EB-2011-0277

ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates and other charges for the sale, distribution, storage and transmission of gas commencing January 1, 2012

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

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1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 On September 30, 2011 Enbridge Gas Distribution Inc. filed an Application for new distribution rates, effective January 1, 2012. The process included extensive interrogatories, a technical conference, an ADR that settled most of the issues, and an oral hearing over two days.

1.1.2 The Application seeks a 2.67% rate increase[1] for 2012. Of that increase, 0.62% arises out of the normal function of the incentive regulation mechanism, including all impacts except Z factors[2], and the remaining 2.05% increase arises out of the proposed Z factors for pension costs and cross-bores, discussed later. In addition, the Applicant proposes a deferral account for Other Post-Employment Benefits ("OPEBs") which, while not impacting 2012 rates directly, would result in amounts totaling about $90 million being collected from ratepayers in the future[3].

1.1.3 This is the Final Argument of the School Energy Coalition.

1.1.4 The ratepayer groups who intervened in this proceeding have worked together throughout the hearing to avoid duplication, including exchanging drafts, partial drafts, or summaries of their final arguments. We have been assisted in preparing this Final Argument by that co-operation amongst parties.

1.1.5 Seven issues remain unsettled after the Settlement Agreement, and they can be grouped under five headings. This Final Argument is organized under those five headings, but SEC has submissions with respect to only three of them.

1.2 *Summary of Submissions*

1.2.1 This Final Argument contains an analysis of some of the issues arising in this proceeding. The following are the main recommendations resulting from that analysis.

1.2.2 ***Pension Z Factor.*** SEC submits that the increase in pension costs does not qualify for Z factor treatment, because:

(a) Its cause, declining interest rates, is one of the normal business "risks" of the utility, a variable that affects many other operating costs both positively and negatively; in fact, the other main impact is a cost saving well in excess of the

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[1] Tr.1:98
[2] Tr.1:98
[3] Tr.2:79

pension cost; and

(b) The cost is something that is entirely within management's control, and something that a prudent utility would seek to mitigate.

1.2.3 ***OPEBs/USGAAP Deferral Account.*** SEC submits that the only item so far identified by the Applicant for inclusion in this account is OPEBs, and all but $3 million of the OPEB adjustment is a prior period cost that is not recoverable due to the rule against retroactive ratemaking. The $3 million applicable for 2012 should be recognized as a Z factor.

1.2.4 ***Cross-Bores.*** The operation of a gas distribution utility involves the identification, minimization, and mitigation of numerous safety and operational risks that arise in the ordinary course of business. Z factors are not intended to address that category of risks. Cross-bores come within that category.

2 GAS COST AND CARRYING COST – ISSUE 9

No submissions

3 PENSION FUNDING – ISSUES 10 & 13

3.1 *The Issues*

3.1.1 At the time the current IRM period commenced, the Applicant was on a contribution holiday and so did not include any pension costs in its base year revenue requirement. As a result of

(a) declining bond yields, which increase the future assumed cost of wind-up obligations under the pension plan[4],

(b) plan investment performance, which did not achieve the same levels as other similar plans[5], and

(c) as new rule requiring an annual cost certificate for employers under a contribution holiday[6];

Enbridge will be required in 2012 to make a contribution to the plan, currently estimated to be $16.6 million[7]. This amount exceeds the materiality threshold of $1.5 million.

3.1.2 Issue #10 is the Applicant's request to increase rates through a Z factor for 2012 to cover this $16.6 million. Issue #13 is a request for a variance account to capture the difference between the Z factor of $16.6 million, and the actual amount the Enbridge is required to contribute to the plan in 2012.

3.1.3 SEC submits that the expenditure in question does not qualify for Z factor treatment, because:

(a) It is an expenditure in the normal course of business of the Applicant, and comes within the Applicant's normal business risks, and

(b) This cost was and remains entirely within management's control.

3.2 *Normal Course of Business*

3.2.1 ***Factual Background.*** The Enbridge Gas Distribution Pension Plan is not actually insolvent in the normal sense. Pension plans are valued three different ways, based on

[4] Tr.1:93, 104, 114. Enbridge admits in numerous places that this is the "primary" or "essential" cause of the requirement to contribute.
[5] Tr.1:93
[6] Tr.1:92
[7] Tr.1:94

the assumptions used:

(a) *Going Concern*. This method assumes that the employer, and therefore the plan, will continue into the future. The key aspect of this valuation is that the plan is assumed to continue to earn market returns, and to meet its pension and other obligations only as they arise in the future. Enbridge is not offside on a going concern basis[8].

(b) *Hypothetical Wind-up*. At the other extreme, this assumes the plan ends immediately, and annuities have to be purchased at today's discount rates to fund all obligations of the plan[9]. Like almost every other Canadian pension plan, the EGD plan is far from being sufficiently funded in this scenario. However, with respect to the funding obligation, there are no consequences to being offside on this basis.

(c) *Solvency*. Between the first two, this method of valuation assumes that the plan ends immediately, but that annuities only have to be purchased at today's discount rates to fund certain of the obligations of the plan (essentially, the basic pension obligations)[10]. For example, under the solvency test the indexing of pension benefits does not have to be funded, and this is the biggest difference in the Applicant's case, since it has an indexed pension plan[11]. The Applicant is expected to be off-side (i.e. underfunded) using this valuation methodology.

3.2.2 Under the pension funding rules in place at the time of the last rebasing, the Applicant was required to do a valuation of its plan every three years on the Going Concern and Solvency bases. If it showed a surplus on both bases, it would continue its contribution holiday. If either valuation showed a deficit, it would have to commence funding the plan on an annual basis until it was able to produce a valuation that had the dual surplus[12].

3.2.3 Under new rules introduced in 2009, a company like the Applicant that is on a contribution holiday is required to file an annual valuation certificate, showing that it continues to have the dual surplus**.** If the annual certificate shows that it has a deficit on either basis, Going Concern or Solvency, then it must recommence annual contributions[13].

3.2.4 ***Declining Interest Rates.*** The primary problem in Enbridge's case is that discount

[8] Ex. B/2/5/App.A
[9] Tr.1:101
[10] Tr.1:101, 105, 114
[11] Tr.1:106
[12] Tr.1:92
[13] Tr.1:111

rates have been dropping, so the assumed cost of meeting all obligations on a solvency basis has increased[14]. As long as the employer and the plan continue, this is not a real-world problem, since the plan does not in fact ever have to buy annuities for all of its obligations at current market discount rates. However, the pension funding obligation is more cautious, requiring funding in these circumstances through renewed payment of annual contributions.

3.2.5 The market interest rate, which in this context drives the relevant discount rates, has been dropping over the last couple of years. Interest rates affect many aspects of the Applicant's business.

3.2.6 For example, as seen clearly in cross-examination by CME, and the subsequent undertaking response[15], the Applicant has benefited under IRM by a total of $65.5 million due to declining interest rates. In 2012 alone, interest expense is forecast to be $21.7 million lower than Board-approved from the rebasing year, so the interest expense saving already exceeds the proposed $16.6 million increased cost associated with pension contributions.

3.2.7 That is one of but many examples. Costs of operating and capital goods and services go down when suppliers are bearing lower interest rates to fund their operations. Interest earned on deposits goes down. All aspects of the economy are affected by declining interest rates, and therefore all aspects of the Applicant's costs are affected as well.

3.2.8 What the Applicant proposes is that it is entitled to cherry-pick one impact of declining interest rates – the requirement to make pension contributions – and treat that as a Z factor, ignoring all others. It is submitted that this is not the intent of Z factor treatment, and would produce an unfair result.

3.2.9 Indeed, the Applicant in its Final Argument sets out its explanation of the Z factor criteria[16] in support of its right to claim Z factor treatment for the pension cost. It is instructive to note that, as they interpret the Z factor criteria, the decline in interest costs on debt should also qualify for Z factor treatment, since it meets each of those criteria in precisely the same way as the pension cost increase.

3.2.10 ***What Is the Z Factor Event?*** What, then, is the difference between the $16.6 million increase in costs for pensions, and the $21.7 million decrease in costs for interest on debt, both in 2012? Enbridge says that the answer lies in the "Z factor event", an external event that "causes" the increase or decrease in costs to occur.

3.2.11 Enbridge takes the position that the Z factor event that gives rise to the requirement to

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[14] Tr.1:111
[15] Ex. J1.9.
[16] AIC para. 24

fund pensions is the addition of the annual valuation certificate requirement in 2010. Without that, no obligation to fund arises, and therefore there is no cost increase[17].

3.2.12 There is no doubt that the change in the rules is a *causa sine qua non*, but it is submitted that this is not determinative of whether the change in the rules was a Z factor event. There can be many such causes (the "but for" category of cause) for a given result. The following are examples of causes that also meet the *causa sine qua non* test:

(a) Enbridge continues to include pensions in compensation packages for employees;

(b) Enbridge decides not to change its plan from a non-contributory to a contributory plan;

(c) Enbridge failed to achieve sufficient returns on plan assets to cover increasing obligations;

(d) Interest rates declined in 2010 and 2011.

3.2.13 There are undoubtedly many other facts, without which there would be no obligation to pay anything this year.

3.2.14 In our submission, the correct causation test for a Z factor event is *causa causans*, a legal term which means, essentially, the primary reason something happened. It is distinguished from *causa sine qua non*, for example, because the latter is a negative cause (something without which the result would not have happened), while the former is a positive (something that created the result). It is also sometimes called the "proximate cause" or the "primary cause". There can generally only be one *causa causans* for a given result.

3.2.15 What is the Z factor event under a *causa causans* test? It appears to us to be unchallenged that the real reason the solvency test was not passed, and therefore the reason funding is required, is that interest rates declined[18]. <u>The change in the rules was about when the effect was measured, but the actual effect itself is driven by interest rates</u>.

3.2.16 The primacy of the declining interest rates cause is essentially admitted by the Applicant's external pension specialist in the following exchange:

> *"MR SHEPHERD: So that increase from 828.5 million to 931.6 million [in the liabilities], 105.1 million, that is entirely driven – tell me whether this is right –*

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[17] AIC para. 26.
[18] Tr.1:114

> *that is entirely driven or almost entirely driven by the change in bond rates?*
> *MR. MONTEIRO: It's primarily driven. It's a year later, so there is also the cost of benefits that accrued during the year. But yes, the key reasons those numbers are as different as they are is because interest rates went way down."*[19]

3.2.17 ***Nature of the Risk.*** An easy way to test this is to look at what would have happened under the old rules. Enbridge focuses on the fact that the old rules did not require the annual valuation certificate, so there would be no 2012 contribution. Contributions would not start until the next formal valuation, which would be 2012.

3.2.18 That approach, it is submitted, fails to consider that in 2009 a valuation was required under the old rules. Enbridge was in IRM, as now, and therefore had the risk that the valuation for 2009 would fail the solvency test due to declining interest rates. As it happened, it did not, but the risk was there.

3.2.19 In those circumstances, would the argument that the valuation created a Z factor event be applicable? The Applicant's answer, clearly, would be no. The Applicant would have to accept, in that case, that declining interest rates was a risk that existed at the time of rebasing. The fact that it caused an increased cost in 2009 would be considered part of their ordinary course of business and not eligible for additional rate recovery.

3.2.20 The question, then, is whether either the cost or the risk are different in 2012. In our submission, the answer is no. There has always been a risk that declining interest rates would cause the plan to fail the solvency test (as well as creating other impacts on the utility's costs), and the cost of that result is that annual contributions must recommence. The fact that this risk is now tested annually rather than every three years does not change either the risk or the cost.

3.2.21 Therefore, in our submission the change in the rules cannot be considered the "cause" of the $16.6 million cost for the purposes of considering Z factor treatment. The cause was the decline in interest rates.

3.2.22 ***Fairness.*** This can be tested another, simpler, way. There are two large known cost impacts in 2012 of declining interest rates: a $16.6 million increase, and a $21.7 million decrease. Should the Board's incentive ratemaking mechanism be interpreted so that the additional cost is borne by the ratepayers, while the additional benefit is allocated to the shareholder?

3.2.23 In our submission, common sense says this cannot be the Board's intent, and the causation analysis above is consistent with this common sense result.

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[19] Tr.1:114-5

3.3 *Plan Performance*

3.3.1 Another requirement for Z factor treatment is that the cost must be outside of management's control.

3.3.2 In this case, the Enbridge Gas Distribution Pension Plan is managed by the parent company, Enbridge Inc.[20]. It would appear to us that, unless the actions of the parent company are considered "outside of management's control", plan performance must be a key issue, since performance is entirely within management's control.

3.3.3 We note, as well, the related requirement that the Z factor cost not be one "in respect of which a prudent utility would take mitigation steps". Pension funding levels are, of course, exactly the sort of risk that is supposed to be mitigated by a prudent utility, whether through investment strategy, management of increasing obligations, or otherwise. In the same way as a utility is expected, during IRM, to maintain control of their union contracts, their staffing levels, their material costs, and other day-to-day business risks, the utility is also expected to maintain its pension plan in a properly funded position, and not let it get off-side.

3.3.4 The Enbridge Gas Distribution Pension Plan has underperformed the market of pension plans by large Canadian companies, falling well below the 50th percentile[21]. If the plan had just performed at the 50th percentile, it would have been worth "approximately $788.0 million" at the end of 2010[22], and met both solvency tests easily. While Enbridge goes on to point out that they believe the value of the assets would have declined, and the value of the liabilities would have increased, to December 31, 2011, the Board has no evidence before it as to that estimate. Further, when asked to provide the valuation certificate as of the end of 2011, the Applicant declined[23].

3.3.5 By itself, this poor plan performance might not be determinative, but for the fact that the investment criteria for the Enbridge Gas Distribution Plan are deliberately set to be more conservative (and therefore generate a lower return), than the investment criteria set for the Enbridge Inc. Plan[24].

3.3.6 Further, the Board has no evidence before it that the Applicant or its parent company even attempted to take mitigating actions to avoid failing the solvency test in 2011.

3.3.7 In our submission, the Applicant at all times had a positive obligation to mitigate this risk, and has failed to do so. Absent extenuating circumstances, of which none have

[20] Tr.1:118-9; Ex. J 1.5.
[21] Ex. I/1/4.
[22] Ex. J 1.4
[23] Tr.1:129
[24] Tr.1:120

been offered, it would appear to us that this additional 2012 cost was within management's control, and management was unsuccessful in controlling it.

3.4 *Conclusion*

3.4.1 It is therefore submitted that the additional pension cost in 2012 does not qualify for Z factor treatment, because:

(a) The cause of the cost, declining interest rates, is one of the normal business risks of the utility, and in fact the utility will benefit in the same period from countervailing impacts that exceed the additional cost. The change in the rules from three year measurement to one year measurement is not the "cause" of the cost. To so find would not only be wrong in law, but would be an inappropriate regulatory policy.

(b) The cost was at all times within management's control, and is a risk that a prudent utility would seek to mitigate. The Applicant failed to properly mitigate this risk, and on the evidence in fact performed below its peers in its mitigation actions.

4 USGAAP ACCOUNTING CHANGES ACCOUNT – ISSUE 15

4.1 *The Issue*

4.1.1 The Applicant seeks a deferral account to reflect accounting changes arising because of its planned move to USGAAP effective January 1, 2012[25]. The only impact it has so far identified is a change in accounting for OPEBs, which in the case of Enbridge involves $90 million of additional future costs that it seeks to recover from ratepayers[26].

4.1.2 There are a number of reasons why this account is not appropriate, including the fact that it is premature since a) it is not necessary right now, and b)the Board has not yet approved Enbridge's request to go to USGAAP for regulatory purposes. Other parties will, we expect, raise those issues.

4.1.3 SEC believes that there is another reason why, in the particular case of this Applicant, the proposed account should not be approved: the only entries proposed for the account at the present time are past period expenses that cannot be collected from ratepayers because the result would be retroactive ratemaking.

4.2 *Deferral Account Qualification - OPEBs*

4.2.1 SEC starts with the proposition that an account should not be set up if the amounts proposed to be charged to it are by definition not recoverable from ratepayers[27]. In this case, it is submitted that the OPEBs that Enbridge seeks to charge to this account are not recoverable.

4.2.2 ***Factual Background.*** OPEBs are benefits other than pensions that are provided to retirees[28], for example, health coverage, life insurance, etc.

4.2.3 Unlike pensions, OPEBs are not funded through a separate plan or fund that holds the money necessary to pay the future cost of those benefits[29]. Instead, under the old rules prior to 2000, companies like Enbridge were allowed to charge as a current expense the cost of providing those benefits to those who were already retired at that time, i.e. the "cash basis" of accounting for OPEBs.. The fact that Enbridge was incurring a future liability for those still employed, who would retire in the future, was not recognized on the balance sheet or income statement[30].

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[25] Ex. C/1/5
[26] Tr.2:5, 55
[27] See, e.g. Tr.2:10-11
[28] Tr.2:6
[29] Tr.2:64
[30] This explanation, in several paragraphs, all comes from Tr.2:5-10, the direct examination of Panel 3.

4.2.4 Starting in 2000, companies under CGAAP were required to move from the cash basis to the accrual basis. Under the accrual basis, the company records as a liability an amount equal to the present value of all future OPEB costs that will be paid on behalf of employees. The increase in the obligation in the year is the current expense. The intent is to capture in the income statement the future cost of the work being done by employees in the current year, i.e. the matching principle.

4.2.5 When CGAAP changed in 2000, companies like Enbridge were given an exemption until 2008, and only had to report the accrual basis expense in the notes to their statements[31]. The expense on the income statement was still on the cash basis, and that is the amount that has at all times been included in rates. The rates under IRM, established in the rebasing year of 2007, include OPEBs on the cash basis.

4.2.6 When the exemption expired, Enbridge was then required to use the accrual basis for OPEBs. However, since rates had been set on the cash basis from 2000 through 2008, Enbridge treated the accumulated difference between the cash basis and the accrual basis as a regulatory asset that it would recover from ratepayers in the future. That is, it set up an asset on its balance sheet, reflecting money owing in the future from ratepayers.

4.2.7 At no time has the Board ever approved this regulatory asset[32]. It was an accounting decision of the Applicant, and the evidence does not show that it was ever brought to the attention of the Board.

4.2.8 As a result of the transition to USGAAP, Enbridge is required to restate its OPEB liability as of December 31, 2010, and include in that liability the entire discounted obligation for future payments[33]. It is also not allowed to treat the potential future recovery from ratepayers – i.e. the regulatory asset - as an asset on the balance sheet.

4.2.9 The effect of these changes is that – unless the requested deferral account is approved - net shareholder's equity will decrease by $84 million as of December 31, 2010, and by a further $3 million in each of 2011 and 2012, representing the difference between OPEBs on the cash basis and OPEBs on the accrual basis in each of those years[34].

4.2.10 The Applicant seeks a deferral account that will capture this total of $90 million, so that in the future it can recover this amount from ratepayers.

4.2.11 ***Retroactive Ratemaking Rule.*** It is trite law that the Board cannot order recovery in a current period of costs incurred in a prior period. The Board sets rates for a future

[31] Tr.2:15
[32] Tr.2:8
[33] Tr.2:9
[34] Tr.2:9-10

period, and thereafter the utility is at risk for actual costs being different from the costs on which rates are set.

4.2.12 There are exceptions to the rule prohibiting retroactive ratemaking. For example, the concept of the "extraordinary event" provides that certain costs are not contemplated in setting rates, and when they arise they are separately recoverable. In fact, there is a generic deferral account set up for that purpose, and as long as a utility advises the Board promptly that it has incurred costs in that category, and they meet the various tests, they are recoverable. Major storm damage is a good example of this kind of incremental cost.

4.2.13 Aside from these limited exceptions, none of which are applicable here, the Board expects utilities to manage within the revenues from approved rates. In cases where there is a particular future cost that is highly uncertain, the Board will establish a deferral or variance account in advance to allow the actual amount to be recovered when it is known. The Board does not do that routinely, and costs protected in this way are not the norm.

4.2.14 It is never acceptable for a utility to come to the Board and say "It cost us more to operate the utility last year than we expected, so we would like to recover that difference". That would be retroactive ratemaking, and is prohibited.

4.2.15 ***Nature of the OPEB Costs.*** All of the OPEB costs sought to be included in this account relate to past periods, and the Applicant admits this:

> *"MR. YUZWA:…So post-employment benefits are the services earned in the period that the employees work. So under USGAAP or IFRS, what we're doing is going back over that period of time as if we had been on that accounting historically, and saying, How would we have had to have recognized the costs that the employees have earned as a result of their service? And then recognize that as our opening balance going forward. Therefore, had we been on that method of accounting at that point in time, it would have been taken into account as part and parcel of the normal operations of the business, and we would have sought recovery in those past periods for those expenses." [emphasis added]*[35]

4.2.16 The question, therefore, is whether past expenses of this type are an exception to the normal rule against retroactive ratemaking.

4.2.17 On the one hand, the amounts recovered from ratepayers over past years have been less than the accounting cost. If the Applicant is not allowed to recover this $90 million from ratepayers through a deferral account mechanism, then it will take a hit to its earnings through an adjustment to its shareholder's equity as of December 31,

[35] Tr.2:27. See alsoTr.2:23, 35, and especially the direct admission in Tr.2:66.

2010. It will, in effect, be paying some of the cost of service for prior years.

4.2.18 On the other hand, in all of those prior years there were variations between the costs on which rates were set, and the costs actually incurred. In virtually every year for the last twenty years, Enbridge has earned more than its Board-approved rate of return, and with few exceptions (earnings-sharing under IRM being the only material one), the ratepayers can never ask for those over-earnings back. In the Ontario system of ratemaking, the utility is at risk for cost increases in the year, but also gets the benefit if they are lower than expected. There is nothing about these costs that is different.

4.2.19 Enbridge also may argue that the Board's approved PP&E adjustment for IFRS transition purposes is a precedent for the account they are seeking here. On this argument, the change in the net obligation going forward is a current adjustment, not a prior period amount, just like the change in rate base under the PP&E account.

4.2.20 The analogy to the PP&E account does not hold up. The PP&E account is designed, not to adjust for past spending, but rather to reconcile the financial value of an asset today with its value on a regulatory basis. Where an asset – a building, for example – has a book value of $1 million under IFRS, but a book value of $800,000 for regulatory purposes, the two figures have to be reconciled to avoid the requirement for two sets of books. The Board's solution is to increase the book value for regulatory purposes by $200,000 (it will then be collected in the future through depreciation embedded in rates), and give that same $200,000 back to the ratepayers. All of this is current actions based on reconciling the current balance sheet and asset values.

4.2.21 While there are undoubtedly a financial asset and liability for OPEBs, there is no regulatory asset or liability. The regulatory system only recognizes OPEBs as they arise as an operating expense each year. Therefore, there is no reconciliation to be done. Any adjustment to the financial balance sheet would have to be reflected in changes to past operating expenses for regulatory purposes. That is where the rule against retroactive ratemaking comes into play.

4.2.22 This difference is alluded to by the Applicant in re-direct examination on this point:

> *"MR. YUZWA: So it's a true liability, and it's a business expense the company has incurred in the past. Under accrual accounting, we have to recognize that amount as an expense in our financial statements."*[36]

4.2.23 ***Retroactive Deferral Accounts.*** There is a simpler way of looking at this, however. In 2008, while under IRM, Enbridge was required to record its future OPEB obligation on an accrual basis, and change to an accrual basis going forward. At that time, it chose to establish a regulatory asset for the amount of that new obligation. It did not

[36] Tr.2:85.

seek Board approval of what it was treating as essentially a deferral account.

4.2.24 Now, three years later, Enbridge is seeking to have the Board recognize that 2008 regulatory asset <u>as if it had been approved by the Board at that time.</u> Indeed, they admit almost exactly that:

> *"MR. SHEPHERD: What you are proposing is, instead, to take the regulatory asset component that you already have on your books, but is not yet approved by the Board, that relates to the things prior to 2010, and you want to change that regulatory asset to an authorized regulatory asset through a deferral account; is that correct?*
> *MR. YUZWA: It is a regulatory asset that is set up under Canadian GAAP, and what we're asking is for that regulatory asset to be set up in rates, yes.*
> *MR. SHEPHERD: As a deferral account?*
> *MR. YUZWA: As a deferral account."*[37]

4.2.25 In our submission, the Board cannot and should not approve a deferral account retroactively. That would be a significant departure from normal regulatory practice, and would undermine the value of deferral accounts, and the entire forward test year concept. The Board establishes deferral accounts for future uncertain costs. What the Applicant is proposing in this case is that the Board approve a deferral account that the Applicant has long since established, unilaterally, and that the Board then allow past known costs to be recorded in it.[38]

4.2.26 ***Current Service Cost Differential.*** There is a differential of $3 million in 2012 between the cash basis and the accrual basis for OPEBs. That amount appears to us to be caused by an external event – the need to convert to either USGAAP or IFRS – and to be a future cost that exceeds the Z factor materiality threshold.

4.2.27 It is therefore submitted that the 2012 cost differential qualifies for Z factor treatment in 2012, and should be added to 2012 rates on that basis. No deferral account is required, as it would be recognized immediately.

4.3 ***<u>Other Reasons for the Deferral Account</u>***

4.3.1 The Applicant is actually seeking a deferral account for all impacts of the conversion to USGAAP, but has made clear that the only material impact that it has identified is OPEBs[39]. Given their past long history reconciling to USGAAP over the years[40], it would seem unlikely that any surprises will arise. They already know USGAAP well.

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[37] Tr.2:71
[38] We note the Applicant's additional suggestion that in effect this is a retroactive request for a Z factor (Tr. 2:43), but it does not appear to us that the Applicant is pursuing this line of reasoning in argument.
[39] Tr.2:5
[40] Ex. I/1/13/Attach. A, p. 4; Tr.2:56

4.3.2 In our submission, it is neither the Board's normal practice, nor a good regulatory precedent, to create a deferral account for costs that have not been identified, are on the evidence not likely to exist, and if they do, highly unlikely to be material. The Board has deliberately moved away from setting up deferral accounts every time "something might happen" in the future. Instead, the Board in the last several years has sought to limit the use of deferral accounts to those situations in which they are demonstrably necessary for an identified cost or risk.

4.3.3 Therefore, it is submitted that, but for the OPEBs issue, there is no reason to establish this account today. On their own evidence, the account will probably not be necessary for anything else. If their continuing review of USGAAP results in a new, material cost change being identified, then it is submitted that Enbridge can apply at that time to establish the account, either in a standalone application, or more efficiently within EB-2011-0354, their 2013 rate application, in which the question of whether they will be allowed to go to USGAAP is being considered in any case.

4.4 ***Conclusions***

4.4.1 SEC submits that the only accounting change from USGAAP relates solely to prior period operating expenses. As a result, the amounts up to the end of 2011 cannot be recovered from ratepayers and no deferral account is required. No other reason for the deferral account has been provided. In those circumstances, it is submitted that the request to establish it should be denied. The 2012 differential between OPEBs on a cash basis and accrual basis should be given Z factor treatment.

5 CROSS-BORES – ISSUES 11 & 14

5.1 *The Issues*

5.1.1 Between 2004 and 2007[41] the Applicant identified an issue with gas lines intersecting sewer laterals (cross-bores) due to the use of trenchless technology. The TSSA, at Enbridge's urging, has instituted in 2011 a requirement that Enbridge (and Union as well) engage in activities designed to minimize or mitigate this risk[42]. The Applicant therefore seeks to recover $3.8 million[43] as a Z factor in 2012 rates, and asks for a variance account to record the difference between that amount and the actual amount spent on the cross-bore project in 2012.

5.1.2 SEC submits that cross-bore costs do not qualify as a Z factor, and therefore neither the rate adjustment nor the variance account is appropriate.

5.1.3 SEC has had an opportunity to review the draft final argument of CME on this issue, and is in substantial agreement. We add the following brief comments.

5.2 *Z Factor Qualification*

5.2.1 From a technical point of view, the question of whether these costs qualify could be seen as another causation issue, i.e. were these costs in 2012 the result of the TSSA ruling in 2011, or from some other cause.

5.2.2 The Applicant answered this question directly and clearly[44]. These costs are being incurred because they are managing their risks prudently, and they would do the same things without the TSSA ruling. They make clear in their evidence that none of the costs being claimed are incremental costs resulting from the TSSA ruling[45].

5.2.3 Enbridge is a very well-run utility, and like all utilities at that level it takes management of its operating risks seriously. That is why it has a Director of Integrity (Ms. Lawlor) at all, and it is clear from her forthright evidence that risk identification and mitigation is important to the company.

5.2.4 In this case, it appears to us that when their U.S. subsidiary St. Lawrence Gas had an accident as a result of a cross-bore, Enbridge investigated and determined that cross-bores are not likely to be a problem in Canada due to the greater depth of sewers in this country.

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[41] Tr.2:90
[42] Tr.2:91, 99
[43] Ex. B/1/2, p. 1
[44] Tr. 2:128
[45] Tr. 2:129

5.2.5 Clearly Enbridge was taken by surprise when it had the incident in Innisfil in 2007[46]. To their credit, Enbridge immediately took action to understand and mitigate the risk. In 2008 a program was developed, which was implemented in 2009. In addition, Enbridge took the initiative to contact the TSSA and Union, and work out standards for how this risk should be handled going forward.

5.2.6 All of these actions are exactly what a well-run gas distributor should do. However, none of them happened because of a Z factor event. All of them happened in the normal course of their business.

5.2.7 SEC submits that identifying, minimizing, and mitigating operational risks is at the core of the normal business activities of a gas distributor. These are the components of the goals of safety and reliability, which every gas distributor would say is their primary operating focus.

5.2.8 It is not enough to manage known risks. Every gas distributor has a day to day responsibility to identify new risks, and bring those under control as well. When a particular type of pipe has multiple failures, it is part of the normal operating regime at Enbridge – or any other distributor – to identify that problem and figure out how to deal with it. When the GIS system sends error messages in some cases, the distributor identifies the new risk, and fixes it. When a new method of connecting gas services to users' premises results in failures, that is identified and solved.

5.2.9 Similarly here, where expanded use of trenchless technology has resulted in an unintended result – gas lines intersecting sewer laterals, creating a future hazard – it is part of the utility's normal course of business to identify that problem, and fix it.

5.2.10 Z factors are not intended to cover the things that a gas distributor does on a day to day basis. Z factors are by definition intended to cover costs over and above those associated with the proper operation of a gas distribution company.

5.2.11 In this case, it is submitted that cross-bores, while a newly identified risk, are an normal operational risk that a gas distributor should be expected to manage during IRM. The fact that Enbridge has been managing this risk since 2009, and still over-earning each year, shows that IRM is working exactly as it should.

5.3 ***<u>Conclusion</u>***

5.3.1 SEC therefore submits that the cross-bore amount should not be included as a Z factor in 2012, and no variance account is required[47].

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[46] Tr.2:90
[47] Tr.2:94

6 COST ALLOCATION OF Z FACTORS – ISSUE 17

No submissions.

7 OTHER MATTERS

7.1 *Costs*

7.1.1 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

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