

April 22, 2014

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
P.O. Box 2319
Toronto, Ontario
M4P 1E4

Dear Ms. Walli:

Re: EB-2012-0459 – Enbridge Gas Distribution Rates – Customized Incentive Regulation Model – 2014-2018

I am a consultant for the Consumers Council of Canada ("Council"), an intervenor in the above-referenced proceeding. Please find, attached, the Council's Final Argument regarding Enbridge Gas Distribution's Application for rates for the period 2014-2018.

Yours truly,

Julie E. Girvan

Julie E. Girvan

CC: EGD Regulatory
Fred Cass, Aird & Berlis
All parties
Consumers Council of Canada

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. for an Order or
Orders approving an incentive regulation
mechanism for the period 2014 through 2018

FINAL ARGUMENT OF THE CONSUMERS COUNCIL OF CANADA

April 22, 2014

I. INTRODUCTION:

On July 3, 2013, Enbridge Gas Distribution Inc. (“EGD”) filed an Application for approval of a methodology for the purposes of setting rates for the period January 1, 2014 through to the end of 2018 (the “Application”). EGD has characterized its five-year approach to ratemaking as a “Customized Incentive Regulation (IR) Plan” under which distribution revenue amounts, or “Allowed Revenues” will be established for the years 2014-2018 (“EGD’s Plan”).

The proceeding included an extensive interrogatory process, a Technical Conference and a Settlement Conference. None of the issues were settled, and therefore the Board proceeded with an 11-day oral hearing that began on February 20, 2014 and concluded on March 25, 2014.

These are the submissions of the Consumers Council of Canada (“Council”) regarding EGD’s Application. For the reasons set out below the Council will be

urging the Board to reject the adoption of EGD's proposed Customized IR Plan for the purposes of setting rates for the period 2014-2018.

The Council submits that main reasons the Board should reject EGD's proposed Customized Plan, which will be elaborated on throughout these submissions, are as follows:

1. EGD's plan is not consistent with accepted IR methodologies, nor is it consistent with the Board's NGF Report;
2. EGD has not demonstrated why it cannot live with a more balanced framework similar to the one Union Gas Limited ("Union") has agreed to, and has been accepted by the Board. In addition, EGD has not demonstrated that it would be unable to manage within the framework that was in place for the period 2018-2012. In effect, EGD is arguing that the continuation of an I minus X framework is not a "workable solution", but those arguments have not been not convincing;
3. Despite EGD's claim that its plan is "in line" with the Board's Renewed Regulatory Framework ("RRFE") there are many ways that the plan is not consistent with the Custom IR approach described by the Board in its RRFE Report;
4. EGD's Plan is essentially a hybrid approach to regulation, taking elements of cost of service regulation (forecasts of costs) and elements of IR (Z-factors, Y-factors etc.) and melding them into a complicated model that is not likely to create incentives for efficiencies;
5. EGD's Plan, with all of its individual components does not represent a proposal that appropriately balances the interests of EGD's ratepayers and its shareholders. Relative to its last framework the risk-reward balance has shifted in favour of EGD's shareholder.

EGD's Rate Proposal – The Application

EGD has summarized its plan in the following way:

Enbridge's proposed Customized IR plan fixes Allowed Revenue for 2014 to 2018 based on forecast costs, inclusive of productivity savings, for each year. The Allowed Revenue for each year of the plan operates as a revenue cap, and upon Board approval of Allowed revenues, the outcome is a decoupling of revenues from actual costs for the five years of the plan.

As stated in Enbridge's pre-filed evidence, just as with an I-X price or revenue setting regime, EGD's model is designed such that future actual costs have no regard to the pre-determined revenue cap. Also, just as with an I-X or

revenue setting regime, there are no adjustments for cost elements throughout the plan term.

The proposed plan includes an annual rate adjustment process for 2015 to 2018, in order to update volumes and pass through cost items (gas costs and amounts determined in other proceedings) and it also includes appropriate protections for ratepayers and Enbridge such as an Earnings Sharing Mechanism (ESM) a Z-factor mechanism and an Off-ramp. (Argument in Chief, pp. 5-6)

The major elements of EGD's proposed Custom IR Plan are as follows:

1. Annual "Allowed Revenue" Determination and Adjustments
2. Cost Items Subject to Annual Updates/Y-factors
3. Z-Factors
4. Off-Ramp
5. Earnings Sharing
6. Treatment of Cost of Capital
7. Performance Measurement including Service Quality Requirements ("SQRs")
8. Sustainable Efficiency Incentive Mechanism ("SEIM")
9. Deferral and Variance Accounts
10. Annual Reporting Requirements
11. Rebasing

In addition, through this Application, EGD is seeking approval of its proposal to deal with Site Restoration Costs ("SRC") during the five-year rate period. This proposal arose out of EGD's 2013 Depreciation Study. It involves the treatment of the prospective collection of SRC amounts, as well as the return (or credit) of the accumulated SRC depreciation reserve variances. The variances were caused by a change in the procedure used to determine required net salvage percentages (Exhibit, D1/T5). EGD has, in effect, over-collected amounts related to SRC that should returned to ratepayers.

From the Council's perspective it is important that the Board consider the merits of EGD's Plan separately from its consideration of the SRC issues. The Board must consider whether EGD's Plan in an appropriate way to set rates, or in the alternative whether another model is more appropriate. The Council submits that EGD's proposal to credit ratepayers going forward, for an over-collection that occurred over time, should not in any way influence the Board's assessment of EGD's ratemaking proposals for the period 2014-2018.

Although EGD has acknowledged that the issues are distinct they have continually characterized the impact of the "Customized IR plan" as resulting in an average rate increase for residential consumers of 2.2% per year. The annual compounded rate is over 4% a year if the SRC impacts are taken out. (Exhibit K.13) EGD has attempted to mute the overall rate impacts of its proposed IR Plan by including the

impact of a credit owing to ratepayers that has nothing to do with the parameters of its plan.

Structure of the Argument:

The case has been complex, involving many inter-related issues. In addition, the implications of this case for EGD's ratepayers are significant because the Board's Decision may ultimately impact the way in which rates are set for the next five years.

From the Council's perspective the Board's Decision in this case is not simply about the Board saying "yes" or "no" to EGD's application. The Board has a range of options with which to deal with the Application. Implementation of any of these options will not be a simple process. These include, but are not limited to:

1. The Board could find EGD's overall Plan acceptable and set rates on that basis;
2. The Board could find the Plan acceptable with a number of amendments or conditions (as suggested as an option by Board Staff in the Board Staff Submissions, pp. 73-78);
3. The Board could find EGD's Plan unacceptable, and not compatible with its requirement to set just and reasonable rates;
4. If the Board rejects EGD's Plan it could leave current rates in place or set rates for 2014 (using a range of options) awaiting a new application for 2015 and beyond;
5. If the Board rejects EGD's Plan, it could require EGD to come forward with a an application, specifying its expectations in terms of how the plan should be designed for either 2014 or 2015;
6. If the Board rejects EGD's Plan it could require EGD's rates to be determined using another model like cost of service, or I minus X (e.g. the Union Model).

In its Argument in Chief, EGD argues that because no party has chosen to file evidence in support of an alternative proposal, there is no evidentiary basis on which the Board could establish an alternative ratemaking framework (Argument in Chief, pp. 20-21). The Council completely disagrees with EGD's position on this point. The evidence in this case was extensive. Clearly, there is sufficient evidence that would allow the Board to set rates in a way that differs from that proposed by EGD.

The Council has organized its submissions in the following way:

1. Section II will set out what we view as the relevant Background and Context within which the Board should consider the Application;
2. Section III will set out the Council's conclusions as to why EGD's Plan is not in the best interests of its ratepayers;
3. Section IV will address the individual components of EGD's Plan which have been enumerated above;
4. Section V will address other rate related issues included in EGD's Application;
5. Section VI will make submissions regarding rate implementation;

The Council has had an opportunity to have many discussions with other intervenors throughout this proceeding regarding the issues, and relative positions of the parties on the issues. In addition, we have reviewed the submissions of Board Staff and those of some of the other intervenors while drafting these submissions. Accordingly, the Council does not intend to comment extensively on each and every issue, knowing others will be making submissions compatible with our views.

II. BACKGROUND AND CONTEXT:

The Council submits that in considering EGD's Application it is important to set out the relevant context, both with respect to Board's ratemaking policies and EGD's Application.

A. Preliminary Issue:

At the outset of this proceeding the Board received a letter from the School Energy Coalition ("SEC") submitting that EGD's proposals, as set out in the Application, run contrary to the Board's usual Incentive Regulation Mechanism ("IRM") approach, which effectively decouples revenues and costs. SEC raised the possibility that, if the Board waited to the end of the proceeding to consider whether EGD's methodology was appropriate, time and money would be wasted. SEC argued that it would be more efficient to consider this issue up front as a "preliminary" issue.

The Board sought submissions from parties as to whether there was a need to determine a preliminary issue, and if so, the rationale for determining the issue prior to hearing the full application. The Board also sought input on what evidence would be relevant to the consideration of the preliminary issue.

The Board determined that the most efficient course was to proceed immediately with the entire application. The Board indicated, however, that it was of the view that it was not obligated to approve or deny the framework as proposed by EGD. Furthermore, the Board expressed a view that it had not heard any compelling case that it would be restricted from establishing an alternative framework were it to find it appropriate to do so and there was an evidentiary basis for it. (Decision and Procedural Order No. 2, dated October 3, 2013, p. 3)

In effect, the Board has already determined that it could approve an alternative to the regulatory approach proposed by EGD and is not bound to consider some form of EGD's proposal and framework.

B. Incentive Regulation For Gas Utilities:

In its Natural Gas Forum Report, "A Renewed Policy Framework", issued on March 2005, the Board considered the merits of Cost of Service ("COS") ratemaking versus Performance Based Regulation. It determined, that in light of its statutory objectives, gas rate regulation must meet the following criteria:

- Establish incentives for sustainable efficiency improvements that benefit both customers and shareholders;
- Ensure appropriate quality of service for customers; and
- Ensure an environment that is conducive to investment, to the benefit of both customers and shareholders.

In addition, the Board added that a ratemaking framework that meets these criteria will ensure the Board's statutory objectives of consumer protection, infrastructure development and financial viability will be met, and the rates will be just and reasonable.

In that Report, the Board concluded, "The Board believes that a multi-year incentive regulation (IR) plan can be developed that will meet its criteria for an effective ratemaking framework: sustainable gains in efficiency, appropriate quality of service and an attractive investment environment. A properly designed plan will ensure downward pressure on rates by encouraging new levels of efficiency in Ontario's gas utilities – to the benefit of customers and shareholders." (NGR Report, pp. 15-22)

This was the genesis of IRM for the Ontario natural gas local distribution companies ("LDCs"). Both EGD and Union Gas Limited ("Union") had their rates determined through COS for 2007, then negotiated IRM plans with stakeholders which were ultimately approved by the Board for rates for the period 2008-2012. Union's plan was a price cap model and EGD's a revenue per customer cap. During that period rates were relatively stable and both LDCs generated earnings in excess of it allowed returns to the benefit of its ratepayers and shareholders.

Union and EGD rebased in 2013. Union subsequently entered into negotiations with its stakeholders in 2013 coming to an agreement regarding an incentive regulation plan. The basic components of Union's plan are the following:

1. A multi-year price cap/revenue cap index (Inflation – Productivity or I-X);

2. An inflation factor (I) based on the actual year over year percentage change in the annualized average of 4 quarters of Statistics Canada's Gross Domestic Product Implicit Price Index Final Domestic Demand (GDP IPI FDD), adjusted annually;
3. A productivity factor (X) of 60% of the inflation factor, inclusive of a stretch factor (no separate stretch factor), which results in an annual rate escalation factor of 40% of inflation;
4. A provision for certain, non-routine adjustments or "Z-factors";
5. A provision for certain, predetermined pass-throughs or "Y-factors";
6. Specifically, Y-factor treatment for major capital projects that meet certain criteria;
7. A provision for certain Deferral and Variance Accounts;
8. An annual adjustment to reflect changes in the normalized average consumption ("NAC") for the general service (not contract) customer classes;
9. A five-year term for the plan;
10. No provision for an off-ramp;
11. An earnings sharing mechanism ("ESM") where actual utility earnings 100 basis points above the 2013 Board-approved return on equity ("ROE") are shared on a 50/50 basis between Union and its customers. Earnings above 200 basis points will be shared on a 90/10 basis. The 2013 Board-approved ROE will be the benchmark ROE for the purposes of calculating earnings sharing;
12. The ROE embedded in 2013 rates of 8.93% will be fixed for the term of the plan;
13. Specified annual reporting requirements; and
14. A requirement for Union to hold an annual, funded stakeholder meeting after the public release of year-end financial results. (Exhibit K1.4)

The Union Settlement Agreement was filed with the Board on July 31, 2013, approved by the Board on October 7, 2013.

C. Renewed Regulatory Framework:

On October 18, 2012, the Board released its Report, “Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach”. In that Report, which is specific to the regulation of Ontario’s electric LDCs, the Board determined that it was adopting a performance-based approach to regulation that is focused on the achievement of “outcomes” to ensure that Ontario’s electricity system provides value for customers. The Board adopted the following desired outcomes: customer focus; operational effectiveness; public policy responsiveness; and financial performance. The Board also established three main ratemaking policies:

1. Three rate-setting methods – 4th Generation Incentive Rate-setting, Customer Incentive Rate-setting (“Custom IR”) and an Annual Incentive Rate-setting Index;
2. A requirement that distributors file 5-year capital plans to support their applications;
3. A scorecard approach linking specific measures to the four performance outcomes (RRFE Report, pp. 2-3)

With respect to Custom IR rates are set based on a five-year forecast of a distributor’s revenue requirement and sales volumes. Although the Report provided a general policy direction for the Custom IR method the Board noted that the specifics of how the costs approved by the Board will be recovered is to be determined individually.

The Custom IR approach was developed for distributors with significantly large multi-year or highly variable investment commitments that exceed historical levels. The Board set out its expectation with respect to this approach:

The Board expects that a distributor that applies under this method will file robust evidence of its cost and revenue forecasts over a five year horizon, as well a detailed infrastructure investment plans over that same time. (RRFE Report, p. 19)

EGD has attempted to justify its plan on the basis that it is consistent with the Board’s Custom IR as defined in the RRFE Report. EGD noted that although it was not meant to apply to gas utilities its plan “lines up extremely well with the approach to IR laid out by the OEB in the RRFE, and in particular, with the Custom IR approach”. EGD pointed to the following ways it views its plan consistent with the Board’s Custom IR approach:

- a) The Customized IR plan is designed to fit the specific circumstances of Enbridge;

- b) The Customized IR plan is appropriate for Enbridge due to significantly large multi-year or highly variable capital spending needs;
- c) While the Customized IR plan is not based on an I minus X approach, Custom IR under RRFE does not have to be based on I minus X;
- d) The Customized IR plan is based on evidence of cost and revenue forecasts over a five year horizon, as well as detailed infrastructure investment plans over that same time frame; and
- e) Enbridge is committed to the Customized IR plan for the duration of the five year term, subject to an Off-Ramp such as that contemplated by the RRFE report.” (Argument in Chief, p. 16)

D. Pacific Economics Group Research Report

Pacific Economics Group Research (“PEG”) and Dr. Larry Kauffman were retained by Board Staff to do a report assessing EGD’s Custom IR Plan. Board Staff, in its Submissions dated April 16, 2014, outlined many of the detailed concerns and issues raised by PEG with respect to EGD’s Plan. From the Council’s perspective the most important issues raised by PEG are as follows:

1. EGD claims its proposal is an example of “building block” regulation, but it’s a version that the UK regulator abandoned nearly a decade ago because of its poor incentive properties. EGD’s proposal creates incentives to inflate capital cost projections. Without independent and external benchmarking evidence the inherent incentive to inflate these forecasts can generate high prices and shift risk to customers (Exhibit L/T1/S2/p. 5).
2. EGD’s proposed Z-factor language is problematic. The language, which is different than that used in the last framework, would allow rate adjustments for cost increases or decreases linked to an “unexpected”, non-routine cause. The unexpected cause language could be interpreted to mean any cost change not reflected in the forecasts. (Ibid, p. 5)
3. The addition of several new deferral and variance accounts shift the risk-reward balance towards EGD’s shareholders (Ibid, p 5);
4. The work of Concentric Energy Advisors (“CEA”) does not support the efficacy of EGD’s projected costs or the reasonableness EGD’s Plan. CEA takes the reasonableness of EGD’s costs forecasts as given and simply evaluates whether alternative rate adjustment formulas calibrated with its research would allow EGD to recover its costs. CEA has not developed any independent evidence that can be used to confirm, reject or otherwise test

the reasonableness of EGD's forecasts over the term of the Customized IR proposal;

5. CEA's benchmarking methodology provides no persuasive evidence on EGD's cost efficiency;
6. PEG provides a detailed critique of CEA's total factor productivity analysis concluding that it is inconsistent with credible TFP analysis that has been presented elsewhere;
7. Given the Company's incentives to err on the high side when forecasting capital expenditures for a Customized IR plan PEG is of the view that EGD must provide compelling evidence that its capital cost projections are efficient and will generate reasonable prices. From PEG's perspective this was not done;
8. The SEIM proposal is not well designed and it proposes to reward EGD up front for promised efficiency gains. In addition it would weaken, and not strengthen performance incentives. It shifts risk to customers since customer rates would be raised to pay for SIEM rewards regardless of whether efficiency initiatives are successful (Exhibit L/T1/S2/p. 29);
9. Overall the proposed plan has poor incentives properties that may generate unreasonable prices and shift risks to customers. The empirical evidence presented By CEA in support of the plan is not compelling and does not allay PEG's fundamental concerns with the proposal (Exhibit L/T1/S2/pp. 5-8).

During his oral testimony DR. Kauffman highlighted his main concerns with EGD's Plan, the ones that have not changed since his initial report. He remains concerned that: a) the plan contains inherent incentives for EGD to inflate its capital expenditure forecast; b) there is no objective evidence to support the reasonableness of EGD's forecasts; c) it does not contain other features that effectively offset the incentives to inflate the forecasts; and d) EGD has not presented independent, objective, or rigorous total cost benchmarking evidence (Tr. Vol. 3, pp. 60-61).

III. SUBMISSIONS ON THE OVERALL PLAN:

A. Observations

During the 2008-2012 period EGD operated under an incentive regulation model based on a "revenue per customer cap". EGD's previous IR plan was relatively simple and resulted in reasonable rate impacts in each year of the plan. EGD over-earned significantly during that period and its ratepayers benefited through the ESM.

In its Argument in Chief, EGD characterized its Customized IR plan in the following way:

1. It is designed to fit EGD's specific circumstances and is "a logical evolution of it previous plan";
2. It is the right plan for EGD and it leads to a fair and balanced outcome for ratepayers and shareholders;
3. The capital cost forecasts take into account capital spending requirements driven by large projects and increased safety and integrity requirement in a manner where the costs are set at the lowest possible prudent level;
4. It provides a fair return on rate base by incorporating a reasonable forecast of costs into the Allowed Revenues;
5. The O&M cost forecasts embed productivity and represent a challenge for the utility;
6. The SRC proposal will result in a the adoption of a conceptually preferable methodology, a substantial refund and reduced rates;
7. It included appropriate mechanisms to encourage investments in sustainable efficiency measures, share rewards and protect the utility from unexpected cost changes beyond its control;
8. The resulting rate impacts average 2.2% per year. (Argument in Chief, pp. 2-3)

The Council submits that it is possible to take issue with this entire list of points EGD has made in support of its plan.

So is EGD's plan an IRM plan and is it consistent with the Natural Gas Forum Report or other accepted IRM plans? No. There is no assurance under EGD's plan that sustainable efficiency gains will be secured for the benefit of EGD's ratepayers. In addition, the Council does not see the plan putting a downward pressure on rates. Under EGD's Plan rates are increasing in excess of 4% per year and this does not include the impacts of the future balances in all of the deferral and variance accounts applied for as part of the Application.

IR plans are typically formulaic and based on the I-X concept. From the Council's perspective EGD's plan takes components of an I-X (Z-factors, Y-factors etc.), and components from COS (forecast capital and operating costs) and melds them together into a hybrid model. In addition, EGD ultimately cherry picks some of the elements of the Board's Custom approach as defined in its RRFE Report.

Board Staff, in its submissions presented an extensive argument as to why EGD's proposals are not compatible with what the Board envisioned as a Customer IR plan as part of the RRFE. Specifically, with respect to the RRFE, Board Staff refers to the fact that EGD did not file a robust asset management plan, objective external evidence supporting the efficiency of the costforecasts, or any reliable any external benchmarking analysis. From Staff's perspective it is troubling that EGD has used the RRFE for its benefit, to support its plan in some areas, but has neglected to abide by or address deviations from the Board's express requirements or preferences in

other areas (Board Staff Submissions, p 32). These are valid points that undermine the overall plan.

EGD has indicated that with respect to capital the budget shave not been developed on the basis of an asset management plan (Tr. Vol. 5, pp. 73-75).

As discussed below, the inclusion of so many deferral and variance accounts reduces the incentive to chase efficiency gains as so many categories of expenditures are subject to pass-through treatment. In addition, the merits of EGD's proposed SEIM have been the subject to considerable debate throughout the proceeding. Even EGD has acknowledged that the design of the mechanism needs to be improved. (Argument in Chief, p. 70).

As will be discussed by others extensively in their arguments EGD has said repeatedly that a fundamental driver as to why an I-X model would not work for them is the nature and level of capital spending requirements over the next five years. EGD specifically cites the fact that it is being faced with significantly large multi-year or highly variable capital costs (Exhibit TCU 3.14).

If you remove EGD's large capital projects - the Greater Toronto Area Reinforcement project and the Ottawa Reinforcement - project EGD's core capital costs are expected to be relative steady state throughout the IRM term. (Exhibit B18.EGDI.SEC.86 and J5.5) Energy Probe, in its submission, has presented a number of graphs to illustrate this point.

From the Council's perspective when large capital projects are known, it is possible to deal with these in an I-X model. That is exactly what is in place for Union. Parties have agreed, and the Board accepted in that case a Y-factor to deal with "major capital additions". This is exactly what is in place on the electricity side given LDCs have the option of using an incremental capital model. EGD has not demonstrated why under an I-X model, with a similar capital account, it could not address its capital requirements. EGD has argued that one of primary reasons that it cannot operate on the basis of an I-X rate-setting model is that its capital requirements preclude it, but the evidence does not support that claim.

With respect to EGD's comments regarding the fact that productivity is embedded in its plan the Council submits that the evidence on this point throughout the hearing was weak. Rather than identifying specific productivity initiatives EGD's final O&M budgets were simply budgets revised from earlier iterations, reflecting in some cases lower numbers. The direct link to specific productivity initiatives was not clear. In addition, the lack of external evidence to support these expenditures undermines any conclusions that they are reasonable.

Many of the components of the plan (described below in Section IV) simply highlight how this is not, as EGD describes it a "logical evolution of EGD's previous plan." As Dr. Kauffman concluded, the proposed plan has poor incentive qualities and creates

an imbalance with respect to risks and rewards relative to EGD's customers and shareholders.

B. The Council's Proposal

EGD's Plan is much like a five-year COS where its revenue requirement is based on internally driven forecasts not having regard to external assessments or benchmarks. The incentive to over-forecast, thereby creating a risk for ratepayer that those budgets are too high is significant under EGD's plan. Given it is a five-year plan those risks are exacerbated relative to a one-year COS approach.

The Council submits that, having considered all of the evidence advanced in this proceeding, the most appropriate method for determining rates for EGD is to apply the framework that has been approved for Union. EGD has not demonstrated that its approach is superior, nor has it demonstrated that it cannot provide safe, reliable service to its customers under a plan that mirrors the one in place for Union.

Having regard to some differences between the utilities, the parameters would be the same as Union with the following exceptions:

1. Base rates should be adjusted to reflect the \$30 million in over-earnings experienced in 2013 (Exhibit J1.2). Base rates should also be adjusted to reflect SEC's proposal (described below) with respect to Site Restoration Costs;
2. Y-factors for "Major Capital Projects" which would include GTA and Ottawa Reinforcements;
3. Y-factor for Pensions and Other Post Employment Benefits (through the Post Retirement True Up Variance Account which has been approved in the rebasing proceeding;
4. Y-factor for CIS and Customer Care as was approved in previous cases;
5. Y-factor for Gas Costs;
6. ESM – as discussed below.

IV. INDIVIDUAL COMPONENTS OF THE PLAN:

This section will provide brief submissions on each of the individual components of EGD's Plan. This discussion supports why, in our view EGD's overall plan is not appropriate. In addition, in the event the Board adopts EGD's model it may choose to include certain elements, exclude certain elements, or make adjustments.

1. Annual "Allowed Revenue" Determination and Adjustments

EGD is proposing that its allowed revenue be determined through a forecast of its capital and operating and maintenance costs for each year of the IR term. As discussed above, the forecasts are not supported by objective external evidence, benchmarking analyses or a robust asset management plan. The Council does not see this as an appropriate way to determine rates.

In addition, in the context of this plan, EGD has an incentive to overstate these forecasts. In the absence of an independent review and benchmarking there is a significant risk to ratepayers that these forecasts are overstated.

If the Board determines that EGD's approach to ratemaking, or some form of it is appropriate (rather than an I-X approach), the Council submits that EGD's capital forecasts should be subject to a review by an independent source. There must be a way to determine whether these spending levels are truly required. Putting in place a five-year budget today, for the purpose of setting rates for five years presents an unfair risk to ratepayers. Another alternative would be to cap the forecasts and require an asymmetrical true-up account to capture significant variances. This would, to some extent, ensure that ratepayers are not prematurely funding assets that have not been put in place.

With respect to EGD's forecasts for operating costs, the Council would support a mandated productivity adjustment as proposed by Board Staff.

Allowed Revenues in each year are set having regard to an updated volume forecast (based on customer numbers and a forecast of heating degree days). In addition, there are a number of other items that are updated annually. This is similar to what was in place under EGD's previous plan and the Council is not opposed to this type of update to capture declining use per customer.

2. Cost Items Subject to Annual Updates/Y-factors

Pension Expense and Employee Future Benefits Costs:

In 2013 rebasing proceeding, parties agreed that it was appropriate for EGD to establish a Post-Retirement True Up Variance Account (PTUVA). The purpose of the account is to deal with changes in pension expenses and the Council has no issue with the account. It was the subject of a previous Settlement Agreement.

Demand Side Management Costs:

DSM costs are subject to a separate framework and have consistently been dealt with on a pass-through basis. The Council is of the view that this should continue. It is especially important for this account to remain in place, given that the Board has initiated a review of gas DSM which could significantly alter the framework, budgets and incentive structures.

Customer Care:

EGD's CIS and Customer Care Costs have been determined through another proceeding – EB-2011-0226 – whereby the updated amounts are calculated in accordance with an approved formula. The Council continues to support this mechanism which can align with any ratemaking approach. It was the subject of a separate Settlement Agreement.

3. Z-Factors

With respect to Z-factors EGD has proposed to change the language used to assess what would qualify as a Z-factor. In addition, EGD is proposing a revenue requirement threshold of \$1.5 million for Z-factor treatment.

The new proposed criteria is as follows:

- i. Causation: The cost increase or decrease, or a significant portion of it, must be demonstrably linked to an unexpected, or non-routine cause.
- ii. Materiality: The cost at issue must be an increase or decrease from amounts included within the Allowed Revenue amount upon which rates were derived. The cost increase or decrease must meet a materiality threshold, in that its effect on the gas utility's revenue requirement in a fiscal year must be equal or greater than the \$1.5 million
- iii. Management Control: The cause of the cost increase or decrease must be: a) not reasonably within the control of the utility management; and b) a cause that utility management is unable to prevent by the exercise of due diligence
- iv. Prudence: the cost subject to an increase or decrease must have been prudently incurred. (Exhibit A2/T4/S1/p. 2)

The primary difference between what EGD is proposing now and what was in place under its original IR plan is that rather than defining Z-factors in terms of unexpected "events", they are seeking to define them as unexpected or non-routine "causes". In the last IR plan Z-factors were also subject to the criterion that they had to be a cost beyond the control of management and not "a risk in respect of what a prudent utility would take risk mitigation steps". EGD is proposing that the wording capture the concept that the "cause" not be within the control of management and that utility management would be unable to prevent it by the exercise of due diligence.

EGD's main issue with the previous wording was that it was crafted in such a way that nothing could qualify, so it was like there really was no Z-factor (Tr. Vol. 2, p. 148). EGD did apply for Z-factors during the last plan, but they were not supported by intervenors or approved by the Board. The Council notes that EGD was able to

operate effectively, and over-earn significantly under the IRM period without any Z-factor relief granted. Z-factor relief should only be granted in very exceptional circumstances, where the relief is truly needed by the Company to deal with an unforeseen circumstance.

Dr. Kauffman expressed concern about the shift from “events” to “causes”. Essentially, from his perspective the assessment of “causes” becomes far more complicated than looking at discrete events (Exhibit L/T1/S2)/p. 24). In his view Z-factor proceedings could become far more costly and contentious.

The Council submits that if Z-factor treatment is approved, the wording should be the same wording that was approved in the Union Settlement Agreement. The language in that Agreement refers to events. Specifically, the cost increases or decreases must casually relate to an external event that is beyond the control of the utility’s management. In addition, it must result from, or relate to a type of risk for which a prudent utility would not be expected to take risk mitigation steps and which is “out of the realm of the basis undertaking of the utility.” (Exhibit K1.4, p. 23) We also note within the RRFE, Z-factors are defined as “events”.

With respect to the Z-factor threshold EGD is proposing that Z-factors apply when the impact on the revenue requirement is equal to or exceeds \$1.5 million. The Council submits that this too should be aligned with the Union approach. A \$4 million revenue requirement impact is much more reasonable especially given the overall size of EGD’s revenue requirement. In order to obtain relief, the impact has to be material. Given the overall size of EGD’s revenue requirement \$1.5 million is not material. EGD has provided no evidence as to why the threshold should be materially different than that in place for Union.

4. Off-Ramp

EGD proposes to maintain the same Off-Ramp as the one that existed in its plan for the years 2008-2012. The treatment is symmetrical. If EGD’s weather normalized actual earnings are greater than 300 basis points or less than 300 basis points than the annual ROE as determined by the Board’s formula, the Off-Ramp is triggered. A review of EGD’s Plan will then occur with supporting evidence (Exhibit A2/S1/p. 37) The Council supports inclusion of an Off-Ramp as proposed by EGD under whatever plan is adopted by the Board. Under EGD’s proposed Plan, given the high level of uncertainty regarding the cost forecasts and Off-Ramp is an essential component.

5. Earnings Sharing

EGD is proposing to have an earnings sharing mechanism (“ESM”) in place for the duration of its five year plan. The mechanics of the proposed ESM are the same as those that were in place during the 2008-2012 period. The ESM will be asymmetrical whereby EGD shares earnings on a 50:50 basis if earnings are more

than 100 basis points above the Board-approved ROE level, calculated each year using the Board's ROE formula. A dead band is in place up to 100 basis points. Earnings would be calculated based on actual weather-normalized results (Exhibit A/T7/pp. 2-3).

The Council has consistently supported ESMs as an important component of any IRM proposal. ESMs provide an essential ratepayer protection mechanism. The structure of an ESM, however, largely depends upon the other elements of a plan. For example, if the LDC is taking on a larger share of risk, then the ESM may be more favourable to the shareholders. If the plan is structured in a way that has the ratepayer subject to more risk, then the ESM must be structured in a way that is more favourable to ratepayers.

As noted earlier, EGD's plan, relative to its previous plan, shifts the risk-reward balance more in favour of the shareholder. Therefore, if the Board decides to approve some form of this plan it should consider adjusting the ESM to account for the greater risk being borne by the ratepayers. This may involve elimination of the deadband with a 50:50 sharing of all of the overearnings. If the Board imposes the parameters of the Union plan on EGD, then the ESM approved for Union should also apply to EGD. Again, the design of an ESM is largely dependent upon the other parameters of a plan.

Union's ESM shares earnings 100 basis points above the 2013 Board approved ROE of 8.93% on a 50:50 basis up to 200 basis points. If earnings exceed 200 basis points the sharing moves to 90:10 in favour of the ratepayer (Exhibit K 1.4).

The Council notes that given EGD's proposed treatment of the cost of capital, EGD's proposal with respect to its ESM is confusing. The ROE embedded in EGD's base rates is 8.93%. EGD is proposing that in each year of the plan the ROE embedded in the Allowed Revenue amounts would differ. The ROE in each year, as discussed below ranges from 9.27% in 2014 and moving to 10.27% in 2018 (Exhibit E2/T1S2). With respect to the ESM EGD is proposing that the fulcrum be the Board-approved ROE level, calculated each year using the Board's ROE formula. (Exhibit A2/T7/S1). It is not clear why EGD is proposing one ROE for the purposes of setting rates and another value for the calculation of ESM amounts.

The Council submits that if the Board approves a form of EGD's Plan the allowed ROE embedded in 2013 rates should continue for the duration of the plan (as is the case for Union) and the ESM should be determined on the basis of that allowed ROE.

6. Treatment of Cost of Capital

With respect to Cost of Capital EGD is not proposing, during the course of its plan to change the 36% equity level approved in the 2013 rates proceeding. The ROE, for the purposes of setting the Allowed Revenue amounts would, under EGD's Plan,

change in each year based on a forecast that has already been developed by EGD using the Board's formula approach. The ROE forecasts for each year are as follows:

- 2014 – 9.27%
- 2015 – 9.72%
- 2016 – 10.12%
- 2017 – 10.17%
- 2018 – 10.27% (Exhibit E2/T1/S1/S2)

When this is compared to embedding the 8.93% in 2013 rates and carrying that forward for the duration of the plan (as in the framework for the period 2008-2012), the impact on the revenue requirement over the IR term is approximately \$130 million (Tr. Vol. 2., p. 38).

The Council urges the Board to reject this approach. ROE is a significant component of the revenue requirement. Under a typical IR approach the ROE set in base rates would remain in place. If this plan is truly an IRM the ROE would remain fixed for the duration of the plan. Union has indicated its willingness to live with the ROE embedded in its base rates, and the Council sees no reason why EGD should not do the same.

With respect to long-term and short-term debt the Council does not support EGD's proposal to forecast out rates for the five-year period. The cost of debt, included in a five-year plan should be that determined at rebasing.

7. Performance Measurement including Service Quality Requirements ("SQRs")

The Council submits that, under any plan EGD should be required to maintain the service quality requirements currently in place. If EGD is regulated under a form of IRM SQRs are critical to ensure that service does not degrade as the Company attempts to find efficiencies and potentially cut costs.

8. Sustainable Efficiency Incentive Mechanism ("SEIM")

A part of its IR Plan EGD is proposing to implement a mechanism that provides a financial incentive for EGD to pursue long-term efficiency gains, ones that would extend beyond the term of the Plan. The Sustainable Efficiency Incentive Mechanism ("SEIM") garnered a great deal of attention during this proceeding.

The idea behind the SEIM is to produce incentives for EGD's management to undertake long-term sustainable efficiencies and to reduce the potential motivations for management to otherwise delay efficiency-enhancing projects at the end of an IR term (Exhibit A2/T11/S3, Att., p. 2)

Dr. Kauffman, in his Report was highly critical of EGD's proposal. He concluded that the proposal was contrary to incentive regulation theory and regulatory practice. He specifically addressed the concept of rewarding the Company up front and how this would effectively reduce performance incentive. In this regard Dr. Kauffman concluded that, "A carrot will only be effective in moving a horse forward if it dangled in front of his nose, not if you feed him before the ride." (Exhibit L/T1/S2/p. 27) He referred to examples of other similar mechanisms like efficiency carry over mechanisms ("ECMs") that have been approved in other jurisdictions. The SEIM is unlike these ECMs because it would reward EGD up front because it has presented an application that promises efficiency gains.

In response to criticism from intervenors and Dr. Kauffman, EGD incorporated into its SEIM proposal some new features. Under the revised approach the SEIM is calculated based on EGD's performance during the IR term and not on future undertakings. EGD must demonstrate that it deserves the reward by showing that the benefits outweigh the costs to customers. EGD has also added a cap on the reward, which from its perspective, mitigates the cost increase exposure to customers at rebasing and is consistent with the goal of managing rate volatility (Exhibit A2/T11/S3/Att. P. 1)

Dr. Kauffman during his oral testimony acknowledged that the revised approach has addressed some concerns, but maintained how view that the SEIM is not well-designed and does not do what it is intended to do (Tr. Vol. 3, pp. 59-60)

In the Board Staff Submission, they have outlined a number of problems that they see with the SEIM, that have not been overcome with the updated proposals made by EGD. Board Staff submitted that the "flaws of the SEIM are of such a profound nature that it needs to be carefully re-thought." (Board Staff Submissions, p. 37).

In its Argument in Chief, EGD acknowledged that it appears stakeholders remain concerned about the design of the SEIM, as was abundantly clear during the oral hearing phase of the proceeding. EGD indicated that it is interested in the improving the design of the SEIM. EGD invited parties to address alternative approaches in their final arguments. In addition, EGD proposed a further amendment that would require EGD to demonstrate that the NPV of efficiency savings be focused exclusively upon gains achieved after the end of the IR term. In the alternative, EGD suggested a consultative process focused on designing a SEIM to be brought back the Board (Argument in Chief, p. 70).

The Council is not opposed the objective embodied in either a SEIM or ECM proposal, that is to create long-term, sustainable efficiency incentives during an IRM term. However, at this time the Board does not have a robust proposal before it for consideration that addresses the concerns expressed by Dr. Kauffman and the intervenors. EGD has even acknowledged that. The Council does not see merit in the Board considering new proposals through this written argument stage of the

proceeding. There would be no opportunity for parties to thoroughly test the reasonableness of any new proposals.

9. Deferral and Variance Accounts

The Council is of the view that overall the number of deferral and variance accounts that EGD is proposing to maintain, and establish as a result of this proceeding, as noted above, simply adds to the argument that the risk-reward balance is shifting in favour of EGD's shareholders. EGD is effectively creating a plan that results in a significant amount of its revenue requirement subject to pass-through treatment.

This not only complicates the plan and the annual deferral and variance account proceedings, but it clearly mutes the incentives to find efficiencies. With deferral and variance accounts in place EGD is permitted to flow through its costs to its customers. There is little incentive to cut costs for the category of expenses that are subject to deferral and variance account treatment. In addition, the existence of these accounts protects EGD's shareholders from some of the most important risks EGD will face over the term of the plan. Again, this simply adds to the risk reward imbalance inherent in EGD's Plan.

The Council is making submissions on the following accounts:

Post Retirement True-up Variance Account:

As noted above, this account was approved in a previous proceeding and remains relevant.

Greater Toronto Area Project Variance Account:

This account to deal with the costs of the GTA projects is acceptable to the Council. However, if the Board adopts the Union approach to rate-setting, EGD should be able to ensure recovery of the prudently incurred GTA costs through the establishment of a more generic account to deal with all major capital projects assuming they pass the pre-determined threshold amounts (Exhibit K1.4). All amounts in this type of account should be subject to a comprehensive prudence review.

Relocations Mains Variance Account:

From the Council's perspective relocations constitute a normal business activity for EGD. EGD has not justified the establishment of this account. The addition of this account is yet another example of EGD attempting to shift risk from its shareholders to its ratepayers.

Replacement Mains Variance Account:

As with the Relocation Mains Variance Account the Council does not support the establishment of this account. Mains replacement is a core distribution activity that should be managed by EGD within EGD's capital forecast envelope.

Transactional Services Deferral Account:

In the 2013 base rates EGD has a forecast of \$12 million for Transactional Services revenue as a credit to rates. Amounts above \$12 million are shared 90:10 in favour of ratepayers. If TS revenue is less than \$12 million the maximum credit to EGD is \$4 million resulting in a guarantee to ratepayers of \$8 million. EGD is proposing to change this such that there is no cap on the amount credited to EGD (Exhibit D1/T8/S1/p. 8). From the Council's perspective the current arrangement should be maintained as it was the result of the 2013 Settlement Agreement through which base rates were established.

Ontario Hearings Deferral Account:

The Council submits that this account, currently in place to record variances between forecast and regulatory costs should be discontinued. Regulatory costs are incurred as a normal business activity. In addition, there are not other Ontario LDCs that are afforded pass-through treatment for regulatory costs. This account eliminates any incentive for EGD to reduce its regulatory costs.

10. Annual Reporting Requirements

Under any plan that the Board approves the Council submits that EGD should be required to make its annual RRR filings available to parties. In addition, EGD should be required to file the same materials that Union has agreed to and set out in the Settlement Agreement dated July 31, 2013.

11. Rebasing

EGD's proposal with respect to rebasing, (assuming a 5-year Plan is approved) is to file a full cost of service application for 2019.

V. OTHER RATE RELATED ISSUES

Site Restoration Costs:

As set out in the Introduction above, the Council urges the Board to consider EGD's Application for its IR Plan separately from its consideration of EGD's proposal to Site Restoration Costs.

The consideration of how to deal with SRC is a complicated issue. As a matter of principle is critically important for the Board to adhere to generally accepted accounting principles in determining how best to deal with these costs. In addition, the Board must consider issues like intergenerational equity. The issues in the context of this proceeding involve a consideration of how to refund SRC amounts that have accumulated in a reserve, and deal with annual accruals going forward.

The SRC represents the requirement to collect and accumulate depreciation expense as a liability of future costs to remove the assets and restore lands when assets are removed from utility service (Exhibit D1/T5/S1/p. 1). Over time, as assets are removed from service the accumulated reserve is drawn down by the actual costs of retirement at the time of the asset retirement. In EGD's case, given EGD is currently retiring only a small percentage of its total plant in service in any given year, and also given the SRC fund is being developed to recover the costs of retirement for all of the assets in service, the accumulated reserve associated with SRC is growing at a faster pace than is being drawn down (Exhibit D1/T5/S1/pp. 4).

Gannett Fleming ("GF") has in recent years undertaken a number of depreciation studies for EGD. In 2011 GF completed a study that indicated that EGD's SRC had accumulated to more than \$700 million. GF undertook a review of the net salvage calculations and developed a recommendation for EGD. The result of that review was a GF recommendation that EGD adopt a Constant Dollar Net Salvage ("CDNS") approach to SRC which would result in a credit to EGD's customers of \$259.8 million by way of a rate rider. The other impacts of adopting GF's recommendations (related to lower depreciation rates, rate base increases and tax impacts) result in reductions to EGD's proposed Allowed Revenues over the period 2014-2018 of \$241.4 million (Argument in Chief p. 58).

The Council has reviewed the submissions of the School Energy Coalition ("SEC") regarding the SRC and is supportive of SEC's proposals. SEC has set out in its submissions an argument that, consistent with US GAAP (which has been adopted by EGD), the appropriate treatment of SRC is to treat them as current operating expenses. EGD has acknowledged that it has no legal obligation to restore sites when assets are no longer used, nor do they have asset retirement obligations (Tr. Vol. 9, pp. 41-48). The Council acknowledges that the specific method of implementing this approach, and its impact on rates will depend upon the form of regulation the Board adopts for EGD.

SEC and the Canadian Manufacturers and Exporters ("CME") have proposed that there be a generic proceeding to deal with rate recovery of future removal and abandonment costs for regulated entities. In light of the complexity of these issues, and the need for consistent regulatory treatment across utilities, the Council is supportive of this idea and urges the Board to consider it.

Effective Date of Rates:

EGD's rates have been declared interim as of January 1, 2014. The Council has submitted that it would be in the best interests of EGD's ratepayers for the Board to approve a ratemaking framework for EGD based on the fundamentals of the Union plan. It is not clear, at this point, on what timeframe EGD could facilitate the implementation of such a plan. The Council submits that the most practical scenario would be for the Board to leave rates in place for 2014, but allow for an adjustment to reflect whatever the Board decides with respect to the SRC. EGD could then file evidence to support implementation of a Union-type approach for the period 2015 - 2019.

The implementation of rates will ultimately be dependent up what ratemaking method the Board chooses for EGD for 2014 and beyond.

VI. COSTS

The Council requests that it be awarded 100% of its reasonably incurred costs associated with its participation in this proceeding. The Council submits it participated responsibly in all aspects of this proceeding.

All of which is respectfully submitted