EB-2011-0354

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, 2013.

ENERGY PROBE RESEARCH FOUNDATION ("ENERGY PROBE")

ARGUMENT

December 6, 2012

ENBRIDGE GAS DISTRIBUTION INC.
2013 RATES

EB-2011-00354

SUBMISSIONS OF
ENERGY PROBE RESEARCH FOUNDATION

A - INTRODUCTION

This is the submission of Energy Probe Research Foundation ("Energy Probe") related to the unsettled issues in the application of Enbridge Gas Distribution Inc. ("EGD") for the approval or fixing of just and reasonable rates and other charges for the sale, distribution, transmission and storage of gas commencing January 1, 2013.

In the Decision on Revised Settlement Agreement and Procedural Order No. 6 dated November 2, 2012, the Board accepted the revised Settlement Agreement that was filed in accordance with the directions of the Board. The Settlement Agreement identified one issue (Issue E2) for which there was no settlement. This issue was stated as follows: *"Is the proposed change in capital structure increasing Enbridge's deemed common equity component from 36% to 42% appropriate?"*

A second unresolved issue (Issue E1) was *"Is the forecast of the cost of debt for the Test Year, including the mix of short and long term debt and preference shares, and the rates and calculation methodologies for each, appropriate?"* There was a partial settlement related to this issue in which all parties agree with the forecast of the cost of debt for the test year based on upon Enbridge`s current 36% level of deemed common equity. The unsettled component of this issue is the appropriate capital structure if the Board were to approve a level of common equity different from the current 36%.

B - UNRESOLVED ISSUES

Issue E2 - Is the proposed change in capital structure increasing Enbridge's deemed common equity component from 36% to 42% appropriate?

a) Introduction

The Board's policy with regard to the capital structure for natural gas utilities is clearly stated in the EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities dated December 11, 2009.

In section 4.3 of that Report, which is pages 49 and 50, the Board stated that its current policy with regard to capital structure for all regulated utilities continues to be appropriate and it noted that in the Board's draft guidelines of March 1997, capital structure should be reviewed only when there is a significant change in financial, business or corporate fundamentals.

The policy is clearly stated on page 50 of the Report. For gas utilities, among others, the deemed capital structure is determined on a case-by-case basis. The Board's draft guidelines assume that the base capital structure will remain relatively constant over time and that a full reassessment of a gas utility's capital structure will only be undertaken in the event of significant changes in the company's business and/or financial risk.

EGD is proposing a significant increase in the deemed common equity component of its capital structure from 36% to 42%. EGD has based this request on their evidence that it has undergone significant changes in its business and/or financial risks (Tr. Vol. 1, pages 34-37). On behalf of EGD, Mr. Lister indicated that the company accepted the Board's policy and that it needed to demonstrate a significant change in its business or financial risk in order to obtain the change in the equity ratio that it was seeking.

Mr. Lister also indicated that there was no direction from the Board of Directors or senior management to investigate the need for a higher equity ratio (Tr. Vol. 1, pages 37-39). Mr. Lister indicated that the perception that there was a need for a higher equity component was his perception alone. Energy Probe submits that the lack of direction from senior management and/or the Board of Directors to consider the need for or the requirement of a higher equity component is because no such need or requirement existed in their view.

b) Enbridge vs. Union Gas Risk

Mr. Lister also indicated that he did not believe that EGD's business risks were materially different from those of Union Gas (Tr. Vol. 1, pages 90-91). Energy Probe notes that in the recent Decision and Order for Union Gas in EB-2011-0210 the Board found that a deemed common equity ratio of 36% was appropriate for the 2013 test year, consistent with the deemed common equity ratio that was in place over the 2007 to 2012 IRM period, inclusively.

In the Union Gas proceeding, Union did not file any evidence to demonstrate its business and/or financial risk had changed over the period that the IRM Settlement Agreement was in place. More to the point, Union indicated a number of times through their proceeding that its business and financial risks had not changed and that it accepted that its overall risk profile had not materially changed since 2006.

In this proceeding, EGD maintains that its business and financial risks have increased over time. If their risks are not materially different from Union at the current time, then it must be that EGD's business and financial risks were lower than Union's in the past. However, given that both utilities had a deemed common equity ratio of 36% over the IRM period, this does not appear to have been the case. Even if it was true that Union was riskier than EGD over the 2007 through 2012 period, EGD acknowledges that they are not materially riskier than Union now.

They operate in the same province, have territories that are intermingled with one another and face the same cost and revenue pressures as one another, along with the same government and regulatory issues.

c) Change in Enbridge Risk Over Time

EGD's entire evidence related to the supposed increase in its business risk is found on six pages at pages 3 through 8 of Exhibit E2, Tab 1, Schedule 2. This evidence is strictly about the change in business risk of EGD over time. The three main factors contributing to the increase in business risk, according to EGD, are the volumetric demand profile, system size and complexity and environmental and technological advancements. Energy Probe provides submissions on each of these factors in turn.

i) Volumetric Demand Profile

First, with respect to the volumetric demand profile EGD notes that this has two components in their evidence being the decline in average residential gas consumption and industrial demand destruction.

With respect to the declining average residential use, EGD indicates that that it has an Average Use True Up Variance Account ("AUTUVA") that has helped mitigate the impact of uncertainty around the declining average use for EGD. EGD indicates in its evidence (Exhibit E2, Tab 1, Schedule 2, page 4) that this account minimizes the intra-year revenue impact associated with the uncertainty of actual residential average use declines compared to the forecast, but indicates that it does not address the longer term implications that result from a trend of declining average use.

Energy Probe submits that the AUTUVA does not minimize the intra-year revenue impact associated with the forecast error, but actually eliminates it.

Energy Probe submits that the EGD evidence related to the declining average use has a number of serious omissions.

First, the AUTUVA did not exist when the Board reviewed the business risk of EGD in the past. The advent of the AUTUVA clearly results in less business risk for EGD because there is now a variance account that eliminates forecast risk in terms of the average use. Moreover, even though EGD appears to confine its analysis of the AUTUVA to the issue of the declining average use for residential customers, the AUTUVA actually applies to both Rate 1 and Rate 6. The applicably of the AUTUVA to the general service rate classes and not just to residential customers is shown in Appendix D, page 20 to the Interim Rate Order dated November 29, 2012. EGD noted this in the response to part (d) of Exhibit I, Issue E2, Schedule 7.2.

Second, a review of the forecasted distribution revenues in Exhibit C3, Tab 2, Schedule 1 shows that the combined revenue from Rates 1 & 6 is more than 96% of the total distribution revenues shown that includes revenues from contract customers. In other words, EGD has protection associated with 96% of its in-franchise revenues.

Third, EGD indicates that the ATUVA does not address the longer term implications that result from a trend of declining average use. Energy Probe notes that EGD has not provided any evidence on this long term trend continuing into the future. It has not provided evidence that natural conservation (conservation that takes place automatically as less efficient equipment is replaced over time with more efficient equipment) will be as significant in the future as it has been in the past. The potential available in the future is subject to efficiency improvements, most of which have already taken place with the replacement of 60% efficient furnaces with 90%+ efficiency units. Moving to 100% efficient units will provide less of a reduction going forward than what has been seen in the past.

Fourth, EGD has not provided any evidence to support the movement by the general service customers from natural gas to some other source of energy. No long term forecasts, for example, of the price of natural gas relative to electricity has been provided. Indeed, a significant increase in the cost of natural gas would still leave gas prices less than that based on current electricity prices, even without factoring in the expected increases in electricity prices that have been forecast to take place over the next number of years.

Fifth, EGD has not provided any rationale as to why the AUTUVA, which is being used in 2013 and was used during the IRM term, will not be in place beyond 2013.

Finally, EGD has completely ignored the impact that has taken place in terms of the shift to fixed revenues from variable revenues that have taken place since 1993. EGD provided the facts in the responses to Exhibit I, Issue E2, Schedules 7.2 and 20.1. In particular, the amount of distribution revenue recovered from fixed charges rose from 18% in 1993 to 33% in 2007, to the forecasted recovery of 51% for the test year. This was achieved by increasing the fixed charges over the IRM period. By maintaining revenue neutrality, this resulted in a decrease in the variable distribution rates.

When asked by Mr. Thompson if this increase in fixed revenues was a risk mitigation measure, Mr. Lister indicated that the intent was to better reflect cost causality and that it did not necessarily alleviate risk (Tr. Vol. 1, pages 69 - 71). Energy Probe disagrees.

While the intent of moving to higher fixed charges was to more closely match fixed revenues with fixed costs, the impact clearly reduced the risk. There is less variance in a customer forecast than there is in a volumetric forecast. Union Gas confirmed this and explained their rational that the customer forecast was inherently more accurate than the volumetric forecast (EB-2011-0210, Tr. Vol. 1, pages 59-60). Energy Probe submits that the same applies to EGD. The fixed charges are based

on the customer forecast while the variable charges are based on the volumetric forecast. By increasing the fixed charge and reducing the volumetric charge, EGD has placed greater emphasis on the more accurate of the two forecasts, thereby reducing its business (forecast) risk from the last time the Board evaluated the business risk.

EGD still has the weather risk as part of its overall business risk. However, this risk has been reduced by the increase in fixed charges relative to the volumetric risk. In other words, the volumetric rates are lower today than they would otherwise be had the fixed charges not increased and provided a greater proportion of the recovery of the distribution revenue requirement. This means that the total revenue variance associated with the weather are less than they would have been if the relative percentages had remained unchanged from 1993 to 2007 to 2013. In other words, the impact on EGD has decreased relative to what it was in the past.

Moving on to industrial demand destruction, Energy Probe notes that it well known that Union's industrial demand makes up a greater portion of its overall distribution revenue than it does at EGD. As noted earlier, Union stated that its business and financial risk had not materially changed since the last evaluation by the Board.

As noted in the footnote on page 5 of Exhibit E2, Tab 1, Schedule 2, the annual reduction in large volume customers, including those customers that have switched to Rate 6, is 1.37% per year over the 2000-2010 period. This included a recession near the end of this period. EGD claims that a long term view is needed to determine business risk, yet it is relying on a short period of only 10 years to support industrial demand destruction. No mention is made of the increase demand for natural gas for electricity generation within its franchise area. No mention is made of the change in industrial demand as the economy grows, albeit slowly. EGD did not provide any evidence to support the contention of fuel switching.

EGD has not provided any evidence that the decline of 1.37% experienced between 2000 and 2010 has not been driven, at least in part, by the same type of natural conservation that is taking place for residential and commercial customers as old equipment is replaced by more efficient new equipment.

In short, EGD's evidence with respect to industrial demand destruction, in the view of Energy Probe, is not supported by evidence and cannot be considered to be credible.

ii) System Size and Complexity

The second main factor contributing to the increase in business risk, according to EGD, relates to system size and complexity. EGD provides a series of bigger figures in its evidence at pages 5 through 7 of Exhibit E2, Tab 1, Schedule 2. More pipe, more customers, more capital expenditures and so on. EGD concludes from this that with greater size and complexity comes greater risk to safety and reliability as it requires management of more assets.

Energy Probe acknowledges that more assets mean the potential for more problems. However, it is submitted that EGD has implemented tools to deal with the increase in assets. For example, in addition to the increase in the number of employees, there have been significant advances in computerized record keeping of assets.

In addition, the TSSA issued new directions for the inspection of pipelines in 2001 and 2006. This integrity management plan should result in less risk to reliability and safety, not more in the longer term. EGD states in its evidence that the large undertaking of labour, resources, and capital on the utility's part to comply with these orders ultimately ensure higher operating standards. Energy Probe submits that these higher operating standards, acknowledged by EGD, reduce risk and do not increase it.

Finally, EGD notes that it has undertaken an asset management plan and that in their view this has increased their risk. However, taking the same long term view as EGD believes the Board should in evaluating business risk, Mr. Lister conceded that:

> ***"In terms of its impact on the long-term risk, yes, the intent of the asset plan and integrity management programs is to reduce risk; that's for sure, for certain. And to increase the safety and reliability of our system."*** **(Tr. Vol. 1, page 170)**

It is only in the shorter term view that EGD believes that the existence of an asset management plan and the integrity management plan increases their risk. Energy Probe strongly disagrees. Energy Probe submits that the actual risk does not change by having more information. The asset management and integrity management plans allow EGD to identify and deal with potential risks sooner and more effectively than they could have in the past, in the absence of the information provided by the plans. The risk has not changed, the identification of the risk has improved. This allows EGD to increase the safety and reliability of its system.

In summary, Energy Probe submits that the asset management and integrity management plans provide EGD with better and more timely information to use to manage the risks associated with an increased asset base. These plans reduce the risks to EGD in both the short term and the long term.

If EGD believes that bigger means more risk, then Energy Probe submits that the Board should take a serious look at how big is too big. If the distribution system is too large to operate on a safe and reliable basis by management of one company, then perhaps it would be in the public interest to cap the size of distributor and to ensure the safe and reliable operation by more than one entity.

iii) Environmental and Technological Advancements

Finally, the third main factor contributing to the increase in business risk, according to EGD, is environmental and technological advancements. Again, the EGD analysis of the environmental and technological advancements is biased and incomplete.

EGD fails to note that technological advancements in equipment that results in a reduction of the amount of natural gas used helps to keep natural gas competitive with other fuels/technologies. There is no mention whatsoever of the benefits to natural gas distributors of the movement from coal fired electricity generation to natural gas fired generation. No mention is made of the additional benefits of co-generation in increasing the efficiency of the natural gas used.

Less carbon intensive fuels or technologies usually come with a high price tag. This mutes the impact on the more carbon intensive fuel. EGD provides the example of the OPA FIT program. The more successful this program is, the higher the cost of electricity. The higher the cost of electricity, the more competitive is the use of natural gas.

Environmental and technological advancements take time to be reflected in the market. Even if electricity, for example, was price competitive with natural gas, residential customers are not going to replace natural gas furnaces with electric based heating systems. Customers may not be convinced that electricity will remain price competitive with natural gas. Customers will not replace long-lived expensive capital investments in their heating systems until those systems are near the end of their lives.

d) Time Period for Analysis

Energy Probe notes that there was a lot of discussion on what the appropriate period was in order to determine whether or not there have been significant changes in the business risks faced by EGD. EGD believes that changes between 1993 and 2013 are relevant, while other believes that changes between 2006 and 2013 are more relevant because the Board dealt with changes between 1993 and 2006 when it increased the common equity ratio from 35% to 36% for 2007 and subsequent years.

Energy Probe submits that it does not matter which starting point is used in the analysis. In both cases Energy Probe submits that there has been little, if any, change in EGD's business or financial risks. This is not surprising given that Union Gas stated this repeated in EB-2011-0210 and that EGD accepts that its risks are not materially different from those of Union.

e) Comparability and Historical Deemed Equity Ratios

EGD has based its request for an increase in the equity ratio from 36% to 42% based on the change in business risk, but it has also provided evidence in support of its proposal based on comparability with North American peers and Ontario Electric Utilities.

Energy Probe notes that the Board dealt with this argument in the EB-2011-0210 proceeding for Union Gas. In the October 24, 2012 Decision and Order in that proceeding, the Board provided its reasons for rejecting this argument (page 49). Energy Probe submits that the same rationale and reasons should be applied by the Board to EGD in this proceeding.

Energy Probe further submits that EGD has provided no compelling evidence that the previously approved deemed equity ratios were not correct and that these ratios did not adequately reflect Union's business and financial risks. As a result, it is submitted that the Board should this argument little or no weight.

Issue E1 - Is the forecast of the cost of debt for the Test Year, including the mix of short and long term debt and preference shares, and the rates and calculation methodologies for each, appropriate?

As part of the October 26, 2012 Settlement Agreement this issues was listed as a partial settlement. All parties agreed with EGD's forecasts of the cost rates for 2013 long and medium term debt, short term debt and preference shares. All parties also agreed with the forecast of the cost of debt for the 2013 test year based on EGD's current 36% level of deemed common equity.

It was agreed that if the Board determined that no change to EGD's current 36% level of deemed common equity was appropriate, then the long term debt of EGD's capital structure would be increased to $2,416.9 million as a result of a required $400 million debt issuance, to occur in August, 2013, at an agreed upon forecast coupon and effective interest rates of 4.10% and 4.18%, respectively. This would result in a reduction of EGD's average long term debt cost rate from the forecasted 5.90% (assuming 42% deemed common equity) to 5.80% (assuming 36% deemed common equity).

The unsettled issue deals with the appropriate capital structure if the Board approves a different level of common equity from the current 36%. In particular, there was no agreement on the appropriate mix of short and long term debt and preference shares and the resulting overall cost of capital.

Energy Probe notes that EGD did not make any submissions on this issue in its November 30, 2012 Argument-In-Chief.

A comparison of Exhibit N1, Tab 1, Appendix A, Parts 1 and 2, page 9 included in the Settlement Agreement shows that EGD proposed to increase the deemed common equity from the current level of 36% to 42%. This results in an increase in the level of deemed common equity of $245.5 million ($1,472.9 million to $1,718.4 million). To accommodate this increase, EGD proposes to decrease the level of short term debt from $56.7 million to $39.7 million, a reduction of $96.4 million. The remaining required reduction of $149.1 million is achieved by reducing the long term debt from $2,461.9 million to $2,312.8 million. There would be no change in the level of preference shares.

If the Board were to approve an increase in the level of the deemed common equity, Energy Probe does not believe that it is appropriate to reduce the level of short term debt. It is certainly not appropriate, in the view of Energy Probe to move to a position where the short term debt is negative. This results in ratepayers paying for additional long term debt to cover off the negative short term debt.

If the Board approves an increase in the deemed common equity component as part of a full reassessment of EGD's capital structure, then Energy Probe submits that this full reassessment has to include a determination of the appropriate level of short term debt.

In the December 20, 2006 Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors, the Board stated that (at page 10):

> ***"As a general principle for ratemaking purposes, the Board believes that the term of the debt should be assumed to be similar to the life of the assets that are to be acquired with that debt. This suggests that, in theory, for an industry with long-lived assets, the majority of debt should be long-term. However, in reality, some short-term debt is a suitable tool to help meet fluctuations in working capital levels."***

Energy Probe supports this matching principle. Long-lived assets should be financed with long term debt and short-lived assets, such as working capital levels, should be financed with short term debt.

If the Board were to determine that the common equity ratio for EGD should be more in line with that of electricity distributors in Ontario, then the same rationale should be used to set a deemed level of short term debt that would be in line with that allowed for rate making purposes for those same electricity distributors. In other words, the deemed short-term debt component of rate base should be set at 4%.

The deemed long-term debt component of rate base would not need to be adjusted until the 4% short-term debt component is reached. In other words, if the Board increased the deemed common equity ratio from 36% to 38.61%, this could be fully absorbed within the overall capital structure by moving the deemed short term debt component from 1.39% (Exhibit N1, Tab 1, Schedule 1, Appendix A, Part 2, page 9) to 4.0%. Any increase in the deemed common equity above 38.61% would result in an increase in the short term debt component to 4.0% and an increase in the deemed long term debt component. Energy Probe does not believe that any change to the preference shares should be made.

The long term debt rate applicable to the higher long term debt component would be reflective of an increase in the amount of long term debt in a manner similar to that illustrated for 36% common equity scenario. The appropriate amount of additional long term debt would be costed at an effective rate of 4.18% with a debt issuance in August, 2013. This would then be factored into the calculation of the average long term debt rate, resulting in a rate somewhere between 5.80% and 5.90%.

C - COSTS

Energy Probe requests that it be awarded 100% of its reasonably incurred costs. Energy Probe has attempted to minimize its time on this application, while at the same time ensuring a thorough review. This has been accomplished through the co-operation with other intervenors throughout the review process.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

December 6, 2012

Randy Aiken

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