EB-2006-0606
EB-2007-0615

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

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

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

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

ARGUMENT OF THE GREEN ENERGY COALITION

Issue 5.1 – Y factored incentive for customer additions

1. GEC's Incentive Proposal:

GEC proposes a targeted symmetrical incentive for total customer additions.

For Union Gas the incentive would be $141 per addition above or below 35.4% of Ontario housing starts in the year. The incentive could be paid or recouped in the following year (or at rebasing for simplicity). For Enbridge the incentive would be $141 per addition above or below 66.2% of Ontario housing starts (or alternatively, 102.6% of housing starts in Enbridge's franchise area). These ratios are the five year averages of the actual experience for each company for the years 2002-2006 as reported by the companies (as set out in exhibits K2.2 and K2.3). The incentive would be symmetrical, returning a similar amount to ratepayers for underperformance. The additions would be calculated on the same basis as the companies did in exhibits K2.2 and K2.3[1].

Rationale for the Incentive:

The rationale for GEC's proposal is that multi-year IR regulation reduces the incentives that the companies had under annual cost of service regulation to invest capital. In the case of customer additions or attachments this threatens to reduce benefits to all ratepayers and to society as a whole. Undoubtedly, the pushes and pulls the companies will face on this are complex. GEC is concerned that the short term revenue reduction due to the delayed recognition of these capital additions in rate base changes the equilibrium and, depending on the circumstances faced by the company at any given time, this could result in some less cost-effective attachment opportunities being dropped. GEC's starting point is that the level of incentive that the companies had under COS to add customers was implicitly judged adequate by the Board, and our proposal simply seeks to maintain that level. It is designed to be revenue neutral if the relatively stable trend of attachments relative to housing starts prevails, and it only takes effect if the companies depart from that trajectory. It is a simple and self-calibrating incentive that only comes into play if the companies do in fact stray from the course. It seeks to reinforce behaviour (additions) which all parties agree is in the ratepayers', government's and public's interest.

[1] Union provided *attachment* data (meters hung) whereas Enbridge provided *additions* data (new bills). However, the economic impact was displayed in Union's C20.4 per *addition*.

2. The Evidence and Position of the Companies:

Need for the Incentive

In its prefiled evidence (B/4/1 page 3, para. 11) in discussing Board Staff's evidence Enbridge stated:

> ...assuming a robust rebasing (update rate base, O&M, volumes customer numbers, revenues, etc) and rates are rebalanced under a COS regulation model, this model provides no incentive for Enbridge Gas Distribution and its shareholders to invest any capital in the business other than the minimum amount to maintain total rate base at the approved 2007 levels. This negative incentive is a function of the robust rebasing and the nature of cash-flows and capital investments for a utility like Enbridge Gas Distribution.

Witnesses for both companies did not challenge the notion that multi-year IR reduces the incentive on the companies to invest capital relative to COS. However, both suggested that it would not be in the interest of the companies reduce spending in the case of customer addition investments (and Enbridge's Mr. Ladanyi went further, suggesting that its model provides a positive incentive for customer additions).

Union's witness, Mr. Birmingham, acknowledged that cutting back on attachments, especially relatively less attractive attachments, would improve short-term earnings (V.2, p. 54, l. 1).

Enbridge's witness, Mr. Hoey was asked by Mr. Klippenstein at v. 2, p. 85:

> MR. KLIPPENSTEIN: ...You've used the orchard analogy. Taking into consideration everything you said, it is still true, in principle, is it not, that Enbridge could reduce its first-year system expansion revenue deficiency by reducing the number of new customer additions which have relatively low PIs? That's true by -- standing by itself; isn't that fair?

> MR. HOEY: In theory, you are correct, that that's what you would do. From a practical management point of view, that's not what you would do.

(As noted above, Mr. Ladanyi did not agree, a matter we will return to.)

At page 45 of volume 2 the situation is summarized:

> MR. POCH: And so you're not going to -- while the rate escalation formula may protect the company's overall position, in terms of the marginal difference that it makes whether you add a customer or not, you're not getting an increase in return on equity for that added equity investment, not until you rebase.
>
> MR. BIRMINGHAM: That's correct, Mr. Poch. I think if you look at the response to Exhibit C20.4, you'll see exactly that. So when we look at the 2006 customer additions as an example, the first year revenue deficiency would be $3.7 million.

Mr. Birmingham agreed that the IR mechanism results in a delayed and depreciated value of capital being added to rate base at rebasing relative to the situation under COS. (v.2, p. 46, l.10)

Union's numerical analysis of the impact based on the 2006 portfolio, rates and operating costs in C.20.4 shows that in an IR context where there is no immediate addition to rate base the company would face a $3.7 million reduction in revenues in the year, which amounts to a loss in the year of $141 for each attachment. The second table in that response shows that the company would not recoup that loss from added net revenues in the first five years and that each subsequent year would incur a further $3.7 million loss partially offset by net revenues in subsequent years coming to a cumulative $10.9 million loss by the end of the period.

Union also provided a forecast scenario based on forecast 2008 inputs (C20.5) but this forecast should be taken with a grain of salt. The cumulative effect shown in the second table in C20.5 is a net sufficiency of $3.9 million (rather than the $10.9 million loss in C20.4 based on 2006 assumptions) – a matter that BOMA *et al* make much of in their argument. However, the 2008 forecast scenario assumes operating costs of $2.7 million in 2008 and $3.5 million in each subsequent year, whereas the 2006 scenario used operating costs of $3.1 million in the first year and $3.9 million in subsequent years. At v.2 page 51 this is discussed:

> MR. POCH: And you have included in here some projections. For example, you've shown your operating expenses coming down. That's just your expectation; is that fair? That's not hard-wired in?
>
> MR. BIRMINGHAM: That's correct.

If the higher margin and lower cost of equity that Union forecasts in its C20.5 are used with the same operating costs that were used in the 2006 analysis, the value would be reduced by $2 million for the 2008 portfolio, $1.6 million for the 2009 portfolio and so on, leading to a net cumulative *deficiency* of 2.1 million dollars.

Mr. Birmingham agreed that the numbers in 20.4 are as if IRR covered the 2006 –2010 period and are an apples to apples comparison. (v.2, p. 47,l.6) He also agreed that the cumulative difference amounts to close to 11 million dollars (v.2,p.48. l.26)

Enbridge did not respond to GEC's request in supplementary interrogatory 6 for such an analysis but Mr. Hoey agreed that the Union first year deficiency value of $141 per attachment would be a reasonable approximation of the value that Enbridge would experience. (V. 2, p. 105, l. 17)

As noted above, Mr Ladanyi suggested that the revenue cap per customer formula would somehow give the company a positive incentive to add customers. He repeatedly pointed to Appendix C of the settlement proposal to suggest that each customer would increase EGDI's revenue by $418. That figure is a gross revenue value based on the prior year's average gross revenue per customer. Accordingly, the added revenue figure does not account for the higher than average marginal capital servicing costs to add a new customer. If the capital costs of a new addition were the same as the average embedded, depreciated capital cost per customer, EGDI's formula would provide some protection as Mr. Ladanyi asserts. However, new additions are at a much higher undepreciated cost, a cost that is not met by the formula which preserves gross (not net) revenue per customer, and does so based on average embedded costs.

For both companies, costs, particularly capital carrying costs, arise with each addition. The formulae, while ensuring that the companies receive a fair return overall if they continue as in the past, do not give the companies the same benefit of increased return that was experienced under COS for *each marginal decision* to add a new customer.

The most obvious concern is that in a warm year or otherwise difficult financial period the companies may forego long-term gain (particularly for relatively low P.I. additions) to improve short-term financial performance.

Witnesses for both companies acknowledge that they have performance pay regimes that reward senior executives for annual financial performance. This means that the IRR approach both reduces company profits for additions and brings into play a new motivation for action – executive performance incentives that will now encourage restriction of additions in tough times. This had not been a factor under COS due to the immediate rebasing.

Nevertheless both companies assert that there is no problem, that our concern is "theoretical only".

Union suggests that this is evidenced by the lack of customer addition cutbacks during the 2001-2003 IRM period. However exhibit K2.2 illustrates that total attachments did in fact lag in 2001:

Year	Ontario	Total Attached	% of Ont. Starts
2000	71,521	24,437	34
2001	73,282	**21,367**	**29**
2002	83,597	29,785	35
2003	85,180	30,066	35
2004	85,114	31,415	36
2005	78,795	28,707	36
2006	73,400	26,346	35

Mr. Birmingham acknowledged the 2001 lag at v. 2, page 61, line 9 and it is notable that he did not volunteer any explanation.

Further, when expressed as a percentage of Ontario housing starts the slowdown in 2001 remains, suggesting it was not simply due to exogenous factors such as housing starts or general economic slowdown. (Mr. Birmingham did acknowledge that housing starts and mortgage rates are the two largest factors at play, with mortgage rates being a factor in housing starts (v.2, p57, l. 15-20).)

In our submission the slowdown Union experienced in 2001 at the start of the IRM period is consistent with the nature of the problem we seek to address. Union's evidence that attachments did not lag in 2002 and 2003 despite economic pressures on the company is not surprising for Union would have been anxious to maintain attachment levels in the year or two prior to the end of its IRM period as it would have been anxious to avoid the Board reducing its capital budget going forward at rebasing.

Thus the *only empirical evidence* is consistent with the GEC's position that the concern is not merely theoretical.

Both companies say that if they face a squeeze they will "find other efficiencies" before cutting attachments (see Enbridge argument at v.2, page 120, line 1). However, many of the expenditures these companies make are not avoidable. Gas must be compressed. Meters must be read. Calls must be answered in conformity with SQR standards. Safety must not be compromised. Staff, and certainly staff costs, cannot be downsized immediately. But optional capital spending such as customer attachments, particularly attachments with relatively lower P.I.s, can be sacrificed if needed. And reducing investment in marginally performing attachments would be a sacrifice that may not be too dear to make in the interest of holding up quarterly earnings – particularly now that executive bonuses are on the table. Further, one might reasonably ask why the companies would not already be harvesting these "other efficiencies" to the extent available under an IR regime?

The choice of housing starts as the external variable that sets the target level of additions was not challenged by either company's witnesses. At V.2, p. 101, line 10 Mr. Hoey agreed that the correlation had been steady for Enbridge. At v. 2, page 57, in the context of discussing the relationship of housing starts to Union's additions given Union's higher commercial and industrial load, Mr. Birmingham was asked:

> And for small commercial and industrial -- or for any commercial and industrial, housing starts would not be a direct measure, but would you agree it might tell us something about the opportunity to add customers to the extent that both housing starts and commercial and industrial growth are reflections of the growing economy and population, at a macro level?
>
> MR. BIRMINGHAM: At a very high level.
>
> MR. POCH: Sure.
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> MR. BIRMINGHAM: I think that's probably true.

It is notable that after assuring the Board that the proposals of Pollution Probe and the GEC are unneeded, Mr. Penny went on to suggest that the proposals will reduce rate predictability and stability. If attachment behaviour is as stable and protected as the companies suggest, one wonders how GEC's proposal could lead to instability in rates.

Administrative Burden?

Both companies suggest that the costs and difficulties of administering our proposal are unwarranted. This is surely disingenuous. Our proposal is the height of simplicity. Take publicly reported housing starts and multiply by the fixed percentage then multiply any difference by $141. It is a virtually automatic incentive mechanism.

Double Recovery?

Ms. Newland raised a concern about double recovery. We are in agreement that a mechanism that rewards additions at levels below the current rate of addition (which we submit is implicitly assumed in the price and rate escalation formulae) would create double recovery. This is precisely the reason GEC proposes a target or pivot at the expected level (adjusted by changes in housing starts to protect the companies from matters outside their control). The companies are presumed to be adequately compensated by the settlements if they continue to add customers at the levels that they have in the past. (Indeed the parties to the Enbridge agreement explicitly reference their reliance on EGDI's forecasts that appear in the appendix to the agreement which includes customer attachments.) Thus it is appropriate that the companies are not rewarded for merely achieving the current levels of attachment. In the same vein, it is appropriate that the companies return monies to customers if they do not reach that level. All customers will be hurt if cost-effective attachments are foregone and the companies should not be unfairly enriched.

Inadequate Notice of the Proposal?

Ms. Newland complains that the companies haven't had an opportunity to wrestle with our proposal during the prolonged ADR phase. GEC's concern with the impact on customer additions has been known to the parties from the outset. GEC's requests for the information relating additions to housing starts were made during the ADR. GEC has repeatedly stated on the record that it seeks a targeted incentive. GEC did not have the values for deficiency to inject into a formula in Union's case until last week and in Enbridge's case, until Mr. Hoey accepted the Union value on the stand (Enbridge having declined to calculate the values in I.R. I/6/6). The nature and value of the required incentive could not be determined until the context was known. The proposal is simple to understand. This is an objection of form, not substance.

SQR in Disguise?

Mr. Penny stressed that the Board should view our proposal as a belated attempt to obtain service quality regulation. As a formal matter we do not seek an SQI. We seek a targeted incentive as part of the incentives created in the IRR. However, it is acknowledged that the relatively small amounts we propose may have less an effect as a direct incentive then as a caution to the companies and an indication of expected performance and in that respect the proposal resembles an SQI. The proposal arises in response to the particular settlement proposals developed by the companies and ratepayers. As the Board will see from a comparison of Enbridge's pre-filed evidence with its proposal today, Enbridge was intending to have a greater proportion of its activities within Y factor treatment (see B/4/1/page 12 at para. 33). Enbridge's evidence proposed to address the changed incentive for capital spending as part of IRR. GEC should not be criticised for suggesting the same. It would not have been possible to conclusively determine an appropriate incentive/penalty level prior to the formulae being crystallized in the settlement proposals

Even if it our proposal is seen as SQR, we are unaware of any prejudice that raising it in this process would cause the companies. In our submission the Board should be guided by the substance of what is in the public interest, not some exaggerated reliance on procedural form and timing.

We have noted our view that the potential for a penalty is the most important feature of the proposal. In our experience, utilities are particularly concerned about penalties. A simple SQR would not have had this feature.

Avoidance of Variance and Deferral Accounts

Mr. Penny argues that the GEC proposal is incompatible with the Board's desire to avoid deferral and variance accounts as expressed in the NGF report. The rationale behind the Board's concern about variance and deferral accounts is surely that these accounts blunt economic signals to the regulated entity. At page 31 of its Report the Board's conclusion was:

> ***In the Board's view, an appropriate balance of risk and reward in an IR framework will result in reduced reliance on deferral or variance accounts, and reliance on off-ramps or z-factors in limited, well-defined and well-justified cases only.***

In other words, these accounts are to be avoided because they can reduce incentives for efficiency and the management of risk. GEC's proposal is the opposite. It adds an incentive for efficient activity. Activity that would reduce rates, help alleviate the difficulties faced on the electric side, and serve government policy. These matters were well canvassed and documented in Mr. Klippenstein's cross of both company panels. The consistency of customer additions with government policy and with Board objectives, particularly those from fuel switching, is not in doubt.

3. Position of other Intervenors

Mr. Penny notes that ratepayers reject the need for a Y factor. We observe that ratepayer groups are often focused on near term cost reduction. In our submission, these parties place a higher value on a bird in hand rather than two in the bush. GEC places greater emphasis on long term net benefits to ratepayers and society. Accordingly, the fact that the ratepayers do not support the proposal should not be equated with its appropriateness from a broad public interest perspective. Indeed the Board has rejected aspects of agreements in the past for that reason.

In their argument BOMA *et al* focus on Union's exhibit C20.5 to suggest that the deficiency is *de minimus.* As discussed above, C20.5 is an optimistic projection that assumes lower operating costs then have been experienced and if we adjust for that fact the projected sufficiency becomes a deficiency.

IGUA is concerned about the application of the proposal to industrial customers. The additions covered are those included in the company responses that are reproduced in exhibits K 2.2 and K2.3. In both cases the numbers include non-residential customers other then large industrial (which are routinely addressed by way of customer contribution and would presumably be less susceptible to the concern we raise).

4. Conclusion

If our concern is misplaced, as the companies' suggest, there is no harm in what would be a revenue neutral result. It is only if we are right that the incentive would have any impact, and in that case it would be entirely salutary. Either additions would be encouraged that will ultimately lower rates, or unearned profits will be returned to ratepayers for performance below the expectations that underlie the productivity assumptions. GEC acknowledges that the incentive is small and submits that the prospect of a penalty is likely to be the most motivating and important aspect of this formulation. Therefore, GEC respectfully urges the Board to adopt a symmetrical incentive.

5. Costs

GEC respectfully requests that 100% of its costs be awarded.

All of which is respectfully submitted this 6th day of February, 2008

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