PUBLIC INTEREST ADVOCACY CENTRE
LE CENTRE POUR LA DEFENSE DE L'INTERET PUBLIC
ONE Nicholas Street, Suite 1204, Ottawa, Ontario, Canada K1N 7B7
Tel: (613) 562-4002. Fax: (613) 562-0007. e-mail: piac@piac.ca. http://www.piac.ca

Michael Buonaguro
Counsel for VECC
(416) 767-1666

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VIA MAIL and E-MAIL

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge St.
Toronto, ON
M4P 1E4

Dear Ms. Walli:

Re: Board File No.: EB-2010-0042
EGDI Earnings Sharing and Deferral Accounts- Stock Based Compensation
Argument of the Vulnerable Energy Consumers Coalition (VECC)

Attached are submissions of the Vulnerable Energy Consumers Coalition on the above noted issue.

Thank you.

Yours truly,

Michael Buonaguro
Counsel for VECC
Encl.

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15 (Sched. B), as amended;

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. for an order or orders approving the clearance or disposition of amounts recorded in certain deferral or variance accounts.

STOCK BASED COMPENSATION (SBC) EXPENSES IN ENBRIDGE'S 2009 EARNINGS SHARING CALCULATION

Submissions of the Vulnerable Energy Consumers Coalition (VECC)

Introduction

1. In this submission VECC will address the following matters regarding EGDI's SBC expense for 2009 Earnings Sharing:

    i. Background to current regulatory treatment of SBC costs;
    ii. The impact of SBC expenses on the ESM during an Incentive Regulation Mechanism period and upon rebasing; and
    iii. Alternative regulatory treatments of SBC costs.

Summary of VECC's position

2. VECC's submission is that although not foreseen at the time of the approval of EGDI's IRM Plan, the manner in which SBC costs are currently treated by EGDI, (vesting over a three-4 year period) creates an out of period expense that progressively reduces earnings sharing throughout the IRM period. This is directionally the opposite of what should happen under incentive regulation.

3. The answer, in VECC's view, is for the Board consider the following alternative regulatory approaches for each type of SBC cost:

    a) Require EGDI to expense the full cost of ISOs charged for EGDI employees by EI based on the average market price in the year of exercise and to claim the related Income Tax credit in the same year;
    b) Also require EGDI to expense the costs of RSUs and PSUs as a regulatory expense only when paid to the employee and to claim the associated income tax credit in the same year.

4. These alternative approaches may, as EGDI claims numerous times in evidence and IR responses, be contrary to CGAAP/IFRS, but the key point is that EGDI is under IRM, not Cost of Service regulation, and the current treatment results in unintended consequences for ratepayers under the IRM regime.

5. There are in VECC's view also two ancillary issues that require clarification:

   i. The prudence of the SBC costs that are being claimed. SBC costs are increasing dramatically, even though the RCAM agreement mitigates the full cost impact; and
   ii. Whether PSUs are expenses that should be borne by EI, since PSUs are linked directly to the performance of EI and its stock.

Background

6. EGDI's evidence[1] sets out the main types and characteristics of the components of Stock Based Compensation (SBC):

> Within each year's SBC expenses, there are a number of components: (a) incentive stock options ("ISOs"); (b) restricted stock units ("RSUs") and (c) performance stock units ("PSUs");
>
>> a) ISOs provide the right to purchase common shares of EI at a specified price during a specific period of time.
>>
>> The purchase price (or strike price) of EI's options are set at the market price of EI's shares on the date the options are granted. Generally, these options vest in equal annual installments over a four-year period and expire ten years after the grant date.
>>
>> The fair value of stock options is determined at the date of grant. Once determined, such fair value does not undergo any change regardless of subsequent changes in stock price and is expensed evenly over each of the four years. Such fair value is determined based on the Black-Scholes model.
>>
>> b) The RSU plan grants *notional* units as if one unit was one EI common share.
>>
>> RSU holders receive cash per outstanding unit equal to EI's weighted average share price at the time of maturity, 35 months

[1] Exhibit B Tab 6 Schedule 1 Pages 4-6

from the date of the grant. The outstanding units accumulate notional dividends during their validity. RSU grants are expensed over the 35 month duration of their validity. Changes in EI's stock prices are typically recognized for RSU expensing calculations.

c) The PSU plan grants *notional* units as if one unit was one EI common share.

PSU holders receive cash awards following a three-year performance cycle. Awards are calculated for each outstanding unit at the end of the performance period using the EI weighted average share price and a performance multiplier.

The performance multiplier is derived through a calculation of specified performance metrics in relation to a specified peer group of companies, relative to targets established at the time of the grant.

PSU grants are expensed over the three year duration of their validity using a formulaic based approach, which makes reference to the EI stock performance relative to the pre-determined peer group.

7. VECC notes that ISOs are a recognized instrument that can be traded on exchanges and has a real cost to EI and its stockholders related to the dilution effect when exercised. It is clear that the Board's EB-2006-0034 II Decision (see below) regarding recovery of SBCs in rates was based on ISOs.

8. RSUs and PSUs are notional rather than real options or stock. No shares are issued nor is there any right to buy any shares. Rather, they are simply deferred cash bonuses in which the stock price is part of the formula to calculate the amount of the bonus.

EB-2007-0034 Phase II Decision

9. The Boards Finding regarding Stock Based Compensation in EB-2007-0034 Phase II [2] is set out at page 6:

> The Board accepts Enbridge's submissions with respect to recovery of the cost of stock options. These stock options are an important element of an executive compensation in any modern corporation. This compensation does have a cost although it may not be a cash cost in the usual sense.

[2] Exhibit I Tab 1Schedule 10 Attachment Page 6
Reference to EB-2007-0606 Decision, January 17, 2008

> If the Board denied recovery of these costs, they would no doubt be replaced by more expensive alternatives which would not benefit the ratepayers or the shareholders. *Shareholders may of course benefit from stock options by way of an increased profit. In this regard, it is important to note that this Utility is now embarking on a five-year rate-incentive mechanism which specifically provides for an earnings sharing mechanism*.[9] [emphasis added]
>
> For the reasons set out above, the Board will allow Enbridge to recover in rates, both the cost of raising equity and the cost of stock options.

10. The Board identified two key considerations :

    i. There is a benefit to EGDI's shareholder from issuing SBUs as part of executive compensation; and
    ii. There is an opportunity for ratepayers to share in the benefit via the Earnings sharing Mechanism under EGDI's Incentive Regulation Mechanism (IRM)

11. Presumably, in noting the shareholder benefit, the Board was referring to the increased profit that Enbridge Inc. would realize as result of sale of ISOs to employees.

12. VECC notes that RSUs and PSUs are often called "phantom stock plans", and unlike ISOs were not considered by the Board in EB-2006-0034. Thus the current proceeding is the first time the Board is faced with considering if and when these cash incentive plans should be recognized as expenses for regulatory purposes.

13. Procedural Order #2, in this proceeding establishes that the amount that should be included as an expense in 2009 for each of these types of SBC is in issue. This raises two questions. First, what is the absolute amount that should be considered an expense for each of these three compensation mechanisms? Second, when should that amount be expensed for regulatory purposes?

14. The direct link between SBUs and Ontario gas distribution rates is the fact that EGDI is charged by EI for the full cost of the stock units for its employees under the Corporate Cost Allocation Methodology (CAM). The full cost is not recoverable in rates due to the RCAM Settlement (there is an overall limit to the amount recoverable in rates under RCAM).

15. With regard to the earnings sharing mechanism under the IRM, this relates to EGDI's after tax earnings (revenues less expenses). EGDI's earnings are directly affected by the costs charged by EI for Stock Based Compensation. Since EI is the shareholder of EGDI it might be reasonable to presume that EIs earnings are indirectly affected by the amount charged EGDI for SBC. However the dynamics of this linkage are changed by the fact that EI receives the full CAM amount for all EI services, including providing ISOs, RSUs and PSUs under the SBC plan.

16. The Shareholder also receives the first 100 basis points of net income above the allowed return. The ratepayers' portion of the earnings sharing is directly affected by any increase in SBC costs.

17. The Board- approved ESM from the EB-2007-0606 Settlement Agreement can be summarized as follows:

> Amount for sharing (50:50) = After tax earnings (revenues less expenses), less allowed ROE, less 100 basis points deadband (shareholder incentive)

Changes in SBC-related costs 2007-2009

18. The 2007 base RCAM amount was $18.1 million, and the related 2007 EGD total SBC amount was $1.7 million; the 2008 RCAM amount was $19.1 million and the related EGDI total SBC amount was $3.1 million.

19. EGD's Evidence[3] notes that 2009 year end corporate financial results are shown in the EGD Consolidated Financial Statements found at Exhibit D1, Tab 1, Schedule 1. Those financial results are the starting point for determining utility results for earnings sharing purposes. Included in the Consolidated Statement of Earnings (at page 4 of Exhibit D1, Tab 1, Schedule 1) are the corporate entity's O&M costs. Those O&M costs include a total expense of $9.3 million for SBC (see page 23 of Exhibit D1, Tab 1, Schedule 1, which is explained at Exhibit I, Tab 4, Schedule 7, Appendix 2) which is comprised of a direct charge and an allocation from Enbridge Inc. for ESM calculation purposes, the Utility O&M and earnings results include the effect of RCAM amounts only. On an aggregate basis, the difference between the total CAM allocated costs and the RCAM determined costs, a difference of $13.1 million, is eliminated in determining Utility O&M expense.

[3] Exhibit B Tab 6 Schedule 1Page 3

20. The application of the RCAM methodology resulted in an allocation of $21.2 million of EI corporate costs to EGD for 2009. As set out at Exhibit I, Tab 4, Schedule 5, this includes an embedded EGD SBC- related amount of $4.3 million.

Impact of Current treatment of SBC costs on Earnings 2009-2012

21. VECC Illustrative Scenario SBU costs 2009-2012 (CAM Total Cost)

Year/Option (vesting)	**2006**	**2007**	**2008**	**2009**	**2010p**	**2011p**	**2012p**
ISOs (4years)	204,900	129,300	215,400	244,350	244,350	244,350	244,350
RSUs (3 years)	-	40,800	51,500	61,350	61,350	61,350	61,350
PSUs (3 years)	-	6,700	8,900	6,900	6,900	6,900	6,900
Total Units[1]	204,900	176,800	275,800	312,600	312600	312,600	312,600
Annual costs@ $40							
ISOs	$2.05m	$3.34m	$5.50m	$7.94m	$8.33m	$9.48m	$9.77m
RSUs	$0.0 m	$0.54m	$1.23m	$2.05m	$2.32m	$2.45m	$2.45m
PSUs	$0.0 m	$0.089m	$0.21m	$0.30m	$0.32m	$0.28m	$0.28m
Total CAM costs[2]	$2.05m	$3.97m	$6.94m	$10.29m	$10.97m	12.21m	12.21m
CAM Actuals[3]		$3.9m	7.6 m	$9.3m	n/a	n/a	n/a
RCAM Actuals[4]		$1.7m	$3.1m	$4.3m	n/a	n/a	n/a

Notes:

1. Data from Exhibit I, Tab 4, Schedule 13,
2. Simplifying assumptions regarding strike price (ISOs), average "cost" (RSUs and PSUs) and # units 2009-2012
3. Actuals differ due to price and other adjustments made by EI/EGDI
4. Exhibit B Tab 6 Schedule 1 Page 8 para 21
5. RCAM Agreement may constrain increases 2010-2012

The above scenario shows that:

- SBU costs charged to EGDI by EI have increased during IRM from $4 million in 2007 to $9.3 million in 2009, an increase of 230%.
- A further increase, assuming no increase in grants, of CAM costs to about $12 million a year (a 300% increase) by the time of rebasing in 2013.
- From the base year 2007 under IRM, RCAM SBC costs have increased by $2.6 million or 250%.

22. EGDI was unable to provide a projection /breakdown of SBC costs for 2010-1012 as requested in VECC IR#13.

23. However, given the historic increase in RCAM SBC costs, it is not unreasonable to assume that under IRM for the years 2010-2012, under the current treatment of SBC costs, earnings will be affected negatively by further increases in RCAM SBC costs.

Impact of SBC Costs at Rebasing/COS 2013

24. The EGDI 5 year IRM period is due to end in 2012 and 2013 will be a Cost of Service rebasing year.

25. As noted above, the difference between CAM SBC costs and RCAM SBC costs is significant. This is detailed in the response to VECC IR#13[4]. This shows that CAM SBC costs are 2007-$3.9 million; 2008-$7.6 million and 2009-$9.3 million. These amounts compare to the RCAM amounts 2007 $1.7 million; 2008-$3.1 million and 2009-$4.3 million. EGDI was unable to provide a projection to 2012 but it is reasonable to assume that if the current level of grants continues then the "gap" could be in the order of $10 million a year. No doubt EGDI will seek to recover these costs as part of its 2013 rebasing year costs.

Changing the Methodology for SBC cost recovery under IRM

26. The treatment of SBC costs for ratemaking purposes as proposed by EGDI for 2009 may be appropriate under the standard COS regulatory compact. However it is not appropriate to an IRM of the type approved for EGDI that also includes an ESM.

27. EGDI has proposed to include SBC costs as expenses based on accounting standards, currently CGAAP (later that will be changed to IFRS),

28. VECC submits that there are many instances where Regulatory Accounting does not always follow standard accounting rules. The regulator has to be concerned with other principles such as fairness and timing relative to matching of costs with benefits achieved, and deferring recovery of costs such as regulatory assets until the amounts to be recovered can be calculated with reasonable certainty.

[4] Exhibit I Tab 4 Schedule 13

Proposed regulatory treatment of ISOs

29. VECC subscribes to the proposition that the ISOs granted to EGDI employees should be expensed in the year that they are granted based on a Black –Scholes valuation of unit price, rather than amortized over four years as at present.

30. VECC supports the analysis on this matter provided by SEC in its submission, including the tax considerations.

Proposed Regulatory Treatment of RSUs

31. As noted above, RSUs are simply a form of deferred bonus that is paid to the employee 35 months after its grant; VECC submits that the expense should be recovered in rates only at the time the "deferred bonus" is paid rather than recovered over 36 months after grant.

32. VECC supports SECs analysis of the treatment of RSUs including the tax considerations.

Proposed Regulatory treatment of PSUs

33. As noted above, PSUs are similar to RSUs , i.e. a deferred bonus, with the additional factor that the amount of the deferred bonus includes an added variable based on the profitability of EI relative to a peer group The value of the PSU can be from 0% to 200% of the EI share price at the time of payment.

34. VECC agrees with SEC that the granting of PSUs is not based on the direct performance of the regulated entity (EGDI), such as expense control, efficiency measures, health and safety, etc., as would be the case in a normal incentive/bonus plan for utility employees. Only the profitability of the parent company is relevant. Accordingly, VECC supports the proposition that no EGDI employee receiving PSUs is incented by the grant of such units to do anything to directly benefit the utility or its ratepayers but rather only to benefit the shareholder.

Conclusion

35. For the reasons set out above VECC submits that the Board should conduct a review of the appropriate regulatory treatment of SBC expenses claimed by

EGDI for 2009 and beyond. If this review suggests that a more appropriate treatment is to expense ISOs at the time exercise and expense RSUs and PSUs (subject to determination of the prudence of PSUs as a regulatory cost to be recovered in rates by EGD) when paid by EGDI as this submission and the submissions of SEC and others advocate, then the 2009 SBC costs claimed and included in the 2009 ESM calculation should be adjusted accordingly.

ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 27th DAY OF AUGUST 2010