# ONTARIO ENERGY BOARD

## BOARD STAFF SUBMISSION

### Enbridge Gas Distribution Inc.

**2013 Cost of Service Rates Application**

**Board File No. EB-2011-0354**

**December 7, 2012**

## Introduction

Enbridge Gas Distribution Inc. ("Enbridge") filed an application on January 31, 2012 with the Ontario Energy Board (the "Board") under section 36 of the *Ontario Energy Board Act, 1998*, S.O. c.15, Schedule B 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. The Board assigned file number EB-2011-0354 to the application and issued a Notice of Application dated March 2, 2012 (the "Notice"). The application employed a cost of service filing presentation using a 2013 test year and was filed on the basis of US Generally Accepted Accounting Principles.

The Board's Procedural Order No. 2 dated May 16, 2012 provided for a settlement conference to be held over nine days in September 2012. A comprehensive Settlement Agreement dated October 26, 2012 was filed with the Board (the "Settlement Agreement"). The Board accepted the Settlement Agreement in its Decision on Revised Settlement Agreement and Procedural Order No. 6 dated November 2, 2012.

The Settlement Agreement indicated that all of the issues in the proceeding had been completely settled, with the exception of the following:

- Issue D11 [Partial Settlement]
  Is the proposal for the Open Bill Access Program appropriate?

- Issue E1 [Partial Settlement]
  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?

- Issue E2 [No Settlement]
  Is the proposed change in capital structure increasing Enbridge's deemed common equity component from 36% to 42% appropriate?

On November 9, 2012, Issue D11 was fully settled and accepted by the Board in its November 26, 2012 Decision on Supplementary Settlement Agreement Open Bill Access Program.

Issue E2 proceeded to an oral hearing on November 19 and 20, 2012. At the oral hearing, the Board made provision for parties and Board staff to file written argument on Issue E2. Enbridge filed its Argument-in-chief on November 30, 2012.

Board staff is making this submission pursuant to the Board's invitation to provide submissions on Issue E2. Issue E1 will be addressed later, if necessary, per the Settlement Agreement language on Issue E1. The submission is intended to assist the Board in evaluating the outstanding matters in Enbridge's application concerning Issue E2 and in setting just and reasonable rates for the year 2013.

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

Enbridge has proposed a capital structure which includes a common equity ratio of 42% for 2013 as compared to the 36% currently included in rates. In support of its proposal, Enbridge retained Concentric Energy Advisors ("Concentric") to provide expert testimony. Mr. James M. Coyne and Ms. Julie F. Lieberman of Concentric provided this testimony and recommended an equity ratio in the 40% to 45% range. In response, intervenors presented the expert evidence of Dr. Laurence D. Booth. Dr. Booth recommended an equity ratio of 35%. Enbridge also provided company witnesses who spoke to the issue at the hearing.

The Board provided for an Experts Conference specifically on Issue E2 and ordered the preparation and filing of a Joint Written Statement (the "JWS") of the experts. In Procedural Order No. 5 dated October 15, 2012, the Board outlined the purpose of the Experts Conference.

> The purpose of the Experts' Conference is to identify, scope, and narrow the relevant issues and sub-issues, identify the points on which the views of the experts differ and are in agreement, and prepare a joint written statement to be filed as evidence at the oral hearing of this matter (the "Joint Written Statement").

The JWS was filed on November 9, 2012 as Exhibit L-22.

### Ratepayer Impact

The ratepayer impact of Enbridge's request to increase its common equity ratio by 6 percentage points to 42% can be derived from the financial statement attachments to the Settlement Agreement.[1] These statements show that in 2013 there would be a revenue requirement increase of approximately $21.9 million stemming from the proposed equity ratio increase from 36% to 42%. This is a material amount and if approved, would continue until another capital structure review is done. It is also notable that Enbridge's planned capital programs, such as the planned $600 million GTA Reinforcement project and new capital related to its Asset Management Plan, will close into rate base over the next few years and as these increases to rate base materialize, the effect will be to amplify the 2013 impact because of the increasing equity percentage in the capital structure.

Board staff submits that the ratepayer impact is always a relevant consideration in ratemaking matters, and that it should come to bear in the Board's determination of the fair and appropriate common equity level.

**How should the Board interpret its Policy on Capital Structure changes?**

The Ontario Energy Board's guiding policy on cost of capital matters is found in the 2009 report entitled: *"EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities*" (the "Policy"). Board staff's view is that the Policy raises a threshold question concerning how the Board should approach a request by a gas utility to change the relative levels of debt and equity in its capital structure. Section 4.3 of the Report, outlines the Board's specific policy on capital structure.

> **The Board's current policy with regard to capital structure for all regulated utilities continues to be appropriate**. As noted in the Board's draft guidelines, capital structure should be reviewed only when there is a significant change in financial, business or corporate fundamentals. The Board's current policy is as follows:
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> The Board has determined that a split of 60% debt, 40% equity is appropriate for all electricity distributors. Capital structure was not a primary focus of the consultation and the Board notes that the comments made by participants in the consultation largely supported the continuation of the Board's existing policy.

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[1] Financial statement attachments to the Settlement Agreement dated October 26, 2012. Exhibit N1/ Tab1/Sch1/Appendix A/Part 1 and Part 2.

> For electricity transmitters, generators, and gas utilities, 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.
>
> (underlining added for emphasis)

The underlined segments of the Board's Policy noted above give rise to threshold questions. In Board staff's submission, based on the Policy's language, the threshold question for a gas utility such as Enbridge is raised in the final paragraph above. The question is:

> Have there been significant changes in Enbridge's business and/or financial risk?

If the answer is "yes", then the Board would proceed to launch a review of the capital structure at Enbridge to determine the appropriate ratios of debt and equity in its capital structure. If the answer is "no", then the threshold test has not been met; therefore no further review is required, and the capital structure should remain unchanged.

When the Board reviews and sets a capital structure and associated debt and equity returns for a gas utility, by definition a fair return has been established. No person other than the tribunal (or the Courts, should there be a judicial review) has the authority to establish what is "fair". The starting point for determining if there has been a significant change in business and/or financial risk would be the last time it was reviewed and set by the Board for the gas utility.

In the case of Enbridge, in 2007, business risk, financial risk, and regulatory risk were all reviewed and determined by the Board in the context of an application for an increase to the equity ratio beginning in 2007. In the Board's Decision with Reasons dated July 5, 2007 in proceeding EB-2006-0034, the Board found that it would be fair to increase Enbridge's common equity ratio from 35% to 36% (Enbridge had requested 38%). This was the last time such a review was undertaken at Enbridge and the company did not challenge the Decision. Intervenors suggested that this was

the appropriate starting point to assess any changes to risk. Mr. Coyne acknowledged that the company and intervenors all appear to be in agreement with 2007 as the starting point and that the relevant time period is roughly 2007 to 2012.[2]

**How does the Board determine what constitutes a "significant" change in business and or financial risk?**

Before assessing whether there have been significant changes in Enbridge's business and/or financial risk, however, it is staff's view that it is important to consider what makes a risk a "significant" risk.

The Policy is clear that any change in risk must be "significant". In Board staff's submission, to qualify as significant, a risk-related event or circumstance must have a fundamental, measurable and lasting impact on the gas distribution business. Board staff would expect a "significant" change in risk to have a measurable impact on the utility's financial state of affairs, which can be assessed both now and on a pro-forma basis. The utility would need to provide evidence demonstrating such financial impacts. The change must not be temporary, but lasting or widely accepted by experts in the industry to be lasting.

Examples of significant changes in business or financial risk could include such things as a new fuel source that would supplant or replace natural gas; or a new government policy that would fundamentally shift the business model of gas distribution. A change in the regulatory compact could also qualify as a financial or regulatory risk. For example if the Board decided to change its policy and make the utility "at risk" for its natural gas supply rather than the current model which has gas supply costs "passed through" at cost to ratepayers, that could, in Board staff's view, qualify. Another example would be if the Board eliminated certain risk-reducing variance and deferral accounts. Such a change could qualify as a significant change in risk, depending on the scale, nature and quantum of the account. The change must, in Board staff's view, be transformative in nature to qualify as "significant".

[2] Tr2 page 93.

There must be tangible evidence that new or increased risks are either happening now or are very likely to happen in the future – it cannot be speculative. There must be some degree of certainty that the event leading to increased risk will happen.

**Assessment Business and Financial Risk at Enbridge**

The evidentiary record in this case contains a lot of material and opinion on the state of Enbridge's business and financial risks, what has changed in the risk profile, and what the future may hold in terms of new or changed risks.

Enbridge's company witnesses testified that the company has experienced increases in both business and financial risks. To summarize, Enbridge laid out the following main risk areas:

- Business Risks have increased with respect to a long term decline in average consumption, the need for increased capital expenditures going forward to address the system's increasing size and complexity, and environmental and technological changes, including government targets aimed at reducing greenhouse gas emissions.

- Comparability with Electric LDCs in Ontario. Enbridge contends that it is unfair that the electrics are acknowledged as less risky than gas, but are entitled to a higher equity ratio (40% versus 36%). This situation leads to a relatively higher financial risk for Enbridge.

In terms of specific risks that have changed since 2007, in the undertaking responses from the technical conference and the hearing, Enbridge identified 24 such risks.[3]

Enbridge categorized the risks according to whether they increased or decreased since 2007, and classified them according to whether they are risks associated with system size and complexity, volumetric profile, environment & technology, or regulatory risk.

[3] See Exhibit JT2.14 (risk assessment since 2007) and Exhibit J1.3 for the categorization of the risks listed in JT2.14.

Concentric's points on Enbridge's business and financial risk covered largely the same ground as that of the Company witnesses.

Dr. Booth stated that Enbridge has not offered extensive business risk testimony in this case and further that what little testimony was offered on increasing business risks at the utility was "insufficient", and not "significant or material".[4]

As evidence of financial stability, Dr. Booth pointed to the fact that Enbridge's weather-normalized, Board-allowed Return on Equity ("ROE") has been exceeded each year since 1985 by about 100 to 200 basis points. Dr. Booth opined that he expects this financial performance to continue in the future.[5]

Dr. Booth indicated that the current very attractive competitive position of natural gas versus competing fuels is a feature that is new since 2007 and is an indication that any risk of long term recovery of Enbridge's rate base has diminished since that time. The collapse in natural gas prices in recent years is cited as a major factor in the lessening of Enbridge's business risk.[6] Indeed, Dr. Booth said that any risk of stranded assets that may have existed in 2007 due to high gas prices at the time has now "basically disappeared".[7] Board staff notes that the table in the interrogatory response to VECC at Exhibit I-E2-21.3 page 7 of 9 demonstrates the current attractiveness of the burner-tip cost of natural gas compared to alternate fuels.

Dr. Booth noted several times that Canadian regulators tend to manage business risks through the extensive use of deferral accounts. Deferral accounts shield the shareholders from risk by shifting costs onto ratepayers. Dr. Booth indicated that this should be taken into account in the setting of appropriate equity ratios.

In terms of financial and credit metrics, Dr. Booth said Enbridge is an "A-rated" utility that has no problem in attracting capital now and in the future, and he offered evidence to support this assertion.[8] Enbridge said that to date, it has not experienced any difficulty in accessing capital.[9]

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[4] Tr2 Pages 41 and 42
[5] Tr2 page 46
[6] Booth pre-filed evidence Exhibit L-21 page 84
[7] Tr2 Page 49
[8] JWS pages 20 and 30
[9] Response to Board staff interrogatory I-E3-1.4 page 4

Booth testified that there is no question that there has been a decrease in the business risks of Enbridge.[10] Overall, Dr. Booth recommended a return to the 35% equity ratio that existed prior to 2007 as being a satisfactory ratio given the current risk profile.

Board staff's view is that none of the 24 risk items listed in Enbridge's Undertaking JT2.14 and J1.3 qualify as a significant risk. The list of 24 items includes five that are listed as being either lower or neutral relative to 2007. Many of the remaining "risks", such as training, price of materials, cost of labour, insurance, litigation, ageing workforce, technical and compliance standards, operational risks associated with underground storage facilities, third party damages, and employee health and safety are in Board staff's view, misclassified. Rather than "risks", they are simply routine matters of utility business operations. They are related to normal operating practice. To speculate that some of these cost items will increase in the future and that therefore they now qualify as a significant business risk for the purposes of increasing the equity ratio is, in Board staff's view, not supportable.

Board staff also submits that many of the "risks" listed are items that are already addressed through the Company's 2013 operations, maintenance, and capital budget regulatory review process, which only recently took place. The 2013 revenue requirement was established in a November 2, 2012 Board Decision accepting the 2013 cost of service Settlement Agreement. The Board should rightfully expect that the 2013 cost of service revenue requirement has covered all of these items. Board staff suggests that if any significant cost increases arise in the future, Enbridge will bring forward a request for a variance account, deferral account, or Z factor to address it.

Despite Enbridge's assertion of the negative effects of declining average use per customer and the "industrial demand destruction" phenomenon, total annual system throughput has remained relatively unchanged since 2000.[11] Enbridge has a robust and relatively consistent rate of new customer additions (averaging in the range of about 30,000 to 40,000 per year) that has helped offset declining average use per customer. The utility is widely regarded in the industry as being a "premier"

[10] Tr2 page 52
[11] Response to Board staff interrogatory I-E3-1.2 page 2

distribution franchise serving the economically stable and high residential growth regions of Greater Toronto, Ottawa and the Golden Horseshoe.

Financial risk has been further insulated in recent years because of steady increases to the monthly fixed customer charge. The rate design is now recovering about 51% of the distribution revenue from fixed charges compared to only 33% in 2007.[12] Also, the Demand Side Management Program ("DSM") provides incentives to Enbridge's shareholders in the range of $4 million to $8 million each year, and includes a lost revenue adjustment mechanism to compensate the shareholder for volumes lost due to DSM activities. As well, Enbridge's recent Settlement Agreement provides for ratepayer coverage of pension and post-employment benefits costs for 2013 and the next incentive regulation period, possibly through until 2019, via the new Post-Retirement True-Up Variance Account. The combined pension and post-employment benefits costs in 2013 are included in the revenue requirement at $42.8 million. In Board staff's view, the fact that the Board has allowed these costs for recovery in rates diminishes financial risk and therefore the need for extra equity.

On the matter of the "unfairness" of Ontario electric LDCs being allowed a 40% equity ratio while the gas distributors are held at 36%, Board staff notes Dr. Booth's recommendation that the electrics and gas are essentially of like risk and therefore the electric LDCs equity ratio should be realigned downwards to 35%, and not vice versa.[13] Board staff notes that the question of appropriate "comparables" was a subject of debate among the experts. The debate appears in the joint summary in the JWS starting at page 32. Although there is merit in looking at comparables, in Board staff's view, such analysis should be secondary to the threshold question of changing business and financial risks at the utility. Without a clear understanding of the latter, the former adds little to the analysis.

## The Fair Return Standard

There was much discussion in the written evidence and at the hearing about the application of the Fair Return Standard (the "FRS") and whether this regulatory standard should take precedence in guiding the Board to its determination of a fair

[12] Response to VECC interrogatory I-E2-20.1 page 2
[13] Tr2 pages 179 & 180

equity ratio for Enbridge. The FRS is discussed in the Board's Policy in Section 3.1 at pages 15 through 23.

Concentric's case for recommending an equity ratio in the 40% – 45% range is largely built around its interpretation of the Policy which is that it is the FRS that is the overarching policy of the Board, and that decisions on capital structure must adhere to the FRS. Concentric's analysis in its pre-filed testimony follows the National Energy Board's articulation of the FRS in its RH-2-2004 Phase II Decision which is also referenced in the Board's Policy at page 18. Mr. Coyne testified, in relation to the importance of satisfying the FRS, "there is only one true north, and you can't have a compass that points you in two different directions".[14]

The Concentric Preamble in the November 9, 2012 Joint Written Statement at page 5 states the following about the FRS:

> The Fair Return Standard, as articulated by the NEB and embraced by this Board, can be met by fulfilling three particular requirements. Specifically, a fair or reasonable return on capital should:
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> 1. Be comparable to the return available from the application of the invested capital to other enterprises of like risk (the comparable investment requirement);
> 2. Enable the financial integrity of the regulated enterprise to be maintained (the financial integrity requirement); and
> 3. Permit incremental capital to be attracted to the enterprise on reasonable terms and conditions (the capital attraction requirement).

Mr. Coyne contended that the Board must look at applying and determining whether the FRS has been met, even if it has already decided that there has been no significant change in risk.[15] Mr. Coyne said that Concentric's analysis of Enbridge shows that it does not meet the FRS. The JWS summarized Concentric's research results at page 6:

> The evidence Concentric has provided shows that Enbridge's lower equity ratio is not justified based on a business risk differential and, in combination with the Board's formula ROE, is insufficient to meet the FRS standard. We have provided quantitative analysis and risk

[14] Tr2 page 106
[15] Tr2 page 112

> assessment of Enbridge in relation to Canadian and U.S. gas distributors to establish a reasonable equity range for Enbridge that would satisfy the FRS.
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> Concentric's analysis supports an equity thickness in the range of 40 to 45 percent, based on a proxy group comprised of North American gas distribution utilities with comparable risk profiles to EGDI.

Dr. Booth also accepted the FRS. He does not dispute that it is Board policy and that the Board must consider it. However Booth noted that, in his judgment, the Board's formula ROE is at the upper end of a fair and reasonable ROE. Booth's approach to dealing with the question of a fair and reasonable return is different than that of Concentric. For example, his evidence focused on how regulators tend to control income risks faced by the utility's shareholders through the use of "tools" such as deferral accounts, frequent rate hearings, changing the common equity ratio and setting the allowed ROE. [16] Board staff agrees that the Board must consider the combination of all of these tools and the results that such an overarching review produces to ensure that a fair return is achieved for the utility.

Board staff reviewed the analysis done and the conclusions reached by Concentric in the context of the application of the FRS to Enbridge's capital structure question. It is an interesting and informative analysis. It may even be the first analysis formally introduced by an expert before the Board for Enbridge employing the NEB's articulation of the FRS as the analytical model. However, Board staff submits that the threshold question of whether there has been a significant change in the business and/or financial risk is fundamental to the Board's Policy.

Board staff views the threshold question to be the correct starting point prior to any consideration of a change in capital structure. As such, in Board staff's submission, broader questions should be addressed only if the threshold test is cleared. The facts and opinion put forward in this case do not point to this. Board staff submits that the threshold question has not been overcome, and there is consequentially no need to embark upon a further review. The evidence did not show a significant change in business and/or financial risks at Enbridge since 2007. In fact, in Board staff's submission, the evidence shows that some risks have diminished.

[16] JWS. Booth Preamble pages 6& 7. Also JWS page 10.

Board staff notes that the Policy allows some potentially helpful discretion in the Board's application of the FRS.

> Notwithstanding this mandatory obligation, the Board notes that the FRS is sufficiently broad that the regulator that applies it must still use informed judgment and apply its discretion in the determination of a rate regulated entity's cost of capital.[17]

If the Board were inclined to set aside the threshold question, and fully consider the analysis offered by Concentric, in Board staff's submission, the points raised by Dr. Booth in his evidence and oral testimony tend to paint a more persuasive and realistic picture of Enbridge, and one that shows its business and financial risks may have lessened markedly in comparison to 2007. Further, Board staff submits that the Board should not necessarily rely on a single analysis such as Concentric's as the basis for deciding on an appropriate equity ratio.

In Board staff's submission, the "informed judgment" referred to in the Policy may be helpful to the Board. Enbridge's financial affairs appear to be in good condition now with evidence suggesting that this will not change in the foreseeable future. Dr. Booth's opinion is that a fair return is being achieved at Enbridge now and will likely continue. Dr. Booth recommends a 35% equity ratio for Enbridge. Based on its view that there has not been a significant change in risk, Board staff would see the continuation of the current 36% equity level at Enbridge as being reasonable.

### Staff recommendations for Board's Next Cost of Capital Review

Board staff notes that the Board's Policy is scheduled for a "periodic review" in 2014. Dr. Booth made several comments on the phenomenon of "double leveraging" and "ring fencing". In his direct testimony, Dr. Booth set out the double leverage issue as this:

> As I will discuss later, there are tax and other advantages to a company using debt - that is, other people's money. For non-regulated firms these advantages flow through to the shareholder. However, for ROE-regulated utilities, the tax advantage flows through to ratepayers in terms of a lower tax charge in the revenue requirement. However, for utilities owned within a holding company

[17] EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities, page 18

(UHCs), this situation is worse, since the parent has an incentive to finance the utility with as much equity as possible, so that the tax advantages to debt are shifted to the parent. In this way, it is the UHC's shareholders that get the tax advantages, instead of the utility ratepayers. This is often called the "double leverage" problem, where the utility assets support debt at both the utility level and then again at the parent level.

As indicated above, S&P rates debt based on the credit rating of the parent. The principle here is that if the parent gets into trouble it will raid the subsidiary unless it is "ring fenced" or insulated from the parent. Without this ring fencing the subsidiary is as risky as the parent **regardless** of its debt ratio - that is, even if the utility subsidiary is almost 100% equity financed, S&P will still rate it the same as its risky parent. Consequently, double leverage cannot just transfer the tax advantages to the parent's shareholders, but it also may result in lower bond ratings and a higher debt cost for the utility. As a result, utility rate-payers lose part of the debt tax shield, and to add insult to injury may also pay for a higher cost of debt, thus getting hit twice. [18]

Board staff submits that these issues are relevant not only to Enbridge but to other regulated utilities in the Ontario. Board staff submits that the Board should consider placing the issues of "double leveraging" and "ring fencing" on the issues list for the next cost of capital review.

- All of which is respectfully submitted -

[18] Booth pre-filed evidence Exhibit L-21 pages 10 and 11