Ontario Energy Board

Commission de l'énergie de l'Ontario

EB-2006-0034

IN THE MATTER OF the Ontario Energy Board Act, 1998, S.O. 1998, c.15

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, 2007.

AND IN THE MATTER OF Phase Two of that Application dealing with the Regulatory Cost Allocation Methodology (RCAM)

BEFORE: Gordon Kaiser
Vice Chair and Presiding Member

Ken Quesnelle
Member

DECISION WITH REASONS

This Decision deals with the regulatory cost allocation methodology employed by Enbridge Gas Distribution Inc. and in particular, two matters on which the parties have been unable to agree upon namely, the cost of raising equity and the cost of stock options.

This issue goes back to Enbridge's 2006 rate application. In that Decision[1], the Board directed Enbridge to conduct an independent evaluation of its regulatory cost allocation methodology ("RCAM"), taking into account the Board's recommendations in that Decision. Pursuant to the Board's directive, Enbridge commissioned an independent review of the RCAM for its 2007 rate case. One of the issues in the 2007 rate case was issue 3.6: Does the revised RCAM conform to the Board's directives in the EB-2005-0001 Decision?

The Board issued a Procedural Order on April 16, 2007 indicating that this matter would be considered as a second phase of Enbridge's 2007 rate application hearing.

In the first phase of the hearing the Board accepted, as part of the "completely settled package", the parties' agreement on issue 3.7 which was the quantum of the RCAM allocation for 2007 ($18.1 million). A supplementary Settlement Agreement was filed with the Board on September 26th, 2007 and presented to the Board at an oral hearing on September 27th, 2007. The Board accepted the Supplemental Agreement during the hearing[2]. The parties were able to reach an agreement on all outstanding issues with respect to the RCAM except the cost of raising equity and the cost of stock options. This Decision deals with those two issues.

The supplementary Settlement Agreement of September 27, 2006 is attached to this Decision as Exhibit "A". The intervenors opposing Enbridge's claim for the cost of raising equity and stock options are set out in Appendix "B". The witnesses testifying on these two issues are set out in Appendix "C".

The Cost of Raising Equity

At one time, the cost of raising equity was undertaken within the regulated utility. That activity is now carried out by Enbridge's parent, Enbridge Inc. ("EI"). Enbridge argues that the fact that the activity is carried out by the parent should not change the ability of Enbridge to claim these costs. The Utility argues that the cost of raising equity capital continues to be an important function and the cost should be recovered in rates as it has in the past.

[1] EB-2005-0001 Decision with Reasons, February 9, 2006, page 88

[2] Transcript, EB-2006-0034, Volume 17, September 27, 2007, page 93

In August 1995, Consumers Gas Limited, the predecessor of Enbridge, applied to the Board for approval to centralize treasury operations in Calgary under the corporate structure of the parent of Consumers Gas at that time, IPL Energy Inc. ("IPL"). This arrangement continues with Enbridge relying on EI to perform these functions.

There is no dispute as to the cost of the treasury functions or their necessity. Rather, the intervenors argue that the cost of raising equity is in fact recovered by EI in Enbridge's regulated rate of return on equity.

The Board does not accept the intervenor's arguments on this issue. The intervenor's own witness, Mr. Mak of Rosen and Associates agreed that the costs incurred in raising capital did not influence the regulated rate of return. Nor do we accept the evidence of the intervenors that EI can be equated to private sector investors who raise capital to invest in various companies.

There is a fundamental difference between investment in an unregulated entity and the investment in a regulated gas utility. In the former, investors strive to maximize profit. But Enbridge's return of equity is set pursuant to the explicit formula set and approved by the Board. Also, when EI acquired the shares of Enbridge, it had good reason to believe that it would be entitled to recover the cost of raising equity for the regulated utility.

MNP concluded in its Report[3] that Enbridge had passed the three-pronged test for investor services and capital market financing and access activities. The intervenors disagree for two reasons.

First, they argued that the cost EI incurs to obtain funds is for its own account. They state that these costs do not arise from a service provided by EI to Enbridge. They claim that equity financing was obtained by EI for the benefit of EI as an investor. Capital market and shareholder relation costs, they say, are investor costs and should be born entirely by EI.

[3] Exhibit D2-T1-S1, MNP Final Report*, Independent Evaluation of EGD's Regulatory Corporate Cost Allocation Methodology*, February 28, 2007

The second argument advanced by the intervenors is that unlike most other companies, Enbridge is allowed to include a rate of return on equity in its rates and its revenue requirement. They state that this ROE is essentially an assured rate of return and that if EI charges Enbridge for the costs of raising equity; this amounts to double-billing. That is; the cost of raising equity is recovered through the RCAM and then a second time through the ROE the parent receives on its investment in Enbridge.

The intervenors suggested that the relevant question is whether the service would be required if it was not provided by the parent company. They argue that even if EI did not perform the capital market function for Enbridge, Enbridge would not need to raise equity from the public equity markets because it is wholly owned by EI.

The Board does not accept this position. It is circular reasoning. If Enbridge was a stand alone utility and not a wholly-owned subsidiary, it would still have these costs. No one disputes that a corporation such an Enbridge requires equity and there is a cost to raising that equity.

The intervenors also argued that allowing equity financing costs will open the floodgates for other utilities such as Toronto Hydro Corporation and Ontario Financial Corp. to claim notional costs for providing equity to Toronto Hydro and Hydro One. Enbridge's response is that such costs would face a Board review and in any event the Enbridge costs are real and not notional. The Board accepts the Enbridge submissions on this point. Enbridge should be allowed to recover the cost of raising equity in rates.

The Cost of Stock Options

Enbridge like many companies offers its executives stock options. The company testified that these options are an important part of the compensation packages and if removed, the Enbridge compensation packages would no longer be competitive. Enbridge also argues that if removed, the stock options would have to be replaced by more costly compensation.

The intervenors agree that if stock options are removed, they would have to be replaced by other compensation which would likely result in higher operating

costs. Nonetheless, the intervenors take the position that because the options do not result in a cash outlay they are not costs recoverable in rates.

Enbridge responds that the intervenors fail to acknowledge the cost to the shareholder of the dilution impact. The Company also claimed that there is a loss to the EI treasury because it is foregoing the receipt of the full-market value of the shares on the date they are exercised. The dilution impact of issuing stock options was 2¢ per share in 2006. Spread over the entire 343.3 million shares, the dilution impact was not inconsequential.

Enbridge also points to prior testimony given by the principal of Rosen & Associates that options should be considered as a reasonable expense by companies. The article in question quoted Mr. Rosen as saying that "the delay in expensing options on the Income Statement outside of Canada is not so much a question of whether options are an expense but rather the best measure of the expense"[4]. Enbridge pointed to the inconsistency between Mr. Rosen's statements and the evidence of the intervenor's witness, Mr. Mak of Rosen & Associates in this proceeding.

In its Decision with Reasons dated July 21, 2001[5] the Board approved Union's implementation of an accounting change to account for pension and other benefits post-retirement on an accrual basis rather than on a cash basis in accordance with generally accepted accounting principles ("GAAP"). Accordingly, recovery by Union was not dependent on a cash outlay.

Enbridge cited other examples where costs are recovered in rates where there was no cash outlay such as a DSM incentive payment. Enbridge also pointed to the Board's Decision in Union Gas 2004 rates proceeding[6] where the Board rejected intervenor arguments and accepted Union's use of incentive payments as a "legitimate compensation package offered to attract and retain qualified managers and staff in a competitive market for human resources."

[4] Accountability Research Corporation, *What to Watch for With Stock Option Expenses*, July 27, 2004, page 3 (KT 11.3)
[5] RP-1999-0017 Decision with Reasons, July 21, 2001, pages 65-69
[6] RP-2003-0063 Decision with Reasons, March 18, 2004, paras 534-537

Enbridge also cites the September 2004 Decision of the National Energy Board[7] which allowed TransCanada to recover 100% of its long term incentive compensation costs. As the National Energy Board stated:

> "In order to be competitive in the marketplace for employees TransCanada must offer a suite of compensation components similar to its comparator group and the focus on shareholder value is not necessarily detrimental to the shipper interests."

Enbridge distinguished the decision of British Columbia Utility Commission regarding BC Gas Utility Limited[8] where the Commission denied recovery of certain stock option expenses. There, as Enbridge states, the issue was whether the compensation packages were overly generous. There is no issue in this proceeding about the benefits to ratepayers or the importance of stock options as part of the competitive compensation package. The issue here is a narrower one; whether a non-cash expense qualifies as a regulatory expense for rate making purposes.

The Board accepts Enbridge's submissions with respect to recovery of the cost of stock options. These stock options are an important element of an executive compensation in any modern corporation. This compensation does have a cost although it may not be a cash cost in the usual sense.

If the Board denied recovery of these costs, they would no doubt be replaced by more expensive alternatives which would not benefit the ratepayers or the shareholders. Shareholders may of course benefit from stock options by way of an increased profit. In this regard, it is important to note that this Utility is now embarking on a five-year rate-incentive mechanism which specifically provides for an earnings sharing mechanism.[9]

For the reasons set out above, the Board will allow Enbridge to recover in rates, both the cost of raising equity and the cost of stock options.

[7] RH-2-2004 Phase 1, Reasons for Decision, September 2004, page 12
[8] Decision, BC Gas Utility Ltd. 2003 Revenue Requirements Application, February 4, 2003, pages 12-15
[9] EB-2007-0606 Decision, January 17, 2008

Cost Awards

Parties who intend to claim cost awards for Phase 2 of this proceeding must file cost claims by June 9, 2008. A copy of the cost claim must be filed with the Board and one copy is to be served on Enbridge. The cost claims must be done in accordance with section 10 of the Board's Practice Direction on Cost Awards.

Enbridge will have until June 23, 2008 to object to any aspects of the costs claimed. A copy of the objection must be filed with the Board and one copy must be served on the party against whose claim the objection is being made.

The party whose cost claim was objected to will have until June 30, 2008 to make a reply submission. Again a copy of the submission must be filed with the Board and one copy is to be served on Enbridge.

ISSUED at Toronto, May 20, 2008

Original signed by

Gordon Kaiser
Vice Chair and Presiding Member

Original signed by

Ken Quesnelle
Member

Appendix A To

Decision with Reasons

EB-2006-0034

May 20, 2008

Supplementary Settlement Agreement

SUPPLEMENTARY SETTLEMENT PROPOSAL

REGULATORY COST ALLOCATION METHODOLOGY

September 27, 2007

3.6 Do the revisions to the Regulatory Cost Allocation Methodology (RCAM) meet the Board's directives in the 2006 decision?

(Incomplete Settlement)

The issue of whether the revisions to RCAM meet the Board's directives from the 2006 decision has been a subject of the corporate cost allocation consultative which has been ongoing. As set out below, parties have been able to come to an agreement to settle certain issues relating to the RCAM.

All aspects of this Supplementary Settlement Proposal are subject to approval by the Board. The parties to the settlement all agree that this Supplementary Settlement Proposal is a package: the individual aspects of this agreement are inextricably linked to one another and none of the parts of this settlement are severable. As such, there is no agreement among the parties to settle any aspect of the issues addressed in this Supplementary Settlement Proposal in isolation from the balance of the issues addressed herein. The parties agree, therefore, that in the event that the Board does not accept this Supplementary Settlement Proposal in its entirety, then (in accordance with the Board's Settlement Conference Guidelines) the Board will reject the Supplementary Settlement Proposal in its entirety and proceed to hearing.

This Supplementary Settlement Proposal, if approved by the Board, will be added to the Settlement Proposal (Ex. N1-1-1) approved by the Board on January 29, 2007 (the "January 29th Settlement Proposal") and the provisions of this Supplementary Settlement Proposal will supersede the references at pages 26 and 27 of the January 29th Settlement Proposal which state that there is no settlement of Issue 3.6. As the January 29th Settlement Proposal settled the level of the Company's O & M Budget for 2007, this Supplementary Settlement Proposal, if approved by the Board, will have no impact on the Company's revenue requirement for 2007.

With that preamble, the following represents the settlement that has been agreed upon.

The Parties agree and accept that, subject to the requirements and exceptions set out below, the Company has complied with the Board's directives from the 2006 decision in respect of its RCAM.

Parties agree that the corporate cost allocation consultative will be continued. Commencing in 2008 and for each year that the Company operates under an incentive rate regulation regime, the Parties agree that where the thresholds set out below are exceeded, the Company will, on an annual basis, provide to members of the consultative the following information:

(i) a summary table setting out the direct and common allocation costs allocated to the Company for each service and all direct charges allocated to the Company for the year in question and the total allocation costs for

each service and direct charge for the immediately preceding year. In addition, the Company will provide the consultative with a table setting out the departmental O & M budgets for Enbridge Inc. for the year in question;

(ii) the Company will give the consultative notice of any service which is discontinued in its entirety. The Company will also provide the consultative with a copy of the service schedule for any new service or direct charge which is undertaken or incurred in 2008 and beyond. The Company will also provide the consultative with notice of its implementation of any of the recommendations made by Meyers Norris Penny LLP in its report dated February 28, 2007.

Furthermore, where the thresholds set out below are exceeded, the Company shall provide the following additional information:

(i) description of the drivers for increases in RCAM costs which exceed the aggregate threshold;

(ii) where the threshold for an individual service or direct charge is exceeded, the Company will provide to the consultative a description of the drivers for the increase and a copy of the most current service schedule for the service/charge in question.

Parties agree that the thresholds which trigger the above obligations are as follows:

(1) The aggregate corporate cost allocation amount for 2007 rates is $18.1 million. Should this amount increase in 2008 by an amount greater than the Ontario Consumer Price Index ("CPI") plus 3%, the aggregate threshold has been triggered. For subsequent years, the aggregate threshold is triggered where the increase in the aggregate of all RCAM allocations to the Company in comparison to the immediately preceding year is greater than the CPI plus 3%.

(2) The individual service threshold is triggered where the corporate cost allocation to any specific service or any direct charge increases in any one year by an amount greater than the CPI plus 10% and the increase is greater than $50,000.

The parties agree that the thresholds set out above are to be interpreted only as triggering mechanisms in respect of the reporting requirements set out herein and are not necessarily indicative of the parties' views regarding reasonable year over year changes in RCAM amounts payable by EGD.

The Company agrees that it will entertain and respond to any reasonable questions received from the consultative in relation to the information it provides to the

consultative as required above. Parties agree that all responses and all information provided to the consultative which it may then share with other intervenors will be on a without prejudice basis and will be treated as if such responses and information had been provided by the Company during a Settlement Conference.

Parties agree that this Supplementary Settlement Proposal in no way infringes upon any existing or future rights that any party may have under the Act or in any future proceeding.

Parties have not settled issues in respect of the following service and Direct charge, but have been able to scope the remaining issues for the purposes of the hearing, as follows:

Capital Market Financing and Access

Are the costs related to obtaining and maintaining equity capital by Enbridge Inc. appropriately recoverable from ratepayers through the RCAM?

EGD Stock Based Compensation

Are stock option expenses appropriately recoverable from ratepayers through the RCAM? (Performance stock units are not in issue)

Participating Parties: All parties participated in the negotiation and settlement of this issue except: ABSU, Coral, Direct Energy, Gazifere Inc., GEC, HVAC Coalition, Networks, Jason Stacey, LIEN, OAPPA, OESLP, OPG, Pollution Probe, Sithe Goreway, SEM, Thomas Matz, TransAlta, TransCanada Energy Ltd., TransCanada, Union Energy LP, and Union.

Approval: All participating parties accept and agree with the proposed settlement of this issue.

Evidence: The evidence in relation to this issue includes the following:

A1-9-1	List of Affiliate Transactions
D1-2-2	Employee Expenses and Workforce Demographics
D1-2-3	Supplementary Evidence RCAM: Stock Option Compensation
D1-3-1	Corporate Cost Allocations
D1-3-2	RCAM: Update and Summary of Independent Evaluation, and Intercorporate Services Agreement
D2-1-1	Corporate Cost Allocation: Meyers Norris Penny LLP Report, February 28, 2007, and Appendices
D2-1-2	MNP Reply to Preliminary Report of Rosen and Associates, September 14, 2007
D3-2-3	Operating and Maintenance Expense by Cost Type
I-1-27 to 28	Board Staff Interrogatories 27 and 28
I-9-1	IGUA Interrogatory 1

I-16-38 to 39, 57	SEC Interrogatories 38, 39 and 57
I-24-2 to 3, 34 to 37	VECC Interrogatories 2, 3 and 34 to 37
KT11.1-1 to 2	Board Staff Interrogatories 1 and 2
KT11.2-1 to 19	VECC Interrogatories 1 to 19
L-28-1	Preliminary Report of Rosen & Associates Limited, May 30, 2007
Tr.	Transcript of Technical Conference, May 1, 2007
JTII.1, 1-10	EGD Undertaking Responses, 1 to 10
KTII.3,1 to 6	EGD Interrogatories 1 to 6

Appendix B To

Decision with Reasons

EB-2006-0034

May 20, 2008

List of Intervenors

ENBRIDGE GAS DISTRIBUTION INC.
2007 RATES CASE – PHASE II
EB-2006-0034

LIST OF INTERVENORS

	Intervenors	Rep. And Address for Service
1.	Consumers Council of Canada ("CCC")	Julie Girvan 2 Penrose Road Toronto ON M4S 1P1 Tel: 416-322-7936 Fax: 416-322-9703 Email: jgirvan@ca.inter.net
	AND	Robert B. Warren Counsel WeirFoulds LLP Barristers & Solicitors The Exchange Tower, Suite 1600 P.O. Box 480, 130 King St. W. Toronto ON M5X 1J5 Tel: 416-947-5075 Fax: 416-416-365-1876 Email: rwarren@weirfoulds.com
2.	Energy Probe Research Foundation ("Energy Probe")	David S. MacIntosh c/o Energy Probe 225 Brunswick Avenue Toronto ON M5S 2M6 Tel: 416-964-9223 ext. 235 Fax: 416-964-8239 Email: DavidMacIntosh@nextcity.com
	AND	Thomas Adams c/o Energy Probe 225 Brunswick Avenue Toronto ON M5S 2M6 Tel: 416-964-9223 ext. 239 Fax: 416-964-8239 Email: TomAdams@nextcity.com

	AND	Mr. Randy Aiken Aiken & Associates 578 McNaughton Ave. West Chatham, Ontario, N7L 4J6 Tel: 519-351-8624 Fax: 519-351-4331 Email: raiken@xcelco.on.ca
3.	Industrial Gas Users Association ("IGUA")	Murray A. Newton President Suite 1201 - 99 Metcalfe Street Ottawa ON K1P 6L7 Tel: 613-236-8021 Fax: 613-230-9531 Email: mnewton@igua.ca
	AND	Peter C.P. Thompson, Q.C. Borden Ladner Gervais LLP Barristers and Solicitors World Exchange Plaza 100 Queen Street, Suite 1100 Ottawa ON K1P 1J9 Tel: 613-787-3528 Fax: 613-230-8842 Email: pthompson@blgcanada.com
4.	School Energy Coalition	Bob Williams Co-ordinator Ontario Education Services Corporation c/o Ontario Public School Boards' Association 439 University Avenue, 18th Floor Toronto ON M5G 1Y8 Tel: 416-340-2540 Fax: 416-340-7571 Email: bwilliams@opsba.org

	AND	Tanya Watson Consultant Institutional Energy Analysis, Inc. 700 - 250 University Avenue Toronto ON M5H 3E5 Tel: 416-214-5218 Fax: 416-214-5418 Email: tanya.watson@shibleyrighton.com
	AND	Jay Shepherd Shibley Righton LLP Barristers and Solicitors 700 - 250 University Avenue Toronto ON M5H 3E5 Tel: 416-214-5224 Fax: 416-214-5424 Email: jay.shepherd@shibleyrighton.com
5.	Vulnerable Energy Consumer's Coalition ("VECC")	Dr. Roger Higgin Managing Associate Econalysis Consulting Services 1102 – 34 King Street East Toronto ON M5C 2X8 Tel: 416-348-9391 Fax: 416-348-0641 Email: rhiggin@econalysis.ca
	AND	James Wightman Econalysis Consulting Services 1102 – 34 King Street East Toronto ON M5C 2X8 Tel: 416-348-0640 Fax: 416-348-0641 Email: jwightman@econalysis.ca
	AND	Michael Buonaguro Counsel for VECC Public Interest Advocacy Centre 1102 - 34 King Street East Toronto ON M5C 2X8 Tel: 416-348-0814 Fax: 416-348-0641 Email: mbuonaguro@piac.ca

Appendix C To

Decision with Reasons

EB-2006-0034

May 20, 2008

Witnesses

Witnesses EB-2006-0034	
Enbridge	
Jane Haberbusch	Director of Human Resources
Narin Kishinchandani	Director of Finance and Control
Patrick Hoey	Director of Regulatory Affairs
Robert Baldauf	Consultant , Meyers Norris Penny LLP
VECC	
Alan Mak	Consultant, Rosen & Associates
Mark Noxon	Consultant, Rosen & Associates