Gouvernements
Ministry of Energy, Province of Ontario
- Mr. E. Sweet

National Energy Board/Office national de l'énergie
- Ms. M. Fowke
- Ms. M. Yuzda

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--- FINAL ARGUMENT BY/ ARGUMENTATION FINALE PAR MR. E. SWEET:

17035. **MR. SWEET:** Good morning, Mr. Chairman and Members of the Board.

17036. It is my privilege to present final argument in this proceeding on behalf of the Minister of Energy and Infrastructure for the Province of Ontario.

17037. Consistent with Board practices, I have provided a copy of the argument to the court reporters and interpreters. That copy includes section headings, transcript and exhibit references. I will not repeat those references to you, but request that they be included in the record.

17038. I would like to preface my opening remarks with one caveat; the fact that I do not address any particular issues raised or position taken by the Applicant or their supporters should not be construed as acceptance of those issues or positions.

17039. TQM seeks a determination by the Board of a fair overall return on its capital for the period January 1, 2007 through December 31, 2008. TQM requests a rate of return of 11 percent applied to a deemed equity thickness of 40 percent of its capital structure or the equivalent through ATWACC *[Exhibit B-1b, Application, December 2007, p.3 of 4, paragraph 11]*.

17040. The determination of a 'fair return' is largely a matter of opinion, and I quote:

> *"TQM's opinion of a fair return is informed by the views of its experts and by its own analysis... It is, of course, the opinion of the Board as to a fair return that determines the level of return that may be included in the revenue requirement and collected in tolls by the pipeline." [Exhibit B-8c, TQM Response to CAPP 219 (e), p.2 of 2]*

17041. As noted in the company's application, TQM and its stakeholders, including Ontario, reached a three-year settlement on all toll and tariff matters excluding those issues before the Board today *[Exhibit B-1b, Application, December 2007, p.2 of 4, paragraph 6]*.

17042. Mr. Chairman, Ontario does not support TQM's 2007 and 2008 Cost of Capital application.

17043. This argument will address the issues set out in the Board's Hearing Order dated 22 January 2008.

17044. Issue One: What is the appropriate methodology for determining the return on common equity for TQM for 2007 and 2008?

17045. In its Additional Evidence filed in February 2008:

> *"TQM proposes no change to the traditional methodology used by the Board for determining the [rate of] return on common equity." [Exhibit B-5b, Additional Evidence of TQM, February 2008, p.1 of 8, lines 12-13]*

17046. Mr. Chairman, Ontario is in agreement and supports TQM's position on retaining the current methodology for determining the rate of return on common equity.

17047. Issue 1.1: Should the Board depart from its practice of basing its decision on the formula established in the RH-2-94 proceeding in determining TQM's ROE for 2007 and 2008?

17048. TQM's position is that:

> *"...the Board should depart from its practice of basing its determination of the rate of return on equity for the formula." [Exhibit B-5b, Additional Evidence of TQM, February 2008, p.2 of 8, lines 13-14]*

17049. The reason TQM seeks relief from the formula has more to do with the quantum of the relief produced than the formula itself. TQM's own evidence is that it would be willing to continue using the formula provided the equity thickness was raised to approximately 60 percent.

17050. One of the Board's primary objectives when determining a utility's rate of return is to ensure that the results are transparent. The Board's formula has the advantage of being transparent and providing clarity.

17051. In his evidence, Mr. Engen identifies research analysts from both RBC and BMO who support the continued use of a formulaic approach to establishing a utility's ROE.

17052. Dr. Maureen Howe, an RBC Capital Markets research analyst, speaks to the advantage of formula in general and with specific reference to the AEUB, and I quote:

> *"We believe the establishment of a generic ROE approach provides greater visibility and increased certainty for AEUB-regulated utilities, resulting in lower regulatory risk." [Exhibit B-1g, Appendix 5, Engen, p.74 of 90, lines 11-12]*

17053. Karen Taylor, a BMO Capital Markets' pipeline and utility analyst, is paraphrased by Mr. Engen expressing support for the formula approach and she says:

> *"As with others, she likes the formula because they are, in a word, transparent." [Exhibit B-1g, Appendix 5, Engen, p.74 of 90, lines 11-12]*

17054. Mr. Engen, however, takes exception with the formula approach because the return it produces is too low *[Exhibit B-1g, Appendix 5, Engen, pp.74-76 of 90, Answer 98]*.

17055. Ontario notes that in past hearings, when the Board was confronted with applications challenging the returns generated by the RH-2-94 formula, the Board's response was not to dispose with the formula but rather increase the equity thickness.

17056. Ontario suggests the option of increasing the equity thickness should be considered by the Board in this application.

17057. Ontario submits the Board's RH-2-94 formula is transparent, is valid and should be retained. However, as discussed elsewhere in this argument, Ontario submits that TQM's equity thickness should be increased to 36 percent which would, in Ontario's opinion, address the issue of providing a fair return to the company.

17058. We've heard a lot of discussion over the past day and a half dealing with theoretical aspects of the application. I'd like to draw your attention now to some of the practical aspects of it.

17059. In Issue 1.2 the question is: "If yes, for what reasons, and in what manner?"

17060. In this section I will examine TQM's rationale for departing from the Board's existing practice of relying on the RH-2-94 formula and I will base it on three categories the company identified within its evidence.

17061. The first; comparisons with negotiated settlements and with U.S. pipelines; the second area; increased risks faced by the company; and thirdly, the firm's ability to attract capital on favourable terms.

17062. By way of summary, Ontario's position on these categories is as follows:

17063. TQM is wrong to have drawn comparisons between the ROE it seeks and the return earned by pipelines that have negotiated settlements. TQM is also wrong to have drawn comparisons between itself and U.S. pipelines.

17064. Ontario has chosen 12 of the risks the company has cited and submits that they are lacking in both substance and fact.

17065. Lastly, Ontario submits the company has the ability to attract capital as a standalone firm on favourable terms with the Board's existing ROE framework.

17066. COMPARISONS

17067. TQM'S COMPARISON WITH NEGOTIATED SETTLEMENTS

17068. Turning to comparisons, TQM proposed a number of pipelines the Board should use as comparators when determining the company's ROE. Included in this sample were pipelines that had negotiated settlement agreements *[Exhibit B-1d, Appendix 2, December 2007, p.2 of 44 lines 14-20]*.

17069. However, the company quite correctly notes that although it may be instructive to consider the total returns determined through negotiated settlements, there are difficulties with this approach, and I quote:

> *"Settlements are by definition characterized by trade-offs which may not be readily apparent to those not directly involved in the settlement. Consequently, the returns delivered through an individual settlement may not always be reflective of a market required return when considered in isolation from other settlement components and the specific facts and circumstances at the time of the settlement." [Exhibit B-1d, Appendix 2, December 2007, p.4 of 44 lines 9-14]*

17070. Submission:

17071. Ontario submits that the unknown trade-offs which are a natural part of negotiations and the resulting lack of transparency in the settlement agreement itself, should caution the Board to not include these settlements as valid comparators when assessing TQM's ROE.

17072. Comparison with U.S. Pipelines

17073. With respect to comparisons with U.S. pipelines, TQM suggests the Board should consider returns earned on U.S. pipelines as being illustrative of the level of returns TQM should earn.

17074. The drawing of comparisons between U.S. and Canadian pipelines has been explored before the Board in previous proceedings. Most recently, in RH-2-2004, TransCanada filed U.S. comparator evidence in support of increased returns on its Mainline.

17075. In the RH-2-2004 proceeding, the Board dismissed U.S. comparator evidence for a number of reasons. Dr. Carpenter acknowledged:

> *"...that the Board has in the past been reluctant to accept or give weight to U.S. data or comparisons." [Exhibit B-1c, Appendix 1, December 2007, p.18 of 22 lines 19-20]*

17076. Dr. Carpenter provides a summary of the reasons given in RH-2-2004 as to why the Board found against the usefulness of U.S. pipelines as comparators when establishing a fair return for Canadian natural gas pipelines.

> *"In the U.S., pipeline rate cases are relatively infrequent, and pipelines typically do not utilize deferral accounts to adjust for deviations in revenues and costs." [Ex. B-1f, Appendix 4, Carpenter, December 2007, p.53 of 64, lines 15-17]*

17077. And Dr. Carpenter went on:

> *"U.S. pipelines are subject to risks not borne by the Mainline, including, among others, risk of underutilization, construction cost overrun risks and risks associated with discounted and negotiated rates." [Ex. B-1f, Appendix 4, Carpenter, December 2007, p.50 of 64, lines 16-18]*

17078. Again, from the RH-2-2004 proceeding, Dr. Carpenter quotes a portion of the Board's Decision where it explicitly dismisses the usefulness of U.S. pipelines for comparator purposes.

> *"In the past the Board has expressed scepticism concerning comparisons between Canadian and U.S. gas pipelines and LDCs. The Board has dismissed comparisons to U.S. gas pipelines on the grounds that the regulatory environment is substantially different in the U.S. The Board has also placed little reliance on comparisons to U.S. gas LDCs, finding that differences in*

> *capitalization (higher equity ratios of the U.S. gas utilities) reflect material differences in business risk." [Exhibit B-1f, Appendix 4, Carpenter, December 2007, p.6 of 64, lines 20-25 and p.7 of 64, lines 1-2]*

17079. One additional factor of significance which separates U.S. pipelines from their Canadian counterparts is the financial liability risk from shippers filing for bankruptcy.

17080. Dr. Carpenter acknowledged that he was aware of several U.S. shippers who had filed for bankruptcy in the U.S. over the past 5 years *[Exhibit B-6l, TQM Response to Ontario 21 (b) p.1 of 1]*. The risk of shipper bankruptcy is carried by U.S. pipelines.

17081. Moody's Investors Service issued a report on North American Natural Gas Pipelines which said in part that pipelines, "*operate under a stable regulatory framework in the U.S. and Canada*" and:

> *"The resultant regulatory support for these Canadian companies is a factor in their A ratings, which are higher than the average Baaa-ratings of their U.S. peers." [Exhibit B-6j, TQM Response to CAPP 178(c), p.17 of 38]*

17082. Ontario has taken the position in previous NEB proceedings, and continues to hold the position, that U.S. pipelines are not appropriate comparators for Canadian pipelines due to differences in the regulatory paradigm and the higher level of financial risk facing U.S. pipelines.

17083. Submission

17084. Ontario submits that Canadian and U.S. pipelines operate under significantly different regulatory and financial liability conditions.

17085. For these reasons U.S. pipelines cannot be used as comparators when determining the appropriate level of return for a Canadian pipeline.

17086. RISK

17087. TQM's Primary Risk

17088. I'll now turn to the risks -- TQM's primary risk. In the Company's 2006 Annual Report, TQM identifies its regulatory overseer, the Board, as its primary risk:

> *"The Company's primary risk is due to the fact that it is regulated by the Board. The Board plays a significant role in approving TQM Pipeline's return on equity, capital structure, tolls and system expansions." [Exhibit B-6b, TQM Response to NEB 1.22(a), p.23 of 55]*

17089. TQM argues the Board should take into account, *"...changed circumstances and new facts that have arisen since the RH-2-94 proceeding..."* which warrant an increase in its return *[Exhibit B-5b, Additional Evidence of TQM, February 2008, p.2 of 8, lines 17-18].*

17090. TQM relies upon the views of its expert witnesses, who having identified a number of increased risks, argue that an 11 percent return is more appropriate than the result produced by the RH-2-94 formula.

17091. Ontario does not agree with the company's risk assessment.

17092. TQM BUSINESS RISK

17093. The company's evidence is that the business risk has increased in the areas of supply risk and competitive risk *[Ex. B-1d, Appendix 2 Business Risk and Total Return Comparison, December 2007, p.13 of 44].*

17094. A large part of those risks are attributable to the challenges faced by Gaz Métro, TQM's largest Quebec-based customer.

17095. The following is a list of 12 risks identified by TQM which, in Ontario's submission, have either remained unchanged or have decreased since the RH-2-94 proceeding.

17096. In an effort to gain a better understanding of the challenges facing TQM, it is worth examining Gaz Métro's position with respect to competition against both electricity and heavy fuel oil.

17097. Competition with Electricity

17098. Competition with electricity, the first risk. Dr. Carpenter's evidence is that TQM's business risk:

> *"...tends to be greater than that of typical pipelines in Canada and the U.S. due to the unusual level of competition between natural gas and electricity in Quebec and Gaz Métro's relatively large industrial load." [Ex. B-1f, Appendix 4, Carpenter, December*

2007, p.5 of 64, lines 18-20]

17099. Dr. Carpenter cites Québec's abundant, inexpensive hydroelectric resources as having a competitive advantage over natural gas for residential customers *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.32 of 64, lines 1-4]*.

17100. The case according to Dr. Carpenter is similar:

> *"...for commercial and industrial customers because of the structure of Hydro-Québec's rates." [Ex. B-1f, Appendix 4, Carpenter, December 2007, p.32 of 64, lines 11-12]*

17101. According to Dr. Carpenter, this issue of competition with electricity within Quebec is worsened by the fact that Hydro-Québec is known to sell power below their marginal costs in some circumstances. *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.32 of 64, lines 12-18]*

17102. While this may have been the case in the past, there is a transformation ongoing within the Quebec electricity sector which will reduce the historic risk natural gas faces when competing against electricity.

17103. In September 2006 Hydro-Québec released its Strategic Plan: 2006-2010 which spoke to their desire to begin raising electricity prices closer to market prices.

17104. The Régie awarded Hydro-Québec Distribution a rate increase of 2.9 percent for 2009. This increase was on top of the "...relatively large increase in electricity rates in 2006..." that it had already approved. *[Exhibit B-15d, Appendix B, Reply Evidence Carpenter, September 2008, p.26 of 44, lines 9-17]*

17105. In addition to Hydro-Québec's success at obtaining rate increases, their strategic plan identified another trend which should be viewed as lessening risk for Gaz Métro: a flat line for future electricity sales until at least 2014.

> *"In view of the (supply/demand) balance established by the Hydro-Québec Distribution's Electricity Supply Plan 2005-2014, Hydro-Québec Production does not foresee any new energy sales in Québec for the 2014 horizon." [Exhibit B-15d, Appendix B, Reply Evidence Carpenter, September 2008, p.28 of 44, lines 12-14]*

17106. The conclusion that can be drawn from Hydro-Québec Production's forecast is that it will not actively compete for market share against natural gas.

17107. Residential

17108. Turning to the residential market specifically, since 2000 Gaz Métro has intensified its efforts to nurture this segment of the market. According to Gaz Métro, the results have been positive.

> *"These additional efforts have increased the numbers of customers within this sector…". [Exhibit B-15c, Appendix A, Reply Evidence of TQM, September 9, 2008, p.37 of 38, lines 20-21]*

17109. A primary competitor of natural gas is electricity in the residential sector. However, the cost of electricity has risen in relationship to natural gas over the past six years. In 2001-2002, electricity enjoyed a 12 percent advantage over natural gas. In 2007-2008, electricity's advantage is projected to diminish to just 3 percent. *[Exhibit B-6k, TQM Response to IGUA 26 (b), p.1 of 1]*

17110. Confirming the improved residential market conditions, Gas Métro announced its success providing natural gas to new housing starts over the past several years to its investors in its 2007 Annual Report. *[Exhibit B-15d, Appendix B, Reply Evidence Carpenter, September 2008, p.30 of 44, lines 3-4]*

17111. And from that Annual Report I quote:

> *"In Québec, electricity has the largest share of the residential market. However, successive rate increases since 2004, combined with lower natural gas prices, have put these two energies on an equal footing in the new housing market." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.36 of 92]*

17112. Gaz Métro's Annual Report spoke to the achievements the Company is having competing against electricity in new housing starts. The Annual Report notes that natural gas was selected by 9.7 percent of new housing in Québec in fiscal 2007, and 19 percent of new housing in the Montreal area. *[Exhibit B-15d, Appendix B, Reply Evidence Carpenter, September 2008, p.30 of 44, lines 3-4]*

17113. Commercial

17114. The commercial sector's outlook is positive according to Gaz Métro.

> *"In the commercial sector, natural gas is generally competitive with both fuel oil and electricity." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.36 of 92]*

17115. Industrial

17116. In terms of the industrial sector, Gaz Métro reported further success competing against other energy sources.

> *"Gaz Métro-QDA's normalized natural gas volumes are up 13.8% to 6,250 million cubic metres during the 2007 fiscal year. This can be explained by higher volumes in the industrial market following the start-up of production by a large electric cogeneration customer, TCE in Bécancour, and by increased consumption in the metallurgy sector." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.18 of 92]*

17117. It is important to note that Gaz Métro's favourable comments concerning the upswing in industrial gas consumption included the metallurgy sector in addition to Bécancour.

17118. Ontario submits that the overall level of risk TQM faces arising from electricity within the Québec residential, commercial and industrial sectors has declined.

17119. Further, given Hydro Québec's strategic plan, one intent of which is to move electricity prices towards market prices, the level of risk natural gas faces from electricity should continue to diminish for the foreseeable future.

17120. Competition with Heavy Fuel Oil

17121. Gaz Métro confirmed that Québec has become Canada's largest industrial consumer of heavy fuel oil. *[Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.5 of 92]*

17122. Aware of the negative environmental consequences associated with burning heavy fuel oil, the Quebec government is taking action to shift the province away from its dependency upon that fuel.

> *"The government of Québec's announcement on October 1, 2007 of a major new program to provide financing to businesses for the purchase of efficient equipment or conversion to other energies that are cleaner than heavy fuel oil could help promote the use of natural gas." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.36 of 92]*

17123. In their 2007 Annual Report, Gaz Métro informs its shareholders of the potentially huge business opportunity for them resulting from the government's

initiative to encourage the industrial sector to switch off fuel oil in favour of cleaner energy options, including natural gas.

> *"Gaz Métro intends to meet this challenge. We plan to get back a large number of our industrial customers that switched to heavy fuel oil in 2001 following the increase in natural gas prices. This represents a potential of 15 billion cubic feet of natural gas, i.e. the equivalent of 7.5% of Québec's total gas consumption last year, and is a huge business opportunity for Gaz Métro." [Emphasis added. Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.5 of 92]*

17124. Gaz Métro also confirmed in their 2007 Annual Report that the industrial market's preference for natural gas is not limited to environmental considerations but includes economic factors as well.

> *"The sharp recent increase in the price of fuel oil has improved its competitiveness with heavy fuel oil in the large industrial interruptible service market... large industrial firm service customers continue to prefer natural gas because the potential savings are generally insufficient to justify the expenditures required to adopt a substitute energy. They also prefer natural gas to heavy fuel oil for its environmental impacts." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.36 of 92]*

17125. These observations all speak to the improving competitive advantage natural gas has over heavy fuel oil in the Province of Quebec.

17126. TQM wrongly portrays what Gaz Métro characterizes as "a huge business opportunity" as being an increased risk.

17127. Ontario submits that the Government of Quebec's initiatives to reduce the reliance of its industry on heavy fuel oil improves TQM's prospects for natural gas consumption and reduces the Company's risk in a significant manner.

17128. The third risk, uncertainty in gas use per customer.

17129. Another of the risks identified by TQM in their evidence concerns the impact conservation measures may have on throughput volumes.

17130. According to evidence filed by Dr. Carpenter, Gaz Métro's data shows "...significant declines in use per customer over time." *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.26 of 64, line 21]*

17131. The message Gaz Métro presented to shareholders in its 2007 Annual Report is decidedly more optimistic. Gaz Métro confirmed the impact:

> *"...of rising volatile energy prices, including natural gas prices, over the past few years, which has contributed to an increase in energy conservation initiatives." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.10 of 92]*

17132. Gas Métro supports these conservation initiatives in spite of the fact that they have reduced average energy consumption per customer *[Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.10 of 92]*.

17133. In the Annual Report Gaz Métro expresses confidence in its future prospects as environmental considerations loom large and all energy consumers reappraise their energy requirements.

> *"However, the Partnership remains confident that the medium and long-term outlook is positive, particularly in Quebec, where acceptance of <<the right energy in the right place>> should generate larger market shares for natural gas in the future." [Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.11 of 92]*

17134. Ontario submits that Gaz Métro's efforts to embrace environmental initiatives, when combined with the low environmental impact of natural gas, will provide a positive effect and further serve to mitigate TQM's risks.

17135. A fourth risk identified by TQM was the Bécancour generation plant risks.

17136. Dr. Carpenter spoke of the concerns he had with the temporary shutting of the Bécancour generation facility.

17137. TQM's use of Bécancour as an example of increased long-term risk is not appropriate. There are three main reasons why:

17138. First, the volume of gas being supplied by TQM for the Bécancour facility "...does not represent a significant new load for TQM...." *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.37 of 64, line 3]*

17139. Second, in spite of the fact that Bécancour did not operate in 2008 in its capacity as a generator, it did provide steam under a separate contract, and "...HQ Distribution will continue to pay TransCanada Energy for the fixed gas transportation

costs to the plant…." *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.37 of 64, lines 8-9]*

17140. Third, TQM has a 12-year contract with TransCanada to transmit gas for the Bécancour facility and the Company will not experience a loss of revenue attributable to the facility's partial closure *[Exhibit Tr. Vol. 6, line 7408].*

17141. This point is confirmed in Dr. Carpenter's evidence "…the shut-down will not result in an immediate loss of revenue to TQM…" *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.37 of 64, lines 11-12]*

17142. TQM is contractually protected through its arrangement with TransCanada which lessens its exposure to risk.

17143. For these reasons, Ontario submits that TQM does not face a financial risk with respect to the operation of the Bécancour cogeneration facility.

17144. Now, we've heard a lot about Portland Natural Gas Transmission System Extension (PNGTS), and that is my fifth risk that I'll look at.

17145. In 1999 TQM constructed an extension to tie into the Portland Natural Gas Transmission System (PNGTS) pipeline to supply the New England market. The extension runs to East Hereford where it interconnects with PNGTS.

17146. Dr. Carpenter identifies the TQM PNGTS extension as another example of the increased business risk faced by the Company "…it exposed TQM to the risks associated with serving that market." *[Exhibit B-6h, TQM Response to CAPP 98, p.1 of 1]*

17147. This view is not shared by others.

17148. In February 2007, DBRS issued a Rating Report on TQM which confirmed the New England market growth prospects.

> *"TQM's connection with PNGTS provides access to the U.S. Northeast market, laying the platform for potential growth in the future." [Exhibit B-11, Appendix 10 Filing Manual Requirements, Attachment P.2-6, p.1 of 13]*

17149. Evidence that the PNGTS extension does not increase risk for TQM is found in the 15-year contract the Company signed with TransCanada to underpin the extension. *[Exhibit Tr. Vol. 6, line 7409]*

17150. Ontario submits that TQM's PGNTS extension broadens the Company's service area and reduces its overall risk through market diversification.

17151. One of the subjects we heard quite a bit about had to do with LNG and the New England market, and that is the sixth risk I will now address.

17152. Dr. Carpenter expresses concerns that TQM's risk exposure to the New England market has also increased as evidenced by the development of new LNG terminals in eastern Canada and off the coast of Massachusetts *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.5 of 64, lines 24-29].*

17153. TQM identified five LNG projects which have the ability to serve the Canadian and New England markets. They are the Canaport LNG project; the Northeast Gateway LNG project; the Neptune LNG project; the Rabaska LNG project and; lastly, the Gros Cacouna LNG project.

17154. These projects were held up as examples of added risk TQM faces in terms of serving its market in the Quebec and New England markets.

17155. I will now look at each of the five LNG projects or proposals.

17156. Canaport

17157. The soon-to-be-completed Canaport LNG project is to have a send-out capacity of 1 Bcf per day. The gas will transit into New England through an expanded Maritimes & Northeast system which received FERC approval to roughly double its capacity. No gas has traveled from that facility as yet. It's got a deal with Repsol to provide the LNG supply and we're waiting for the first shipments to come.

17158. Northeast Gateway

17159. This is a project which came online in December 2007 *[Exhibit B-15d, Appendix B, Reply Evidence Dr. Carpenter, September 2008, p.10 of 44, lines 14-15].* Northeast Gateway has a peak-day send out capacity of about 800 million cubic feet per day and will ship its gas through the Algonquin pipeline. *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.40 of 64, lines 11-17]*

17160. The Northeast Gateway project is not the risk TQM perceives it to be. In response to an Information Request, TQM confirmed, "The terminal has yet to receive a cargo of LNG." *[Exhibit B-6l, TQM Response to Ontario 17(a), p.1 of 1]*

17161. The lifeblood of an LNG receiving terminal is its supply contracts. Northeast Gateway is likely not to pose any risk to TQM for some time given that

"…long term supply contracts have not been secured…." *[Exhibit B-6l, TQM Response to Ontario 17(b), p.1 of 1]*

17162. Neptune

17163. The third LNG facility identified is Suez Energy's Neptune LNG project which is under construction with an expected in-service date of sometime in 2009 *[Exhibit B-15d, Appendix B, Reply Evidence Carpenter, September 2008, p.10 of 44, lines 15-16]*. This project is to have a maximum send out capacity of 750 million cubic feet per day and is expected to interconnect with Algonquin's system as well *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.40 of 64, lines 18-21]*.

17164. Similar to the Northeast Gateway project, Neptune does not have a dedicated supply of LNG. According to Dr. Carpenter, "…Suez Energy will have available corporate supply some of which could be directed to the Neptune LNG project." *[Exhibit B-6l, TQM Response to Ontario 18(b), p.1 of 1]*

17165. Gros Cacouna

17166. TransCanada, in partnership with Petro-Canada, were the proponents of the Gros Cacouna LNG project. The Gros Cacouna regasification terminal was to be constructed on the south shore of the St. Lawrence River near Rivière-du-Loup and had a designated maximum daily send-out capacity of 500 million cubic feet.

17167. The facility has been approved but construction is not proceeding at this time due to its inability to secure a long-term LNG supply contract.

17168. In its 2006 Annual Report, TQM wrote of its ongoing support to undertake the construction of a 250 kilometre long, $700 million pipeline to connect the Gros Cacouna LNG project to its existing infrastructure.

> *"TQM Pipeline continues to be well positioned to benefit from the advent of imported liquefied natural gas….The company has sufficient flexibility under its $85 million Term Loan to cover the development costs that are forecasted for 2007." [Exhibit B-6b, TQM Response to NEB 1.22(a), p.5 of 55]*

17169. Rabaska

17170. Gaz Métro in partnership with Enbridge Inc. and Gaz de France are the developers of the proposed Rabaska LNG project with a send out capacity of 500 million cubic feet per day. The Rabaska Limited Partnership sought to develop an LNG facility at Lévis, Québec. The project has been approved but construction has

not commenced. Rabaska lacks a long-term LNG supply contract.

17171. LNG Supply Constraints

17172. TQM's risk from LNG is not certain for 3 reasons:

17173. First, in response to an information request, the company acknowledged that LNG deliveries to the New England market would only occur during periods of peak demand.

> *"It is Dr. Carpenter's impression that much of the expansion in gas supply and transmission in the New England region is in response to growth in peak demands for gas and to capture the premium market associated with the high prices New England has traditionally experienced during peak periods when transmission infrastructure entering the region from the south has been constrained." [Exhibit B-6l, TQM Response to Ontario 19 (a), p.1 of 1]*

17174. Second, during cross examination, a company witness confirmed that the existing LNG facilities have not been utilized this year.

> *"Some recent indications I've seen indicate that basically the new re-gas capacity that's been added in the last few years has essentially not been filled this year. So LNG deliveries have been flat or declining relative to historical levels." [Exhibit Tr. Vol. 8, lines 10082-10083]*

17175. Third, during cross-examination Dr. Langford touched on the price disparity between North American gas and LNG, and he said:

> *"...it will continue to be a tough world for LNG imports so long as you have very, very high oil prices relative to North American gas prices." [Exhibit Tr. Vol. 8, line10094]*

17176. Gaz Métro's Comments on LNG

17177. Now, it's instructive to look at Gaz Métro's comments on LNG, and that's what I'll turn to now.

17178. Gaz Métro holds a 50 percent ownership position in Rabaska and its views on the two Quebec LNG projects are favourable and are in contrast with those in Dr. Carpenter's evidence.

17179. Commenting after Rabaska's regulatory approval and its continuing efforts to secure a long-term LNG supply, Gaz Métro made the following statement in its 2007 Annual Report:

> *"Gaz Métro is pleased with this news and is continuing to work with its partners to secure a long-term gas supply contract for the project." [Exhibit B-6c, CAPP Information Request 11, Attachment 2, p.13 of 92)*

17180. Gaz Métro notes the benefits which could accrue to TQM should these LNG facilities be developed:

> *"In terms of the outlook for the future, TQM could benefit from growth opportunities that will arise from the possible arrival of liquefied natural gas (LNG) from overseas." [Exhibit B-6c, CAPP Information Request 11, Attachment 2, p.11 of 92)*

17181. TransCanada Corp.'s Comments on LNG

17182. What about TransCanada Corp.'s comments on LNG?

17183. TransCanada, the other 50 percent owner of TQM does not view LNG as being a significant risk to the North American natural gas market.

17184. In December 2007 Mr. Kvisle, President and CEO of TransCanada Corp., was quoted saying that North American deliveries of LNG tend to occur in the off-peak summer period when world market demand has temporarily ebbed and European storage is full:

> *"Thus far the only time that North America is really competitive with Europe is when all the storage gets filled up and they don't have a lot of storage there, so we tend to get LNG in the summer and then Europe draws it all away." [Ex. C-1-29, Nickle's Daily Oil Bulletin, December 20, 2007, p.1 of 4]*

17185. The evidence in this proceeding confirms that the proposed North American LNG projects will not be built for some time due to constrained LNG supplies and gas costs.

> *"Supply shortages, capital cost pressures, excess North American re-gas capacity and world-wide natural gas economics have put a strain on the development of LNG import projects in North*

America." [Exhibit B-6l, TQM Response to Ontario 2 (a), p.2 of 3]

17186. Further, there are indications that LNG gasification projects, such as Gazprom's proposed Baltic LNG venture, have been cancelled *[Exhibit B-6l, TQM Response to Ontario 2 (a), p.2 of 3]*.

17187. The evidence confirms that TQM does not face increased risk attributable to the development of new LNG terminals in Canada nor New England as both TransCanada and Gaz Métro, TQM's parents, are involved in separate partnership agreements to develop LNG receiving terminals which would be tied into TQM. This would result in a reduction of risk as TQM's reliance on WCSB-sourced gas would be further lessened.

17188. Even if one was to accept the premise that additional LNG delivered into the New England market would adversely impact TQM's competitiveness, the evidence is clear that New England regasification terminals are underutilized, with some terminals having been built and not received any gas, and other LNG terminal projects cancelled or put on hold due to their inability to secure long-term LNG contracts.

17189. Submission

17190. Ontario submits the potential gas volume from the Canaport LNG terminal is significantly small when measured against the New England market it was designed to serve and therefore does not increase TQM's risk.

17191. Ontario submits that if the two Québec-based LNG terminals were built, TQM's risk would diminish.

17192. Ontario submits that due to the uncertainty of long-term LNG supply contracts, the U.S. LNG terminals do not pose a risk to TQM.

17193. Divergence between TQM and Mainline Contractual Underpinnings

17194. The seventh risk, divergence between TQM and the Mainline contractual underpinnings: TransCanada has integrated TQM into its Mainline system and has contracted virtually all of TQM's transportation capacity until 2013: *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.24 of 64, lines 2-3]*

> *"TQM recovers virtually its entire cost of service through its contracts with TransCanada. Specifically, 99 percent of TQM's annual cost of service is charged to TransCanada and rolled-in to*

the Mainline's cost of service." [Ex. B-1f, Appendix 4, Carpenter, December 2007, p.24 of 64, lines 7-9]

17195. However, Dr. Carpenter points out that there is a divergence between the length of the TransCanada contract with TQM and the underpinning contracts TransCanada entered into with its shippers *[Ex. B-1f, Appendix 4, Carpenter, December 2007, p.6 of 64, lines 7-8]*.

17196. Dr. Carpenter suggests that TransCanada's contractual underpinning risk should be reflected in TQM's business risk:

> *"This divergence between the contractual underpinnings on the integrated Mainline and TransCanada's contract with TQM introduces uncertainty in the future viability of the integrated Mainline concept, which exposes TQM to long term business risk." [Ex. B-1f, Appendix 4, Carpenter, December 2007, p.6 of 64, lines 8-11]*

17197. However, during the course of the hearing TQM and its expert witnesses have consistently requested the Board not consider the financial wherewithal of its parents when deciding on the merits of the Company's application. They have argued that TQM should stand on its own merits.

17198. Therefore, it is inconsistent for Dr. Carpenter to disregard TQM's long-term contract in favour of shorter term contracts TransCanada signed to underpin its own contract with TQM.

17199. Ontario submits that the Board should only consider TQM contracts when determining the company's risk.

17200. Ontario submits that TQM faces no increase in risk from the divergence between TQM's contracts and TransCanada's underpinning contracts.

17201. TQM's risk relative to the Mainline Foothills and Alliance Pipelines:

17202. One of the accepted methods of determining a pipeline's return is to make comparisons between itself and other pipelines.

17203. So the eighth risk: TQM versus Mainline and Foothills.

17204. TQM uses this approach when it draws comparisons with two pipelines; the Mainline and Foothills.

17205. Initially in its evidence, TQM asserts that its relative risk remains similar to that faced by the Mainline and Foothills, and that this relationship has remained unchanged since the Board's RH-2-94 Decision. *[Exhibit B-1d, Appendix 2, December 2007, p.13 of 44 lines 7-21]*

17206. Yet, some 30 pages on within the same body of evidence, the company contradicts itself.

> *"The TransCanada Mainline and Foothills have somewhat greater supply risk than TQM, since TQM has some potential for greater supply diversity." [Exhibit B-1d, Appendix 2, December 2007, p.43 of 44, lines 3-4]*

17207. From Ontario's perspective it is clear that a distinction must be made between the supply risks faced by TQM and these two pipelines.

17208. The Mainline and Foothills are both fully reliant on sourcing their gas from the WCSB. TQM is not.

17209. A minimum of 20 percent of TQM's gas supply is sourced from other North American basins. Further, TQM has the potential of receiving gas from LNG terminals, an option not available to either the Mainline or Foothills.

17210. Recently, TransCanada acknowledged the Mainline's risks were not uniform across its system.

17211. In its latest five-year settlement agreement TransCanada severed the Mainline, for the purposes of depreciation, into three distinct sections. There's the Prairies section, the northern Ontario line, and what is referred to as the eastern triangle.

17212. TransCanada identified the eastern triangle segment of the Mainline as having the longest life for the purpose of depreciation, an indication of TransCanada's positive outlook for this region. *[Exhibit B-6e), TQM Response to CAPP 39(a), p.232 of 256]*

17213. TransCanada's change in depreciation methodology is attributable to its WCSB production forecasts and competing demands for this gas within Alberta.

17214. Should TQM wish to make a comparison with either of these two pipelines, it would most closely resemble the Mainline's eastern triangle which has the longest potential economic life. This section shares similar characteristics to that of TQM as they both have access to gas supply from numerous North American

basins through Dawn and are located within close proximity to their customers' burner tips.

17215. Mr. Chair, I see it's noon and you were interested in taking a break. This might be an appropriate spot.

17216. **THE CHAIRMAN:** Thank you very much. We'll accept your offer, Mr. Sweet.

17217. So we'll break for 15 minutes, until 12:15.

17218. **MR. SWEET:** Thank you.

--- Upon recessing at 12:00 p.m./L'audience est suspendue à 12h00
--- Upon resuming at 12:16 p.m./L'audience est reprise à 12h16

17219. **THE CHAIRMAN:** Mr. Sweet, please.

--- FINAL ARGUMENT BY/ ARGUMENTATION FINALE PAR MR. E. SWEET: (Continued/Suite)

17220. **MR. SWEET:** Thank you, Mr. Chairman.

17221. Continuing with the relative risks, the next pipeline TQM compared itself to was Alliance.

17222. The Company's evidence draws a comparison in business risk between TQM and Alliance with the statement:

> *"The overall business risk of Alliance is similar to that of TQM." [Exhibit B-1d, Appendix 2, December 2007, p.24 of 44, line 11]*

17223. A primary tenet of recent TransCanada arguments has been the increased risk the Mainline faced since the Board's approval of the Alliance Pipeline system.

17224. TransCanada has argued that the construction of the Alliance system forever changed the nature of the Mainline's business risk, relegating it to what TransCanada refers to as the "swing pipeline" out of the WCSB. The implication being that the "swing pipeline" faces increased business risk beyond that of Alliance.

17225. From Ontario's perspective, this is a puzzling comparison given that elsewhere in TQM's evidence it describes the long-term contact protection the company has with TransCanada (its shipper) as being similar to that which Alliance

enjoys with its own shippers. TQM has the advantage over WCSB-sourced pipelines in that it is not totally reliant upon the basin for its gas supply.

> *"TQM's contract with TransCanada expires in 2013, providing contract protection similar to that of Alliance. TQM's supply risk related to the WCSB is somewhat offset by access to alternative supply basins through Dawn and the prospect of LNG supplies." [Exhibit B-1d, Appendix 2, December 2007, p.25 of 44, lines 5-7]*

17226. In this proceeding we find ourselves attempting to square conflicting evidence.

17227. We are asked to accept that TQM has comparable risk to the Mainline, Foothills and Alliance. In other proceedings TransCanada has argued the Mainline's risks are above those of Alliance. However, TQM acknowledges that its risks are lower than the Mainline, Foothills and Alliance.

17228. We are asked to accept that TQM shares the same supply risks as the transmission pipelines exiting the WCSB. Yet the company acknowledges TQM's supply risks are offset by access to alternative supply basins and the potential of new LNG imports. The Mainline, Foothills and Alliance cannot avail themselves to either of these supply options.

17229. And we are told that for a period extending at least another five years, until 2013, TQM has the benefit of contracted protection which significantly reduces its overall risk, an advantage not enjoyed by the Mainline.

17230. For these reason, Ontario submits that TQM's business risk is below that of the Mainline, Foothills and Alliance.

17231. The tenth risk; TQM's Risk Comparison with Oil Pipelines:

17232. TQM Compared to Enbridge's Mainline.

17233. TQM makes comparisons with oil pipelines and argues that Enbridge's Mainline, as an oil pipeline, is a relevant and meaningful comparator for the company. *[Exhibit B-1d, Appendix 2, December 2007, p.32 of 44, lines 9-10]*

17234. The matter of the appropriateness of using oil pipelines as valid comparators has been the subject of previous Board hearings, specifically TransCanada's Mainline RH-2-2004 proceeding II.

17235. In that proceeding the Board concluded that such comparisons were not

appropriate.

> *"The Board does not agree with TransCanada's proposition that Enbridge is of comparable risk to the Mainline. The Board notes that it has traditionally viewed oil pipelines as riskier than gas pipelines, given oil pipelines' common carrier status supported only by monthly nominations, and because of operational complexities arising from the multi-product nature of their operations." [Exhibit B-1d, Appendix 2, December 2007, p.26 of 44, lines 10-16]*

17236. Additionally,

> *"Further, even if these pipelines were of comparable risk, the Board notes that Enbridge's financial parameters have been determined through negotiation for the past decade and are reflective of the package agreed to for an oil pipeline at the time those settlements were negotiated, not for cost of capital for a gas pipeline in 2004. The Board gave no weight to the comparison with Enbridge." [Exhibit B-1d, Appendix 2, December 2007, p.26 of 44, lines 19-25]*

17237. The three primary conditions cited by the Board in their RH-2-2004 Phase II Decision to exclude gas on oil pipeline comparisons have not changed.

17238. First, the common carrier status of an oil pipeline precludes useful comparisons with natural gas pipelines. The oil pipelines continue to be supported by monthly nominations yet natural gas pipelines and, in particular TQM, have longer term contracts.

17239. Second, oil pipelines have different operational constraints, noticeably the multi-product mix of petroleum goods which they transport. This is in stark contrast with natural gas pipelines where the good being transported is fungible.

17240. Third, the financial parameters under which the original pipeline negotiations were undertaken are not comparable to those under which natural gas pipelines operate.

17241. In its evidence, TQM suggests it has addressed the Board's previous concerns. However, Ontario will address two additional points cited by TQM which illustrate the continuing weakness of the company's argument.

17242. Fourth, TQM compares the decline in its average contract term, which has

decreased by approximately 33 percent since 1994, as having the effect of increasing its risk to a near equivalent of Enbridge's risk exposure of operating under a common carrier regulatory model with one month contract terms *[Exhibit B-1d, Appendix 2, December 2007, p.28 of 44, lines 19-21]*.

17243. It is Ontario's opinion that the operating exposure risks of Enbridge and TQM are at opposite ends of the risk continuum.

17244. Fifth, TQM dismisses the risk Enbridge's oil pipeline faces due to the complexities arising from:

> *"...operating a multi-product, batched pipeline [which] could result in contamination, degradation and the loss of liquids that would affect an oil pipeline's earnings..."*

17245. Since Enbridge:

> *"...has traditionally recovered any such costs as a part of its cost of service." [Exhibit B-1d, Appendix 2, December 2007, p.29 of 44, lines 3-7]*

17246. Ontario does not agree with TQM's dismissal of the physical and financial risks attributable to contamination due to the nature of Enbridge being a multi-product batched pipeline. To argue that Enbridge has traditionally recovered any costs attributable to contamination does not address the issue of risk that those costs may not be recovered in future instances.

17247. TQM Compared to Alberta Clipper, Line 4, Trans Mountain and Southern Lights

17248. Ontario argues that for the same reasons TQM's comparison with Enbridge's Alberta Clipper and the Line 4 Extension should be dismissed *[Exhibit B-1d, Appendix 2, December 2007, pp.35-37 of 44]*.

17249. Comparisons with Trans Mountain Pipe Line and Southern Lights should also be dismissed for the same reasons *[Exhibit B-1d, Appendix 2, December 2007, pp38-41 of 44]*.

17250. Submission

17251. Ontario submits that natural gas pipelines have intrinsically lower risks than oil pipelines and that they are inappropriate comparators for the purpose of determining TQM's rate of return.

17252. 2.11 SUPPLY RISK: WCSB vs. North American Supply Basins

17253. The eleventh risk is supply risk: WCSB vs. North American Supply Basins.

17254. Supply risk is another of the risks raised by TQM, and centres on the pipeline's reliance upon the WCSB for its gas supply *[Exhibit B-1d, Appendix 2, December 2007, p.14 of 44 lines 3-6]*.

17255. The company's evidence speaks to diminishing WCSB reserves coupled with increasing demand for gas within Alberta which may result in less supply available to ship on TQM:

> *"Since 2004 TransCanada's supply forecast for the Western Canada Sedimentary Basin ("WCSB" or "Basin") has declined, and TQM's supply risk has increased. There is no longer an expectation of future supply growth, and the likelihood of a sustained production decline has increased." [Exhibit B-1d, Appendix 2, December 2007, p.14 of 44 lines 6-9]*

17256. However, TQM is not reliant upon the WCSB to the same degree as it has been in the past.

17257. In 1994, 99.8 percent of gas destined for TQM was sourced from the WCSB. In 2007, with the emergence of alternate gas supply options available to TQM, only 79.3 percent of its gas supply was sourced from the WCSB. Over a fifth (20.7 percent) of gas destined for TQM is now sourced at Dawn *[Exhibit B-6g, TQM Response to CAPP 53, p.1 of 1]*.

17258. Through Dawn, located in southwestern Ontario, TQM shippers have access to virtually all North American basins. For example, gas transported on TransCanada's ANR system can be sourced from the Rockies, Mid Continent, and Gulf of Mexico regions along with Gulf of Mexico-sourced LNG. All of this gas can be delivered to Dawn and then short hauled to the TQM system *[Exhibit B-6g, TQM Response to CAPP 56 (f) and (g), pp. 3-4 of 4]*.

17259. At a November 2007 Investor Day presentation, Mr. Girling confirmed TQM's ability to source gas from other basins:

> *"The Canadian Mainline will continue to be an integral part of the TransCanada Pipeline System. Its traditional role as our, sort of, header across the northern tier of North America, using it as a*

header to feed gas into Great Lakes, into Eastern Canada, Quebec, into our TQM system, into Portland, and in Iroquois will continue, but as well, it can actually, now with the addition of our Great Lakes pipeline system, can be used as a system where we can feed gas from the United States into our Canadian system and fill that Eastern Triangle with more gas." [Ex. C-1-26, TransCanada Corporation Investor Day, November 21, 2007, p.13 of 78]

17260. Mr. Girling continued:

> *"We can now link to Texas and Oklahoma supplies, Louisiana onshore supplies, Louisiana offshore gulf supplies, other gulf supplies, as well it interconnects with the Northern Border Pipeline System at Great Lakes, which gives the system access to Western Canadian supplies, and through things like the Rockies Express, it gives us connections to Rockies Gas. So, I think it's, sort of, unparalleled in terms of our ability to source gas from numerous locations and move gas to the marketplace." [Ex. C-1-26, TransCanada Corporation Investor Day, November 21, 2007, p.14 of 78]*

17261. During cross-examination it became apparent that there are four proposed pipeline projects which are designed to deliver additional gas from North America basins to Dawn. These projects are:

17262. TransCanada's ANR Dawn Express Project with a delivery capacity of 1 Bcf a day;

17263. The Spectra-DTE Dawn Gateway Project with a delivery capacity of 0.4 Bcf;

17264. The Great Lakes Gas Transmission's Dawn Eclipse Project with a delivery capacity of 0.4 Bcf per day; and

17265. An additional proposed expansion of the Vector pipeline. [*Exhibit Tr. Vol. 7, lines 8693-8749]*

17266. While not all of these projects will be built, their existence is confirmation that additional gas supply will find its way to Dawn.

17267. Even without these projects, Dawn does not face immediate constraint in terms of pipeline supply capacity. In 2007 TransCanada's deliveries at Dawn were at 50 percent of their capacity; Vector was at 78 percent of its capacity; and Bluewater,

Panhandle and Mich-Con collectively were at 46 percent of their capacity *[Exhibit B-6g, TQM Response to CAPP 65 (f), p.5 of 9]*.

17268. Submission

17269. Ontario submits that TQM's supply risk, which has been overstated, and shippers on TQM have demonstrated their ability to shift from the WCSB to other North American basins.

17270. Ontario submits that this trend will only strengthen as access to WCSB supplies diminishes.

17271. 2.12 TQM's Regulatory Risk

17272. The twelfth and final risk I'll address is TQM's regulatory risk.

17273. TQM believes it faces increased regulatory risk due to the Board's approval of the Alliance project in 1996. According to TQM:

> *"...there was a significant change in Canadian regulatory policy with the approval of the Alliance project in 1996 and the accompanying increased competition, and thus long term utilization risk, that was recognized by the Board in RH-4-2001..." [Exhibit B-6l, TQM Response to Ontario 23 (a), p.1 of 2]*

17274. When asked to explain the connection between the Alliance project in '96 and TQM's regulatory risk in 2007-2008, the company's response was twofold:

17275. First, TQM faced increased competition in terms of its customers securing WCSB supply.

17276. Second, TQM shared the Mainline's supply and toll risks resulting from the presence of the Alliance Pipeline.

> *"As part of the integrated Mainline, TQM faces greater competition for WCSB supply from new ex-Alberta pipelines such as Alliance and may face greater competition from other pipelines in the future. The changed regulatory policy has also exposed TQM to toll increases on the Mainline which translates into a higher price for gas in Quebec markets and a decrease in competitiveness." [Exhibit B-8b, TQM Response to NEB 2.10, p.1 of 1]*

17277. Ontario argues that TQM has failed to acknowledge that its shippers' business models have changed since the Alliance project was approved in 1996.

17278. As previously discussed, TQM's reliance on the WCSB gas has ended. Today, over a fifth of TQM's gas supply is sourced at Dawn. And there is available capacity to increase that percentage.

17279. Submission

17280. Ontario submits that TQM's regulatory risk due to the NEB's approval of the Alliance project in 1996 is not a risk to the company and that the Board should not consider it when determining the ROE.

17281. 3. CAPITAL ATTRACTION

17282. Switching to capital attraction, the third of the three primary categories; the ability of a firm to attract capital as a standalone entity and on favourable terms is important and is in part a reflection on the firm's ability to earn a fair return.

> *"What matters is whether NEB-regulated pipelines (which are subject to the 94 formula), on a stand-alone basis (such as TQM), would be able to raise capital on reasonable terms and conditions throughout the business and financial cycles." [Exhibit B-1g, Appendix 5, Engen, December 2007, p.86 of 90, lines 10-13]*

17283. Ontario agrees that TQM's ability to raise capital should not be reliant on its parents' financial wherewithal; particularly TransCanada Corp., which can raise what Mr. Engen terms "abundant capital". *[Exhibit B-1g, Appendix 5, Engen, December 2007, p.84 of 90, lines 4-5]*

17284. TQM acknowledged that while it remains capable of attracting:

> *"...'going-concern value' capital at '8.46 on 30' or '8.71 on 30' [this] does not mean that it is fair that it be required to do so." [Exhibit B-1c, Appendix 1, December 2007, p.21 of 22 lines 4-5]*

17285. TQM is concerned that the company have the ability to raise capital in the future. Hence, TQM's evidence is that the capital attraction test must be forward looking:

> *"...the capital attraction test must be forward looking rather than a backward-looking exercise, considering whether a pipeline will be able to attract capital on reasonable terms and conditions in the*

future." [Exhibit B-15b, Appendix A, Reply Evidence of TQM, September 9, 2008, p.7 of 38, lines 25-27]

17286. Ontario does not disagree with TQM on this matter. However, Ontario suggests that the forward-looking aspect should match the period under review, which in this application is for the years 2007 and 2008.

17287. TQM has a history of making large capital investments during the period since the adoption of the Board's RH-2-94 formula and the setting of TQM's equity thickness at 30 percent.

17288. In the 10 years preceding this application, TQM made three significant capital investments, plus proposed an additional investment which has yet to be undertaken, but not due to the company's reluctance or inability to raise sufficient capital.

17289. First, in 1996 TQM extended its system to the south shore of Quebec City.

17290. In 1999, second, the company completed the 217 kilometre PNGTS extension. This extension was put in service at a cost of $317 million. This was a significant investment for TQM as it increased its rate base from $307 million in 1997 to $556 million by the end of 1999.

17291. The TQM extension currently represents over half (53 percent) of its remaining undepreciated rate base. *[Exhibit B-15d, Appendix B, Reply Evidence of Dr. Carpenter, September, 2008, p.8, lines 18-23]*

17292. Third, in 2006 TQM increased its investments in infrastructure by $27.9 million over the previous year, primarily due to the costs incurred for the construction of the Lachenaie compressor station.

17293. And fourth, during the period of this application, TQM demonstrated interest and indeed a willingness to undertake the construction of a new pipeline from the eastern terminus of its system at St. Nicolas to the proposed Gros Cacouna LNG receiving terminal.

17294. This project was estimated by Gaz Métro to cost approximately $700 million, as we've heard. *[Exhibit B-6c, TQM Response to CAPP 11, Attachment 2, p.12 of 92]*

17295. The willingness of TQM to undertake the construction of the Gros Cacouna pipeline is tangible evidence of TQM's current financial wherewithal and demonstrates the company's ability to attract capital for major projects.

17296. The only reason this project was not built was due to Petro-Canada's inability to secure a long-term LNG contract. *[Exhibit B-15d, Appendix B, Reply Evidence Dr. Carpenter, September 2008, p.12 of 44, lines 10-12]*

17297. And as reported in TQM's 2006 Annual Report, the company is not experiencing any difficulty with its credit rating:

> *"A balanced financial structure and sound management enabled the company to maintain its credit ratings, namely "A (low)" from Dominion Bond Rating Service and "BBB+" from Standard & Poor's. The company's ability to generate adequate amounts of cash in the short term and the long term when needed, and to maintain financial capacity and flexibility to provide for planned growth, remains strong." [Exhibit B-6bTQM Response to NEB 1.22(a), p.12 of 55]*

17298. Mr. Engen agrees with TQM's assessment of its financial status.

> *"In Mr. Engen's opinion, and barring material adverse market or TQM-specific events, TQM should be able to access debt capital in the foreseeable future." [Exhibit B-6i, TQM Response to CAPP 126 (c), p.1 of 2]*

17299. TQM has demonstrated that it has the ability to attract capital and a willingness as a functioning enterprise to undertake investments that are beyond what could reasonably be characterized as "going-concern value" capital.

17300. Submission

17301. Ontario submits that TQM, as a stand-alone entity, continues to be capable of attracting sufficient capital. An increase in the company's equity thickness to 36 percent and the retention of the RH-2-94 formula will be more than sufficient to maintain TQM's ability to attract capital on favourable terms for both the short and long term.

17302. ISSUE 1.3 What principles should guide the determination of TQM's ROE for 2007 and 2008?

17303. Issue 1.3 addresses what principles should guide the determination of TQM's ROE for '07 and '08. On this matter Ontario agrees with the company that the Board:

> *"...should be guided by the principles stated in the RH-2-94 Phase II Decision." [Exhibit B-5b, Additional Evidence of TQM, February 2008, p.4 of 8, lines 11-12]*

17304. I need to check that reference because obviously '94 did not have a Phase II, so I'll confirm it.

17305. Ontario does not challenge TQM on the point that:

> *"The Formula is not a principle, but a mechanism for determining a rate of return on equity." [Exhibit B-5b, Additional Evidence of TQM, February 2008, p.5 of 8, lines 6-7]*

17306. Ontario is in agreement with TQM that the product of the RH-2-94 formula (8.46 percent for 2007 and 8.71 percent for 2008) when coupled with an equity thickness of 30 percent does not produce a fair return.

17307. However, Ontario believes it is not the RH-2-94 formula which requires changes. Rather it is the thickness of the equity which should be increased.

17308. Ontario believes TQM's equity component should be raised from 30 percent to 36 percent.

17309. In our opinion, this change would result in returns for TQM that are commensurate with other Canadian natural gas pipelines, while reflecting TQM's lower level of risk.

17310. Ontario submits that the Board should continue to use the RH-2-94 formula to calculate TQM's return.

17311. Issue Two: What is the appropriate ROE for TQM for 2007 and 2008?

17312. TQM argues that its appropriate ROE for '07 and '08 is the product of an 11 percent return on a 40 percent equity thickness. *[Exhibit B-5b, TQM Additional Evidence, February 2008, p.5 of 8, lines 14-16]*

17313. Ontario submits for the reasons identified in response to Issue 1 and below in Issue 3, the appropriate return on equity for TQM for the fiscals 2007 and 2008 can be calculated using the Board's RH-2-94 formula on an equity thickness of 36 percent.

17314. Ontario submits that this calculation will result in an overall return that meets the Board's own fair return standard.

17315. Issue Three: What is the appropriate capital structure for TQM for '07 and '08 and what principles should guide this determination?

17316. TQM has taken the position that the appropriate capital structure is 40 percent deemed equity and 60 percent deemed debt. *[Exhibit B-5b, Additional Evidence of TQM, February 2008, p.6 of 8, lines 5-6]*

17317. However, should the Board retain the present formulaic rate of return then TQM would:

> *"...request that the deemed equity component of the capital structure be set at 60 percent for 2007 ... and 57.5 percent for 2008..." [Exhibit B-5b, Additional Evidence of TQM, February 2008, p.6 of 8, lines 20-24]*

17318. TQM's request in this application is considerably beyond what the company felt was reasonable and fair in the second quarter of 2007.

17319. In the Message from Management section of TQM's 2006 Annual Report (issued April 2007) the company identifies what it believes to be its correct level of equity.

> *"The company is of the view that its equity ratio should be increased from 30[percent] to 36 percent." [Exhibit B-6b, TQM Response to NEB 1.22(a), Attachment: TQM Pipeline – Achievements 2006, p.3 of 55]*

17320. And TQM made no mention of either dispensing with or altering the RH-2-94 formula in its Annual Report when it identified its equity thickness should be increased.

17321. A February 2007 DBRS Rating Report concurred with TQM's intention to request an increase in the company's deemed equity to 36 percent. DBRS held the opinion that TQM's request was:

> *"...in line with other Canadian pipelines regulated by the NEB." [Exhibit B-1l, Appendix 10 Filing Manual Requirements, Attachment P.2-6, p.2 of 13]*

17322. We've heard much talk about ATWACC in this proceeding and I was uncertain as to where I could or would address ATWACC so I've just put it in right here and it's short and I'll proceed with it.

17323. In this Application TQM has relied upon its witnesses to determine the level of return it has requested from the Board.

17324. And those witnesses, Drs. Kolbe and Vilbert, have relied upon the After Tax Average Weighted Cost of Capital model to make their recommendations.

17325. In his evidence, Dr. Kolbe relegates to a footnote the salient information that no North American regulatory bodies have adopted ATWACC.

17326. There are however two U.S. jurisdictions, the U.S. Surface Transportation Board and the Pennsylvania Public Utilities Commission which have, according to Dr. Kolbe, only adopted the basic principles of ATWACC. *[Exhibit B-1j, Appendix 8, Kolbe, p.7 of 68, footnote 8]*

17327. Dr. Kolbe's response as to why ATWACC has not been adopted by regulatory bodies in North America is confusing given his previous appearances before the NEB and other North American regulatory bodies.

17328. Dr. Kolbe states that ATWACC has not been accepted by North American regulators because it has not yet been proposed to them. *[Exhibit B-6l, TQM Response to Ontario 33 (a), p.1 of 1]*

17329. This is not correct.

17330. Drs. Kolbe and Vilbert have presented evidence on ATWACC before this Board over the course of the past seven years.

17331. TransCanada relied upon Drs. Kolbe and Vilbert's ATWACC evidence most recently in RH-2-2004, Phase II and before that in RH-4-2001.

17332. In both these proceedings the Board dismissed the ATWACC evidence.

17333. While testifying in this proceeding, Dr. Kolbe acknowledged the tenacity of TQM's parent, TransCanada, in continuing to push for acceptance of the ATWACC model.

> *"I've had other clients try this and give up faster. I've never seen a client with the persistence of TransCanada in trying to effect this change within North America." [Tr. Vol. 9, line 11848]*

17334. TQM summarized the Board's concerns with ATWACC in the RH-2-2004 proceeding as being empirical in nature:

> *"A number of empirical concerns limit [ATWACC-based methodologies'] usefulness as a tool to assess cost of capital or the Mainline's appropriate deemed equity ratio." [Exhibit B-1j, Appendix 8 Kolbe, p. 7 of 68, lines 10-12]*

17335. There continue to be issues with ATWACC which have not been resolved such as sample sizes, betas and the relative risk of the Canadian sample. With respect to selection of a proxy group consisting of natural gas pipelines in Canada or the U.S. TQM's evidence is that it…

> *"…is not possible because there simply aren't enough pure play natural gas … companies from which to choose." [Exhibit B-8b, TQM Response to NEB 2.15 (a), p.1 of 2]*

17336. Dr. Kolbe acknowledged in cross-examination the following:

> *"No one last time believed the Canadian sample values of zero were right. Nobody used the values of zero.*
>
> *We are now moving back towards something that is more reasonable, but I would submit we're not there yet." [Exhibit Tr. Volume 9, lines 113994-11395]*

17337. The current market upheaval may play havoc with companies' betas and bring into question the ability of ATWACC to establish an appropriate rate of return.

> *"Of course, now we have all this turmoil in the market as we sit here this week, and I don't know what that's going to do to the betas of these companies as we go forward. It may be a new source of error." [Exhibit Tr. Volume 9, line 11397]*

17338. On the matter of why ATWACC has not been adopted in North America Dr. Kolbe confirms it has to do with the decades of public oversight during which sound regulatory jurisprudence evolved.

> *"North America has benefited for decades from the more efficient private-ownership, public-oversight model, but to do so we had to develop regulatory procedures long before the modern understanding of financial economics developed." [Exhibit B-6l, TQM Response to Ontario 33 (a), p.1 of 2]*

17339. Dr. Kolbe acknowledged that regulatory bodies require compelling

evidence to effect a change as significant as the adoption of ATWACC.

> *"People have to be convinced that it's truly a meritorious change." [Exhibit TR 9, line 11846]*

17340. The reluctance on the part of North American regulatory bodies to adopt ATWACC may also be explained because its adoption can create "winners and losers" and not necessarily benefit everyone in the short term. *[Exhibit B-6l, TQM Response to Ontario 33 (a), p.2 of 2]*

17341. There is no necessity to adopt ATWACC.

17342. Dr. Kolbe agrees:

> *"Yes, absolutely. It's not required to adopt ATWACC in order to give a fair return." [Exhibit Tr. Volume 9, line 11690]*

17343. Submission

17344. Ontario submits the Board should dismiss TQM's proposal to adopt ATWACC as the method of setting the company's ROE.

17345. Ontario also submits that TQM's appropriate capital structure should be based on the Board's Formula with an adjusted equity thickness of 36 percent.

17346. Issue Four: What is the appropriate cost of debt for TQM for 2007 and 2008 and the appropriate method for determining this?

17347. TQM requests it be granted its actual cost of debt for 2007 and 2008. *[Exhibit B-5b, TQM Additional Evidence, February 2008, p.7 of 8, lines 7-8]*

17348. Ontario notes the Board's standard practice of allowing TQM to include the actual cost of debt in its revenue requirement for recovery from customers through tolls and has no objection to continuing this practice.

17349. Submission

17350. Ontario submits that TQM be granted its actual cost of debt.

17351. CONCLUSION

17352. In conclusion, the three recognized requirements of the fair return standard are: the comparable investment standard (market competitive return), capital

attraction and financial integrity standards (the firm's ability to maintain and undertake new investments). *[Exhibit B-6c, TQM Response to CAPP 18, p.1 of 1]*

17353. For the reasons discussed above, the Province of Ontario supports an increase in TQM's deemed equity thickness from 30 percent to 36 percent for the years 2007 and 2008.

17354. With respect to the company's ROE, Ontario supports the continued use of the reliance upon the Board's RH-2-94 formula.

17355. Thank you.

17356. **THE CHAIRMAN:** Thank you, Mr. Sweet.

17357. Mr. George, please.

17358. **MEMBER GEORGE:** So it's my understanding that the Ministry of Energy's position is to grant the formula on 36 percent equity thickness; is that correct?

17359. **MR. SWEET:** Yes, it is, sir.

17360. **MEMBER GEORGE:** And going through the very detailed list of business risks, it would be your conclusion that there was no or little or maybe even less risk that TQM is facing?

17361. **MR. SWEET:** That is correct.

17362. **MEMBER GEORGE:** And the increase in equity thickness to 36 percent would be based -- and this is a question -- would be based on comparing it to somehow comparable Canadian utilities?

17363. **MR. SWEET:** Right. Ontario did not introduce evidence. We hired no expert parties to adduce what an appropriate rate of return is; simply, a recognition of the increased returns earned by other Canadian utilities in recognition that TQM's risk is below those other utilities and that an appropriate return of 36 percent equity thickness would generate what we consider to be a fair return for the company.

17364. **MEMBER GEORGE:** Okay, one last question; quite detailed actually.

17365. You mention that over a fifth of TQM flows is sourced at Dawn. And without asking you to put any new evidence here, can you direct me to the existing evidence on that?

17366. **MR. SWEET:** Yes, I can. I'll just -- first off, it should be in the transcripts because it is there but ---

17367. **MEMBER GEORGE:** Well, if it's already there that answers my question.

17368. **MR. SWEET:** Yes. Firstly, everything was footnoted throughout, so that definitely is in the evidence.

17369. **MEMBER GEORGE:** Now, a sub-question to that is -- if it is on the evidentiary record, of course -- how much of Dawn is based on WCSB? Or would you know that?

17370. **MR. SWEET:** I do not. I would have to check that. The imprints of the 20 percent, just over 20 percent, some of that gas may be coming from the WCSB. However, the gas may also be sourced from other basins.

17371. It's a recognition of the fact that TQM's reliance on long haul gas contracts to deliver gas to its pipeline has lessened over the time and that its shippers, or the parties that are sourcing their gas, has increased from what was 99.8 percent to just over -- just under 80 percent now. And the difference is being made up from gas which is being short-hauled from Dawn.

17372. **MEMBER GEORGE:** Thank you very much, Mr. Sweet.

17373. **MR. SWEET:** You're welcome, Mr. George.

17374. **MEMBER GEORGE:** That is all for me, Mr. Chairman.

17375. **THE CHAIRMAN:** Thank you, Mr. George.

17376. Thank you, Mr. Sweet. Those are all the questions from the Board. Thank you for your argument.

17377. **MR. SWEET:** Thank you very much.

17378. **THE CHAIRMAN:** Now, on the way back up I think the first party we encounter is Mr. Smith for the Canadian Gas Association.

--- REPLY ARGUMENT BY/RÉPLIQUE PAR MR. L. SMITH:

17379. **MR. SMITH:** Thank you, Mr. Chairman.