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February 6, 2008

BY PERSONAL DELIVERY (11 COPIES) AND EMAIL

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
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Dear Ms. Walli:

Re: Pollution Probe – Written Argument
EB-2007-0606 / EB-2007-0615 – Union Gas / Enbridge – 2008 Rates

In accordance with the discussion at the hearing on Friday, February 1, 2008, please find enclosed Pollution Probe's written argument for this matter.

Yours truly,

Basil Alexander

BA/ba

Encl.

cc: Applicants and Intervenors per List of Applicants & Intervenors dated August 24, 2007 by email
Board Staff per Procedural Order #1 by email

EB-2007-0606
EB-2007-0615

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule B;

AND IN THE MATTER OF an Application by Union Gas Limited for an Order or Orders approving or fixing a multi-year incentive rate mechanism to determine rates for the regulated distribution, transmission and storage of natural gas, effective January 1, 2008 (the "Union 2008-2012 Rates Application");

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. for an Order or Orders approving or fixing rates for the regulated distribution, transmission and storage of natural gas, effective January 1, 2008 (the "Enbridge 2008-2012 Rates Application");

AND IN THE MATTER OF a combined proceeding before the Board pursuant to section 21(1) of the *Ontario Energy Board Act, 1998*.

WRITTEN ARGUMENT
on behalf of POLLUTION PROBE

February 6, 2008

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Introduction

Pollution Probe's submissions with respect to the applications by Enbridge and Union Gas for incentive rate mechanisms for 2008-2012 focus on whether revenue deficiencies associated with new customer additions should be treated as a Y factor (Issue 5.1).

As detailed below, Pollution Probe submits that such revenue deficiencies should be treated as a Y factor to retain an incentive in favour of new customer additions, given the benefits of system expansion, the Board's statutory mandate to facilitate rational system expansion, the Government of Ontario's conservation policy, the Board's guidelines for natural gas incentive rate regulation, and the current existing status-quo regulatory treatment of such system expansion. The partial settlements should therefore be modified accordingly on this one point.

In the specific case of Enbridge, its proposal may have built in a specific commitment to provide a minimum yearly amount of system expansion during the term of its settlement agreement, in which case Pollution Probe submits that the revenue deficiencies associated with system expansion <u>above these set minimums</u> should be treated as a Y factor.

Detailed Submissions

The Benefits of Adding More Customers to Ontario's Natural Gas System

Pollution Probe submits that attaching new customers to the Enbridge and Union natural gas distribution network provides the following benefits to Ontario and the gas utilities:

1. New attachments lower the overall energy bills of the new customers;
2. In the long run, new attachments lead to lower natural gas distribution rates for all of the utilities' customers;
3. By reducing the overall demand for electricity for space heating, water heating, cooking and drying, new attachments reduce the need for new high-cost electricity infrastructure;
4. By reducing the overall demand for electricity and oil for space heating and other needs through increased natural gas use, new attachments reduce Ontario's total greenhouse gas emissions; and
5. By increasing the utilities' rate base, new attachments permit the utilities to increase their earnings per share.

Pollution Probe submits that the above benefits underlie and are implemented through various measures as detailed below.

The Board's Legislative Mandate to Expand Ontario's Natural Gas System

As a result of the above-noted benefits of adding new customers to Ontario's natural gas distribution system, the Ontario Energy Board has a statutory mandate to facilitate the rational expansion of Ontario's natural gas distribution system. Specifically, according to section 2 of the *Ontario Energy Board Act*:[1]

> The Board, in carrying out its responsibilities under this or any other Act in relation to gas, shall be guided by the following objectives:
>
> ...
>
> 3. To facilitate the rational expansion of transmission and distribution systems.
>
> ...

The Government's Conservation Policy to Expand Ontario's Natural Gas System

In addition, as a result of the above-noted benefits, it is Government of Ontario policy that end-use fuel switching from electricity to natural gas should be promoted to help achieve its energy conservation goals with respect to electricity.[2]

This is significant because, as the Board is aware, the *Ontario Energy Board Act* requires the Board, when regulating Ontario's gas utilities, to promote energy conservation in a manner consistent with Government policy:[3]

> The Board, in carrying out its responsibilities under this or any other Act in relation to gas, shall be guided by the following objectives:
>
> ...
>
> 5. To promote energy conservation and energy efficiency in a manner consistent with the policies of the Government of Ontario.
>
> ...

The Board's IR Guidelines – Creating An Environment Conducive to Investment

In March 30, 2005 the Ontario Energy Board issued its guidelines for natural gas incentive regulation, i.e., for this proceeding. According to the Board's *Report*, the gas utilities' new multi-year incentive regulatory framework must "create an environment that is conducive to investment, to the benefit of both customers and shareholders."[4]

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[1] Exhibit K2.1, Tab 1 (*Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule A, s. 2).
[2] Exhibit K2.1, Tab 4.
[3] Exhibit K2.1, Tab 1 (*Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule A, s. 2).
[4] Exhibit K2.1, Tab 2 (*Natural Gas Regulation in Ontario: A Renewed Policy Framework – Report on the Ontario Energy Board Natural Gas Forum* dated March 30, 2005, pg. 18)

The Existing Board-Approved Regulatory Framework for Gas Utilities

Under the Board's existing cost of service regulatory framework for Ontario's gas utilities, attaching new customers is in the long-run self-interest of the gas utilities since it leads to more rate base and hence the potential for the utilities to increase their earnings per share.

However, on a stand alone basis, new customer additions are not economic during their early years. That is, their stand alone revenues are less than their stand alone costs.

For example, according to Union Gas, on a stand alone basis, its year 2006 revenues from its year 2006 new customer additions were $3.7 million less than their costs. Furthermore, according to Union, if one assumes that every year of the 5 year term of incentive regulation has the same revenue sufficiency/(deficiency) impact as the 2006 customer additions, the resulting cumulative revenue deficiency would be $10.9 million.[5]

According to Enbridge, on a stand alone basis, the cumulative 5 year revenue deficiency of its year 2006 new customer additions was $4.458 million.[6]

As a result, on a stand alone basis, new customer additions are not in the utilities' short run self-interest since they will reduce their earnings per share. To eliminate this conflict between the utilities'short run and long run self interest, the Board has permitted the utilities to submit annual rate applications to recover, via higher rates spread over all of their customers, their stand alone revenue deficiencies from their new customer additions.

In short, since the creation of TransCanada pipeline system in the late 1950s, attaching new customers has been in the short run and long-run financial self-interest of Enbridge and Union with only one brief exception, namely, Union's trial PBR term between 2001 and 2003. This is probably one reason why Ontario's gas utilities have experienced a very dramatic customer attachment growth during the past half century.

The Issues with the Partial Settlement Proposals re: System Expansion

The Board is now being asked by Enbridge and Union and selected intervenors to establish a new regulatory regime which would deny Enbridge and Union their right to apply to the Board, on an annual basis, to recover their revenue deficiencies associated with new customer additions.

According to Enbridge and Union their proposal is in the public interest since: a) it will lead to lower natural gas distribution rates in the short term; and b) there is no evidence that denying the gas utilities the right to recover their new customer addition deficiencies will reduce their number of new customer additions.

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[5] Exhibit K2.1, Tab 6, pgs. 13-14 (Union Exhibit C20.4 – Updated) and Transcript, Volume 2 (February 1, 2008), pg. 33.
[6] Exhibit K2.1, Tab 7, pg. 20 (Enbridge Exhibit I, Tab 9, Schedule 5, Attachment).

Specifically, according to Vice President Birmingham of Union Gas, allowing Union to continue to raise its rates to recover its new customer additions is contrary to the public interest because it is not needed:[7]

> What you would be talking about is annual rate increases to reflect any revenue deficiencies for the new customer additions. That will result in rate increases with no discernable benefit to ratepayers. And ***it's not going to change Union's behaviour at all.*** [emphasis added]

Furthermore, according to Union's counsel, Mr. Penny:[8]

> So the fundamental premise of the entire argument of my friends, in my submission, is that Union will cut customer additions for short-term gains during the incentive regulation plan, and there's simply no support for that premise. ***There's no historical support.*** There's no support in the forecast evidence, and ***the company clearly has no financial incentive to do that.*** As you heard repeatedly, the last thing you would do is reduce revenue-producing capital. [emphasis added]

Pollution Probe respectfully disagrees with Mr. Birmingham and Mr. Penny.

Pollution Probe agrees that new customer additions are in the long-run self interest of Enbridge and Union. Therefore Pollution Probe is not suggesting that if the partial settlement agreement is approved, that they will stop making new customer additions. Rather, Pollution Probe submits that, if the settlement agreement is approved, they will make fewer new customer additions relative to what they would implement if the existing regulatory framework is maintained (on this point).

Pollution Probe's reasons for these submissions are as follows.

First, while Enbridge and Union want to grow their businesses by adding new customers, they also want to ensure that in each and every year they earn, at least, their Board-approved return on equity. In a year with a mild winter or an economic recession or both, Enbridge and Union will have to dramatically reduce their spending to ensure that they continue to earn their Board-approved return. As a result, they may be required to sacrifice their long-term self-interest by cutting back on their new customer additions.

Second, Enbridge Gas Distribution and Union Gas are owned by Enbridge Inc. and Spectra Energy respectively – both of which are traded on the New York Stock Exchange. As the Board is aware, both of these companies are under intense pressure from the investment community to achieve ever increasing earnings per share. As a result of this pressure, under the respective partial settlement agreements, Enbridge and Union would be able to increase their short-term earnings by cutting back on their new

[7] Transcript, Volume 2 (February 1, 2008), pg. 34.
[8] Transcript Volume 2 (February 1, 2008), pg. 117.

customer additions ***even in good years***. Accordingly, the utilities' respective parent companies might require or pressure them, explicitly or implicitly, to cut back their new customer additions in order to help Enbridge Inc. or Spectra Energy increase their next quarter's earnings (i.e. the short-term interest would trump the long-term interest).

Third, according to Mr. Penny, there is no historical support for Pollution Probe's proposition that the utilities will cut back their customer additions to increase short run profits if they cannot recover their new customer revenue deficiencies by raising their rates. In fact, there appears to be evidence to support precisely that.

During the last fifty years or so, the gas utilities have always been able to recover their new customer addition revenue deficiencies via annual rate increases with only one brief exception, i.e., Union Gas was not able to do so during the term (2001 to 2003) of its trial PBR (performance-based regulation). Therefore, if there is to be Ontario-specific historical support for Pollution Probe's proposition, it will have to be with respect to actions by Union Gas during the 2001 to 2003 time period.

According to Mr. Birmingham, in 2003 Union's parent was in dire financial straits and was looking for ways to cut back its capital budget:[9]

> In 2003, which was the final year of our trial performance-based regulation framework, in that year we had a 2.3 percent rate reduction. So, not the rate increase that we're looking for 2008 and the rate increases that we would be expecting through the incentive regulation period, but a 2.3 percent rate decrease.
>
> ***We had a shareholder who was in dire financial straits and so we were in the situation where we were looking to constrain as much capital as we could.*** [emphasis added]

According to Pollution Probe's submissions, in such a situation Union would feel pressure, explicitly or implicitly, to reduce its least profitable new customer additions in order to ration its capital and minimize its short-run rate deficiency. Furthermore, as Mr. Birmingham conceded under cross-examination, reducing its least profitable new customer additions (i.e., customer additions with a low P.I. or profitability index) entails that the overall P.I. of its portfolio of new customer additions would rise:[10]

> MR. KLIPPENSTEIN: Could Union reduce its first-year system expansion revenue deficiency by reducing its number of new customer additions which have relatively low PIs?
>
> MR. BIRMINGHAM: Well, to the extent that those customer additions are contributing to the first-year revenue deficiency, reducing those customer additions would reduce the first-year impact. The problem with that approach is

[9] Transcript, Volume 2 (February 1, 2008), pg. 12.
[10] Transcript, Volume 2 (February 1, 2008), pg. 28 line 13 to pg. 29, line 3

> that you give up all of the future years' revenue that then contributes to the earnings of the company.
>
> MR. KLIPPENSTEIN: Given what you said, it would also be true, I take it, that ***Union would reduce its first-year system expansion revenue deficiency by reducing its number of low PI customer additions and thereby increasing the aggregate PI of its portfolio of new customer additions?***
>
> MR. BIRMINGHAM: I guess to the extent that those are customer additions that are not caught under the obligation to serve, ***that's a theoretical possibility, but it's not a practical approach for us.*** [emphasis added]

In fact, the evidence suggests that in 2003, when its parent company was in dire financial straits, the "theoretical possibility" became "a practical approach" for Union. Specifically, in 2003 the P.I. of Union's portfolio of new customer additions rose to 1.46 from a base of 1.29 in 2002.[11] By reducing, to the fullest extent practical, its low PI new customer additions, Union appears to have rationed its capital and reduced its revenue deficiency, just as Pollution Probe's argument would predict.

Responding to IGUA's Argument Regarding a Potential Enbridge Windfall

According to the Industrial Gas Users Association ("IGUA"), if the Board accepts Pollution Probe's recommendations, Enbridge will earn a windfall profit:[12]

> Further, EGD's witness, Mr. Hoey, confirmed that the introduction of Y factor treatment to costs arising from customer additions, as proposed by GEC and Pollution Probe, would result in over-recovery or double-recovery by the company [Transcript, Vol. 2, p. 106]. Thus, ***Y factor treatment of these costs would result in a windfall for the utility.*** [emphasis added]

IGUA's submissions assume that the Enbridge partial settlement agreement is based on a commitment by Enbridge that it ***will*** undertake a certain minimum number of new customer additions during each of the next 5 years. If this is the case, Pollution Probe invites Enbridge in its reply argument to specify the minimum number of new customer additions it will make during each of the next 5 years. If IGUA's submissions about Enbridge's commitment are correct, Pollution Probe's argument above would still fully apply with the modification that, for Enbridge, revenue deficiencies for new customer additions <u>above these minimum amounts</u> should be treated as a Y factor.

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[11] Exhibit K2.1, Tab 7, pg. 17 (Exhibit C20.6).
[12] IGUA Submissions by letter dated February 4, 2008 at the last paragraph of pg. 1.

Conclusions and Submissions

Pollution Probe submits that the respective partial settlement proposals, insofar as they effectively revoke the Board's long-standing policy of allowing the utilities to apply for annual rate adjustments to recover their revenue deficiencies associated with new customer additions, should ***not*** be approved.

Pollution Probe's reasons for this submission are as follows..

1. Pollution Probe submits that new customer additions that pass the Board's E.B.O. 188 guidelines are in the public interest,[13] and such attachments should thus be encouraged and promoted. The Board should accordingly ***not*** adopt a new ratemaking framework that financially penalizes the gas utilities in the short-term for attaching new customer additions that pass the E.B.O. 188 test. If such a framework were adopted, the Board would be effectively and practically repealing in part the intent of the E.B.O. 188 guidelines without proper notice and consideration.

2. Pollution Probe further submits that it would be contrary to the Board's statutory obligation to facilitate the rational expansion of Ontario's natural gas distribution system to financially penalize the gas utilities for attaching new customer additions that pass the E.B.O. 188 test.

3. Pollution Probe further submits that it would be contrary to the Board's statutory obligation to promote energy conservation in a manner consistent with the conservation policies of the Government of Ontario to financially penalize the gas utilities for attaching new customer additions.

4. Pollution Probe further submits that it would be contrary to one of the Board's key criteria for performance-based regulation in the natural gas sector (i.e. creating an environment that is conducive to investment to the benefit of both customers and shareholders) to financially penalize the gas utilities for attaching new customer additions.

Pollution Probe thus submits that the Board should allow the gas utilities to recover the annual revenue deficiencies associated with their new customer additions as a Y factor.

With respect to Enbridge, Pollution Probe's argument would apply, potentially subject to a modification to adjust for one alleged feature of Enbridge's proposal. Specifically, if Enbridge's reply argument provides:

1. confirmation that its partial settlement agreement is based on the assumption that Enbridge will make a specified number of new customer additions during each of the next 5 years; and

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[13] Exhibit K2.1, Tab 3 (Excerpt from *Final Report of the Board* in E.B.O. 188 dated January 30, 1998).

2. the minimum number of new customer additions that Enbridge will make during each of the next 5 years, then

Pollution Probe submits that the Board should allow Enbridge to recover as a Y factor its annual revenue deficiencies associated with new customer additions that are <u>in excess</u> of these minimum commitments. If Enbridge does not confirm the above two points in its reply, Pollution Probe submits that the Board should make an order allowing Enbridge to recover as a Y factor its annual revenue deficiencies associated with all its new customer additions.

Costs

Pollution Probe respectfully requests that it be awarded 100% of its reasonably incurred costs of participating in this proceeding. Pollution Probe submits that its participation was responsible and assisted the Board in its consideration of the issues. In addition, Pollution Probe is a registered charity that has no pecuniary interest in the outcome of this proceeding, and its membership includes thousands of gas consumers.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

February 6, 2008

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Basil Alexander, Counsel for Pollution Probe

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