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Our File No. 116102

February 14, 2011

VIA EMAIL AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, Suite 2701
Toronto ON M4P 1E4

Dear Ms. Walli:

Re: Board File No. EB-2011-0277
Enbridge Gas Distribution Inc. – 2012 Rates Application
Building Owners and Managers Association, Toronto (BOMA) Argument

Please find attached the Argument of BOMA in the EB-2011-0277 proceeding.

Yours truly,

FOGLER, RUBINOFF LLP

Thomas Brett
TB/dd
Encl.
cc: All Parties (*by e-mail*)

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EB-2011-0277

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 Enbridge Gas Distribution Inc. for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, distribution, transmission and storage of gas commencing January 1, 2012.

BUILDING OWNERS AND MANAGERS ASSOCIATION, TORONTO (BOMA) ARGUMENT

<u>Cross-Bore Issue – Z Factor Treatment and Deferral Account</u>

Background

Enbridge has requested Z factor treatment for a plant safety initiative that they put in place in 2008 and 2009. The purpose of the initiative, then called the Sewer Lateral Program, was to mitigate the risk of serious accidents arising from new and existing gas lines intersecting existing sewer lines ("cross-bore").

Enbridge became acutely aware of the magnitude of the cross-bore risk when a fatal accident occurred at a home served by its US subsidiary, St. Lawrence Gas, in 2004. The St. Lawrence accident was one of the earlier US accidents. Enbridge stated that it was aware of "at least twenty other incidents in the US related to cross-bores and natural gas liens, many of them occurring after the St. Lawrence Gas accident" (Ex. B, T2, Sch. 6, pp. 4-5). Various American Gas Association committees and other related US Groups had been issuing warnings about cross-bores even earlier (for a full discussion of the history and a list of references to other papers, see the Canadian Gas Association ("CGA") White Paper. Natural Gas Pipelines and Sewer Lines, The Cross Bore Issue [I, T2, Sch. 4, Att. B, p. 28].

Enbridge was instrumental in the formation of the CGA Task Force on cross-bore risks in early 2010, and assisted Union with the establishment of its program in early 2010.

Enbridge applied for Z factor treatment as part of its 2010 rates application (EB-2009-0172). The application did not go to hearing as all issues were settled pursuant to a Settlement Agreement. As part of that Settlement Agreement, Enbridge withdrew its request for Z factor treatment of its cross-bore initiative (EB-2009-0172; Ex. N1, Sch. 1, p. 12).

The governing Settlement Agreement for the current Enbridge IRM sets out the criteria for determining whether this event qualifies for Z factor treatment. The criteria are:

> "The Parties agree that Z factors generally have to meet the following criteria:
>
> 1. The event must be causally related to an increase/decrease in cost;
> 2. The cost must be beyond the control of the Company's management and is not a risk in respect of which a prudent utility would take risk mitigation steps;
> 3. The cost increase/decrease must not be otherwise reflected in the per customer revenue cap;
> 4. Any cost increase must be prudently incurred; and
> 5. The cost increase/decrease must meet the materiality threshold of $1.5 million annually per Z factor even (i.e., the sum of all individual items underlying the Z factor event)".

The utility must meet all the above criteria for the expenditure to qualify for Z factor treatment.

BOMA is of the view that the Enbridge cross-bore initiative does not qualify for Z factor treatment for several reasons.

First, it was not triggered by the issue of the TSSA Order in August 2011, as Enbridge had stated (see, for example, Ex. B, T2, Sch. 6, pg. 1).

Enbridge initiated the risk mitigation activity voluntarily in 2008, more than three years before the Order, as part of its comprehensive plant safety program, acting as any prudent utility would upon realizing the seriousness of the risk posed by cross-bore.

Enbridge's costs were largely controllable, or at the very least, as controllable as the costs of any safety program which the utility developed from time to time. While not insignificant, the costs were modest in the context of Enbridge's total plant O&M budget.

Enbridge further testified that Enbridge had known of the risk for a considerable period of time, at least as early as 2004, and probably earlier.

Like a statute, the Z factor criteria must be interpreted as a whole. Taken as a whole, the "event" the utility is relying on is the issuance of the TSSA Order. For the costs to be outside of the control of the utility's management, they have to be triggered, or caused, by the event, which they were not. To the contrary, they were steps that Enbridge, as a prudent utility, would, and did, take, to mitigate the risk. Enbridge had, several years before the issue of the Order, developed and deployed its risk mitigation measures, as a normal evolution of its safety programs. In fact, Enbridge helped instigate the formation of the CGA Task Force which in turn eventually led to the TSSA promulgating an order. Enbridge was a key player in the development of the order. When the TSSA acted, while late in the game, it did in order to fulfill its statutory mandate, and presumably, to ensure that all relevant parties remained focused on this issue in the future.

Enbridge testified that if the Board did not grant Z factor treatment, it would continue on with the initiative, in its entirety (TV2, pg. 129, line 129).

If the Board does not establish Z factor treatment for cross-bore, the proposed deferral account is unnecessary.

Z Factor 2012 Pension Funding (Issue 9) and
Variance Account for Z Factor 2012 Pension Funding (Issue 13)

1. Enbridge has a non-contributing deferred benefit pension plan for its employees. It is a registered funded plan, subject to the *Pension Benefits Act* (Ontario) ("PBAO").

2. Historically, Enbridge has accounted for pension expenditures on its financial statements on a cash basis, that it is, the pension expense for the year has equaled Enbridge's cash payment into the plan for that year. Both the PBAO, and the *Income Tax Act* (Canada) govern the amount of funds that Enbridge pays into the plan each year. The PBAO prescribes minimum contributions to ensure maintenance of the plan solvency, while the *Income Tax Act* (Canada) caps the amount of tax-deductible contributions that can be made in years when the plan is in surplus, to deter tax avoidance strategies (Enbridge's pension expenses are deductible when computing its taxable income). The historical use cash-based accounting for pension expenses means that Enbridge's earnings were higher than they would otherwise have been, had accrual accounting been in place. The shareholder benefited from this practice. On the other hand, the remaining portion of the annual service cost, as determined by annual actuarial calculations, went unreported in the company's accounts, for both financial reporting and regulatory purposes,

notwithstanding the fact that it represented a substantial potential future liability for the company.

3. As it happens, the pension fund was in a surplus position over the years 1998 to 2008, and the PBAO regulations allowed a suspension of contributions, while the *Income Tax Act* (Canada) regulations prohibited contributions at least over the latter years of that period, 2006 through 2009 (TV1, pg 179, line 20). The surplus or deficit position of the fund is determined by periodic actuarial analysis, which takes into account the increase in the fund's assets (the performance of the investments made by the plan managers), changes in the number of beneficiaries, changes in the benefits, mortality rates, and, most important, the level of bond interest rates. Interest rates, at the time the periodic analysis is done, are the most important single factor in determining the plan status, as they determine the discount rate applied to the future financial obligation to pay pensions to employees, in order to determine the present value of that obligation. The two most important factors in the calculation are interest rates, and plan performance, in that order. Interest rates are volatile, and plan performance can be volatile. Well run plans are less volatile than less well run plans. Sharp reversals in interest rates in either direction can cause the move from surplus to deficit (reduction in rates) or from deficit to surplus (increase in rates).

As noted above, the plan remained in a surplus position for many years in the late 1990's and early 2000's, in part because the plan's returns like those of most pension plans over the period were acceptable, and in particular because interest rates were relatively high (at least relative to post-2008 crash levels), the ideal combination for producing and sustaining a surplus. Conversely, as interest rates dramatically declined post-2008, and the plan's investments lost twenty percent (20%) of their value in 2008, and recovered only a modest portion of that loss in 2009 and 2010, the plan fell in to a deficit (on a solvency basis) at the end of 2011, and a projected deficit, on a solvency basis, by the end of 2012.

Accordingly, Enbridge is required to make a further cash contribution to the pension plan in 2012 of approximately $16.6 million.

PBAO regulations, as amended in 2009, required any plan not currently receiving contributions from its sponsor, to file an annual cost certificate within ninety days of the end of the year in question to prove the plan would still have a surplus (solvency) at the end of that year. An actuarial study by Mercer, conducted in August 2011, showed that the plan would very likely be in deficit by the end of 2011. A further contribution would be needed in 2012. The amount of the contribution in such circumstances is also set by regulation, equivalent to the annual service cost as determined in the most recent triennial evaluation. That number is $16.6 million.

4. Z Factor Treatment - Enbridge seeks, in this case, Z factor treatment for the $16.6 million it must inject into the plan in 2012 (the final year of its IRM plan; it will rebase in 2013), as well as a variance account to adjust the payment to reflect the actual amount. Enbridge argues that had it not been for the change in PBAO regulations in 2009, it would not have had to file an annual cost certificate in 2012, and would have been entitled to extend its contribution holiday until December 31, 2012.

The onus is on the applicant to justify Z factor treatment for an expenditure. In BOMA's view, Enbridge has not justified Z factor treatment for the pension contribution required in 2012.

Interest Rates

First, while the change in the PBAO regulations may have been the proximate cause of having to make the payment in 2012, the underlying causes of the plan moving from surplus to deficit was the sharp decline in interest rates over the 2008-2011 period, and the recent lackluster performance of the investments made by the managers of the Enbridge pension fund. As noted above, both these factors are dominant factors in the actuarial calculation that determines whether the fund is in surplus or deficit. The company's future liability to fund the pension benefits earned by the employees in the year in question is fairly constant from year to year, reflecting a stable benefits structure and number of employees entering retirement. The determining factors are the bond interest rates, which determine the discount rate used to determine the present value of those future obligations and the performance of the markets for the securities and other assets in which the fund's managers have invested. The company confirmed this second factor in evidence in Transcript, V1, pg. 93, line 17. Mr. Kancharla stated:

> "The second one was...the pension's assets did not keep up with the increase in the pension liabilities increase".

Mr. Monteiro testified to the importance of interest rates at V1, pg. 113, line 27, when, in answer to a question from Mr. Shepherd, he stated:

> "Yeah. I mean, the plan is in deficient now compared to a year ago is mainly because interest rates have declined very significantly".

Later, he testified that, in order for the plan to change from a deficit on December 31, 2011, as determined on a solvency basis test on August 31st, to a surplus, on December 31st:

> "So we said the pension fund return would have to have been 16% for those 4 months, with no interest rate changes, <u>or interest rates would have to have increased by one percent with fund returns being as expected</u>" (our emphasis).

Later, at pg. 115, when commenting on the Mercer Report (Ex. B, T2, Sch. 5, Appendix B, pg. 15 of 32), which showed, under the section entitled Discount Rate Sensitivity, that Solvency Liabilities increased from $789.4 to $920.7 million, or about $130 million, due to a reduction of the discount rate by one percent. Mr. Monteiro stated:

> "But yes, the key reason those numbers are different is that interest rates went way down".

Mr. Culbert stated at pg. 172, in response to a question from Mr. Thompson:

> Mr. Thompson: "Well, if the interest rates had not declined, there would not be difficulty now".
>
> Mr. Culbert: "If the change in the economy hadn't occurred that has occurred, that would be one of the factors that would continue to allow us to be in a surplus, potentially".

The decline in interest rates also affected the amount of interest Enbridge paid on its outstanding debt over the period 2008 to 2012. Enbridge's actual interest costs on its outstanding debt in 2011 (unaudited) were $141.5 million, which represents a decline of $24 million from the Board-approved interest costs for the 2007 rebasing proceeding, with similar substantial reductions of $14 million, $13 million, and $4.3 million in 2010, 2009, and 2008, respectively (J1.9). These differences between actual interest paid and forecast interest included in the 2008 base rates for the IRM program, resulted in an increase in utility earnings over the first four years of the IRM plan, of about $55 million. From a fairness point of view, the Board should direct Enbridge shareholders to absorb the $16.6 million in pension expenditures in 2012.

Plan's Investment Performance

While bond interest rates and, therefore, the discount rate used to calculate the plan's liabilities are beyond the control of management, the performance of its fund managers in growing the plan's assets is not. Enbridge executives are accountable for the investment management talent they hire to manage the funds, and, to some degree at least, the asset allocation and risk orientation of the plan. It is accepted business knowledge that management, be it Enbridge Gas Distribution Inc.'s or Enbridge Inc.'s, the parent company), have the authority to hire and fire various fund managers, and often do so, based on the performance of the overall fund and/or some of its components.

A significant contributing factor to the change from surplus to deficit is the indifferent performance of the investments in the Enbridge Gas Distribution Inc. plan ("EGDI Plan") since 2006.

Enbridge's prefiled evidence (Ex. B, Sch. 5, Appendix A, pg. 1) shows that the EGDI Plan lost $167 million in 2008, or about twenty percent of its value. It recovered $64 million of that loss in 2009, and another $37 million in 2010, but was estimated to have lost a further $20 million in 2011. As of the end of 2011, it had recovered less than fifty percent of its 2008 loss ($81 million of $167 million). It would have had to end the year 2011 at $824 million to retain its surplus position, given the low interest rate levels. So the loss incurred in 2008, as yet unrecovered, is an important factor in the plan's fall into deficit.

More important, Enbridge was responsible for managing the EDGI Plan, and they have managed it poorly. Ex. I, Tab 1, Sch. 4, pg. 1 reveals that in the five years from 2006 to 2010, inclusive, the EGDI Plan's return was:

- only once above the fiftieth percentile (2009)
- in between the twenty-fifth and fiftieth percentile, that is somewhere between the worst twenty-five percent and worst half of all surveyed plans, in three of the five years (2006, 2008, and 2010), and
- in one of the five years, between the tenth and twenty-fifth percentile, that is, among the worst ten percent to twenty-five percent of all reporting plans (2007).

For a company the size and sophistication of Enbridge Inc. with the resources at its disposal, this is a mediocre performance. It is not what one would expect.

For example, J1.4 demonstrates that had the plan performed merely at the fiftieth percentile over the five years (the average of all plans), the 2010 year end balance would have increased from $736.2 million (actual) to $788.0 million, an increase of $52 million, which would have placed it in a surplus (solvency) of $85.6 million on December 31, 2010.

Notwithstanding the efforts of the Enbridge witness to avoid responsibility for this performance, the fact is, and it is common business knowledge, that company pension managers are ultimately judged on the overall performance of the plan portfolio, whether one or more investment management firms are hired to manage the portfolio or parts of it.

Either the Enbridge pension managers are responsible for setting the asset allocation for the plan, or some of those asset allocation decisions may be given over to one or more investment management firms. Whatever option is employed, the overall performance of the plan is the result of both asset allocation and the increase or decrease in the value of each of its asset categories. In neither case can Enbridge Inc. and Enbridge Gas Distribution Inc. management abdicate responsibility. Management are responsible for the Plan's Investing Policies and Procedures. The company's attempts to insulate itself from responsibility are at best disingenuous. Perhaps the companies have too many parties involved.

BOMA notes that asset mix in the plan has not been revised since 2007.

The BNY Report, filed as Exhibit J1.6, does not change BOMA's conclusions because, as noted above, the asset allocation itself is part of the performance of the company's pension group. Moreover, the BNY client universe would have been largely US firms, the investments of which would be weighted towards US securities. The Canadian equity markets outperformed their US counterparts in most of the years in the ten year period. So a benchmark relative to average US returns would have been much easier to satisfy. Finally, it is impossible to tell from the BNY-Mellon report what are the actual benchmarks for various asset classes used by BNY which are being used as "benchmarks" for the performance of investment managers hired by Enbridge Inc.

Moreover, with respect to the plan return, the company, in consultation with Mercer, chose a factor of 0.11% as the increase in the return in the pension plan assets due to the fact that it is being actively, rather than passively managed (that is, entirely based on market indices). The 0.11% of the fund's value may be compared to 0.5% (half of one percent) of the value of the fund spent for an annual management and administration fee. One half of one percent of the fund's value at January 1, 2011, of $736 million is approximately $3.7 million. If we subtract the pension administration expenses at Enbridge Gas Distribution Inc. of approximately $350,000.00 in 2011 (TV1, pg. 154, lines 5-21; J1.3), the remainder represents a fee of $3,080,000 paid to the fund managers. I assume similar numbers would have been paid in each of the previous ten years. The premium accorded for active management of 2011 was .011 x $736 million, or approximately $730,000.00, or about twenty percent of the fees paid in 2011. The compensation is clearly out of line with the perceived advantage to Enbridge, its shareholders, and its ratepayers, from utilizing active plan managers.

BOMA is of the view that the mediocre results of the pension plan's performance over the last few years, both in good markets and in bad, as well as the sharp decline in interest rates over the period 2008 to 2012, have both contributed in a major way to the need for Enbridge to make a payment of $16.6 million to the plan in 2012, and to seek to collect that amount from ratepayers, in the final year of a four year IRM plan. BOMA believes that the mediocre performance of the plan's investments were well within the control of management. Not only did management not intervene, it appears that the payments to fund managers may have been imprudent, given what the company expected to get in return.

Moreover, as changing bond rates were the largest single determinant of the growing deficit, and given that the sharp decline since 2008 in bond rates led to a $55 million windfall in the reduced debt payments and increased earnings by Enbridge over the term of the IRM to date, it would be appropriate for the Board, to the extent that it concluded that the increase in the present value of the liabilities for the purpose of determining the solvency ratio was outside of Enbridge's control, to order that $16 million should not be collected from ratepayers, but be absorbed by Enbridge's shareholders as an offset to the $55 million benefit to Enbridge generated by the lower rates.

Transition to US GAAP Deferral Account

Enbridge has requested a deferral account to be created in 2012 to which it intends to charge:

> "the difference between the cash amount to be paid out by Enbridge and the OPEB expense calculated in accordance with the accrual basis of accounting for each of the 2011 and 2012 fiscal years. This amount is estimated to be approximately $3 million in each of the 2 years".
>
> "The charge to Retained Earnings in Enbridge's 2010 US GAAP financial statements resulting from the removal of the regulatory asset account and the setting of the OPEB liability in accordance with US GAAP. This amount is estimated to be approximately $84 million".

Other Post Employment Benefits are non-pension benefits that Enbridge employees are eligible for upon retirement, including health and dental plans, life insurance coverage, and health accounts.

Enbridge does not propose in this case how the credits in the deferral account would be collected from ratepayers. They suggested this would be done in the 2013 rebasing case. Nor does Enbridge, in this case, present a comprehensive discussion of the accounting and cash flow impacts, if any, in moving to US GAAP. They propose to do this in their rebasing case EB-

2011-0354. Moreover, the projection of accounting impacts and the amounts they propose to credit or debit for their proposed deferral accounts are, by their own admission, not finalized (TV1, pg 61). They also want the scope of the deferral account to cover not only OPEB matters but any other, as yet undiscovered, differences between US GAAP and Canadian GAAP, and presumably Canadian GAAP and IFRS, depending on whether or not they are allowed to adopt US GAAP (TV2, pg. 75, line 22). So Enbridge is seeking in effect to create a broad generic account for US GAAP or IFRS related impacts, occurring at the date of transition. The scope of the proposed account is much too broad and too many uncertainties remain for the Board to establish this account at this time.

Furthermore, the Board, in its Addendum to the Report of the Board, entitled Implementing IFRS in an IRM Environment, stated, at pg. 19:

> "that the utility, in its first cost of service application following the adoption of the new accounting standards, must set out the benefits and potential disadvantages to the utility and its ratepayers of the alternate accounting standard for rate regulation".

This has not yet been done, so the request for the deferral account is premature.

Apart from the objections noted above, BOMA does not agree to the establishment of the deferral account at this time because it is not required for any legitimate regulatory purpose.

First, Enbridge has agreed that the account is not required in 2012 to deal with any out of period costs issues (TV2, pg. 74, lines 14 to 24):

> "MR. THOMPSON: Thank you. And I believe you've answered this, but if you haven't, am I correct it's not necessary to have a deferral account to track differences? You can do that outside of the regulatory accounting sphere?
>
> MR. YUZWA: Yes.

> MR. THOMPSON: Thanks. Now, again, I believe that's on the record, that this account is not needed to reflect any uncontrollable costs being incurred in 2012, i.e., it's not needed for any 2012 rate-making purpose?
>
> MR. YUZWA: Agreed."

The Board has discretion on whether or not to establish deferral and variance accounts and the party requesting one has the onus of demonstrating a need for the account. The Board requires that the need for this account be very clearly justified. Enbridge has not done that in this case.

Second, as outlined above, the nature of the account proposed is too vague, and it is premature as the context within which the account will operate will be determined in a proceeding that has only recently commenced.

Third, it is not yet clear that some or all of the credits that Enbridge seeks to record in the account are eligible for recovery from ratepayers, and since likely recoverability is one of the criteria the Board considers in deciding whether or not to establish a deferral account, the Board should wait until the change in accounting standards, and related matters, can be carefully and fully examined in EB-2011-0354. BOMA provides below a brief context for the issue around recoverability.

Under a cash accounting regime, companies, including Enbridge, have historically paid OPEBs to employees as required on a yearly basis. Enbridge collects the amount of these payments each year in rates under traditional cost of service ratemaking or they are included in the base year revenue requirement under IRM regimes. The forecast OPEB payment was part of the cost of service incorporated in the base rates established for Enbridge's five year IRM program in 2008. Unlike the case with pension benefits, there is no trusteed intermediary plan that is funded, and in turn pays benefits.

Prior to the year 2000, as noted above, reporting companies (prior to 2008 for Enbridge and some other regulated utilities), accounted for OPEB payments made to retirees on a cash basis. As a result, the future obligations being accumulated by the company to pay OPEBs earned in that year by present employees were not shown in the financial statements. Neither was the ongoing cumulative build up of this liability from year to year. Since no payments were made or reserves created in respect of these future payments, no money for them was collected in rates. One effect of this practice was that the company's earnings were higher, by the unreported annual amount, that they would have been had that future obligation been treated as a current year expense.

In 2000, the Accounting Standards Board promulgated chapter 3461, which required companies to use accrual accounting to report both pension and OPEB expenses, effective January 1, 2001. Enbridge, along with certain other regulated entities, was able to obtain a deferral of the need to adopt 3461 until January 1, 2009.

Between 2000 and 2009, Enbridge continued to account for OPEB as a cash basis, but disclosed in a footnote to its financial statements what the impact on its financial statements would have been, had it used accrual accounting, as mandated generally by 3461.

As of January 1, 2009, Enbridge had to adopt accrual accounting for OPEB. In other words, it had to report as an annual OPEB expense, an amount which was the sum of the cash amount paid out in OPEBs to retirees in that year together with the present value of the amount of future benefits "earned" by the company's current employees in the year. These "earned" or "accrued" benefits would not be paid out to these employees until retirement, but companies were required to record the incremental "earned" benefits in the year in question as an expense. One result of the change was that, since the OPEB expense increased, company earnings, all else being equal, would be lower than they were under the previous cash accounting method. However, since the company did not increase the amount of cash it paid out in that year, it did not have to increase the amount it collected in rates, nor would it have obtained Board approval to do so, had it been under cost of service ratemaking, as such an amount would have been viewed as an interest-free loan to the utility. It would have continued to collect in rates only the amount it actually paid out to retirees in that year. That amount was also reflected in the base amount for OPEB in the IRM program, which commenced on January 1, 2008.

In addition, section 3461 required Enbridge to record as a liability on its balance sheet, the actuarially determined present value of the sum of future OPEB payments to eligible employees over their retirement years on a cumulative basis since the beginning of the plan. That amount was calculated annually and would fluctuate based on changes in interest (discount) rate, plan changes, and mortality rates, among other things. The initial amount was $68 million and was recorded on its 2010 Financial Statements (TV2, pg. 59).

Fourth, section 3461 required companies to record a transitional liability. The transitional liability of $16 million Enbridge shows on its 2010 financial statement (TV2, pg. 59) is the unamortized amount of all accrued liabilities that existed on December 31, 2000, when section 3461 came into effect and the change to accrual accounting took place. The amount accrued of OPEB liabilities at December 31, 2000 was determined to be $55 million, of which $5 million was deemed to be a current liability. Section 3461 allowed companies to amortize the remainder, and Enbridge did amortize the remainder, $50 million, over a fifteen year period, which was the estimated average remaining service life of the employees covered under the plan (TV2, pp. 67-70, line 3 et seq.). As at the end of 2010, only $16 million of that transition liability remained "unrecovered". The $16 million was added to the $68 million to arrive at $84 million, the value of the OPEB liability, in its 2010 annual financial statement.

However, in 2009, Enbridge was faced with taking a charge to retained earnings because of the section 3461 requirement to create a liability for the unamortized accumulated future service costs and transitional costs as at January 1, 2009. Rather than do this, it created two "offset accounts" as assets on its balance sheet which matched the $84 million; $68 million which it termed a "deferral asset", and a similar offset account which it called the "transition" asset to offset the $16 million transition liability (TV2, pg. 59). Enbridge believed that these offset accounts effectively allowed it to continue to utilize the cash method of accounting for OPEBs, and, to avoid taking a charge to detained earnings.

However, the company did not seek OEB approval for these accounts. Moreover, the company continued to recover in rates only the cash payments for OPEBs in rates in 2009, 2010, 2011 and 2012 via the OPEB amount embedded in the 2008 base year revenue requirement. Enbridge testified it created the offset accounts on the basis of its interpretation of the principles set out in General Accounting Section 1000, financial statement concepts ("concepts document") (J2.1, Attachment 1). The company testified that it created the asset, pursuant to the principles set out at paragraphs 29 and 30 of the concepts document on the basis that it believed it would be able to collect the amount of the asset at some future date from its ratepayers, based on decisions of its regulator. Enbridge now seeks to incorporate that accounting interpretation into a more permanent legal vehicle, the deferral account. It wants to then credit the account with an amount of $84 million, as a prelude to proposing, in its rebasing case, to recover that amount from ratepayers.

Enbridge decided to apply for US GAAP effective January 1, 2012. US GAAP has a provision equivalent to section 3461, which requires accrual accounting for OPEB, and which required companies which had, prior to the creation of that rule, accounted for OPEB on a cash basis and collected in rates only that cash amount, to amortize the accumulated future benefit amount existing at the date of the transition, over the period equal to the average term life of the OPEB plan members. However, the US equivalent of section 3461, was implemented earlier than in Canada, in 1986, and the allowed amortization period for the transition cost liability (our emphasis) as it would apply to Enbridge's circumstances, had expired in 2001. Since a transition to US GAAP must, under US GAAP rules, be done "retrospectively", as if the transitioning company had always been under US GAAP, Enbridge cannot continue to have an offsetting asset account for its future OPEB liability and would have to charge the outstanding liability to retained earnings. Enbridge seeks to avoid this result by the creation of a deferral account, in effect a regulatory asset account into which, as noted above, it would place as a credit, the entire unamortized OPEB liability as at December 31, 2010 of $84 million. It will then seek to recover all of that amount, in addition to the $6 million noted on page 1, from ratepayers over some as yet undefined period of years, beginning in 2013. The evidence in this case does not show how US regulators deal with the recovery of any amounts in excess of the current year cash payment from ratepayers.

To summarize and restate the recoverability issue, and highlight the issues that need to be addressed in the rebasing case, under the previous (pre-2000-2008) accounting regime in Canada, Enbridge showed, as an expense in its financial statements, the amount that it paid out in cash in that year to retirees for their medical and dental benefits, and recovered the same amount from the ratepayers in its annual cost of service rate case. Prior to 2000, the long term liability associated with future benefits earned by existing employees was not recorded on the companies' financial statements. When the Accounting Standards Board issued section 3461 in 2000, reporting companies had to show as an OPEB expense on their income statements, in addition to the amount of cash OPEBs paid out that year, an amount that equaled the value of future benefits earned by employees, and an amount sufficient to amortize the benefits for the accumulated, unrecognized liability to past employees as of January 1, 2000, over a period commensurate with the average remaining life of the employees entitled to the benefits, in the case of Enbridge, fifteen years. For Enbridge, the effective date of the change in accounting was January 1, 2009, as regulated utilities were given an eight year grace period to continue using the old cash method. For each year since at least January 1, 2000, actuarial reports were done annually to determine the present cost of future benefits which the employees earned each year, and the present value of the outstanding cumulative OPEB liability for past service of current employees, including the remaining amount of the transitional liability. These liabilities were reported in a footnote to Enbridge's financial statement beginning in 2001.

For Enbridge, the total of these two liabilities was $84 million as at December 31, 2010. By far, the dominant driver of the amount of that liability determined each year by the actuarial calculation is the discount rate used to calculate the present value of the benefits that will eventually have to be paid for past service of the employees eligible for benefits. Given the financial crisis of 2008 and its aftermath, the discount used to calculate the present value of the benefits was very low in 2008, 2009, 2010, and 2011, resulting in a higher than "normal" liability. However, the discount rate may well change in future years, and if, for example, it were to increase to levels seen in the earlier part of the first decade of 2000, the $84 million would decline very substantially. Therefore, the amount of the liability on Enbridge's balance sheet would fluctuate as the discount rate fluctuates, according to changing level of Canadian bond rates. Given historically low current bond interest rates, the discount rate will likely increase, and, therefore, the present value of the future liability will likely decrease.

To accommodate the new CICA requirement, Enbridge established a liability on Enbridge's balance sheet, on January 1, 2009. Establishment of that liability did not have any cash consequences for Enbridge, nor was it reflected in the OPEB expense shown on the income statement, which was still reported on cash basis. Left on the balance sheet, without an offsetting asset, it would have triggered a one-time charge against Enbridge's retained earnings of an equal amount. To avoid this result, Enbridge created an offset account (which it called a regulatory offset account, on the asset side of the balance sheet). Enbridge testified that it interpreted Canadian GAAP (chapter 1100) to allow it to do so, on the grounds that it would reasonably expect to recover that amount from the company's ratepayers over time. Enbridge did not apply for or receive OEB approval to create the account as a regulatory asset. It simply assumed that the account would eventually acquire that status. It continues to make that assumption when it applies to have a deferral account created for the transition to US GAAP.

Enbridge states that, as a result of creating that asset account, it was able to continue to report its OPEB expense on a cash basis, just as it had done before January 1, 2009, in other words, to avoid the implementation of 3461, and to be entitled to collect that amount in rates assuming it had been operating at the relevant time under cost of service rates.

In effect, absent the proposed move to US GAAP, the liability for past service, including the transitional liability, would remain on the balance sheet, balanced by the offset account, indefinitely, and the utility would pay and collect in rates, only the current year cash requirement indefinitely. The asset would presumably have to be adjusted to the changing amount of "liability" annually, and be subject to fluctuation because of changing interest rates, reduced annually by the amount of benefits paid out, but increased by the OPEB earned during the year, by its employees.

When Enbridge decided to move to US GAAP, it was faced with a requirement that it discontinue the use of the "offset" account and the need to charge the outstanding balance of the liability to retained earnings. This requirement did not emanate from US accounting rules for OPEB, as such they are virtually identical to the rules under Canadian GAAP. Like Canadian GAAP, the US rules allows amortization of the transition cost (the unrecorded liability for future benefits for past service fixed as of the date of the change to accrued accounting for OPEBs) to be amortized over the average life of the benefit recipients. They also require, as does Canadian GAAP, that, absent some special arrangements for regulated utilities, Enbridge show as an expense its annual cash payments to retirees plus the present value of the future benefits they earned in that year, plus a share unamortized of the transition cost. The need to report OPEBs for financial statement purposes on an accrual basis is common to both systems. However, the change from "cash to accrual" was made in the US (in US GAAP) much earlier than in Canada, in approximately 1986, as opposed to in 2009, with the result that the fifteen year amortization period expired in 2001. Because the conversion to US GAAP must be done on a retrospective basis, Enbridge is unable to maintain the liability and "regulatory offset" accounts under US GAAP. But even had the utility not transitioned to US GAAP, without OEB approval of a deferral account, it would have been required to account for OPEB on an accrual basis.

Consequently, it must both make a one-time change in retained earnings, and it must increase its annual OPEB expense to reflect the benefits accrued during the year, but it would have had to do the latter had it stayed in Canadian GAAP, unless they could be left in the old liability/asset accounts indefinitely.

However, neither the increase in pension expenses, nor the reduction in the retained earnings account, require the company to use any more cash. There is no funding requirement for either of these proposed changes.

The reduction in retained earnings would lower the book value of the company, but not, in all likelihood, its market value or enterprise value, given the size of Enbridge Inc. and Enbridge Distribution, it would likely not be material. Nor would the $3 million credits be based on a cash payment. There is, therefore, no reason at this time to expect Enbridge to seek to collect additional revenue in rates, or to establish a deferral account in anticipation of doing that. The results of authorizing the recovery of these accounts would create a growing interest-free loan from the ratepayers to the company. Moreover, there is no evidence on the record in this case whether US GAAP requires companies to record accrued OPEB liabilities as part of the OPEB expense, and if so, to collect that total amount from ratepayers.

In addition, crediting the deferral account with $6 million in 2011 and 2012 raises the additional issue of the propriety of establishing a new deferral account in the middle of an IRM program. The appropriate course of action for Enbridge, if it were to seek to recover the $3 million of additional "costs" in 2011 and 2012 (those amounts being the present value of the benefits earned by current employees in those years would have been to apply for a Z factor in each of the years in question, as these amounts were not included in the OPEB base rates set out in 2007.

With respect to the impact on the renewed requirement due to changes in accounting standards or the time of implementation to US GAAP compared to Canadian GAAP, the Board noted, at page

20 of its Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment; EB-2008-0408 that:

> "In addition, the Board emphasizes to utilities that it retains the authority to require specific accounting standards and practices for regulatory purposes in any case where the Board finds that the public interest requires uniformity in those standards and practices among utilities".

The Board may eventually decide, for example, that given the magnitude of the accounting changes necessary in dealing with pensions and OPEBs, and for the purpose of consistency of treatment among utilities, some of whom will be on US GAAP and some on IFRS, it may be appropriate to retain the current accounting treatment of OPEB for regulatory purposes, and leave the utilities to explain the difference in notes to their financial statements.

All of which is respectfully submitted, this 14th day of February, 2012.

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