EB-2011-0354

THE ONTARIO ENERGY BOARD

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.

WRITTEN ARGUMENT

OF THE CONSUMERS COUNCIL OF CANADA

December 7, 2012

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I Introduction and Overview

1. Enbridge Gas Distribution Inc. (EGD) applied to the Ontario Energy Board (Board) for approval of its rates for the sale, distribution, transmission and storage of gas commencing January 1, 2013. In its Decision and Procedural Order No. 6, issued November 2, 2012, the Board accepted a Settlement Agreement that left one issue for oral hearing.

2. The issue that was left for oral hearing, Issue E2, is the following:

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

3. These are the submissions of the Consumers Council of Canada ("CCC") on that issue.

4. The Board, in its *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* dated December 11, 2009, (Cost of Capital Report) established the test, for a

change in a utility's capital structure. For the reasons set out below, the CCC submits that EGD has not met that test.

5. EGD has attempted to reformulate the test by positing what amounts to an overriding consideration, namely whether EGD's existing equity structure, combined with its return on equity, meets the fair return standard (FRS). Again for the reasons set out below, the CCC submits that the FRS does not play the role EDG ascribes to it. CCC further submits that the Board should reject EGD's attempt to reformulate the test for determining whether a change in equity structure is required.

II Analytical Framework

6. Before considering EGD's evidence, the CCC will consider the appropriate analytical framework within which the Board should consider EGD's request for a change in its equity structure.

7. In its Cost of Capital Report, the Board found that its current policy with regard to capital structure for all regulated utilities continued to be appropriate. It set out its current policy as follows:

> 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. [1]

8. It is important to note several things about the Board's unequivocal reiteration of the test for a change in capital structure.

9. The first thing to note is that a change in capital structure is to be considered on a case-by-case basis. The focus, in other works, is on the circumstances of the particular utility seeking the change.

[1] Ontario Energy Board's *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* , December 11, 2009, pages 49-50

10. The second point to note is that the test has a materiality component. The evidence of a change in business and/or financial risk cannot be hypothetical, notional or speculative. The risk must be concrete or measurable.

11. A third, and related point, is that the change in business and/or financial risk must be within some proximate timeframe. If evidence of a change in business and/or financial risk is of circumstances that may or may not occur at some indeterminate time in the future, then the evidence doesn't satisfy the Board's test. In the case of EGD, the Board must be satisfied not only that there is evidence of a significant change in business and/or financial risk, but that the change will affect EGD in 2013 or in the near term beyond that.

12. Finally, the Board did not state that that test was subject to a determination of the FRS. The Board did not, in other words, state that the FRS was some overriding test for the consideration of a change in capital structure.

III EGD's Evidence

13. EGD suggests that the changes in its business risk are in three general categories. Those three categories are EGD's volumetric demand profile, its system size and complexity, and environmental and technological advancements to which EGD is subject.

(a) Volumetric Demand Profile

14. EGD argues that its volumetric profile has changed over a long period of time. In that context it refers to its exposure to weather, the volatility in gas prices, to a continued decline in average use consumption, and to an increase in the pace of average use decline[2].

15. EGD argues that declining consumption puts upward pressure on distribution rates, and that such increases in distribution rates <u>can</u> have the effect of reducing the competitiveness of natural gas and increasing the likelihood that customers will look to fuel-switch or reduce consumption further. (Emphasis added).[3]

[2] Transcript, Vol. 1, p. 8
[3] Enbridge Gas Distribution Inc.'s Argument-in-Chief, EB-2011-0354 (AIC), p. 6

16. EGD's argument that it faces the risk of reduced competitiveness of natural gas is, in the face of sharp declines in the price of natural gas, counter-intuitive. A sharp decline in the price of natural gas should logically result in making natural gas more competitive, thus increasing the level of consumption.

17. EGD's suggestions, and they can be put no higher than that, that somehow there will be a reduction in the competitiveness of natural gas flies in the face of not only the sharp decline in the price of natural gas, but sharp increases, forecast to continue for several years, in the price of electricity.

18. EGD's business risk testimony, filed in support of its 2006 request for a change in its equity thickness, cited what it called four "major risk factors". Those four factors were the following:

1. Volume risk, based on the fact that volumes have been steadily declining since at least 1995;

2. Natural gas price risk, namely that commodity price levels had increased and become more volatile;

3. Customer dynamics, that is a trend towards multiple housing units; and

4. Regulatory and legislative environments, namely the number of proceedings and the intensity of intervention causing greater uncertainty and regulatory outcomes.[4]

19. With respect to price risk, EGD now appears to argue the exact opposite, namely that in a period of low gas prices, its business risk is increasing.

20. The first argument on this point, advanced by EGD's expert Mr. Coyne, is that there is no guarantee of continued lower gas prices, since natural gas is now an increasingly global commodity and subject to global supply and demand in relation to competing fuels[5]. That argument is, with respect, entirely speculative. Mr. Coyne offered no evidence in support of the

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[4] EB-2011-0354, Exhibit I, Issue E2, Schedule 21.3, pp. 4 and 5.
[5] Joint Written Statement, p. 16

assertion. There is also no evidence that, even if Mr. Coyne is correct in his speculation, that gas prices will suddenly spike, significantly, in 2013 or in the near term thereafter, thereby constituting a significant change in EGD's business risk.

21. The second argument is that it is not the low price of gas, but the volatility and uncertainty of gas prices that is the problem[6]. CCC submits that that second argument does not make any sense. To begin with, it does not account for the obvious benefits that low gas prices confer on EGD. A variation in price, when the price of gas is dropping precipitously, is a good thing. So it is not volatility *per se* that is the problem. It must be the prospect of an imminent upward variation in the price that is the risk. Neither EGD nor Mr. Coyne offered any evidence that the price of gas is likely to increase, materially or otherwise, in the immediate or near-term future. In addition, neither Mr. Coyne nor EGD offered any evidence of the point at which rising gas prices would make natural gas less competitive than electricity prices.

22. It should also be noted, when considering this second argument about the impact of gas prices, that in 2006, Dr. Carpenter, in his testimony in support of EGD's request for a change in its capital structure, pointed to high gas prices as evidence of a change in EGD's business risk. In the succeeding five years, EGD consistently earned more than its allowed ROE, and was able to attract capital on remarkably favourable terms. Given that, the argument that EGD's business risk is somehow materially changed, in a period of remarkably low gas prices, is simply not credible.

23. The Board can take notice that declining average use is in large measure attributable to the effect of demand management programs, including, for example, the use of more efficient gas-fired appliances. EGD is protected from the effect of those demand management measures by regulatory measures, such as variance accounts. EGD is kept whole from the effects of those demand management programs.

24. The fact that EGD has a variance account mechanism available to it points to an important distinction in any consideration of EGD's business risk, namely that it can seek regulatory relief to compensate for even marginal changes in its revenue stream.

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[6] Transcript, Vol. 2, p. 199

(b) System Size and Complexity

25. Reduced to its essence, EGD's argument in this category is that its capital expenditure needs are likely to be significant. It relied on its Asset Plan as evidence of a need for "higher and growing capital expenditures by EDG in the future"[7].

26. Forecasts of capital expenditure requirements are dealt with in rate applications. EGD, as is the case with any other utility, can make the case that its capital expenditure requirements require increases in its rates. EGD presented no evidence that the regulatory system has not been able, or will not be able, to adequately address its capital expenditure requirements.

27. EGD also presented no evidence that its capital expenditure requirements will be, for example, more significant that those of electricity distribution utilities. The Board can take notice that electricity distribution utilities, particularly those in major urban areas like Toronto, have repeatedly argued that they have material capital expenditure requirements, requirements which, if approved, will certainly drive up electricity distribution rates.

28. What is odd about this line of argument is that EGD entered into a settlement agreement in which the level of capital spending for 2013 was agreed to. If EGD felt that that agreed-upon amount was not adequate, it would not have entered into the settlement agreement. EGD should not now be allowed to argue that it requires Board protection, in the form of a change in its capital structure, from the effects of its decision to enter into the settlement agreement.

(c) Environmental and Technological Advancements

29. EGD argues that "policy and laws that are aimed at decreasing greenhouse gas emissions and reliance on fossil fuels and increasing opportunities for renewable energy sources" will ... "add to uncertainty about the future of Enbridge's gas distribution business in Ontario".[8]

30. As an example of those changes in policy and law, EGD pointed to Ontario's *Green Energy Act* (GEA). The GEA promoted the development of renewable energy electricity

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[7] AIC, p. 7
[8] AIC, p. 8

generation. EGD could have, but did not, provide evidence of the impact on it of the GEA initiative to this point. EGD could have, but did not, provide a forecast of the impact on it if all of the initiatives contemplated by the GEA and in particular the emphasis on the development of renewable electricity energy sources, came into effect.

31. The significance of the GEA line of argument is that it is the one law that has come into effect, and that has had tangible results that could be measured or forecast in terms of the impact on EGD. All other laws, for example, those of the federal government dealing with greenhouse gas emissions, have had no tangible effects that would allow the Board to conclude that they will have a significant impact on EGD.

32. Accordingly, EGD has left the Board to speculate about the possible effects on it of the GEA and actual or potential federal legislation on greenhouse gas emissions. Such speculation does not constitute evidence of a significant change in business risk that would affect EGD in 2013 or beyond.

33. The actual effect of the GEA is almost certainly, for the foreseeable future, the exact opposite of what EDG suggests. As the Board well knows, the renewable energy initiatives created as a result of the GEA have had the effect of increasing the price of electricity.[9] In addition, the phase-out of the coal-fired generation facilities in Ontario has required the government to build gas-fired, back-up electricity generation facilities. If anything, the effect of the GEA has been to make natural gas more competitive, in relation to electricity, and to increase, rather than decrease, the consumption of natural gas.

34. In its discussion of these three categories of risk, EGD provides no account of the impact on its business risk of regulatory mechanisms. Dr. Booth, in his testimony, points out that it is the practice in Canada to "manage the business risk of the utility, to lower the business risk, basically so that we can get lower rates for shareholders because they are better able to bear

[9] In the "2011 Annual Report" of the Office of the Auditor General of Ontario, the Auditor General observed, on page 89 of the Report:: "In November 2010, the Ministry forecast that a typical residential electricity bill would rise about 7.9% annually over the next five years, with 56% of the increase due to investments in renewable energy that would increase the supply to 10,700 MW by 2018, as well as the associated capital investments to connect all the renewable power sources to the electricity transmission grid."

a lot of this risk[10] Dr. Booth further points out that adjusting the common equity ratio is one of the mechanisms available to a regulator to manage business risk. As he points out, "common equity is a risk management tool, exactly like deferral accounts, exactly like the other panoply of tools available to the regulators.[11]

35. Dr. Booth summarizes this point as follows:

> So the regulator has a variety of options in terms to regulate the utility to make sure the return to the common shareholder was fair. It can basically pass on all of the risk to the ratepayers and then they get a lower rate of return or they get more debt in the capital structure, or it can leave the utility as being riskier, without deferral accounts, without regulatory protection, and then have a lower debt ratio, more common equity and a high rate of return.
>
> What you can't have is a combination of all of these. You can't have a higher ROE, higher common equity ratio, and all of the regulatory protection that we give our utilities in Canada.[12]

36. The CCC submits that there is no evidence, in the three categories on which EGD relies, of a significant change in EGD's business or financial risk.

37. In addition, EGD's analysis of its business risk fails to account for the significance of the variety of mechanisms the Board has used, and can use in the future, to mitigate EGD's business and financial risk.

38. Had there been significant changes in EGD's business or financial risk, or the imminent prospect of such changes, they would have been reflected in EGD's earnings and in its ability to attract capital.

39. The evidence is that EGD has consistently earned more than its allowed ROE, notwithstanding a period of acutely difficult economic circumstances, in the face of the risks that it said in 2006 that it faced, and in the face of declining average use.[13]

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[10] Transcript, Vol. 2, p. 29
[11] Transcript, Vol. 2, p. 30
[12] Transcript, Vol. 2, p. 34
[13] Exhibit I, Issue E2, Schedule 21.1, pp. 2 and 3

40. The rating agencies have consistently given EGD a high credit rating citing, among other factors, the favorable regulatory system within which EGD operates. For example, Standard & Poor's, in its December 15, 2011 report gave EGD a corporate credit rating of A/Stable, citing, among other things, the fact that "Enbridge Gas will continue to have solid relationships with its banks, a generally high standing in credit markets, and very prudent risk management."[14] DBRS, in its April 25, 2011 Report on EGD, confirmed EGD's A rating, stating that "the rating confirmation is based on EGD's low business risk operations, stable regulatory environment in Ontario, strong franchise area, and stable financial profile."[15]

41. EGD has been consistently able to attract capital at very favourable rates. In that context, Dr. Booth points to the fact that EGD has been able to issue fixed rate debt for a period of forty years as evidence that it constitutes "a very, very comfortable, low-risk investment."[16] Finally, EGD acknowledges that it faces the same risk as Union.

42. However, Union has recently conceded, in its 2013 main rates case, that it has experienced no change in its risk profile.

43. The CCC submits, in conclusion, that EGD presented no evidence of a significant change in its business and/or financial risk. Its evidence of risk is entirely speculative. CCC submits, therefore, that EGD has failed to meet the test, in the Board's Cost of Capital Report, that a change in its capital structure is warranted.

IV The Fair Return Standard

44. In the absence of any evidence of a significant change in its business and/or financial risk, EGD imports the FRS in an attempt to rescue the case. The rescue attempt fails.

45. EGD first argues that the relationship of the FRS to capital structure is an item of "unfinished business" in the Cost of Capital Report. The CCC submits that that is wrong. It is clear from the Cost of Capital Report that the Board put its mind to the appropriate policy for the capital structure of regulated utilities and decided that the existing policy would continue. The Board clearly expressed the test of the circumstances under which it would consider a change in

[14] Exhibit I, Issue E2, Schedule 14.7, Attachment 1
[15] Exhibit I, Issue E2, Schedule 14.7, Attachment 3
[16] Transcript, Vol. 2, p. 51

a utility's capital structure. The Board did not, directly or by necessary implication, suggest that the FRS would be an overarching consideration in dealing with a proposed change to the capital structure of a utility.

46. EGD's position on the relationship between the FRS and the Board's precisely-stated test for a change in capital structure, is clear. EGD's witnesses were asked for their position on the relationship. In response to the questions they were asked, they repeatedly stated that, if there were no change in business risk, then a change in capital structure was not warranted. EGD's witnesses' testimony on this point is reflected in the following exchanges:

(a) Mr. Thompson: Right. So you are asserting, if I understand you correctly, that you are entitled to an increase in your equity ratio because the company has undergone significant changes in its business and/or financial risk. Have we got that straight?

Mr. Lister: Yes.

Mr. Thompson: OK. And so you accept that the policy applies to determination of this application? A utility-specific change in risk policy applies?

Mr. Lister: That's correct. And that's the case that we've made here, that there's been a change in business risk and, therefore, our request complies with this policy.[17]

(b) Mr. Thompson: A fair return standard isn't something that is out in the air there, deluding that requirement, is it?

Mr. Lister: No. I actually see them as one and the same. They work in accordance with each other. [18]

(c) Mr. Shepherd: If… Take the hypothetical. You say since 2007 there's been no change in business risk for Enbridge. An the Board says that if there's been no change in business risk then the policy says that you don't have a greater equity thickness. Is it your position that, despite that, the Board still has to determine – regardless of the policy – whether the fair return standard is met with your current equity thickness? Do you understand what I mean?

[17] Transcript, Vol. 1, p. 34
[18] Transcript, Vol. 1, pp. 35-36

> Mr. Lister: It is our position that if the Board found that there is no change in business risk, then by definition the Board were to be saying that the fair return standard has been met. [19]

47. The FRS has three requirements: the comparable investment requirement; the financial integrity requirement; and the capital attraction requirement.

48. Dr. Booth, in his oral summary of his position, stated that the comparable return standard component of the FRS applies to securities. He stated that the comparable return standard "…applies to securities, because you're looking at investors taking their investment out of one utility and placing it elsewhere in the capital market".[20]

49. The CCC submits that Dr. Booth correctly interprets the FRS. CCC submits that, by contrast, EDG and its experts have distorted the interpretation of the FRS to suit their own purposes.

50. Reduced to its essence, EGD's argument is that if it does not have the same equity structure as what it regards as comparable utilities, its business risk is changed and the equity structure must be changed accordingly. What EGD and its experts have done is not used comparability as the term is used in the FRS, but as a category of business risk, on the same footing as, for example, price volatility.

51. EGD's argument, namely that if its capital structure is not the same as what it regards as comparable utilities, in Canada and the United States, that it is at greater risk is, at its highest, theoretical. If in fact EGD were at greater risk than what Concentric says are the comparable utilities, there should be some evidence of the adverse effects on EGD of that risk. However, all of the evidence is to the contrary. As noted in paragraph 40 above, the rating agencies consistently rate EGD as a safe investment. EGD consistently earns more than its allowed ROE. EGD is consistently able to attract capital on vary favourable terms.

52. The CCC acknowledges that comparison between the circumstances of the utility may help inform an analysis of business and/or financial risk. The critical requirement, however, is that there be a detailed analysis of the utilities claimed to be comparable. That is what Dr.

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[19] Transcript, Vol. 1, p. 92
[20] Transcript, Vol. 2, p. 26

Booth did, in response to a question from Ms Chaplin. He looked at the particular circumstance of the five province-sized gas distributors that might be regarded as comparable to EGD. For each of those distributors, Dr. Booth identified circumstances that distinguished their position from that of EDG.[21] By contrast, Concentric embarked on what can only fairly be regarded as a superficial comparison of EGD with Canadian and US utilities in order to reach its conclusion that they were comparable.

53. The larger problem with EGD's argument on comparability is that it requires the Board to base its determination on the capital structure of a utility less on the specific circumstances of that utility than on the circumstances of other utilities. Were the Board to accept that, it would be compelled to accept the notion that every time the equity structure on some other utility, whether in Canada or the United States, that was arguably comparable to EGD had changed, then EGD's capital structure would have to be changed, correspondingly. That formulation of the test puts the Board in the impossible position of, in effect, surrendering its jurisdiction on the issue of the structure to other regulatory agencies.

54. The CCC submits that, with respect, EGD's use of the FRS is both misleading and unhelpful. The Board's test, for determining whether a change in the capital structure of a utility is required, is clear. EGD has failed to meet that test.

V The Union Gas Limited Decision (the Union Decision)

55. As the Board is aware, Union recently applied for a change in its capital structure, comparable to what EDG is seeking herein. The Board denied Union's request.[22]

56. EGD argues that the decision in Union's case can be distinguished because Union failed to lead any evidence of significant changes in its business risk. That, with respect, misses the point. The significance is that Union led no evidence of changes in its business risk because it conceded that there was no such evidence.

57. EGD conceded that the business risk between it and Union were not materially different.[23] Given that, the Board is left in the awkward position of having to conclude that

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[21] Transcript, Vol. 2, pp. 181-184

[22] *Decision and Order in EB-2011-0210*, October 25, 2012, pp 48-50.

Union did not know what it was talking about. In addition, were it to accept EGD's arguments, the Board would have to find that the business risk of EGD was different from that of Union, even though EGD concedes that it is not.

58. CCC submits that, absent compelling evidence, the Board should not find that the business risks of the principal natural gas distribution utilities are not only different, but so different as to warrant different equity structures.

59. The other important implication of the Union Decision is that the Board considered, and rejected, the vary comparability argument that EGD advances in this case. Union advanced the argument that its equity structure was not the same as that of what it regarded as comparable US utilities, and that that difference, in and of itself, warranted a change in its business risk. In making that argument, Union also had reference to the FRS. Union was, in other words, advancing the very argument that EGD advances in this case.

60. In rejecting that argument, the Board, in the Union Decision found as follows:

> Union would have the Board increase (and potentially reduce) its deemed common equity ratio in lock-step with the decisions of other regulators, without an analysis of whether the utilities to which it is compared are enterprises of like risk.
>
> The Board further found:
>
> However, no evidence was filed in this proceeding that set out the risks that resulted in findings supporting higher deemed common equity for these utilities and no evidence was filed that demonstrates Union faces similar risks.[24]

61. EGD has attempted to rectify the deficiencies in Union's evidence, with respect to comparable utilities, through Concentric's analysis. But what Concentric's analysis does not do is what the Board actually required in that Union Decision, namely provide evidence that there were risks that resulted in findings supporting higher deemed common equity for the comparable utilities and EGD's evidence does not do that.

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[23] Transcript, Vol. 1, p. 90
[24] Union Decision, p. 49

62. The CCC submits, therefore, that the Board can and should dismiss EGD's request for a change in its capital structure on the same grounds that were applied in the Union Decision. To do otherwise would require the Board to, first, find that EGD's risk profile is different from that of Union, notwithstanding EGD's assertion that it is not, and second, find that EGD's evidence on comparable utilities was materially different from, and better than, the evidence provided in the Union case. The CCC submits that the Board should not do that.

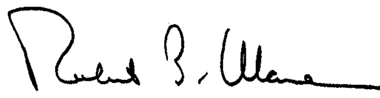
VI Relief Requested

63. CCC asks that the Board dismiss EDG's request for a change in its capital structure.

VII Costs

64. The CCC asks that it be awarded 100% of its reasonably-incurred costs.

All of which is respectfully submitted.



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