EB-2011-0354

ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates for the sale, distribution, transmission and storage of natural gas commencing January 1, 2013

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

December 7, 2012

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1 INTRODUCTION AND SUMMARY

1.1 *Introduction*

1.1.1 On January 31, 2012 Enbridge Gas Distribution Inc. filed an Application for new rates effective January 1, 2013. The process included extensive interrogatories, a technical conference, and a largely successful ADR. Only Issue E2 remains, i.e. the appropriate equity thickness for the Applicant in the Test Year.

1.1.2 This is the Final Argument of the School Energy Coalition on the unsettled issue.

1.1.3 The ratepayer groups who intervened in this proceeding have followed their normal practice of working together throughout the hearing to avoid duplication, including exchanging drafts or partial drafts of their final arguments or discussing what will be in those final arguments. We have been assisted in preparing this Final Argument by that co-operation amongst parties. SEC was also part of the Consortium, four intervenors who jointly sponsored the evidence of Dr. Booth on Issue E2.

1.2 *Summary*

1.2.1 As a result of the extensive submissions by others on key aspects of Issue E2, SEC does not believe it can provide additional useful input to the Board in some of those areas. In particular:

(a) BOMA has provided the Board with a detailed analysis of the case law, which we adopt.

(b) Energy Probe, CME and CCC have provided the Board with detailed analysis of the alleged changes in risks of the Applicant, with which we largely agree.

(c) Board Staff has set out a clear and concise analysis of the Board's current (and longstanding) policy on equity thickness, and subject to some brief comments below, we adopt that analysis.

1.2.2 This SEC Final Argument therefore deals with only four components of the outstanding issue:

(a) The appropriateness of some of the evidence provided by the experts.

(b) The relevance of the Board's decision in EB-2011-0210 relating to the equity thickness of Union Gas.

(c) The interaction between equity thickness, ROE, and the Fair Return Standard.

(d) The implications of this proceeding for the Board's expected 2014 review of the cost of capital of regulated utilities.

2 EXPERT EVIDENCE

2.1 *Introduction*

2.1.1 In this section we provide submissions on two aspects of the evidence of the cost of capital experts:

(a) What is the relevance and impact of their evidence purporting to interpret the case law on the Fair Return Standard, and the Board's policies on cost of capital generally and equity thickness specifically?

(b) To what extent, if any, does an expert witness speak for the sponsors who retained that expert?

2.2 *Scope of Expertise*

2.2.1 The first of these aspects of the expert evidence arises because of the extensive commentary given by Mr. Coyne and, perhaps reluctantly, Dr. Booth, on the Fair Return Standard and Board policies. This arises in the original Concentric evidence, and in the Joint Experts' Statement, but it was perhaps most notable (and lengthy) in the oral hearing.

2.2.2 SEC notes that none of the experts were qualified as having expertise in the interpretation of legal cases, or in the policies of this Board (or any other regulator, for that matter). Therefore, nothing of what any of the experts said about either of those areas qualified as expert opinion.

2.2.3 In the case of the Fair Return Standard, for example, to have an expertise in that area would require that the experts show special expertise in reading and interpreting court cases. Since none of them have studied law, it would be surprising if any of them claimed such an expertise. Indeed, Dr. Booth, at least, was very clear that he is not a lawyer and cannot express an expert opinion on legal matters. Whether admitted or not, the same would necessarily be true of the Concentric witnesses.

2.2.4 Similarly, the experts cannot be said to have any special expertise in Board policy. In fact, the Board are the experts in Board policy.

2.2.5 So, for example, when Mr. Coyne expressed his view on more than one occasion that the Board's policy on the review of equity thickness is just administrative, and the Fair Return Standard is the real, overarching principle that must be applied, that view is not an expert opinion, and the Board should not give it any weight at all.

2.2.6 In the same way, when Mr. Coyne called equity thickness "unfinished business" from

the 2009 Cost of Capital Report, this will inform the Board about the usefulness of his opinions within his area of expertise (see below), but it does not tell the Board anything about how the Board dealt with equity thickness in 2009.

2.2.7 In the case of both legal interpretation, and interpretation of Board policies, it is submitted that, in fact, the Board cannot as a matter of law give the views of any of the experts any weight.

2.2.8 With respect to the Fair Return Standard, the Board is charged with the responsibility of interpreting legal rules affecting its work. While the Board can listen to the views of anyone, those views are just "menu options" for the Board. The actual interpretation must be by the Board. So, the fact that a particular analysis was provided can be useful as showing the Board one way to analyze the cases. The fact that the analysis came from Mr. Coyne, or Dr. Booth, for example, cannot legally be relevant to the Board in reaching its own interpretation.

2.2.9 The same is true of Board policies. When Dr. Booth goes through the history of Board decisions on equity thickness, that may well be useful. However, it is only useful because the Board can independently determine that it is factually correct. Any gloss Dr. Booth or anyone else puts on it is not relevant, as the evidence giving that history is not expert evidence.

2.2.10 This does not mean that the commentary provided by the experts on Board policy, or on the Fair Return Standard, is unimportant. Their interpretations of policy and legal parameters will affect, sometimes fundamentally, their conclusions within their area of expertise.

2.2.11 It is submitted that in fact the interpretations provided by the experts must be considered to be the first part of "if/then" statements that will control the usefulness of their expert evidence. By way of example, Mr. Coyne's view that the equity thickness of the Applicant should be increased should be read as "If the Board's policy on equity thickness is X, then in my expert opinion the equity thickness should be increased". His interpretation of the Board's policy is inserted as "X", an assumption on which his expert opinion is built.

2.2.12 It follows that, if the Board determines that his assumption is incorrect, his expert opinion is no longer valid.

2.2.13 SEC is concerned that, throughout the proceeding, the witnesses from Concentric appeared to focus on trying to persuade the Board that their interpretations are their expert opinion, and should be adopted by the Board. The opposite is in fact true. The Concentric interpretations of legal rules and Board policy are assumptions made outside their area of expertise, and they act as a fundamental restriction on the validity of the real expert opinion being proposed.

2.3 ***Experts and Their Sponsors***

2.3.1 In cross-examination by Mr. Cass, Dr. Booth says [Tr2:217-8, quoted in AIC, p.11] that he believes the equity thickness of the Applicant should be lowered, and this would be an appropriate case in which to do it. He further is characterized as stating that his sponsors agree with that statement.

2.3.2 In its Argument in Chief, at paragraph 35, the Applicant then goes on to conclude that SEC and others have agreed that equity thickness should be reviewed in this proceeding, and cannot now take a contrary position.

2.3.3 At the simplest level, this cannot be correct, because this would require that Dr. Booth express an expert opinion on when the Board should review equity thickness. As noted above, that is not his area of expertise, and he cannot express such an opinion in his expert capacity. We do not believe that he did so.

2.3.4 However, this is a more fundamental issue. While it may well be true that Concentric, as experts hired on behalf of Enbridge, had a role as advocates and representatives for Enbridge (which seemed fairly clear in the hearing), Dr. Booth did not have such a role on behalf of his sponsors.

2.3.5 When SEC hires an expert, that expert has only one role: the development and communication of their independent expert opinion on an issue before the Board. They do not "represent" SEC, nor do they speak for SEC in any way. We will, presumably, have retained them because we believe their expert opinion will provide an evidentiary basis for our positions. We therefore may agree with the expert, and often do. We do not cede our right and obligation to speak for ourselves.

2.3.6 In this particular case, we do not agree with Dr. Booth that this is an appropriate time for the Board to review the equity thickness of Enbridge. On our interpretation of the Board's policy, and lacking any significant change in risk, the next time this should be reviewed is in the Board's planned generic review of cost of capital in 2014.

3 THE UNION GAS DECISION

3.1 *Background*

3.1.1 On October 25, 3012, the Board released its Decision with Reasons in EB-2011-0210, an Application by Union Gas for rates commencing 2013. One of the unsettled issues in that case was Union's proposal to increase its equity thickness to 40%. The Board denied that increase.

3.1.2 In this proceeding, Enbridge has taken the position that the Union Decision should not be considered, because the evidence on risk is specific to each individual case [Argument in Chief, para. 46-7].

3.1.3 Enbridge's "expert", Mr. Coyne, goes a step further. He claims [Tr2:125] that for this Board panel to consider the Union Decision would be self-referencing ("circular", he calls it). His startling view – and perhaps further proof that he is not an expert in the Board's regulatory policies – is that this Board should look at the results of decisions of other regulators, in both Canada and the U.S., without even reading those decisions, but should expressly ignore a contemporaneous decision of this Board that had an identical issue in an almost identical regulatory and geographic environment.

3.2 *Consideration of the Result*

3.2.1 SEC disagrees. Not only is the Union Decision useful in its analysis, but it is also important for the Board, as much as possible, to maintain consistency in its decisions between utilities. Just as the Board is careful to ensure consistency, for example, in its handling of issues in the many rate cases for electricity distributors, it should seek consistency in its gas distribution decisions as well.

3.2.2 Therefore, in our view the Union Decision is a critical aspect of the Board's consideration of Issue E2 in this case.

3.2.3 In SEC's submission, there is a simple logic to the consideration of the Union Decision. Only one of three conclusions can be reached by this Board panel:

(a) As a result of the Board's decision rejecting a change in the equity thickness for Union Gas, the return for Union's shareholder no longer meets the Fair Return Standard. That is, the Board "got it wrong" in EB-2011-0210. The Board could conclude that it "got it wrong" because Union presented their case badly, or for some other procedural reason, but the result would still be the same: non-compliance with the Fair Return Standard.

(b) Enbridge has experienced a significant increase in its business risk since 2007 that was not experienced by Union Gas over the same period.

(c) The equity thickness of Enbridge should not be changed.

There are no other possibilities. One of the above must be true.

3.2.4 In the case of the first choice, in our submission this Board panel should not make a decision that another Board panel got the same issue wrong, unless it has clear and incontrovertible evidence that was the case. No such evidence was provided in this proceeding, and no such evidence is apparent in the Union case.

3.2.5 In the case of the second choice, Enbridge has admitted that their business risk is about the same as that of Union Gas [Tr1:90], and the Board found in the Union Decision that Union's business risks have not increased significantly since 2007. Enbridge would therefore have to identify significant changes in business risk that Enbridge experienced, and Union did not. None of the proposed changes in business risk could reasonably be considered to be Enbridge-specific.

3.2.6 This leaves only one option, (c). In our submission, this conclusion is inescapable.

4 FAIR RETURN STANDARD, ROE AND EQUITY THICKNESS

4.1 *Analysis*

4.1.1 Concentric took the position that satisfaction of the Fair Return Standard requires comparison with market comparables for both ROE and equity thickness. Enbridge tries to piggyback on that position in its Argument in Chief [p.2].

4.1.2 In our submission, this is not correct. While the two issues are clearly related, the Fair Return Standard is about the appropriate rate of return allowed on a given amount of equity. It says nothing about the appropriateness of that given amount of equity. Equity thickness is an input to the standard, not an output.

4.1.3 SEC believes that equity thickness is driven by protection of debt. The higher the amount of equity that is invested, the lower the risk to the creditors, and therefore the lower the cost of debt. Leveraging is considered a type of risk, and increasing or decreasing the level of leverage increases or decreases the risk to investors.

4.1.4 In purest theory, the overall cost of capital of a company should not change based on equity thickness. If the equity is thicker, the cost of both equity and debt will be lower, and the weighted cost between the two will be the same. The ROE of a company with 100% equity should be the same as the interest cost of the same company with 100% debt.

4.1.5 In the real world, this is of course not true. As equity is increased, thus increasing cost of capital because equity is typically more expensive, the cost of debt goes down because it is less risky. That drop in the cost of debt is not linear. It depends on a number of market forces. There is, for any given company, a theoretical optimum level of equity to keep the overall cost of capital at its lowest amount.

4.1.6 None of this is particularly revolutionary, but there is an important implication for the Board's consideration of equity thickness.

4.1.7 Concentric asks the Board to conclude that, even if the Board has the ROE right, if it doesn't allow the shareholder to invest sufficient equity in the company, the shareholder is not being allowed to earn a fair return, and the Fair Return Standard is being breached. The ROE is right, but the thickness is wrong, and both have to be right. This sounds quite logical, but it has the analysis backwards.

4.1.8 In fact, the determination of the appropriate equity thickness should be independent of the Fair Return Standard. Equity thickness should be established based on optimizing debt costs and access to the debt markets. While it is not really a science, it is something that companies do every day, so it is a tractable problem.

4.1.9 The Fair Return Standard only kicks in once the amount of equity has been determined. Once that decision has been made, the Fair Return Standard requires the Board to allow the shareholder to earn a fair return (essentially a risk-adjusted market return) on that amount of equity.

4.1.10 So yes, the equity thickness and FRS are related, but sequentially. You cannot set a fair return until the equity thickness has been established. A return is fair only for a given level of equity investment.

4.2 ***Implications***

4.2.1 SEC is not offering the above analysis with the intent that the Board will accept it. This would have to be pursued through expert evidence, something that was not done in this proceeding.

4.2.2 However, we are concerned with attempts by Concentric to expand the Fair Return Standard to include equity thickness. This would appear to us to be incorrect, and contrary to the legal precedents.

4.2.3 To the extent that there is any doubt about this formulation of the legal test, then in our submission it would be appropriate for the Board to include the relationship between equity thickness and FRS as an issue to be considered in its 2014 generic cost of capital proceeding.

5 GENERIC COST OF CAPITAL REVIEW

5.1 ***General***

5.1.1 The Board has said on a number of occasions that it expects to undertake a review of the cost of capital for regulated entities five years after the last one, i.e. in 2014.

5.1.2 The Applicant, and perhaps other utilities, take the view that the profits they include in revenue requirement are insufficient relative to the market or to the decisions of other regulators. This may be because the equity thickness is too little, or the ROE is too low, but the end result is that allowed net income, in their view, should be higher.

5.1.3 Some intervenors, including SEC, believe that the income levels of regulated utilities in Ontario are too high, as evidenced by the fair market value premiums on the sale of utility assets, and the equity returns forecast or assumed by pension funds and other investors.

5.1.4 It is submitted that to the extent utilities or intervenors want to raise these concerns, a generic review is the appropriate forum. Conversely, reviews of the elements of cost of capital within an individual rate case are, with few exceptions, less productive and, in our view, should be discouraged by the Board.

6 OTHER MATTERS

6.1 *Issue E1*

6.1.1 In light of our position on Issue E2, SEC does not need to provide any submissions on Issue E1.

6.2 *Costs*

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

All of which is respectfully submitted.

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