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September 3, 2010

VIA RESS, EMAIL AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
Suite 2700
Toronto, Ontario,
M4P 1E4

Dear Ms. Walli:

Re: Enbridge Gas Distribution Inc. ("Enbridge")
2009 Earnings Sharing Mechanism and Other Deferral
And Variance Accounts Clearance Review
Ontario Energy Board ("Board") File No. EB-2010-0042

Pursuant to the Board's Procedural Order No. 2 dated July 8, 2010, enclosed please find two paper copies of Enbridge's Reply Argument on the Stock-Based Compensation ("SBC") Issue.

The above document has been filed through the Board's RESS and will be available on our website at www.enbridgegas.com/ratecase, on September 4, 2010.

Sincerely,

A handwritten signature in blue ink, appearing to read 'L Chiasson'.

Lorraine Chiasson

encl.

cc: Mr. F. Cass, Aird & Berlis LLP
All Interested Parties EB-2010-0042 (email only)

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.

**ENBRIDGE GAS DISTRIBUTION INC.
REPLY ARGUMENT**

**STOCK BASED COMPENSATION EXPENSES IN
EGD'S 2009 EARNINGS SHARING CALCULATION**

On August 20, 2010, Enbridge Gas Distribution Inc. (EGD, or the Company), filed its Argument in Chief on the “SBC Issue” related to EGD’s stock-based compensation (SBC) expenses included in its earnings sharing mechanism (ESM) calculation for 2009. In response, arguments were filed by School Energy Coalition (SEC) and Vulnerable Energy Consumers Coalition (VECC).¹ In accordance with Procedural Order No. 2, EGD is now providing its Reply.

The starting point for evaluating the SBC Issue is the Incentive Regulation (IR) Settlement Agreement, which sets out the manner in which EGD’s earnings sharing calculation is to be undertaken. The relevant provisions of that Agreement state:

(ii) for the purpose of the ESM, Enbridge shall calculate its earnings using the regulatory rules prescribed by the Board, from time to time, and shall not make any material changes in accounting practices that have the effect of reducing utility earnings;

(iii) all revenues that would otherwise be included in revenue in a cost of service application shall be included in revenues in the calculation of the earnings calculation and only those expenses (whether operating or capital) that would be otherwise allowable as deductions from earnings in a cost of service application, shall be included in the earnings calculation.²

Thus, EGD’s calculation of earnings, which includes the SBC expenses, must be carried

¹ Other intervenors (BOMA, CCC, CME, Energy Probe) filed submissions in support of the arguments filed by SEC and VECC.

² EB-2007-0615 Settlement Agreement, dated February 4, 2008, at section 10.1.

out as in a cost of service application. That is understandable, given the fact that earnings sharing is meant to address “overearning” in any particular year. Perhaps inadvertently, VECC appears to acknowledge that EGD has complied with the requirements of the IR Settlement Agreement in its ESM calculation, because it notes in its submissions that “the treatment of SBC costs for ratemaking purposes as proposed by EGD for 2009 may be appropriate under the standard COS regulatory compact”.³

As seen above, EGD’s ESM calculation must also use the Board’s regulatory rules, as they exist from time to time. Those “regulatory rules” include the Board’s Uniform System of Accounts for Gas Utilities. That document recognizes that unless the Board has specifically decided otherwise, then generally accepted accounting principles (GAAP) are to be used to determine a gas utility’s expenses.⁴

As explained in detail in EGD’s prefiled evidence⁵ and Argument in Chief, the Company calculated its 2009 SBC expenses using the same approach as used in the determination of EGD’s Board-approved 2007 base rates and EGD’s Board-approved 2008 ESM amount. In accordance with relevant accounting standards (GAAP), EGD’s SBC costs are expensed over the period when the related employee services are received. This means that EGD’s 2009 SBC costs relate to SBC grants from 2009, as well as those from previous years, to the extent that they have not vested. This approach recognizes that the employee services being rewarded by the SBC grants are being provided over a number of years (since the employee will not receive the compensation related to the SBC grant until it vests), and matches the expense related to the SBC grant over that same time period.

Intervenor arguments fail to establish (or even assert) that EGD’s 2009 ESM calculations do not comply with the IR Settlement Agreement. Instead, they argue for different accounting treatments of EGD’s SBC costs, in a manner that departs from GAAP. Intervenor offer no explanation as to how their proposed approach is consistent with the IR Settlement Agreement. In EGD’s submission, if the intervenor positions were accepted, the result would be an ESM calculation that does not comply with the IR Settlement Agreement. It would also create a mis-match between the way that EGD’s revenues (which come from the adjusted base rates, which include SBC expenses calculated in accordance with GAAP) and expenses are determined for earnings sharing purposes.

³ VECC Argument, at para. 26.

⁴ See discussion under the heading “Generally Accepted Accounting Principles” in the USOA for Gas Utilities.

⁵ Ex. B-6-1, at paras. 15 to 18.

The main thrust of intervenor arguments is that SBC costs should be expensed at the time that an SBC instrument is exercised, rather than in accordance with accounting standards. Intervenors assert that this issue has never been addressed by the Board.

The suggestion that the timing of when SBC costs should be expensed has never been before the Board is misleading. During phase II of the EB-2006-0034 proceeding, the Company's witnesses testified about the different SBC instruments used, and the valuation method (the Black Scholes methodology) used to determine the costs of Incentive Stock Options (ISOs).⁶ Evidence was also given about the fact that ISO costs would be expensed over four years.⁷ Neither the Board, nor intervenors, raised any concerns.

The intervenor assertion that SBC costs should only be expensed when employees exercise the SBC instruments flies in the face of GAAP requirements. Intervenors justify their position by stating that regulatory accounting does not always follow standard accounting rules.⁸ Importantly, no authority or precedent is cited for a situation where different regulatory treatment from GAAP is used for specific types of expenses. In particular, no precedent is cited for the proposed treatment of SBC expenses. As noted, the Board's Uniform System of Accounts for Gas Utilities recognizes that unless the Board has specifically decided otherwise, then GAAP is to be used to determine a gas utility's expenses.

Expensing SBC costs only at the time of exercise fails to acknowledge the nature and purpose of SBC instruments. As explained in the EB-2006-0034 proceeding, these instruments are retention bonuses, intended to incent employees to maintain their employment with EGD.⁹ Thus, it is appropriate that the associated costs be spread over the time during which EGD benefits from the employee's continued service.¹⁰

Intervenors premise their position on tax treatment, stating that the way that SBC costs are expensed for tax purposes (rather than under GAAP) should inform how the Board treats these expenses for regulatory purposes. That premise is flawed. The manner in which the OEB determines accounting income for utilities (GAAP) is different from the rules used to determine EGD's taxable income. For example, EGD does not expense the full cost of IT investments over a short time period that is less than their useful life,

⁶ See, for example, EB-2006-0034, 17 Tr. 67 to 68 and 115 to 118.

⁷ EB-2006-0034, Ex. J17.2.

⁸ See, for example, VECC Argument at para. 28 and SEC Argument at para. 2.3.3.

⁹ 17 Tr. 50-51.

¹⁰ As an analogy, if EGD buys a backhoe, it does not expense the entire cost of that backhoe when the cost is paid. Instead, the expense is spread over the entire service life of the asset.

even though that is how such expenses are treated for tax purposes. It amounts to “cherry picking” to use this one situation (SBC costs) as a scenario where tax rules should be used to determine when something should be expensed for regulatory accounting purposes, and then use GAAP in other cases.

On the assumption that ISO costs will be expensed at the time of exercise, SEC seeks to further depart from the current approach to valuing ISO expenses by proposing a new three step approach to determine the amount of the expense.¹¹ It appears that VECC and SEC diverge on this point, as VECC’s argument asserts that the valuation of the ISOs should continue to use a Black Scholes valuation of unit price.¹² SEC’s proposal to have ISOs valued at the lower of two different values (as explained in SEC’s submissions) is unfair, and overly complicated. It is unfair because it opens the possibility that EGD’s regulatory expense will be less than the expense determined for accounting purposes at the time that the ISOs are granted. It is overly complicated because it would require tracking every ISO that is granted, to determine whether the exercise cost of any option was different from the Black Scholes value determined at the time that the option was granted.

Intervenors further assert that no expenses for Performance Stock Units (PSUs) should be included as expenses for ESM purposes.¹³ There is no basis for considering the expensing of PSU costs differently from Restricted Stock Unit (RSU) or ISO costs. PSUs are part of EGD’s overall long term incentive pay package. The goal of this incentive compensation package is to attract and retain talented employees. The Board has specifically determined that incentive compensation is an important element of an executive compensation package and that if recovery of the expenses were denied, then they would be replaced by alternatives that would be more expensive to

¹¹ SEC Argument, at para. 6.1.8.

¹² VECC Argument, at paras. 29 and 30. VECC’s position is consistent with the approach that has been used under RCAM to value ISOs, an approach that was explained to the Board in the EB-2006-0034 proceeding (17 Tr. 67 to 68 and 115 to 118) and which has not been the subject of any objection up to this time.

¹³ As an aside, EGD disagrees with the intervenor suggestion that this proceeding is the first time that the Board has considered EGD’s PSU and RSU instruments. At all times leading into and during the current IR term, EGD has made clear that its SBC costs include ISO, PSU and RSU costs. Indeed, EGD provided written and oral evidence about these instruments in phase II of the EB-2006-0034 proceeding, and the Board panel asked specific questions about RSUs at that time (See, for example, EB-2006-0034, 17 Tr. 52 to 53 and 128 to 130). Intervenor argument in that proceeding described each of EGD’s “three types of SBC” (EB-2006-0034, phase II, Final Argument of the Intervenors VECC, IGUA, CCC and Energy Probe, dated October 16, 2007, at para. 37). Subsequently, it was clear from EGD’s 2008 ESM Application that PSU and RSU costs were part of EGD’s 2008 SBC expenses, yet no issue was raised by intervenors or the Board, and those costs were approved.

ratepayers.¹⁴

Like EI stock options (which the Board has specifically found to be legitimate expenses), the value of PSUs is linked to Enbridge Inc. (EI's) stock price. Parties and the Board have been aware that PSUs are part of EGD's SBC costs for a number of years, and to this point there has been no issue about expensing PSU costs. The linkage to EI's stock price does not make PSUs less legitimate expenses for regulatory purposes. To the contrary, EGD is a significant contributor to EI's operations, so success by EGD will impact on EI's success. In any event, ratepayers also benefit from the fact that PSUs are part of EGD's compensation package that is designed to ensure the retention of experienced and expert managers for the utility.¹⁵

In its argument VECC points to the increase of SBC costs over the past several years, and estimates how those costs could increase in future years.¹⁶ No specific issue is taken by VECC, or any other party, with any of the particular SBC expenses that are part of EGD's earnings sharing calculation (intervenor concerns relate to the methodology used to determine the SBC expense amounts, not to SBC grants that underlie those amounts). There is no evidence to suggest that EGD's 2009 SBC costs are anything but prudent. Concerns about what those costs may be at rebasing are speculative, and not relevant to the determination of a 2009 earnings sharing amount. Enbridge submits that there is no need for the Board to provide "clarification" about the prudence of the 2009 SBC costs being claimed.

In conclusion, EGD submits that it has calculated its 2009 earnings sharing calculation (including SBC expenses) in accordance with the IR Settlement Agreement, and the \$19.3 million earnings sharing amount should be approved as filed.

All of which is respectfully submitted this 3rd day of September 2010



Fred D. Cass, Aird & Berlis LLP
Counsel to Enbridge



David Stevens, Aird & Berlis LLP
Counsel to Enbridge

¹⁴ EB-2006-0034 Phase II Decision, May 20, 2008, at p. 6 (attached to Ex. I-1-10 in this proceeding).

¹⁵ EGD witnesses testified about the benefits of the LTIP program in the EB-2006-0034 proceeding – see 17 Tr. 55-56.

¹⁶ VECC addresses these matters at paragraphs 5 and 18 to 25 of its submissions.