

2

Ontario Energy Board Commission de l'énergie
de l'Ontario



EB-2006-0034

IN THE MATTER OF AN APPLICATION BY:

ENBRIDGE GAS DISTRIBUTION INC.

2007 RATES

DECISION WITH REASONS – PHASE 1

July 5, 2007

Enbridge's claims regarding the challenges in interest coverage and access to debt capital, IGUA argued that this is only temporary and will disappear as the Company's long term debt issues mature. IGUA termed Enbridge's proposal as a "base year stuffing" measure before the long-term incentive regulation is implemented. IGUA argued that Enbridge's actual normalized EBIT interest coverage ratio for the "stand alone" utility is more than adequate. IGUA particularly noted that the exclusion from normalized actual earnings of the sums paid by Enbridge to its parent and affiliates in excess of Board-approved amounts.

Energy Probe supported IGUA's arguments. It further noted that the Company is far from facing a crisis. The Company's proposal is in effect a request for costly insurance, to the tune of \$9.5 million annually, which does not represent the least overall cost solution.

VECC submitted that Enbridge's problem of access to the MTN market is temporary and should be addressed by short-term solutions that provide access to needed capital until existing debt is retired. The best and least cost solutions according to VECC are either using commercial paper swapped into medium term debt or a medium term preferred share issue. Either one of these solutions would allow Enbridge to access capital on reasonable terms until its high coupon debt gets refunded over the next few years. Since 2008 is likely to be the first year of incentive regulation, establishment of a deferral account would allow Enbridge the opportunity to recover any prudently incurred incremental costs of maintaining access to the MTN market. In VECC's view, Board Staff's regulatory symmetry with Union Gas is not appropriate, since it does not take into account the fact that Enbridge has lower business risk than Union Gas, or that Union Gas' equity was the result of a negotiated settlement.

Board Findings

The Company's proposal for a thicker common equity in the deemed capital structure is grounded on business and financial risk considerations as well as its deemed common equity has fallen out of line with other Canadian utilities.

While the Board is of the view that Enbridge has presented credible evidence of a trend among Canadian regulators in finding thicker common equity for utilities, the Board does not generally find a comparison of Enbridge's common equity ratio with those in other jurisdictions to be necessarily determinative of the issue. An applicant must still satisfy the threshold requirement of independent evidence that material changes have occurred to justify a thicker common equity. Moreover, the hazard in doing so is that it engages issues of oversimplification and circularity, which downgrade the specificity that is required to make decisions pertaining to a particular utility. With those caveats, the Board nevertheless is mindful of the increasing trend and has factored this in its deliberations.

There is some value in considering evidence on the relative risk profile of the two large Ontario gas utilities. While Union's current 36% common equity was the result of a negotiated settlement, Enbridge's proposal for a 38% common equity level is materially higher than Union's, which is not consistent with the relative business risk profile of the two utilities. In fact, there was no dispute that Enbridge is a lower risk utility than Union Gas.

The Company claims that its business risk has increased over the last 10 to 15 years on several fronts. These are addressed below.

The Board agrees with parties who argued that the regulatory and legislative risks which Enbridge currently faces are not greater than they were last year or in prior years, at least not materially greater.

With respect to the risk of bypass noted by the Company, the Board is of the view that the Company has under-estimated the risk mitigation through the development and approval for rate options to specifically address the need of gas fired generators and mitigate any potential for bypass risk.

With respect to the claim by Enbridge that incentive regulation could lead to increased regulatory risk, Enbridge has operated under a performance based mechanism before. Moreover, the tenet behind an incentive regime is that the utility can reap the benefits of

newly found efficiencies and it is only upon rebasing that these efficiencies will be shared with or passed on to ratepayers. From these perspectives, an incentive rate regime is not necessarily an arrangement that negatively affects the risk of the utility.

From the market reports that were filed in the proceeding, there is no evidence on balance that Enbridge no longer enjoys a reasonably stable legislative and regulatory environment.

Even if there was some recognition of increased business risk in the totality of the Company's arguments, this must be weighed against other positive considerations. For example, the Company's evidence indicates that customer growth continues to be strong and natural gas remains the predominant fuel of choice in Enbridge's franchise area. Enbridge's customer base is consistently growing year after year. The Board does not see this as indicative of increased business risk.

In the result, the Board finds that the evidence presented by Enbridge does not warrant an increase in the common equity thickness to 38% on account of increased business risk, but the evidence on the trend of common equity thickness suggests that the 35% level in existence since 1993 should be considered as a floor.

This leaves the Company's proposal to also be evaluated on the basis of its claimed inability to raise capital, at least on reasonable terms.

The Board accepts that decreases in interest rates in 2006 have impacted the Company's EBIT adversely as there is a lag between the reduction in ROE and reductions in the total debt interest liability. The warmer than normal weather in 2006 contributed to the impact on EBIT. To worsen matters, the Company has paid out considerably more to its affiliates than what was reflected in the Board's 2006 revenue requirement decision. Whether or not the Company will be able to raise long term debt in the 2007 test year will very much depend on weather and its overall performance going forward.

The Board accepts that there may not be a practical way to circumvent the interest rate covenants in the current trust indenture. To alter these covenants would require

agreement by current debt holders and this will likely come at a cost. To be clear, the Company is not suggesting that this would be a reasonable remedy. It is unfortunate that these covenants pose such a high restriction. The Board notes that the Company is considering ways by which the existing covenants may be replaced in the longer run. The Board encourages the Company to pursue this initiative.

The Board agrees with the many intervenors who argued that the problem is or may be temporary. On the assumption of a continuing low interest rate environment, as debt matures and is replaced the lower interest charges would provide some relief. If interest rates increase, the relief may be quicker. Relief may well even come from weather.

In any event, like many intervenors the Board is not convinced that the Company's proposed remedy to what is or may be a temporary problem represents the least cost solution. The common equity component of Enbridge's capital structure is and should be a matter that is reviewed infrequently. The Company's proposal to increase the common equity thickness from 35% to 38% carries an annual cost of about \$10 million to ratepayers. In view of that substantial cost, the Board must consider other remedies.

In consideration of all of the above, and on balance, the Board finds an increase in the common equity thickness from 35% to 36% to be reasonable. While this finding should alleviate somewhat the financial pressure currently experienced by the Company, it alone might not fully address the immediacy of the problem, if the problem continues indeed to exist. The Company therefore might need to engage in financing alternatives other than issuing of long term debt in the shorter term. This may involve a number of market instruments that are available to the Company, if indeed the Company cannot issue long term debt when it needs it. The Company must also be more wary of the impact of excessive payments to its affiliates on EBIT.

The Company's evidence was that, in the period 1993 to 2006, the Company lost \$107 million in EBIT due to warmer-than-forecast weather and that the average impact of weather in either direction on EBIT was \$35 million, which is two times more than the \$16.8 million currently reflected in rates according to the Company's evidence. The

Board is of the view that, given the large influence of weather on EBIT, this risk may need to be removed from the utility.

The Board recognizes that a move to removing weather risk from the Company is a decision that has implications for all regulated gas utilities regulated by the Board, and perhaps for electricity utilities as well. The Board considers this to be worthy of evaluation in the near future.