EB-2012-0459

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
ON BEHALF OF THE
SCHOOL ENERGY COALITION

April 22, 2014

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INTRODUCTION AND SUMMARY

1.1 *Introduction*

1.1.1 On July 3, 2013 Enbridge Gas Distribution Inc. filed an Application for a mechanism, which they called Customized IR, to set distribution rates for the five years 2014 through 2018, including setting final rates for the period commencing January 1, 2014. The Application was supplemented by extensive updates and modifications. After a thorough process to establish a Board-approved Issues List, the Application was tested by numerous interrogatories, a three-day technical conference, and an eleven day oral hearing.

1.1.2 This is the Final Argument of the School Energy Coalition.

1.1.3 This Final Argument is not organized in a manner identical to the approved Issues List. For ease of understanding, we have structured it to follow the logic of the Application and its implications. Thus, after dealing with some general issues, we start with the nature of the mechanism to be used to set rates for the five year period. This leads to a detailed review of each of the Empirical Method and the Forecast Method, the two primary methods used by the Board to set just and reasonable rates for entities regulated by the Board. It also leads to consideration of the Fair Return Standard. Once we reach SEC's recommendation to the Board as to the preferred approach, we then consider other issues unrelated to that choice. This includes deferral and variance accounts, accounting for site removal costs, and other material issues.

1.1.4 The ratepayer groups who intervened in this proceeding have followed their normal practice of working together throughout the hearing to avoid duplication, including discussing issues and exchanging drafts or partial drafts of their final arguments. Because of this complexities inherent in this five year proposal, that co-ordination and co-operation has been unusually thorough. We have been assisted in preparing this Final Argument by that co-operation amongst parties.

1.2 *Summary of Submissions*

1.2.1 This Final Argument contains an analysis of the issues in this proceeding, and recommendations from SEC to the Board with respect to the resolution of those issues. The following is a summary of that analysis, and those recommendations.

1.2.2 The overriding theme of our submissions is succinctly stated in a phrase we have used later: **"This is how much we want" is not the same as "This is how much is reasonable."** The Applicant has sought rates on the basis of forecasts, but has failed to support what are, at their root, unsupported statements of how much they think they need. SEC proposes that the Board reject that request, and set rates on the basis of the

objectively supportable evidence it currently has before it.

1.2.3 ***Rate-Setting Mechanism.*** The Board uses two main methods to set rates: the Forecast Method, used mainly for rebasing applications, and the Empirical Method, used for most IRM applications. The Forecast Method relies on forecasts of future cost levels by the Applicant from a bottom up approach. The Empirical Method relies on forecasts of reasonable cost levels from past data and trends, i.e. a top down approach. Both are valid methods of setting just and reasonable rates, and both, if done properly, can be used by the Board to meet the Fair Return Standard.

1.2.4 The Forecast Method has the advantage that it provides more cost detail, and that is valuable where future spending is expected to vary materially from past spending. However, unless bottom up forecasts are benchmarked to external data, they present a challenge for an adjudicator required to assess reasonableness. Utility forecasts of future spending are subjective and, as they get more and more remote in time, increasingly unreliable.

1.2.5 The Empirical Method has the advantage that its sole purpose is to estimate a reasonable overall level of costs using reliable external data and proven techniques. This is one reason why most rates, for most years, are set using this method. Its main disadvantage is that it assumes that the future will be similar to the past. Where that is not true, there are techniques to adjust materially different cost patterns within the Empirical Method, such as Y Factors and Z Factors. Where the future is going to be fundamentally different from the past, though, the Empirical Method does not work as well.

1.2.6 In this case, the Board has an Application using the Forecast Method, but with cost forecasts that the Applicant admits are materially different from what they currently expect they will spend, and that do not have any external benchmarking or other justification.

1.2.7 **In SEC's submission, the Board should reject the proposal of the Applicant, regardless of whether the Board determines that it can set rates on an alternate basis**.

1.2.8 The Board also has evidence of the result if the Empirical Method were applied. That evidence demonstrates that, to the extent that certain aspects of the Applicant's costs will not be the same as in the past, those can be adjusted effectively using tried and true methods within an "I-X+Y" framework.

1.2.9 SEC therefore recommends that the Board set rates for Enbridge for 2014-2018 using the Empirical Method, largely on the same basis as the recently approved Union Gas five year IRM plan.

1.2.10 ***Proposed Plan***. SEC believes that the Board should set rates using a plan similar to the Union Approved IRM Plan, on the following parameters:

(a) ***Base Year Adjustments.*** Reduce the 2013 Board-approved revenue requirement by $31.2 million to reflect a realistic starting point for 2014 and beyond.

(b) ***Inflation Factor.*** GDPIPPI.

(c) ***Productivity Factor***. 60% of inflation.

(d) ***Y Factors.*** Through either variance accounts or traditional Y factor treatment, the following should be flow-throughs:

(i) Major Capital Projects, including GTA and Ottawa Reinforcements, but not WAMS.

(ii) Pensions[1].

(iii) DSM[2].

(iv) CIS and Customer Care[3].

(e) ***Z Factors.*** Retain current wording and increase threshold to $4 million.

(f) ***Earnings Sharing.*** Same as Union Approved IRM Plan.

(g) ***SEIM***. Reject this seriously flawed proposal.

1.2.11 ***Site Restoration Costs.*** The Applicant has adopted USGAAP which, if certain requirements are met, mandates reporting of Asset Retirement Obligations and Asset Retirement Costs. The Applicant advises that these requirements are not met, because Enbridge has no legal obligation to incur site restoration costs in the future, and in any case the need to retire assets in the future is too remote. The Applicant instead has created a reserve of $903.9 million, by collecting from ratepayers depreciation in excess of the historical cost of the assets being depreciated. Annually the amount collected has exceeded the amounts expended on actual site restoration by more than $50 million, and there is no current expectation that this pattern will change.

1.2.12 Based on the Applicant's evidence, SEC believes that, consistent with the

[1] Through the existing PTUVA account.
[2] Which will be the subject of a separate application, as it has been in the past.
[3] As approved in EB-2011-0226.

requirements of USGAAP, site restoration costs should be treated as a current expense, as incurred, at a level of about $16 million per year. The depreciation of net negative salvage should be terminated commencing in 2014.

1.2.13 Further, SEC submits that the reserve fund of $903.9 million should be refunded to ratepayers over ten years, including all rate base, cost of capital and tax impacts of those refunds. In order to smooth this refund, SEC proposes a refund pattern that will provide for greater refunds in the early years, and lesser amounts in later years. This avoids rate shock at the end of the ten year period.

1.2.14 It also has the effect that, if at the time of the next rebasing in 2019 the Applicant wishes to seek reinstatement of this reserve, or if the Board adopts the suggestion of some parties, with which we agree, to institute a generic proceeding to deal with this, the remaining balance at the end of 2018 will be roughly what it should be under the Applicant's proposal, properly calculated.

1.2.15 ***Deferral and Variance Accounts.*** SEC submits that the Ontario Hearing Costs Variance Account should be terminated, effective January 1, 2014. Enbridge is the only regulated entity in Ontario with this protection, and has provided no cogent evidence that it should be treated differently than everyone else.

2 GENERAL ISSUES

2.1 *Introduction*

2.1.1 There are a number of more general issues – meta-issues, perhaps – that are easier to deal with at the outset. They form a subtext to the specific issues being dealt with throughout this Final Argument.

2.2 *Is this an IRM Application?*

2.2.1 A great deal of time was spent in this proceeding discussing the largely semantic issue of whether the Application "qualifies" as an incentive regulation proposal at all.

2.2.2 The Applicant has called this Application "Customized IR", insisting that it is an IRM application, and saying that it "decouples revenues from future costs"[4].

2.2.3 On the other hand, under cross examination the Applicant's witnesses admit that the method used to establish the revenue requirement each year under this plan is essentially identical to cost of service[5], and that the only differences between this plan and cost of service are a) it is five years long instead of one, and b) it includes an ESM and a SEIM[6].

2.2.4 SEC was the first to jump on this debate, of course. In its letter of July 20, 2013, SEC asked the Board to consider, as a preliminary issue, whether this Application qualified as IRM at all.

2.2.5 The Board responded by asking for submissions on whether to have a Preliminary Issue stage in the proceeding. SEC made a number of submissions, both in its original letter and in reply, essentially expressing concern that, by filing on a cost of service basis, Enbridge was making cost of service the de facto form of its rate plan.

2.2.6 The Board determined that it did not need to have a Preliminary Issue phase, and that such a phase would in any case not make the hearing process more efficient. The Board also concluded that, in addition to either accepting or rejecting the Applicant's proposal, it could determine that rates be set on an alternative framework, based on the evidence before it[7].

2.2.7 As the proceeding has evolved, SEC's view on "whether this is really IRM" has also evolved. As we discuss at length in Section 3 of this Final Argument, it appears to us

[4] Tr.1:10.
[5] Tr.2:93.
[6] Tr.1:32.
[7] Decision on Need for Preliminary Issue and Procedural Order #2, October 3, 2013.

that the essential difference between what was filed, and what would have been appropriate, was that Enbridge filed unsupported forecasts. The lack of objective evidence – benchmarking, independent reviews, etc. – is what is fatal to the Application. The difference between IRM, as the Board uses the term, and everything else is that IRM sets rates based on objective, empirical data demonstrating reasonableness.

2.2.8 In our discussion, we refer to the method used in the Application as the "Forecast Method", and the method used in most IRM plans as the "Empirical Method". We are, in essence, avoiding the IRM vs. COS debate by using less charged names for the two methodologies.

2.2.9 SEC remains concerned that Enbridge, in its Reply, will raise the "Gotcha" arguments that we foreshadowed in our submissions on the Preliminary Issue question, e.g.:

(a) "Now that we've told you what our costs are going to be, you are legally obligated to determine whether those costs, line by line, should be funded, or you breach the Fair Return Standard"[8].

(b) "The only ratemaking method on which the Board has evidence is the Enbridge proposal, so that is the only way that the Board can set rates in this proceeding"[9].

2.2.10 Having said that, based on the Board's decision on the Preliminary Issue question, and based on the evidence in the proceeding as it unfolded, SEC believes that the Board can set rates based on the Empirical Method, and still fully comply with the Fair Return Standard. Further, if it chooses not to set rates on that approach, the Board can also choose to reject the Application completely.

2.2.11 We therefore believe that the question of whether the Application is really IRM, or not, is now moot.

2.3 ***The Rate Proposal vs. the SRC Proposal***

2.3.1 There has also been considerable discussion in the proceeding trying to get at the impacts of the rate proposal component of the Application, separate from the SRC proposal. Implicit in this ongoing discussion has been the notion that the refund to ratepayers of money (unintentionally) over-collected through the years could somehow mask or obscure the real impacts of the rate proposal.

[8] There are many references to this in the evidence, such as Tr.2:26, and Tr.2:101.
[9] Mr. Cass specifically referred to this argument in cross-examination of Dr. Kaufmann, at Tr.4:126.

2.3.2 To that end, witnesses were asked whether there is any inherent connection between the SRC proposal and the rate proposal. The clearest statements that the two should be considered separately came from both Mr. Culbert and Mr. Ryckman, responding to questions from Ms. Girvan, as follows:

> *"MS. GIRVAN: Would your plan have been different if you didn't have this SRC proposal?*
> *MR. CULBERT: I don't think so. The SRC proposal is a review of our depreciation rates solely on their own merit.*
> *…MS. GIRVAN: Did you look at it as a package, or did you look at it without the SRC proposal?*
> *MR. RYCKMAN: I think the answer is yes, we looked at it in terms of the individual components. And my belief is that the Board should be looking at the individual components."*[10]

2.3.3 SEC agrees, and we have structured this Final Argument to deal with the rate application on its own, without any influence from SRC changes at all. We then look separately at the appropriate way to handle site restoration costs, and propose a solution to that issue. It is only then that the two components are integrated.

2.4 ***Absence of Senior Executives***

2.4.1 A number of parties, including SEC, asked the Applicant whether they were planning to bring senior executives to support their request for more than $6 billion from the ratepayers. The Applicant was given the opportunity to explain why no senior executives were coming, and declined to do so[11].

2.4.2 It is, of course, possible to invent many theories for why this would be the case. Is there a sense at Enbridge that the Application is a loser, and no senior executives want to be seen to be responsible for its failure? Is there a fear that senior executives know too much about the Applicant's real thinking, and if cross-examined under oath could say something damaging? Those are only two examples of this type of speculation.

2.4.3 The fact is that the Applicant presented a wide range of experienced and knowledgeable witnesses to speak to both the overall plan, and the specific elements of that plan. SEC may disagree with their conclusions, but it would not be reasonable to say that they failed, together, to provide evidence from the Applicant on why they are seeking what they are.

2.4.4 Would the presence of senior executives have assisted the Board? Perhaps. We can't know the answer to that. What we do know, though, is that it is the prerogative of the Applicant to decide how they want to present their Application. They have the onus

[10] Tr.2:64.
[11] Tr.1:30, for example.

and burden, and they decide how to meet it.

2.4.5 SEC therefore believes that in the end whether senior executives showed up, or not, is a complete red herring. The Board should deal with the Application before it, as it was presented, and should set rates based on the evidence. Any "what if" about senior executives is, in our view, unproductive.

2.4.6 We note, however, that it is central to our Final Argument on the rate plan proposed that the lack of objective, independent evidence to support it is fatal. This has nothing to do with whether the President showed up. It is about whether the Application is anything more than an unsupported request for money from a regulated monopoly.

2.5 ***The Evidence of Jim Coyne***

2.5.1 As the Board will recall, SEC went to some lengths to challenge the independence and therefore value of the work done by Jim Coyne of Concentric[12]. In subsequent cross-examination, Mr. Janigan also raised questions about his expertise in IRM, noting that he appears to be an expert in many things ("perhaps I am unusual", he responded), and his experience reviewing IRM plans is limited[13].

2.5.2 SEC will, on the substantive issues later in this Final Argument, raise questions about the views of Mr. Coyne on some of those issues.

2.5.3 However, in terms of his overall evidence, in our view the record has been established, and the Board does not need any further input from SEC on how to assess the Concentric evidence.

2.6 ***Relevance of Enbridge Earnings History***

2.6.1 The Board heard evidence that Enbridge invariably earns more, on a regulatory basis, that its Board approved ROE[14]. In fact, Enbridge admits that it has earned more than the allowed ROE every single year from 1985 to 2013[15]. As Mr. Ryckman says, "We do manage the business well.[16]"

2.6.2 We note that, during that period of nineteen years, Enbridge has been regulated on the basis of a) forward test year cost of service; b) targeted PBR, c) one year I-X price cap (2004), and d) five year revenue cap per customer. Notwithstanding the variation in method and level of allowed revenue, Enbridge exceeded its allowed ROE under every scenario.

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[12] Tr.2:162-179; Tr.3:3-34.
[13] Tr.4:4, 8.
[14] Tr.1:28.
[15] Tr.2:29.
[16] Tr.1:43

2.6.3 Is this because the Board is not being tough enough on Enbridge? Or, is Enbridge simply very good at managing the regulatory process? Is this, in some way, a failure of regulation?

2.6.4 In SEC's view, the answer to those questions is No. What this stellar earnings record shows, in our view, is that Enbridge understands – and has understood for decades – a fundamental reality of rate regulation. Once your revenue requirement is set, no matter what it is, that's what you have to work with. If it is not as much as you wanted, or even as much as you thought you needed, that is irrelevant. It is what it is, and to run your business properly you have to control your spending accordingly.

2.6.5 This is important because of all the hand-wringing around the Fair Return Standard, and Enbridge's "need" for more money than the Empirical Method ("I-X+Y") would allow. Yes, the Board has to set rates based on a well-thought-out approach. Of course, the Board cannot be capricious. But, the Board does not have to be concerned that Enbridge will actually have insufficient money to run its business properly and earn a fair return. History makes it clear: that is not going to happen.

2.6.6 As long as the Board uses a sensible and reasonable approach to setting rates, Enbridge will demonstrate, as they have in the past, that Mr. Ryckman is correct: they do indeed manage the business well. They will maintain safety and reliability, as they have done in the past. And, they will continue their record of earning more than their allowed ROE, year after year.

2.6.7 SEC anticipates that, in the Reply Argument, Enbridge will argue that if they don't get their cost forecasts funded, they will not "have the opportunity to earn a fair return". That is not correct. Every time Enbridge applies for rates, they ask for more than they eventually get. And, every time, they still over-earn. There is no reason to expect that this time will be any different.

2.7 ***Size of the Rate Increase Requested***

2.7.1 There was some discussion about the actual size of the rate increase being requested by Enbridge in this proceeding.

2.7.2 SEC has adjusted Exhibit K1.3, as suggested by Enbridge[17], to treat Pension Costs as a Y Factor and thus remove it from indexing. To do that fairly, it also has to be removed as an adjustment in the Enbridge Proposal part of the table. The end result is annexed as Appendix 1 to our Final Argument, and will be referred to in a number of places throughout our discussion of the issues.

[17] Tr.7:131.

2.7.3 The calculation shows that the impact of treating pensions as a Y factor is to reduce the differential between Union and Enbridge from $333 million, in K1.3, to $331 million. It also has the effect of reducing the effective rate increase requested in the Enbridge Proposal, and the effective rate increase under the Union approved rate plan.

2.7.4 What this shows – and these numbers are consistent with those Enbridge has already accepted during the hearing[18] - is that Enbridge is seeking additional revenues of $889 million from ratepayers over five years. Of that, $213 million comes from customer growth, and $676 million comes from increasing rates. Mathematically, that means that rates have to increase, overall, by 20.82% over those five years, which is 3.86% per year compounded annually.

2.7.5 This can be contrasted to the approved Union Gas rate plan. That plan, if applied to Enbridge (and without taking into account any base year adjustments), would give Enbridge additional revenues of $558 million over five years, of which the same $213 million would come from customer growth, but only $345 million would come from increasing rates. On the same basis, rates would have to increase by just over half as much, by 10.83% over five years, which is 2.08% per year compounded annually.

2.7.6 Looked at from Enbridge's point of view, the Union Gas plan means they don't get to collect $331 million that they believe they "need". However, looked at from the point of view of the ratepayers, the Union Gas plan would provide Enbridge with rate increases well in excess of inflation – and three times the level of inflation minus productivity - for each of the next five years. Against that backdrop, Enbridge wants even more.

2.7.7 The ratepayers participating in this proceeding, including SEC, believe that what Enbridge is requesting is blatantly unreasonable, and should be rejected. An annual rate increase of almost 4% per year is inconsistent with their past spending levels, inconsistent with their nearest comparator, Union, and inconsistent with the rate increases allowed by the Board for other regulated entities.

2.7.8 We note that, in addition to this high level of increase, Enbridge also wants the Board to ignore its over-earnings in 2013. They point out that they are not asking for their capital overspend to be included in rate base, but they fail to note that, by implication, they are also seeking to start their IRM period more than $30 million to the good. As we will note later, that is an additional amount of more than $150 million over five years that they seek to keep for the shareholder.

[18] Tr.1:77 et seq.

2.7.9 SEC therefore submits that this Application should be considered by the Board through its normal prism of common sense. It is all very well and good to provide thousands of pages of budgets and forecasts. Asking for a lot of money is still asking for a lot of money.

2.8 ***Comparisons to Union Gas***

2.8.1 Throughout this Final Argument, SEC makes references to Union Gas and its approved rate plan. Enbridge has been resistant to comparing itself to Union[19], even while admitting that Union is its closest natural comparator in terms of business conditions[20].

2.8.2 No doubt there are differences between Enbridge and Union Gas, just as there are differences between Enbridge and any other utility to which they might be compared. The Board is very familiar with both utilities, and there does not appear to us to be much value in trying to assist the Board in comparing the two. They are what they are.

2.8.3 There is one area, though, that we wish to bring to the Board's attention. Differences between the two entities, and differences in their rate plans, can be informed by differences in starting point. If the rates of one utility are higher than the other, that could be relevant in considering whether the one with lower rates should have higher future increases, or the one with higher rates should have lower future increases (or the converse in either case).

2.8.4 Most of the customers of both Union and Enbridge are general service customers. SEC has attached to this Final Argument as Appendix 2 a simple comparison of those rates for typical Residential and Commercial customers. There is nothing particularly unusual about this comparison. It uses current published rates, and a standard usage pattern commonly used by gas distributors. We have provided the live Excel spreadsheet to Enbridge, the Board and the parties, so that anyone can test whether the comparison is robust across all reasonable assumptions. It is.

2.8.5 What is striking here is not that Enbridge has higher distribution rates than Union. That was generally known before this. What is surprising, though, is the size of the differences. For the typical Residential customer, at 2500 m^3 per year, Enbridge charges 18.37% more today. And, for the typical Commercial customer, at 35,000 m^3 per year (such as many schools), Enbridge charges 86.75% more today.

[19] E.g. I.A1.EGDI.SEC.6, Tr.1:97 and TCU2.2.
[20] Tr.2:22.

2.8.6 This is, of course, not a full across the board rate comparison, and differences in customer mix and other factors will play a part in any such comparison. None of those change the fact, however, that for the vast majority of their customers, Enbridge charges more than Union Gas today, and in this Application is seeking to increase that differential by a further 10%[21].

[21] SEC is conscious that this information would have been of more assistance to the Board if it had been provided earlier in the proceeding, and for that we apologize. While we were aware that there were rate differences, we didn`t realize they were as large as they are. We only discovered the size of the difference after the hearing, while doing bill comparisons for a completely unrelated purpose. At that point, we had to determine whether to bring this information to the Board`s attention, or not. While technically it is simply mathematical calculations using factual information on the public record at the Board, and therefore can properly be referred to in argument, it is not as useful as if it were provided during the hearing. We determined that we had to provide it in any case, and the Board can make its own determination on whether it is in any way helpful. We have provided the live calculations to the parties and the Applicant so that they are able to challenge the data if they feel it is not correct, or not representative.

3 METHODS OF SETTING JUST AND REASONABLE RATES

3.1 *Introduction*

3.1.1 From the point of view of the Board, this case presents somewhat of a conundrum. It was originally expected to be a case to set the formula for Enbridge's rates for 2014-2018. What the Board got, instead, is a detailed review of Enbridge's forecast costs for that period, and a proposal to set rates on that basis.

3.1.2 This raises the obvious question: On what basis, if any, should the Board set rates for Enbridge for 2014 through 2018? This involves questions of law – both statute and cases – Board policy, and regulatory theory.

3.1.3 In this section, SEC analyses the choices available to the Board to set rates for Enbridge for 2014-2018, and what approach is appropriate.

3.2 *The Ontario Energy Board Act*

3.2.1 As with any statutory body, the starting point has to be whether the Board is required by its statute to exercise its mandate in a certain way, or granted any particular discretion in how it exercises its mandate.

3.2.2 Obviously, the two key statutory requirements are the following:

> *"s. 36(2) The Board may make orders approving or fixing **just and reasonable rates** for the sale of gas by gas transmitters, gas distributors and storage companies, and for the transmission, distribution and storage of gas.*
> *s. 36(3) In approving or fixing just and reasonable rates, **the Board may adopt any method or technique** that it considers appropriate.*
> *s. 36(5) Upon an application for an order approving or fixing rates, the **Board may**, if it is not satisfied that the rates applied for are just and reasonable, **fix such other rates as it finds to be just and reasonable.**"*[22] *[Emphasis added]*

3.2.3 This seems a bit trite, but in SEC's view it is important to emphasize the three ratemaking principles that both bind and empower the Board in this case:

(a) The emphasis of the statute is on reasonableness and justice. Those concepts are so central to the Board's mandate that the Board is not empowered to do anything with respect to rates, unless those rates are just and reasonable. It

[22] Ontario Energy Board Act, SO 1998, Chapter 15, Schedule B, s. 36(2), (3) and (5) .

will be a theme in this Final Argument that the Enbridge proposal fails in large part because it fails to provide a basis for the Board to determine that the proposal is just and reasonable. "This is how much we want" is not the same as "This is how much is reasonable".

(b) The Act gives the Board a broad discretion to decide how it should set rates, but that discretion is only applicable to the setting of just and reasonable rates. Another way to read this is "If you get the right answer, how you get there is not as important". Of course, there are procedural requirements that must be followed (for example, in the SPPA), but the methodology is neither proscribed nor limited in any way.

(c) The Act explicitly empowers the Board to reject the rates proposed by an Applicant, and instead approve different rates. Coupled with the second principle, this means that the Board can reject this Application, but in this same proceeding choose to set rates on a different basis altogether, as long as those rates are just and reasonable.

3.2.4 In these conclusions, SEC finds support in the seminal decision of the Federal Court of Appeal in TransCanada v. NEB, where the court said[23]:

> *"a) The Board is not required to adopt any specific methodology in determining tolls.*
>
> *[30] The authority of the Board to determine just and reasonable tolls is not limited by any statutory directions. The broad authority of the Board was well articulated by Thurlow C.J. in British Columbia Hydro and Power Authority v. West Coast Transmission Company Ltd. et al., [1981] 2 F.C. 646 at 655-56 (C.A.):*
>
> *There are no like provisions in part IV of the National Energy Board Act. Under it, tolls are to be just and reasonable and may be charged only as specified in a tariff that has been filed with the Board and is in effect. The Board is given authority in the broadest of terms to make orders with respect to all matters relating to them. Plainly, the Board has authority to make orders designed to ensure that the tolls to be charged by a pipeline company will be just and reasonable. But its power in that respect is not trammelled or fettered by statutory rules or directions as to how that function is to be carried out or how the purpose is to be achieved. In particular, there are no statutory directions that, in considering whether tolls that a pipeline company propose to charge are just and reasonable, the Board must adopt any particular accounting approach or device or*

[23] *TransCanada Pipelines Limited v. Canada (National Energy Board)*, 2004 FCA 149, per Rothstein, J.A. (as he then was).

> *that it must do so by determining cost of service and a rate base and fixing a fair return thereon.*
>
> *[31] The Board has adopted a cost of service method for determining the Mainline's tolls. Before this Court, counsel for a number of the respondents suggested different methodologies for determining just and reasonable tolls that would be open to the Board, such as:*
>
> *1. tolls based on agreements between pipelines and shippers;*
>
> *2. tolls based on charges of other pipelines;*
>
> *3. use of base year tolls adjusted for inflation;*
>
> *4. tolls based on mechanisms to encourage utilities towards greater efficiency.*
>
> *As no particular methodology is required by the National Energy Board Act, the Board could have adopted a different methodology for determining just and reasonable tolls for the Mainline.*
>
> *b) Having adopted a cost of service methodology, the costs determined by the Board must be just and reasonable to both the Mainline and its users."*

3.2.5 Although this was a case under the NEB's statute, for the purposes of this case the principles enunciated by the court in that case are equally applicable here.

3.2.6 SEC believes, therefore, that the Act provides the Board will a broad ability to get to the right answer in this case, and that should be the starting point. The case law on Fair Return Standard, and considerations of regulatory policy, may focus those options, but the Board starts with a wide range of options available to it.

3.3 ***The Fair Return Standard***

3.3.1 What does it mean that rates are "just and reasonable"? The courts have helped define the concept as follows:

> *"The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested. By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and*

certainty equal to that of the company's enterprise."[24]

3.3.2 We tend to think of this, the Fair Return Standard, as something to do with cost of capital, but of course it is not so limited. What it actually refers to is a level of revenues that is sufficient that, when other reasonable costs have been incurred ("net to the company"), is capable of leaving a return on equity that meets the test.

3.3.3 As the *TransCanada* case, cited earlier, points out, the Fair Return Standard can be met using any number of methodologies, including cost of service, agreements, formulae based on inflation, efficiency-driven formulae, etc.

3.3.4 It is important to note that the court in the *TransCanada* case tied the review of cost forecasts to the selection of methodology by the regulator, saying: *"Having adopted a cost of service methodology, the costs determined by the Board must be just and reasonable to both the Mainline and its users."*[25]

3.3.5 It is submitted that this link between the selection of methodology, and the requirements to ensure that the rates are just and reasonable, applies no matter what methodology is selected.

3.3.6 In Ontario, the Board uses two basic methods of setting just and reasonable rates.

3.3.7 The first method is cost of service, which for the purposes of this Final Argument we will call the Forecast Method. In that method, costs are forecast, so as the court points out, the Board must determine if those forecast costs are just and reasonable. That's how you get to just and reasonable rates.

3.3.8 The second method is an IRM formula, which for the purposes of this Final Argument we will call the Empirical Method. In that method, costs are not forecast, but a rate of change formula is derived from past empirical data. It is the formula that the Board must ensure is just and reasonable, in order to get to just and reasonable rates.

3.3.9 The Applicant admits – agreeing with the courts - that the Fair Return Standard can be met using either method. This is demonstrated in the following exchange[26]:

> *"MR. SHEPHERD: Okay. You refer here to the fair return standard. I am going to come back to this in a minute. But you do agree that the fair return standard can be met either from a top-down budget or a bottom-up budget; right?*
>
> *You said that, as well, in the technical conference, I think.*

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[24] *Northwestern Utilities Ltd. v. Edmonton (City)*, [1929] S.C.R. 186 at 192-93.
[25] *TransCanada*, op. cit.
[26] Tr.1:60. Although Mr. Fischer doesn't specifically refer to IRM vs. COS, it is clear from the context that is the distinction being made.

MR. FISCHER: Yes, I would agree with that."

3.3.10 Here's why this concept is important. Throughout the evidence, and even in the oral hearing, the Applicant and its witnesses continually refer to their claim that an I-X approach to ratemaking doesn't cover Enbridge's cost forecasts, and therefore doesn't meet the Fair Return Standard. For example, Mr. Lister says, in response to Mr. Janigan[27]:

> *"…given those capital spending requirements, mathematically an I-X outcome couldn't provide the utility with an opportunity to earn a fair return*."

3.3.11 What the Enbridge witnesses fail to point out, however, is that if the Board elects to set rates on the basis of the Empirical Method – I-X, in Enbridge's terminology – there is no requirement or expectation that the Board accept or even analyze the proposed condition, i.e. "*given those capital spending requirements*". If the formula selected by the Board is a reasonable one, the fact that the Applicant has forecasts that are different is irrelevant. Forecast costs must be just and reasonable under the cost of service methodology. The whole point of using the Empirical Method is that the Board doesn't have to assess the reasonableness of cost forecasts, because a reasonable revenue requirement is established a different way.

3.3.12 SEC expects that the Applicant will argue as follows. The Board has received and considered cost forecasts from the Applicant. The Board can reject those cost forecasts, and find that different levels of costs are reasonable. What the Board cannot do is ignore the cost forecasts, or reject them without finding other cost levels to be reasonable. If it doesn't either accept or modify the forecast costs, and set rates on that basis, the Board will be breaching the Fair Return Standard.

3.3.13 In our opinion, this is not the law. The law is that the Board must determine whether it will set rates based on cost forecasts. If it decides to do so, it must then determine what forecast cost levels are reasonable in order to meet the Fair Return Standard. However, the Board is equally entitled in law to determine:

(a) The cost forecasts presented to it are unreliable, incomplete, insufficient, or otherwise unpersuasive, and so will not form the basis of the Board's decision;

(b) The Board will set rates for Enbridge based on a methodology other than forecast costs, and therefore doesn't even need to consider the forecasts offered by the Applicant;

(c) Either (a) or (b) with respect to any part of the revenue requirement of the

[27] Tr. 2:26.

Applicant; or

(d) The Board will not set rates at all in this proceeding, because it has determined that there is insufficient information on the record to set rates using the methodology the Board believes is appropriate.

3.3.14 In SEC's submission, on the evidence in this proceeding it is open to the Board to choose any of the above options, and in each of the first three choices, the rates it sets would not breach the Fair Return Standard simply because they fail to rely on, or consider, the forecasts.

3.3.15 SEC will urge the Board to set rates using the Empirical Method, both because it is a superior way of ensuring that rates are just and reasonable, and because the subjective cost forecasts provided by Enbridge are an insufficient foundation for rate-setting. In the alternative, SEC will argue that the Board should reject the Application in its entirety, and instead establish interim rates until such time as the Applicant can re-apply.

3.4 ***The Renewed Regulatory Framework for Electricity***

3.4.1 The Applicant and its witnesses have referred a number of times to the Custom IR option provided by the Board for electricity distributors in the RRFE Report[28].

3.4.2 In fact, the Applicant argues that the Custom IR option represents an evolution in the Board's thinking on IRM[29]. This appears to be supported by Board Staff, which in their September 4, 2013 submissions on the Preliminary Issue question, referred to Custom IR as "*a stated future direction of regulation by the Board*[30]".

3.4.3 Other parties may provide a more detailed analysis of the RRFE Report and how it could inform the Board's consideration of this Application. The only point that SEC wishes to make about the Custom IR available to electricity distributors is that it is intended, not to rely on the Forecast Method on its own, but rather on an amalgam of the Forecast Method and the Empirical Method. This is demonstrated by the following clear statement of the Board's intent with respect to Custom IR rates:

> *"The allowed rate of change in the rate over the term will be determined by the Board on a case-by-case basis* ***informed by empirical evidence*** *including:*
>
> - *the distributor's forecasts (revenues and costs, including inflation and productivity);*
> - ***the Board's inflation and productivity analyses****; and*

[28] *Renewed Regulatory Framework for Electricity*, Report of the Board, October 18, 2012.
[29] Tr.2:16.
[30] Board Staff Submission, September 4, 2013, p. 3.

- ***benchmarking*** *to assess the reasonableness of distributor forecasts" [emphasis added]*[31]

3.4.4 As we note below, this emphasis on empirical support is necessary to test the reasonableness of the forecasts.

3.4.5 In our submission, the current Application, if filed by an electricity distributor as a Custom IR application, would not comply with the above approach and would not meet the Board's expectations.

3.5 ***The Forecast Method***

3.5.1 The Board is already very familiar with rate applications based on the Forecast Method, because that is the starting point for most rebasing and other cost of service applications. The Board has been considering forecast-driven applications for decades.

3.5.2 The Forecast Method of determining revenue requirement is essentially a two-stage process:

(a) The applicant provides detailed forecasts of costs for a future year, against a backdrop of a historical year or years of actual costs, and an expectation of the costs of the current, or bridge, year. The forecast includes explanations of any variations from past spending patterns.

(b) The Board assesses the forecast costs for reasonableness, and establishes rates, typically for one year, on the level of costs the Board thinks is reasonable.

3.5.3 Each of those two steps has some important considerations.

3.5.4 ***Realistic Forecasts.*** In terms of the forecasts themselves, the Board expects the applicant to provide their best determination of what they actually expect to spend on each item in the Test Year. While it is anticipated that, as reality kicks in during the Test Year, the applicant will actually spend in different ways, responding to circumstances, there is no question that the forecast itself is supposed to be an honest estimate of how much will be spent, and on what.

3.5.5 It is submitted that if an applicant told the Board "We actually have a list of other things that we expect to spend money on, so we don't expect to spend the amounts listed in our forecast", the Board would say "Well then this is not your real forecast. Come back when you have a forecast that you can actually support."

[31] RRFE Report, pp. 19-20.

3.5.6 ***Reasonableness Testing.*** Once the Board is satisfied that it has the applicant's realistic spending estimates, the Board then tests that against empirical data. In this respect, the Board has three reference points that it commonly uses: past spending by the applicant, past and current spending patterns by similar regulated utilities, and external benchmarking studies.

3.5.7 ***Past Spending.*** In a typical cost of service proceeding, one of the key contexts within which to view forecasts is the history of that same utility's past spending on the same items. Distribution companies tend to be stable businesses, so spending patterns tend to be similar over long periods of time. Where there are changes year to year, they are often cyclical, or they have identifiable reasons.

3.5.8 Review of past spending benefits from the fact that the forecast period is smaller than the past data period. Trends discernible from the past five years (or sometimes more), only have to be applied to the single forward year that has been forecast. The scope for the forecast to diverge from the past trend is more limited.

3.5.9 Regulated utilities sometimes complain when the Board applies an "envelope" approach to setting components of revenue requirement, particularly OM&A. The Board doesn't do that out of laziness. The Board applies past data because its job is not to determine if the utility had a thorough budget process. Its job is to ensure that the result of the process – however it was obtained – is reasonable. Reasonableness is tested by an objective frame of reference or context, of which past spending trends is one.

3.5.10 The difficulty comes when a utility wants to break from its past trends and spend on a new trajectory in the future. Then it is expressly rejecting the validity of the past trend as a test of reasonableness. In order to test the new trajectory, the Board needs another context.

3.5.11 ***Peer Group Comparisons***. The Board is, in one sense, lucky in its regulation of electricity distribution, because the number of LDCs increases the ability to establish a reasonable peer group. It is still difficult, but possible.

3.5.12 For this reason, the Board regularly looks at the costs of any given electricity distributor in comparison to similar costs for other distributors. This is sometimes on a line by line basis, and sometimes on an overall basis. If two or three similar distributors have widely disparate rates and costs per customer, both the Board and the utilities (not to mention the ratepayers) should want to know the reasons for those differences.

3.5.13 We note that, in addition to looking at these comparisons on a formal basis, the Board develops a knowledge base of what things should cost, because the Board sees so much actual cost data from different electricity distributors. If the OM&A per

customer of an electricity distributor is $400, the Board doesn't have to look anything up to know that is high, and the reasons need to be explored.

3.5.14 We also note that, in general, peer group comparisons are more valuable for comparisons of current levels of cost, rather than rate of change. Generally speaking, rate of change is considered primarily through past trend data in cost of service situations. It is only when the trend is being rejected by the utility that the Board has to look elsewhere. The main value of looking at peers, in this context, is that the Board can ask "If this utility wants to ramp up spending, where do they stand right now?"

3.5.15 There are exceptions to that. Where a utility wants to increase their tree trimming budget, for example, the Board can benefit from looking at the tree trimming protocols of other utilities, not only to see where there are, but to see whether others are also ramping up spending in this area. A common change may be more likely to be reasonable than a change by one utility in isolation.

3.5.16 So, for example, when we come to look at the proposed increase in system integrity spending, we will ask the question "What is everyone else doing?" If there is no evidence that others are increasing system integrity spending at a similar rate, the Board has to question why Enbridge is out of step with the rest of the industry.

3.5.17 In gas distribution, Enbridge's closest peer is Union Gas, which shares broadly similar geography, economic factors, and size, although it differs in both customer mix and level of growth. Union Gas cannot be considered as a peer comparator in a rigorous way, because one company cannot form a statistical sample group. However, Union Gas can be useful to the Board as a diagnostic indicator. If there is a material difference between Enbridge forecasts, and Union Gas, the Board should want to know why. It may not determine reasonableness, or lack of it, but it raises a question that should be answered.

3.5.18 ***Formal Benchmarking Studies.*** The third, and least common, method the Board can use to test the reasonableness of utility forecasts is formal benchmarking, almost always done by an independent third party. This essentially brings in a key aspect of the Empirical Method.

3.5.19 There are basically three types of benchmarking studies commonly seen by the Board:

(a) Formal peer group studies.

(b) Econometric benchmarking.

(c) Engineering or other opinion-based reviews

3.5.20 In this case, a peer group study was filed. Sadly, it has such serious underlying problems – with the choice of the proxy group, and the metrics compared, and other things – that it is not helpful to the Board. This is often a problem with formal peer group comparisons. It is so sensitive to the choice of the peer group that "rigour" can be lost in the process.

3.5.21 The Board has had more success with econometric benchmarking. By using statistical analysis to identify the relationships between business conditions and costs, the Board is able to test cost forecasts using powerful reasonableness tools. Unfortunately, it is also complex and data-driven, so it can't always be used effectively.

3.5.22 The "benchmarking" – although using the word here may be a stretch – that is now being used more often in some jurisdictions is engineering or other expert reviews. This is especially useful for capital plans, where an independent engineering firm can consider the applicant's risk analyses, and the spending levels proposed to deal with those risks, applying an expert perspective. This is being used in the UK, for example.

3.5.23 ***The Board as Experts***. The Ontario Energy Board is a regulatory tribunal with a specialized expertise. That is one reason, for example, why courts give deference to the Board's decisions. Board members are usually chosen from the industry. In the rare cases where they are not, they become immersed in energy issues, and develop strong foundations of knowledge of the sector.

3.5.24 Board members are not, however, expected to do their own "expert reviews" of the forecasts of regulated entities. Mr. Elsayed, an engineer, is not expected to "read up" on amp fittings and form a professional opinion on the risks and appropriate replacement rates. Ms. Conboy and Vice-Chair Chaplin, both economists, are not expected to develop an econometric model for the main cost drivers applicable to Enbridge.

3.5.25 Board members are not expected to do the expert work themselves. They are adjudicators, and they are supposed to respond to the evidence before them. The fact that they are experts allows them to understand that evidence better than most people, and thus to make more sophisticated and nuanced decisions, but they still respond to the evidence. They are not supposed to <u>create</u> the evidence.

3.5.26 We sometimes think of the Board as performing an expert role, however, because in so many cases there are no expert reports filed on the bulk of the issues. To see them as, in effect, creating their own evidence through application of their expert training would be misleading, however.

3.5.27 To put it in the vernacular, Board members don't look at a utility forecast and say "I'm an engineer. I understand these things. Looks good to me." Board members look at the evidence surrounding the forecast – the past trends, the spending levels of other

utilities, etc. – to determine whether the evidence shows the forecast is reasonable.

3.5.28 As the Board will see, below, SEC is of the view that Enbridge, in this case, failed to provide sufficient evidence for the Board to determine that its forecasts are reasonable. Enbridge appears to be expecting that the Board members will review the forecasts line by line, applying their own expertise, and forming their own professional opinion[32]. That is, in our view, asking more from the Board members than is either fair, or appropriate. It misunderstands the Board's role.

3.5.29 ***Multiple Years***. The Forecast Method works best where there is a strong empirical context, and a short forecast period. Forecasts diverge from reality quickly over time[33], and thus are notoriously difficult past the first year. As the number of years of forecasts increases, the empirical base necessary to test those forecasts also increases.

3.5.30 This relationship between actual data and forecasts applies first to trends, which is the obvious aspect. One year will likely not produce a trend for the next year, but 365 days may establish a trend for the 366th day (for example, weather). Five years of actuals can be a reliable trend for year six. Five years of actuals will usually not be a reliable trend for the next decade.

3.5.31 In SEC's submission, a proposal to set rates on the basis of forecasts for five future years requires considerably more external validation and testing than would rates based on a forecast for a single year. Indeed, this is one of the key reasons why the Empirical Method is used for multi-year rate-making plans, i.e. its stronger level of empirical support for the future cost levels.

3.5.32 It is an important issue in this proceeding whether the Applicant has provided sufficient external validation and support for their forecasts in light of the five year time period covered by those forecasts.

3.6 ***The Empirical Method***

3.6.1 Where the Forecast Method starts with a forecast, and then tests it for reasonableness, the Empirical Method seeks to go directly to a reasonable spending level.

3.6.2 It is important, in our view, to keep firmly in mind the fact that both methods have as their goal the establishment of a reasonable level of spending[34]. In the Forecast Method, the costs are forecast, and then empirical data is used to test the reasonableness of the forecast. It is infused, at the outset, with subjectivity and opinion, but in the end it has to be empirically justified. In the Empirical Method, a reasonable cost base is established, and then statistical analysis is used to identify a

[32] E.g., Tr.4:93, Tr.4:86 and other references.
[33] As Enbridge found out in trying to forecast five years of future costs.
[34] And thus, by implication, a fair return.

reasonable rate of change of that spending. One of the benefits of the Empirical Method is that subjectivity and opinion is supposed to be minimized.

3.6.3 The Empirical Method relies for its validity on the fundamental assumption that reasonable utility costs bear a predictable relationship – on a rate of change basis - to an external metric, normally inflation. In the case of electricity distribution, for example, the Board commissioned research, had an extensive consultation, and ultimately concluded that for a normal LDC the total of all costs should in the next several years increase at the level of inflation.

3.6.4 The Empirical Method doesn't posit that each cost will bear a predictable relationship to inflation, nor that in any given year that relationship will hold true overall. What it posits is that, over time, the rate of change of the measurable metric (inflation) will be predictive of the rate of change of the target metric (reasonable utility costs) using a known formula.

3.6.5 ***Two Steps***. Of course, economic regulators don't regulate rate of change. The Board's job is to set rates, not percentage change. Thus, to ensure that rates are just and reasonable using the Empirical Method, two steps are required:

(a) The Board must start with rates or costs that are reasonable and representative of a normal year.

(b) The Board must identify a formula that relates a measurable factor, inflation, to the rate of change of utility costs, and then apply it to the starting point.

3.6.6 The Board is not new to these steps. In many respects, the Board is a leader in the use of empirical analysis to set just and reasonable rates, as it has been using that approach in various forms for more than fifteen years in a number of different circumstances.

3.6.7 Of course, many issues surround the method of determining the inflation factor that is appropriate, and the techniques for calculating and applying the productivity factor and any stretch factor[35]. These issues, while certainly complicated, are tractable problems that the Board has tackled and resolved in both the gas and electricity contexts.

3.6.8 Thus, the Board's policies for IRM today reflect a regulator that has come a long way up the learning curve, and has refined its understanding of the Empirical Method a number of times.

3.6.9 In our submission, the Board's current policies on rate-setting include the following general principles:

[35] Get enough lawyers and economists in a room….

(a) Rates should be determined to be reasonable based on objective, not subjective, evidence.

(b) Formula-based rates should be the standard approach, both because they are methodologically superior in most cases, and because they achieve greater regulatory efficiency.

(c) Flexibility to deal with diverging futures must be added to any formula approach.

(d) Rate-setting that is not based on a formula approach should be the exception, rather than the rule, and still must comply with the objectivity principle.

3.6.10 SEC believes that the Empirical Method is the superior approach because of its reliance on objective evidence, and further believes that this conclusion is consistent with the Board's view of available rate-setting options.

3.7 ***Conclusions***

3.7.1 The main challenge with the Forecast Method is determining the reasonableness of the forecasts, a problem that increases as the period of the forecasts goes further into the future. This challenge is met by the Board and other regulators through importing the use of past and current trend and benchmarking data, the central elements of the Empirical Method.

3.7.2 The main challenge with the Empirical Method is that actual cost pressures are not always exactly the same as the statistically predicted costs**.** This challenge is met in two ways: first, by starting with a robust rebasing year using the Forecast Method; and second, by identifying material changes in costs going forward and accounting for them through Y factors and similar methods (again, using the Forecast Method).

3.7.3 Neither a method based solely on forecasts, nor a method based solely on statistical analysis, will produce just and reasonable rates. The Board has advanced well beyond that simplistic approach. Custom IR uses multi-year forecasts, but requires benchmarking and analysis against inflation and productivity factors, or it doesn't work. Fourth Generation IRM is not I-X, but actually I-X+Y, with periodic rebasing, an ICM, and other elements to ensure that it works properly.

3.7.4 In the next two sections of this Final Argument, SEC looks at the Enbridge proposal, and at the alternative approach using the Empirical Method. Central to our argument is that the Enbridge proposal fails by its lack of empirical backup for its forecasts. However, an alternative approach can be constructed by the Board - starting with the

rebasing that has already occurred - that integrates a strong empirical foundation with appropriate adjustments for known past and future cost differences.

4 THE ENBRIDGE FORECAST PROPOSAL

4.1 *Introduction*

4.1.1 In this section we will look at aspects of the Enbridge rate proposal, based on the Forecast Method.

4.1.2 SEC is aware that some other parties will be looking at individual aspects of the Applicant's forecasts in some detail. Rather than be repetitive, we will instead look at some of the most material issues only, and leave the details to others. On our view of the Enbridge rate proposal, it fails and should be rejected, so looking at it line by line is not, we believe, necessary.

4.1.3 SEC believes that the Board should reject the Enbridge proposal in its entirety, because it fails to properly implement each of the two steps required to make the Forecast Method work:

(a) ***Real Cost Estimates.*** For the Forecast Method to work, the Applicant must tell the Board what they actually expect to spend on each cost item, and why. Enbridge admits throughout that they already know their cost estimates are not realistic. The Board can't set rates based on a straw man.

(b) ***Objective Evidence of Reasonableness***. The Forecast Method also requires robust evidence that the forecasts are reasonable. That evidence must be objective, and should include solid benchmarking information. Enbridge has failed to provide ANY objective validation of their cost forecasts, and in fact expressed surprise that this would even be required[36].

4.1.4 In recommending to the Board that it reject the Enbridge rate proposal completely, SEC is anticipating that the Board can still set 2014-2018 rates on an alternative basis, as detailed in Section 5 of this Final Argument.

4.1.5 However, we want to make clear that the position of SEC on the Enbridge proposal is not dependent on the Board agreeing with our arguments on the alternative basis for setting rates. Whatever the Board's view of setting rates on the alternative basis, in our submission the Application as filed is insufficient and should be rejected, as it cannot, and should not, be used to set rates.

4.2 *Capital Plan*

4.2.1 ***Reason for Use of Forecast Method.*** The Applicant says that their capital plan is the

[36] Tr.5:117.

main reason they needed to use a cost of service approach to setting rates[37].

4.2.2 Indeed, from the moment the hearing started the Applicant was referring to their capital plan as "extraordinary"[38], and justifying the high rate increases in the Application on the basis of capital spending pressures, particularly safety and reliability.

4.2.3 This is not the first time Enbridge has used this approach. In EB-2005-0001, its 2006 rates case, it adopted a similar strategy, which was described by the Board in its Decision as follows:

> *"Enbridge proposed an increase in capital expenditures from the estimated $250.5 million in 2005 to $458.8 million for 2006.* ***The Company claimed that it needs to address mounting demands on its gas distribution infrastructure being driven by requirements for pipeline integrity and remediation work****, a need to support the provincial government in its effort to replace coal-fired electricity generation, new community attachments and new customers."*[39] *[emphasis added]*

4.2.4 In fact, the reason why so many people in the current proceeding expected to see senior management in the hearing room is because, in that proceeding, Enbridge led a panel of several executives, including its CEO, to describe pressing needs to spend on cast iron and bare steel mains, for example, and other safety and reliability risks.

4.2.5 The approach was surprisingly similar to the current one, as evidenced by the following description in the Board's decision:

> *"Enbridge described its approach to the budgeting process as a "bottom up" approach and explained that the capital budget is developed by assessing the needs of the business including customer growth, system reinforcement and infrastructure rehabilitation for safety and reliability needs.*
>
> *Enbridge asserted that it has an ongoing legal obligation to address emerging legislative change in a timely manner. In this regard, the Company said that it has put into place certain policies and plans to respond to pipeline integrity legislation that has been introduced in Canada and the United States. As well, it is beginning to consider the appropriate response to distribution integrity related legislation that it expects will take effect in the near future."*[40]

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[37] Tr.5:10.
[38] Tr.1:10 and many other places.
[39] EB-2005-0001/EB-2005-0437 Decision with Reasons, p. 6.
[40] Ibid,. p. 7.

4.2.6 The Board rejected the company's request in that case, allowing a capital budget of $300 million rather than $458.8. The Board explained its overall reasoning as follows:

> *"It is not the Board's role in a rates case to micro-manage Enbridge's capital spending plans for any given year. Generally, Enbridge must determine for itself what level of spending is appropriate for a relevant period. This process within the Company must involve a thoughtful and programmatic assessment and prioritization of projects that have ripened to the extent that there is confidence that they can and should be accomplished within the period. This is particularly so in an environment that has seen significant increases in energy prices and where the Company is seeking a very substantial increase in overall capital spending. It may be that the Company will have to make choices about which projects are most critical, and which may have to await completion until future periods.*
>
> *The Board's role is to ensure that the Enbridge's total spending program is balanced in that it is not so low as to threaten the orderly maintenance and development of the system, nor so high as to place undue upward pressure on rates, either in the test year or some future period. In fulfilling this role the Board attempts to place the capital spending plans within historical norms, which can be presumed to have found that appropriate balance. If spending well in excess of historic norms is proposed, the Board must assess whether the increase is justified through the presentation of evidence regarding the Company's analysis, prioritization, and judgement respecting budget components."*[41]

4.2.7 The Board specifically talked about the cast iron and bare steel mains – essentially the system integrity component, and a significant amount of the increase - and had a clear rationale for its approach:

> *"What is clear from the evidence is that the acceleration of the bare steel and cast iron mains replacement program is the result of a change in senior management's risk tolerance, and not with any demonstrable change in the technical challenges presented by that pipeline stock. While it is laudable that the Company's senior management is focused on this program and determined to manage it aggressively, such a change in attitude without a change in the actual risk cannot justify an increase in the capital spending budget of the magnitude sought by the Company. Enbridge may choose, and perhaps, given Mr. Schultz' testimony, has already chosen, to afford the replacement program a priority beyond that*

[41] Ibid. p. 9.

> *which its own engineering forces identified, but it must do so within a budget that has not been unduly inflated to account for changes in mere risk tolerance."*[42]

4.2.8 In our submission, the Applicant is seeking a higher capital budget for the same reasons that it asked for an increase in 2006. Now, as then, in our view the Board should be reviewing the Applicant's capital spending proposals with a careful eye, and with the understanding that sometimes tough judgments have to be made by the company in order to stay within a reasonable budget.

4.2.9 What is important to note here is that, without the dramatic inflation of their capital budget, the Applicant does not need to move away from the Empirical Method of setting rates. They can live with I-X, but for the expansion of their capital spending program.

4.2.10 In the following paragraphs we look at some of the issues raised by the Applicant's capital spending proposals. While we do consider a few specific line items, for the most part we are considering issues relevant to the entire capital budget.

4.2.11 ***Unrealistic Forecasts.*** A hallmark of the Forecast Method, i.e. forward test year cost of service, is that the utility provides forecasts of its spending for the test period that represent its real expectations as to what it needs to spend. That is, those forecasts must not just be reasonable, but also real. If a utility wants the Board to offer a $100 revenue requirement because it "needs" to spend $100 on widget replacements, then it must legitimately believe that it needs to spend, and expects to spend, $100 on widget replacements.

4.2.12 In this case, by contrast, the Applicant openly states, on numerous occasions, that they are quite certain their actual spending will be materially different from what they are forecasting.

4.2.13 This is not just the normal situation: the future as it unfolds will be different from what we expect, so we will have to re-prioritize. That is a standard aspect of any forecast. What is different here is that the utility already knows some of the ways in which it will spend differently from the budget put forth to the Board, and openly admits that the details of its forecasts are already known to be wrong. If the future unfolds <u>as expected</u>, the spending will not be as presented in the forecasts.

4.2.14 This is stated clearly in the opening statement of the Capital Overview panel, where Mr. Sanders said:

> *"The company has identified $164 million in uncertain or variable capital*

[42] Ibid. p. 12.

> *costs over the 2014 to 2016 period that we have not included in our capital budget. This represents 12 percent of the company's core capital budget that we expect to have to cover in some degree over the forecast period, and these are just the items we know about at this time.*
>
> *There will be other capital challenges that arise through the normal course of business that we have not anticipated, and many of these costs will have to be managed through a combination of productivity improvements and project prioritization over the five-year term.*[43]*"*

4.2.15 Later, under cross-examination by Mr. Thompson[44], Mr. Sanders estimates that, of the $164 million already identified, more than $100 million will actually have to be spent, but that it will be covered through productivity improvements and project prioritization. He goes on to say that they "haven't identified all of those productivity improvements".

4.2.16 We could provide a dozen examples where the Applicant makes clear that the capital budget you see is not what they actually expect to happen[45].

4.2.17 What Enbridge apparently fails to see is the fundamental difference between a revenue requirement based on a bottom-up approach, and a revenue requirement based on a reasonable envelope.

4.2.18 This is best illustrated by example. Enbridge says: we need $100 for widget replacements, $150 for vehicles, and $200 for computer stuff in our capital plan. Here is why we absolutely need each of those. Therefore, our "reasonable envelope" as a capital budget is $450. Ah, but we also know right now that we need at least $100 for buildings, but we haven't included that in our budget. We will find a way to do the widget replacements, vehicles, and computer stuff cheaper, so that we can afford the money for the buildings.

4.2.19 Well, you can't have it both ways. Do you "need" the $450 for widget replacements, vehicles and computer stuff, or not? The answer is clearly not. However, if you aren't going to spend $450 on the things you have identified as "needs" in your budget, what is the evidentiary basis for the $450 budget? If a forecast is based on components, and the components are identified as being incorrect, then the forecast is incorrect[46].

4.2.20 Enbridge has offered no other support for its capital plan, other than the components of

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[43] Tr.4:175.
[44] Tr.5:56-58.
[45] E.g., Tr. 5:122 and Tr.5:137.
[46] Contrast this with a $450 budget that you really expect to spend, but then a building falls down, and suddenly that spending has a higher priority than some of the vehicles (which may have to be operated past a normal replacement date). The forecast was fine at the time. The future was different from what was expected, so the spending was as well.

which it is constructed. If those components are not, in fact, supportable, neither is the plan, and neither is the capital budget or the revenue requirement on which it is based.

4.2.21 There is, of course, another way to do this. The Applicant could say – and maybe this is what they are trying to say – that their forecast is for $550 of capital spending, because they need that much for all four components listed above. However, because of the requirement to build in productivity, they believe that a $450 budget is appropriate, and that's what they are asking for.

4.2.22 That would be great, except that then the Board has no basis for the $450 number. It is not the sum of "needs", because that is higher. In order to determine that $450 is just and reasonable, the Board needs some other evidentiary support. None is provided in this Application. It appears to be just a number picked out of the air.

4.2.23 Enbridge will argue, one thinks, that the Board can exercise its judgment as to whether a $100 productivity reduction to a $550 capital budget is sufficient. The Board does that all the time in one-year cost of service proceedings, cutting companies back from proposed "needs" to a reasonable envelope. However, as discussed earlier the Board doesn't do that in a vacuum. It does that based on empirical evidence. First, it insists on having forecasts that the applicant really believes it needs. Then it looks at context. In a one-year COS, the normal evidence is several years of past data, and the context of a capital plan. In this case, five years are at issue, and neither past data nor the capital plan provide a useful empirical framework to support the company's number[47].

4.2.24 Enbridge appears to be seeking to have its cake and eat it too. On the one hand, it is saying: "These forecasts are not what we actually expect to spend." On the other hand, they are saying: "Please rely on the reasonableness of these forecasts to support our revenue requirement".

4.2.25 In SEC's submission, forecasts that are known to be incorrect cannot be said to be reasonable, so the requirement to establish the reasonableness of the company's forecast costs[48] could not be met based on the bottom-up approach espoused by Enbridge.

4.2.26 ***GTA and Ottawa Reinforcements.*** SEC does not oppose the inclusion in the capital plan of the GTA and Ottawa reinforcement projects. These are leave to construct projects, so the need and cost are not really part of this proceeding.

4.2.27 As we will note later, however, these projects are easily accommodated within rate-

[47] Indeed, given the huge increases from the 2012 Asset Management Plan to the 2013 Asset Management Plan, and the many references in the evidence to Enbridge "still learning" about that process, it is difficult to know how the Board would rely on those plans for forecasts five years out. See, e.g. Tr.5:68, among other places where this is discussed.
[48] See previous discussion of the TCPL v. NEB decision in the Federal Court of Appeal.

setting using the Empirical Method. There is no need to go to full-blown cost of service forecasts, with all of its problems, if the real issue is the reinforcement projects.

4.2.28 ***WAMS.*** The Work and Asset Management System is software designed to replace the EnVision system, an outsourced field automation system operated for Enbridge by Accenture[49].

4.2.29 WAMS could also be accommodated in an I-X+Y environment. However, as we will argue later in our analysis of the application of the Empirical Method to the Applicant, the benefits of WAMS may exceed its costs during the 2014-2018 period, meaning that none of the cost needs to be included. Under I-X+Y, the costs are borne by the Applicant, but the Applicant enjoys the benefits, and ends up ahead of the game.

4.2.30 ***System Integrity Spending.*** The real issue in this proceeding appears to be the ramp up in system integrity spending. Aside from the major reinforcement projects, and WAMS, this is the only area of the capital plan that is seeing significant and sustained increases.

4.2.31 We are aware that other parties will be looking in some detail at the proposed increase in system integrity spending. Rather than duplicate their effort, we will focus on three basic points that we think are the most critical.

4.2.32 First, the need to focus on system integrity is not new. In our discussion at para. 4.2.3-4.2.7 above, we quote the Board describing Enbridge's desire to ramp up this spending to reduce risk in 2006.

4.2.33 The "requirement" to do this is also not new. We have had an opportunity to review parts of the FRPO argument dealing with the TSSA Director's Order, and its history, and we agree that Enbridge has known about this, and been acting on it, for many years.

4.2.34 Second, this is not a "blip" in the capital plan, or a cyclical period of greater spending. The Applicant intends that this be a permanent increase in capital spending related to system integrity[50]. It is not the first time system integrity spending has been significantly increased, and the Applicant advises that further increases may well be coming[51].

4.2.35 Third, the Applicant has offered no external evidence that this kind of increase in system integrity spending is either a) common in the industry, or b) a new and emerging trend. If this is an industry-wide phenomena, as Enbridge witnesses stated,

[49] Tr.6:97.
[50] Tr.5:106.
[51] Tr.5:130

then it should be reasonably easy to demonstrate that system integrity budgets for gas distributors are increasing all over North America, or at the very least that other distributors, aside from Enbridge have proposed similar increases and been successful.

4.2.36 The question of external verification was put to the Applicant in an interrogatory[52], and they said they did not have any corroboration available:

> *"Question: (c) Please provide all studies, reports or other documents in the possession of the Applicant reviewing the system integrity & reliability capital spending of other gas distributors, including any such documents that show a similar permanent increase in capital spending in those categories.*
>
> *Answer: (c) EGDI does not have any such reports, studies, or documents that review the system integrity and reliability capital spending of other gas distributors."*

4.2.37 This was sufficiently surprising that we followed up in cross-examination. The Applicant was, if anything, more blunt:

> *"MR. SHEPHERD. [after quoting the IR response] So, it is true, isn't it, that when you decided to increase your spending in that category by $80 million a year and ask for more money from the ratepayers, you had no external empirical basis to do that, did you?*
> *MR. SANDERS: That's correct."*[53]

4.2.38 It is hard for SEC to understand how the Applicant could legitimately ask for a permanent and significant increase in their system integrity budget, merely on the say-so of their internal staff.

4.2.39 Our confusion is exacerbated because, if we look at the other large gas distributor in Ontario, Union Gas, there is no such proposal in any of their rate cases over the last decade.

4.2.40 ***Permanent Increase in Capital Budget/Asset Management Process.*** This theme of increasing the capital budget is not just a one-off. The Applicant has said that, due to the increasing use of asset management, their capital spending is likely to continue to increase in the future. As they learn more about the risks associated with their assets, they will identify increasing needs to spend more[54].

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[52] I.E48.EGDI.SEC.149
[53] Tr.5:115.
[54] This, by the way, seems counter-intuitive. As asset management becomes more comprehensive, it should also become more efficient and productive, which should drive costs down, not up. That is the whole point of doing it - efficiency. For example, asset management normally includes how to operate most effectively so that capital

4.2.41 For example, under cross-examination by Mr. Thompson, Mr. Sanders described his expectations of the future as follows:

> *"MR. SANDERS: I look at the asset planning process as a very good tool. It is a good process to go through to start to quantify and understand your assets and the life cycle of those assets to develop a reasonable plan for replacement.*
>
> *But clearly, the quantity of replacement that we're undertaking right now is not sustainable in the long term, and again, I believe the asset planning process is the right way to do that, is the right method to arrive at the optimized life cycle of our assets.*
>
> *But I am very sceptical that the asset planning process is going to yield a lower number going forward.* ***My belief is that that number is just going to climb****." [emphasis added]*[55]

4.2.42 The implication of this, of course, is that the Applicant is just going to keep asking for higher and higher capital budgets until someone – presumably the Board – says "Enough!"[56]

4.2.43 If the Applicant was buttressing its requests for increases with external support, those requests might have to be looked at more carefully. However, their only justification is that they have decided they need more. Given the size and impacts of the increases, one would assume that they would develop external support, or empirical data, to support those increases. If they have not, a rational person must assume that they are not able to do so, because the data would not in fact support their requests. That is especially true since the data that does relate to their requests indicates that they are more likely to be excessive (see below).

4.2.44 SEC submits that the evidence supports that inference, and the Board should so conclude.

4.2.45 ***Benchmarking or Other Empirical Foundation.*** There was considerable discussion about benchmarking relating to the capital budget.

4.2.46 The Applicant says that the benchmark they used for their capital budget was the 2013 Board-approved capital budget of $386 million[57], which had been agreed to voluntarily by the Applicant in a settlement. Then, after a lengthy capital budgeting

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spending is not required at all, or is deferred (maintenance programs, for example, or operating protocols). In response to Mr. Elsayed, Enbridge admits that they haven't reached that level of sophistication as yet: Tr.5:165.

[55] Tr. 5:68-9. See also Tr.5:130, 131, 134.

[56] In fact, given that the Board has already said "Enough!" in EB-2005-0001, and they are back for more using essentially the same arguments, the Board may have to say "Enough!" repeatedly.

[57] Tr.5:113.

process that included both decreases and increases, they ended up with a five year capital budget that, relative to their own benchmark, was about 20% higher ($300 million). The reason, according to Mr. Sanders, was:

> *"MR. SANDERS: And we recognize that the 386 agreed to in 2013 was wrong. It was not a number that was reasonably achievable."*[58]

4.2.47 Indeed, in 2013 they overspent by almost $60 million, consistent with the suggestion that the agreed budget was $60 million a year too low.

4.2.48 What they did not do is look to any external sources to determine if their capital spending levels were reasonable[59]:

(a) They had Concentric reviewing many aspects of their IRM plan, at great expense, but Concentric took no steps to determine if their capital spending was reasonable[60].

(b) They had Union Gas, their closest comparator, but they took no steps to see whether their capital spending plans are similar to those of Union Gas, or even in the ballpark[61].

(c) They claim that some parts of their capital spending are the result of cold weather impacts on their capital needs, but they have made no effort to determine the extent, if any, to which cold weather affects gas distributor capital costs[62].

(d) As discussed earlier, they propose a permanent increase in system integrity spending, with no empirical basis for that increase.

(e) And they reject the notion that an external engineering firm could review their plan because no-one would have sufficient expertise[63], although they admit that there are major firms that do exactly that sort of work.

4.2.49 In short, the Applicant took no steps to provide empirical support for its capital forecasts[64]. Earlier in these submissions, we have discussed at length the need for

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[58] Tr.5:114.
[59] Tr.4:201.
[60] Tr.3:98.
[61] TCU2.2.
[62] Tr.4:180-1.
[63] Tr.5:119-20.
[64] One of the most shocking, perhaps, is that despite many references to "aging infrastructure" as justifying capital spending, Enbridge has made no attempt to determine if their aging infrastructure problem is greater than, less than, or the same as other gas distributors: Tr.7:138. In our submission, you can't claim you have a "problem with aging infrastructure", if in fact your system is on average newer than the systems of your peers.

benchmarking or other external validation/confirmation of the reasonableness of forecasts. In our submission, the failure of the Applicant to provide any such evidence relating to its internally-generated capital budgets is, in and of itself, fatal to the Application.

4.2.50 ***Role of Board or Board Staff.*** We have discussed earlier the apparent error in the Applicant's thinking, in assuming that the members of the Board panel could take on an added role as the external technical experts reviewing the capital budget for reasonableness[65].

4.2.51 In the same vein, counsel for Enbridge implied that Board Staff should have retained an engineer to look at the capital budgets[66].

4.2.52 Trying to shift the onus to demonstrate the reasonableness of the Applicant's capital budgets to the Board panel members, or to Board Staff, completely misunderstands the responsibilities of an Applicant in this situation. In fact, that misunderstanding was stated clearly by Mr. Sanders in cross-examination, as follows:

> *"MR. SANDERS: Mr. Shepherd, I am not aware that in the regulatory process that is a requirement, that we would benchmark external budgets. I am not aware of ever going through that process in the past.*
>
> *This exercise in and of itself is the opportunity for external stakeholders to have and scrutinize our plan, and that is what we have endeavoured to do, is to provide enough detail to allow that process to happen."*[67]

4.2.53 With respect, providing support for company forecasts is always solely the responsibility of the Applicant. It is not enough to put a budget out there, let people take pot shots at it, and then say that, if it has not been undermined, it must be accepted by the Board. That does not meet the Applicant's onus, in our submission.

4.2.54 ***Contrast with Union Gas and Other Peers.*** There are two groups of external information that the Board can consider.

4.2.55 The first is the standard metric of capital spending used by many utilities, capital expenditures as a percentage of depreciation expense. That relates the capital plan to an external and rigorous measure of the value of existing assets being "used up" each year.

4.2.56 With respect to capital spending as a percentage of depreciation, the Applicant's capital spending can most easily be compared to its closest peer, Union Gas.

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[65] Para. 3.5.23 et seq.
[66] Tr.4:148.
[67] Tr. 5:117.

4.2.57 In their 2013 approved revenue requirement, Enbridge had approved (and agreed) capital expenditures of $386.0 million (excluding major reinforcements) , and depreciation expense of $279.3 million[68]. Their capex ratio was therefore 138.2%.

4.2.58 In their 2013 Board-approved revenue requirement, Union Gas had capital expenditures of $267.7 million (excluding major reinforcements)[69], and depreciation expense of $196.1 million[70]. Their capex ratio was therefore 136.5%.

4.2.59 The fact that the two ratios, both of which were voluntarily agreed by the utilities in settlement discussions, are similar should not be surprising, nor should the fact that Enbridge is slightly higher, since it has higher customer growth.

4.2.60 What is surprising is that, come 2014, Enbridge is proposing capital expenditures of $480.1 million (excluding major reinforcements, again), against depreciation expense of $250.1 million, for a capex ratio of 192.0%. In fact, even if the WAMS project is removed from the capex line (with which we disagree), the ratio would still be 177.4%.

4.2.61 The Applicant denies the value of any comparison between Enbridge and Union, but facts are facts. In 2013, the two utilities voluntarily agreed to almost identical capex ratios. For 2014-2018, Union Gas still thinks that's fine, but Enbridge wants to increase that ratio by more than 50%.

4.2.62 In the absence of evidence from the Applicant showing how their business has changed relative to Union Gas in the last twelve months (and they refuse any comparisons at all), SEC submits that it is open to the Board to conclude that the Enbridge proposed increase is excessive.

4.2.63 The second external comparison that can be done is net plant per customer. This allows the Board to assess the Applicant's starting point in capital infrastructure, relative to its peers.

4.2.64 As discussed earlier[71], Enbridge's net plant per customer is high relative to the peer group selected by Concentric. This suggests the reasonable inference that the Applicant does not have a pressing need to increase its capital spending. If anything, it might be able to ease up on the accelerator on that score, in order to get more in sync with the peer group.

4.2.65 SEC has, of course, criticized the peer group selection of Concentric, but it is still useful to point out that the only capital comparison evidence provided by Enbridge

[68] EB-2011-0354, Ex. N1/1/1/A/1, p. 1
[69] EB-2011-0210, Settlement Agreement, p. 4.
[70] EB-2011-0210, Settlement Agreement, App.B, Sched.2
[71] Tr.3:47.

tends to imply that their capital spending forecasts are too high.

4.2.66 ***Conclusions.*** From all of this, SEC concludes the following:

(a) The Applicant's capital budgets are not what they really expect to spend, so are of no assistance to the Board in determining what they "need", or what is reasonable.
(b) The Applicant has made no attempt to support their capital spending proposals with benchmarking or other empirical support, despite the Board's clear direction that such support is required. This is particularly critical where the Applicant has proposed a permanent change in the level of system integrity spending, without any credible support for that proposal.
(c) The only external evidence available to the Board – comparisons to Union Gas or to the Concentric peer group – suggests that the Applicant should have capital spending levels significantly lower than it is proposing.
(d) The capital forecasts of the Applicant, with the exception of the information on the two major reinforcement projects, considered in other proceedings, are of no value to the Board in setting just and reasonable rates.

4.2.67 SEC therefore believes that the Board should reject the capital spending forecasts of the Applicant in their entirety.

4.3 ***Operating Costs***

4.3.1 The forecast operating costs have many of the same problems as the capital plan, but perhaps require less analysis. The reason is that, at the forecast level, the operating costs are, by the Applicant's own admission, fully covered under an I-X+Y model[72].

4.3.2 Enbridge has provided operating cost forecasts for each of the 2014-2018 years. The forecasts are detailed for the first three years, and then escalate at the same rate per year for years four and five, producing an unusual hybrid of forecasts and formula, neither of which is sufficiently credible to be the foundation for rates.

4.3.3 ***Unrealistic Forecasts.*** As with the capital plan, the operating forecasts are, on their face, unrealistic. In fact, at one point the witnesses even admitted they were unrealistic[73], but then, perhaps realizing what they had said, backtracked on that statement.

4.3.4 Admitted or not, the forecasts are clearly unrealistic in two key ways. First, they exclude costs that they know now they will have to incur. Second, they exclude savings that they know now they will achieve.

[72] Tr.3:28, and others.
[73] Tr.1:61.

4.3.5 ***Exclusion of Known Future Costs.*** This point does not have to be canvassed in depth. Throughout the evidence, and again in the hearing, the Applicant listed operating costs that they are "sure" will actually be higher than the costs they have forecast. They admit this generally, saying, in J1.6 "the forecast costs to be included in Allowed Revenues are lower than what Enbridge believes will be the actual costs." In addition, for a number of specific costs they advise the Board, categorically, that the forecasts are not correct.

4.3.6 For example, in their direct evidence, they list[74] the following categories of costs that they know today, and knew at the time they did their forecasts, will be higher than the forecasts presented to the Board:

(a) Outside contractor rates.

(b) Bad debt expense.

(c) Employee benefits (6%, not 2%). In 2018, for example, their budget for the Board is $28.6 million, but they actually expect to spend $34.0 million[75].

(d) Salary increases (3%, not 2%). Even the 2014 salary and wages forecast of $170.6 million is not what they actually expect to spend[76]. In 2018, their number presented to the Board is $188.8 million, but their actual expectation is $194.4 million[77].

(e) Short term incentive program[78].

4.3.7 We note again that none of these, or any of the other examples the Applicant has given[79], are situations in which they think the future may be different than they expect. If the future unfolds exactly as they currently expect, their forecasts do not include the correct amounts for these and other items.

4.3.8 ***Omission of Known Savings.*** On the other side, the operating forecasts do not include savings from a number of initiatives that they either have implemented, or plan to implement at the expense of the ratepayer.

4.3.9 Two examples are the replacement of Envision with WAMS, and the rollout of GPS.

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[74] Tr.7:35-37.
[75] Tr.7:147.
[76] Tr.7:148.
[77] Tr.7:148.
[78] Interestingly, they say this will be higher than forecast – they forecast that they will meet their allowed ROE – because historically they have done better than that.
[79] For example, FTEs, Tr.7:77. Although, given that FTEs went up by 15% in 2012, keeping them flat after such a big increase may be easier than some of these other areas: see Tr.7-145-6.

4.3.10 In the case of Envision, the budget does not include the removal of the annual operating cost component of the Envision payments, about $1.25 million per year[80], but that is not the biggest component of the known savings.

4.3.11 The witnesses describe WAMS as like getting a new cell phone, ten years later. It will have all sorts of bells and whistles that were not in the old, obsolete one. The Applicant agrees that those new bells and whistles will result in improvements in productivity accruing over the 2014-2018 period[81].

4.3.12 Despite the fact that they expect savings, Mr. Brophy expressed surprise that the ratepayers, after paying for the productivity initiative through the cost of WAMS in the forecasts, would want the benefits of that investment as well[82].

4.3.13 The GPS system is expected to result in operating savings, at least some of which can be quantified today[83]. Despite this fact, the operating budgets do not include any savings associated with the rollout of this technology[84].

4.3.14 These are just two examples. It is clear that throughout the Applicant's forecasts, the benefits of productivity initiatives paid for by the ratepayers have not been built in[85]. They are instead replaced with the "embedded productivity" mantra that we hear time and time again.

4.3.15 In our submission, you can't ask the Board to rely on your forecasts to determine reasonable costs, and then selectively exclude from those forecasts cost savings that you already know are going to arise[86]. Those are not real forecasts, and they tell the Board nothing of value.

4.3.16 ***Lack of External Benchmarking.*** The lack of external benchmarking of the Applicant's operating cost forecasts is essentially the same problem as has been discussed elsewhere in this Final Argument.

4.3.17 There are two additional comments on this point that specifically relate to the operating costs.

4.3.18 First, Mr. Kancharla proposes that the best benchmark for their O&M forecast increases is the past history of O&M cost per customer[87].

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[80] Tr.7:98-9. The transcript refers to $900,000, but the actual amount in rates is $1,250,000: I.B18.EGDI.SEC.97.
[81] Tr. 6:102.
[82] Tr.6:105.
[83] Tr.7:32.
[84] Tr.7:121. The surprising reason for this is found at page 124, where they say they couldn't get a savings number, because the operating people don't know the rollout schedule from the capital people!
[85] Another example is ENTRAC: Tr.7:120.
[86] And in fact will arise because of investments paid for by the ratepayers.
[87] Tr.7:144.

4.3.19 The evidence on this is found in Exhibit D1[88]. What that evidence in fact shows is that Enbridge did keep O&M cost per customer increases very low for the period 2007 through 2011, less than 1% increase per year for four years while they were under their previous I-X+Y rate formula. Then, in the run-up to rebasing, in 2012 they increased by 7.6%[89], and in 2013 by a further 3.3%.

4.3.20 So yes, it is true that the 2014-2018 forecasts result in lower increases in O&M cost per customer under IRM, but the reason appears to be the intervening 11% bump in those costs.

4.3.21 Second, Enbridge appears to have used its own rough form of objective data to establish its forecasts for O&M in the first place. Those forecasts may not be what they actually expect to spend, as discussed above, but they were developed to fit an external "benchmark", inflation of 2.24%, with no increase for customer numbers.

4.3.22 Mr. Kancharla described this as follows:

> *"What we are demonstrating is that the company is committing to keep the overall O&M at close to inflation, and as the years progress of the IR term, the company will find productivity to -- and is committed to those net numbers."*[90]

4.3.23 Pressed to admit that the forecasts are not real, and what is really being proposed is an inflation escalator, he was not so direct:

> *"MR. SHEPHERD: So your argument, then, is not –- and what the company is proposing is not that these budgets are right, right?*
> *What you are proposing is that a limit of inflation is right?*
> *MR. KANCHARLA: We provided both areas, in a sense. We provided the bottom-up budget, which shows the cost pressures, and we've articulated in Board Staff 19 as well where the cost pressures are coming.*
> *So those need to factor in as the year processes progresses as well, but we will find other areas to mitigate that."*[91]

4.3.24 In our submission, the operating forecasts from Enbridge are of no use to the Board in their component parts, which are admittedly wrong, but are simply a way of displaying the true intent, which is O&M budgets increasing at about 2.24% per year.

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[88] D1/3/1, p. 20, Table 8.
[89] In years past, in another Enbridge case, Mr. Thompson coined the term "base year stuffing" to describe this practice.
[90] Tr.7:150.
[91] Tr.7:150.

4.3.25 As the Board will see in our subsequent discussion, SEC does not agree that inflation should be forecast at 2.24%[92]. However, what is interesting is that customer growth (1.7%), plus 40% of real inflation (0.8%) totals 2.51% per year (when multiplied). In effect, Enbridge is proposing a formula using a high inflation rate of 2.24%, but a 1.7% per year productivity factor.

4.3.26 SEC believes that this approach – getting to an I-X+Y through the back door, rather than directly – is not an appropriate way to set rates, or forecast costs. Since Enbridge is apparently satisfied with operating costs set on a formula basis, use a proper formula for the whole revenue requirement, and do it right.

4.3.27 ***Indexing Years Four and Five.*** It is perhaps appropriate to point out that, where for years 2014-2016 Enbridge purports to use a bottom-up approach, even though in the end getting to a formula result, in 2017 and 2018 they don't even try to provide bottom-up numbers. Those two years are just indexed at the average rate of increase of the previous three years.

4.3.28 Thus, all five years of the Enbridge operating cost forecast are, one way or another, ways of getting to an I-X+Y result.

4.3.29 ***Conclusion.*** From this analysis, SEC concludes:

(a) The operating cost forecasts provided by the Applicant to the Board are not what they expect to spend in fact, and thus are of no more value to the Board than their capital forecasts, perhaps less.

(b) The only benchmarking offered by the Company suggests that they can keep O&M costs down during IRM, but seek to get a bump on rebasing. Other than that, and the impugned Concentric study, they have no benchmarking support for their operating cost forecasts.

(c) The end result is a forecast that is set based on a high inflation factor of 2.24%, but an implied productivity factor equal to customer growth, i.e. 1.7%.

(d) As a result, Enbridge can easily live within the Union Gas I-X+Y plan for their operating costs. It would, in fact, produce more revenues than they would need for this purpose.

4.4 *Cost of Capital*

4.4.1 Enbridge has proposed that its cost of capital be forecast today for the five years in issue, rather than fixed at the base year rate, as is the Board's normal practice. This

[92] Or, 2.45%, the number proposed by Concentric to this Board.

represents a significant percentage of the additional money Enbridge is requesting, over and above a more conventional I-X+Y formula.

4.4.2 The Applicant's rationale for this request is set out in the re-direct of Panel 1, as follows:

> *"MR. CASS: Why does Enbridge say that its proposed treatment of the cost of capital under the customized IR model is appropriate?*
> *MR. LISTER: It is our view that the cost of capital as recognized in the fair-return standard is a legitimate utility cost.*
> ***Since we are forecasting the utility's costs, a cost that has to be considered is the cost of capital.***
> *And that is our -- why we have chosen to forecast the cost of capital as we have, and that evidence is found at Exhibit A2, tab 5, schedule 1.*
> *MR. FISCHER: If I could just add to Mr. Lister's comments, so cost of capital is a cost like all other costs that a utility must bear. And in terms of the customized IR approach, which is -- has strong analogies to the custom IR method available to electric utilities, you know,* ***it needs to be included as a forecast cost element, to be consistent with that approach****.*
> *So that is why it is important that those costs be included in a determination of the revenue cap on a go-forward basis."*[93] *[emphasis added]*

4.4.3 There is some logic to this[94].

4.4.4 Of course, no-one else with rates set on an IRM basis has a forecast cost of capital, and you can be sure that, if ROE were expected to go down over the next five years, fixing it at the 2013 levels would have been looked at more favourably by Enbridge.

4.4.5 However, on SEC's view of the situation, the Board does not have to consider these questions. In our submission, rates should be set using the Empirical Method, I-X+Y, and under that method individual cost items are not forecast for the 2014-2018 period. By Enbridge's own logic, cost of capital when rates are set on that basis would be kept at 8.93%, just as is the case with both gas distributors in 2007, with Union Gas now, and with the electricity distributors on 3rd Generation or 4th Generation IRM.

4.4.6 We do note that, if the Board does set rates based on the Forecast Method, either as requested by the Applicant or with modifications, the cost of capital elements would be an issue. In that case, there are two points that should be made.

4.4.7 First, Union Gas does not have an increasing ROE. A decision by the Board to give

[93] Tr.2:155.
[94] Although the Board would have to be concerned about the implications of this for Custom IR applications in the electricity distribution sector, given that most of the largest distributors have filed, or plan to file, on this basis.

Enbridge the benefit of an increasing ROE would indirectly penalize Union Gas for proactively, and collaboratively with its stakeholders, developing a simple and effective IRM framework for the 2014-2018 following the Board's stated policies.

4.4.8 Second, Enbridge has provided little evidence supporting its cost of capital assumptions, and no expert evidence. Yet, it wants to lock in those assumptions for the full five years[95]. If the Board were to agree to that, it would be doing so on the basis of less evidence in this proceeding than in any other proceeding that SEC has seen dealing with future cost of capital parameters beyond one year. Given the significant impacts of the cost of capital proposal, including the $130 million impact of the increasing ROE[96], SEC believes that the evidence in this proceeding is insufficient to support this component of the forecasts.

4.5 ***Revenue Forecast***

4.5.1 The Applicant has proposed a change to the weather methodology used to forecast degree days and therefore volumes.

4.5.2 In SEC's submission, the Board should be approving rates based on the Empirical Method. Under that method, a change in degree day methodology would not be appropriate. Rebasing is the time at which changes of that nature are made, so the appropriate time for that change would be at the next rebasing, if the Applicant wished to lead evidence to that effect at that time.

4.6 ***Embedded Productivity***

4.6.1 Throughout this proceeding, the Applicant has repeatedly claimed that it has "embedded productivity" in its forecasts. In this context, it appears to SEC that "embedded productivity" really means "didn't give the departments everything they asked for".

4.6.2 In our submission, approving internal budgets that are less than the original ask is not productivity, but just the normal budget process. The Applicant's witnesses essentially admitted this a number of times during cross-examination[97]. They even admitted that there was nothing particularly special about the size of the cutbacks from the original ask[98].

4.6.3 The Applicant's approach, in our submission, is essentially setting up a straw man and then "showing" that they were able to defeat that straw man through tough budget

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[95] Tr.10:4.
[96] Tr.1:90, although this is offset by about $51 million of reductions in revenue requirement due to the other components of cost of capital: Tr.10:5.
[97] See, e.g. Tr.5:156 et. seq.
[98] If anything, the asks were more inflated than would normally be the case: Tr.7:114.

decisions. For example, although told to keep their operating budgets within a cap of inflation, the departments did not do so[99]. In some cases, those amounts were rolled back. In other cases, they were not.

4.6.4 There is no doubt that showing productivity when a budget is being set on a cost of service basis is a difficult task. Since you don't have an objective baseline budget, you can't show that your envelope is less than you would otherwise objectively need. This is a problem that we expect will plague Custom IR applications in electricity as well.

4.6.5 That having been said, presenting your budget for approval, and saying no more productivity is required because "This budget is already productive" is not the right answer. Neither is it the right answer to say "Our budget doesn't include everything we'll have to spend, so we will have to be productive". All that is saying is that the budget presented to the Board is not the Applicant's real budget.

4.6.6 These, of course, are additional reasons why benchmarking and objective data is necessary if the Forecast Method is to be used to set rates. Evidence that the forecasts would out-perform a reasonable external benchmark could, in our view, be evidence of productivity in the right circumstances. This might even be done for components of a forecast, if the claim was that some cost elements are going to be different from the past, but others are not.

4.6.7 In our submission, the Applicant's evidence on its embedded productivity does not provide any credible basis for the Board to conclude that rates based on the Application would include productivity.

[99] Tr.1:106-7.

5 THE EMPIRICAL METHOD

5.1 *Introduction*

5.1.1 The previous Section demonstrates, in our submission, that the Enbridge proposal for setting rates, based on the Forecast Method, must be rejected by the Board entirely. The next question, then, is whether the Board has sufficient evidence before it to set rates on a different basis, as it is authorized to do under the statute.

5.1.2 SEC believes that the Board has sufficient evidence to set rates, for the period 2014-2018, using the Empirical Method to set just and reasonable rates using an I-X+Y formula.

5.1.3 This section will look at the sources of evidence available to the Board to determine those rates, and will propose an IRM plan, very similar to the Union Gas Approved IRM Plan, but with changes to reflect Enbridge's different circumstances.

5.2 *Sources of Evidentiary Foundation*

5.2.1 As Enbridge has pointed out, and will undoubtedly repeat in their Reply Argument, no-one has presented the Board with an alternative plan for setting Enbridge's 2014-2018 rates. If Enbridge is correct, and the lack of an alternate plan means that the Board is stuck with the Enbridge proposal, or nothing, then in SEC's submission, the correct answer is nothing. The Application should be rejected, and Enbridge should be told to come back with a new proposal that is consistent with good ratemaking.

5.2.2 However, SEC doesn't agree that the Board can only set rates on an alternative basis if it has a fully formed alternative proposal before it. The test is not whether someone filed an expert report. The test is whether the result the Board obtains is just and reasonable. In our submission, there is sufficient information on the record for the Board to construct an I-X+Y formula for Enbridge, and set rates on that basis. The sources of that information are, at least:

(a) The IRM plan agreed to by Union Gas with its stakeholders, and approved by the Board, for Union Gas rates 2014-2018.

(b) The IRM plan agreed to by Enbridge with its stakeholders, and approved by the Board, for Enbridge rates 2007-2012.

(c) The review by Pacific Economics Group of the performance of both Union Gas and Enbridge under their prior plans[100], plus the PEG review of the

[100] L/1/1.

Enbridge Customized IR proposal, and other expert evidence provided by PEG in this proceeding.

(d) The Board's approved structure for 4th Generation IRM for electricity distributors.

5.2.3 Of course, not all of these can be used for all aspects of an alternative plan, but together they form a substantial body of evidence, data, and analysis informing the Board.

5.2.4 ***Union Gas Approved IRM Plan***. Enbridge is very hesitant to get into any discussion of the Union Gas plan, and dismisses it as "specific to their needs"[101]. There is no evidence as to why it should not be applicable to Enbridge, except that it doesn't provide as much money as Enbridge feels they need[102].

5.2.5 The Board does know some things about the Union Gas plan.

5.2.6 First, the Board knows that the plan was developed in an extensive collaborative process between Union Gas and its key stakeholders. There was a lot of expertise at the table. Union Gas is a gas distributor in a similar situation, and having a similar level of expertise available to it. Many of the key stakeholders are also key stakeholders of Enbridge, and participated in this proceeding.

5.2.7 Those parties developed a comprehensive plan that, they all concluded, provided an appropriate balance of costs, risks and benefits between the utility and the stakeholders. In one sense, one could say that it is an expression of the "market" for gas distribution rates. That is, if the competitive market balances the interests of buyers and sellers, so too the Union Gas settlement is an expression of that same balance between one of Ontario's two large gas distributors, and its customers.

5.2.8 Therefore, the Board is able to conclude, on the evidence, that the Union Gas plan is, at the very least, an example of a fair balance between utility and stakeholders.

5.2.9 Second, the Board knows that the Union Gas plan, and the formulae within it, produce just and reasonable rates. The reason the Board can be sure of that is that the Board has already approved the plan, and is using it to set just and reasonable rates for Union Gas[103].

5.2.10 Third, the Board knows that, at least in some respects, Union Gas is similar to Enbridge. As discussed earlier in these submissions, Union and Enbridge have

[101] Tr. 1:102.
[102] There is a $331 million shortfall, says Enbridge: see K1.3 as amended by Schedule 1 to this Final Argument.
[103] As discussed in Section 3.3 above, when the Board is using the Empirical Method a key to its acceptability is that the formulae are reasonable.

differences. However, it is also admitted that they have some important similarities as well.

5.2.11 For example, Enbridge and Union have similar business risks[104]. This was in fact determined by the Board for equity thickness purposes in EB-2011-0354, and has not been challenged by anyone in this proceeding.

5.2.12 Similarly, Union is, according the Enbridge's experts, a good comparator to Enbridge. In an exchange with Mr. Thompson, Mr. Coyne provided the following:

> *"MR. THOMPSON. Is Union one of the most comparable utilities to EGD, Mr. Coyne?*
> *MR. COYNE: It is, in the sense that it operates in a similar environment -- i.e., Ontario -- and it has similar cost drivers."*[105]

5.2.13 Mr. Coyne goes on to discuss why Union should not be used as a proxy for benchmarking purposes, but does not resile from the basic point that it is a good comparator.

5.2.14 In our submission, and barring any evidence to the contrary – there is not – the Union Gas plan has the potential to be a good basis for the Board to establish rates for Enbridge for the 2014-2018 period.

5.2.15 ***Enbridge 2008-2012 IRM Plan.*** Enbridge operated under an I-X+Y plan for the period 2008-2012, and over-earned every single year. That happened notwithstanding the fact that, having been denied an additional budget in EB-2005-0001 to look after their cast iron and bare steel mains, they still managed to remove all those mains by 2013.

5.2.16 Enbridge argues that their ability to over-earn in the last IRM period was heavily driven by declining interest rates, and that is clearly true. However, it is also true that Enbridge expects their overall costs to go down by $51 million or more in the 2014-2018 period due to declining interest rates as well[106]. The total of that $51 million, plus the aggregate over-earnings in the 2008-2012 period, $146.2 million[107], plus the tax gross-up for those over-earnings, $52.7 million[108], produces a $250 million cushion for the 2014-2018 period that should be more than sufficient to accomplish the same result.

5.2.17 There are some key differences between the 2008-2012 Enbridge Plan and the 2014-

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[104] Tr.2:22.
[105] Tr.4:59.
[106] Tr.10:5.
[107] J1.3.
[108] $146.2/(1-.265)-$146.2.

2018 Union Gas Plan. Two are worth flagging at this point.

5.2.18 First, the Enbridge plan was a revenue cap per customer, rather than a price cap. The effect of that was to ensure that Enbridge was kept whole if there were changes in volumes per customer that impact revenues per customer.

5.2.19 As it turns out, the new Union plan has a more comprehensive adjustment for changes in normalized average use. In fact, that adjustment causes Enbridge to refer to the Union plan as a revenue cap, rather than a price cap.

5.2.20 On the face of it, it would appear to SEC that this enhancement to the Union plan solves the Enbridge problem, and would allow them to operate under a price cap as well. However, as noted below, the same result can be accomplished multiple ways, and a price cap with comprehensive volume adjustment, vs. a revenue cap per customer, is not to our minds a fundamental difference of substance in plan structure.

5.2.21 Second, the Enbridge plan contained more deferral and variance accounts, Y factors, and other risk protections than the Union plan. The current Enbridge proposal continues the same trend.

5.2.22 To the extent that the current Application seeks additional protections, SEC does not believe they are warranted. However, with respect to the existing Y factors and variance accounts, with one exception SEC does not think it is necessary to reduce Enbridge's risk protection at this time.

5.2.23 One thing that is not a key difference between the plans is the productivity factor. In the Union plan, productivity is a percentage of depreciation, in this case 60%. In the former Enbridge plan, productivity was also a percentage of depreciation, changing over time, but ending up at 55% in 2012.

5.2.24 What is clear from this is that in 2012, with a productivity factor almost identical to the Union productivity factor in their current plan, and with inflation at 1.72%[109], and with an increase in OM&A of 7.6% over the previous year[110], and with an accounting error that seriously reduced net profit[111], Enbridge still managed to over-earn.

5.2.25 ***PEG Evidence.*** Board Staff"s experts have filed extensive information that can assist the Board in determining rates on an alternative basis. Although they quite clearly did not prepare an alternative proposal for Enbridge[112], they have done extensive work on productivity, inflation, and other information relative to the Enbridge situation. This is contained in two main reports, plus their responses to interrogatories and oral evidence

[109] EB-2011-0077, Ex. B/1/3, p. 2
[110] D1/3/1, p. 20, Table 8.
[111] J1.3.
[112] Tr.4:126.

in the hearing. The two main reports are:

(a) "Assessment of Union Gas Ltd. And Enbridge Gas Distribution Inc. Incentive Regulation Plans", July 2012, Pacific Economics Group.[113] (the "Performance Review")

(b) "Enbridge Gas Distribution's Customized Incentive Regulation Proposal: Assessment and Recommendations". October 2013, Pacific Economics Group[114] (the "Assessment Report").

5.2.26 The evidence also includes a number of examples of the extensive work PEG has done, throughout North America, calculating TFP in the gas distribution industry, and benchmarking gas distributors' costs.

5.2.27 In SEC's submission, while the PEG evidence does not propose an alternative rate plan for Enbridge, it provides a solid foundation of evidence that the Board can use to test the reasonableness of any given rate plan it is considering, including the existing Board Approved Union IRM Plan for 2014-2018.

5.2.28 ***4th Generation IRM for Electricity Distributors.*** Everyone appears to agree that the basis on which the 4th Generation formula is derived is not directly applicable to gas distributors, at least with respect to productivity and stretch. It may not be so clear with respect to the inflation factor, as we discuss later.

5.2.29 That having been said, while the form of the 4th Generation is of assistance, and certainly the principles used in that plan are general principles to which the Board adheres overall, the details of that plan with the exception of the inflation factor are probably not of value to the Board in this Application.

5.2.30 ***Conclusion.*** It appears to us that Enbridge went into this hearing thinking that either a) there would their proposal, and a competing proposal, and the Board would choose one, or b) the Board would be limited to considering whether to accept Enbridge's proposal, with or without amendments.

5.2.31 SEC submits that, in fact, the Board has a broad range of information now available to it in this comprehensive proceeding, and can use that information, coupled with the ratemaking principles that the Board applies in every proceeding, to establish rates on any basis that it determines is just and reasonable. The Board is not limited in its options, by reason of any limitations on the evidence it has to work with.

5.2.32 Throughout the remainder of this Section of our Final Argument, SEC will describe its proposal to set Enbridge rates, which is in many key aspects closely based on the

[113] L/1/1.
[114] L/1/2.

current Union Approved IRM Plan.

5.3 ***Plan Structure***

5.3.1 SEC proposes that the Board use the Empirical Method, I-X+Y, and adopt the basic price cap structure of the Union Approved IRM Plan.

5.3.2 While we believe it would be simpler for the Board and all parties to use the same basic structure, we accept Enbridge's take on the Union Plan, i.e. that it has significant elements of a revenue cap. In the event that Enbridge has a strong preference for a revenue cap per customer structure, SEC believes that would be appropriate. In our view, the Union Approved IRM Plan, and a revenue cap per customer plan, will in the end be functionally equivalent.

5.4 ***Base Year Adjustments***

5.4.1 A plan based on I-X+Y depends for its strength in part on a robust starting point. That is normally a rebasing year, which is taken to be a "normal" year and so applicable to revenue requirement going forward.

5.4.2 There are typically two reasons you would adjust the starting point.

5.4.3 First, there may be components of the revenue requirement (high or low), that are peculiar to that year, and so should be normalized in order to make it a representative revenue requirement going forward.

5.4.4 Second, the baseline is only useful if it actually represents a revenue requirement that meets the Fair Return Standard, and no more. If the results of the base year show a high or low level of ROE, then unless there is some explanation for that anomaly, it must be adjusted to a revenue requirement that meets that test.

5.4.5 ***Individual Line Items.*** SEC has reviewed the components of the Applicant's approved revenue requirement for 2013, as set out in EB-2011-0354, and has not identified any material items that should be adjusted[115].

5.4.6 ***2013 Overearnings.*** Enbridge had grossed-up over-earnings of $31.2 million in 2013[116]. SEC has reviewed the material explaining those over-earnings, and there doesn't appear to be anything about those amounts that are sufficiently unusual to be ignored. It appears that Enbridge was simply able to operate the regulated gas distribution business in the manner expected, but without needing the full amount of the revenues generated by its EB-2011-0354 rates.

[115] Subject to our comments on site restoration costs, below.
[116] J1.2, p.2.

5.4.7 Therefore, to adjust 2013 to be a reasonable base year, in our submission the 2013 revenue requirement and rates should be reduced by $31.2 million. Otherwise, the year on which the formula is based would have $31.2 million of excess return built in, a total of $156 million plus escalation over five years. It would be the equivalent of increasing the Applicant's return on capital by more than 53 basis points[117].

5.4.8 ***SRC Method Change.*** We note that, in addition to the $31.2 million base year adjustment described above, SEC will, in Section 7 of this Final Argument, propose a further adjustment to account for the proposed change in the method of accounting for site restoration costs. In keeping with our practice throughout this Final Argument, we are keeping our analysis and recommendations with respect to SRC completely separate from our analysis and recommendations with respect to Enbridge rate proposal. The two are completely separate, and should be reviewed in that way.

5.5 ***Inflation Factor***

5.5.1 The inflation factor is, in our submission, the easiest of the plan parameters for the Board to establish in this case.

5.5.2 ***Concentric Proposal.*** Mr. Coyne and his firm have calculated an inflation factor of 2.45%[118], based on a multi-factor inflation formula. In our submission, the Concentric inflation proposal has been shown conclusively to be inappropriate in the analysis by PEG in their Assessment Report[119], supported by their oral evidence and interrogatory responses.

5.5.3 ***RRFE Result.*** In the RRFE process, the Board concluded that a two-factor inflation formula should be used, based in part on GDPIPPI (70%), and in part on the Ontario labour index (30%)[120]. The result for 2014 is 1.7%[121].

5.5.4 While it is true that generally factors applicable to electricity distribution will not be directly applicable to gas distribution, that may not be the case here. The figure used for all non-labour, including capital, is GDPIPPI, which is an economy-wide inflation measure applicable as much to gas distribution as to electricity distribution. The figure used for labour is the Ontario Average Weekly Earnings, All Items, which again is just as applicable to gas as to electricity distribution.

5.5.5 In our submission, it would be open to the Board to adopt the same formula for Enbridge, although if it were to do so, SEC submits that it may have to review the labour and non-labour weights relative to Enbridge's 2013 revenue requirement

[117] J1.2, p. 2, line 10.
[118] Tr.4:71.
[119] L/1/2, p.44-5.
[120] EB-2010-0379: Report of the Board on Empirical Work, December 4, 2013, p. 7, App. B.
[121] Ibid, App. C.

components. Those weights may be to be altered.

5.5.6 The other advantage to use of the same formula as the electrics is that all regulated utilities on IRM in Ontario, except for Union Gas, would be on the same inflation factor.

5.5.7 ***GDPIPPI.*** The Union Approved IRM Plan uses GDPIPPI as the inflation factor. SEC believes that there is value in using this simpler approach for Enbridge, rather than the RRFE approach. Union and Enbridge would then be on the same inflation factor, which may be appropriate.

5.5.8 GDPIPPI and the RRFE formula are almost the same for 2014, but if wages start to increase more or less rapidly than general inflation – something that has happened in the past – they will diverge[122]. It was for that reason that the Board added an explicit wages component for electricity distribution, and that may have merit here.

5.5.9 ***SEC Recommendation.*** In our submission, the Board should go with the simpler approach for Enbridge, i.e. GDPIPPI. While either of the two options could be justified, on balance we prefer the Union Gas solution in this case.

5.5.10 We note that the real problem with both options is that there is no explicit component for capital[123]. That component was removed in RRFE due to volatility effects, and the same would likely arise here. SEC anticipates that the Board will be doing extensive work in the next few years on ways of incorporating an express capital component into inflation, and on rebasing both Enbridge and Union will benefit from that additional work.

5.6 ***Productivity Factor***

5.6.1 The productivity factor is likely the most contentious aspect of an Enbridge plan, but in our submission it is actually the easiest for the Board to determine, because of the extent of the information available.

5.6.2 ***Concentric Proposal.*** Concentric has proposed a productivity factor of zero for Enbridge, having selected a proxy group of low growth utilities with little TFP potential. We have had an opportunity to review the Submissions of Board Staff, and draft arguments from a number of other intervenors, and in our view the poorly designed and implemented Concentric study has now been thoroughly debunked. It is submitted that it provides the Board with no useful information.

5.6.3 ***Enbridge Calculation.*** Prior to getting Concentric to do their TFP analysis, Enbridge

[122] Although not greatly, given the 70% weight to GDPIPPI in the RRFE I factor.
[123] Which was Dr. Kaufmann's key concern as well.

did their own[124]. That showed Enbridge productivity of 1.33% per year for the period 2000-2009[125], with lower productivity in the pre-IR period 2000-2007 of 1.10%, and higher productivity in the IR period 2007-2009 of 2.15%.

5.6.4 The Enbridge analysis is not looking at peers, but at their own performance. It appears to be methodologically sound, despite the fact that it is approached in a simple way. Although Enbridge is highly critical of its own internal study in its response to J3.1, SEC believes that the analysis has some merit. It is also consistent with Enbridge's consistent ability to over-earn every year.

5.6.5 That having been said, SEC is not proposing that the Board rely on the Enbridge analysis. Rather, SEC believes that, once the Board determines a productivity figure, it can use the Enbridge analysis as a type of sanity check.

5.6.6 ***Enbridge 2008-2012 IRM Plan.*** As noted earlier, the productivity factor in the last Enbridge IRM plan was 55% of inflation in the last year of the plan. Again, this acts as a sanity check, particularly given that with higher spending, and other significant challenges, Enbridge still managed to over-earn in that year even with that productivity factor.

5.6.7 ***Union Gas Approved IRM Plan.*** Also as noted earlier, the productivity factor in the Union Approved IRM Plan is 60% of inflation, which in our view is indicative of a reasonable range. With inflation at 2.0%, that would be productivity of 1.2%, and with inflation at 1.7%, that would be productivity of 1.02%, both figures within the same range as the Enbridge productivity calculations, and the PEG TFP calculations.

5.6.8 ***PEG Evidence.*** In the Performance Review, PEG calculated the Enbridge TFP over its study period of 2005-2010 at 1.07%[126]. This is consistent with the extensive TFP work done by PEG relating to the US gas distribution industry, where TFP levels of around 1% are common[127].

5.6.9 ***SEC Recommendation.*** In SEC's submission, only the Concentric report is out of step with the rest of the evidence on productivity for gas distributors like Enbridge. All of the other analysis, including the past Enbridge and current Union plans, the internal Enbridge analysis, and the work by PEG relating to Enbridge and to gas distributors generally, supports a TFP in the 1.0% to 1.3% range for gas distributors.

5.6.10 In our submission, it is therefore appropriate for the Board to apply to Enbridge the Union Gas productivity factor of 60% of inflation, which in all anticipated scenarios results in a productivity level in that range.

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[124] J3.1.
[125] Mr. Coyne said their study had no X – Tr.3:7 – but that appears to be incorrect.
[126] L/1/1, p. 6 of 160.
[127] TCU1.3.

5.7 *Y Factors or Similar*

5.7.1 The Y factors in this proceeding appear to be largely non-controversial, with the possible exception of WAMS.

5.7.2 ***Major Capital Projects.*** The Union Approved IRM Plan includes a comprehensive definition of major capital projects, which would include at least the GTA and Ottawa Reinforcement Projects. It is also sufficiently flexible to include other major capital projects as they arise over the IRM period.

5.7.3 SEC proposes that the Board apply this same definition to establish a major capital projects Y factor for Enbridge.

5.7.4 ***WAMS.*** The Work and Asset Management System is a new software system being put in place to replace the Envision service from Accenture. The total amount to be added to rate base for this project is about $67 million[128]. All other things being equal, it might qualify for major capital project treatment, but there would be some significant complications.

5.7.5 One problem is that the WAMS option replaces an expensive solution already in place, so in order to calculate the revenue requirement impact of WAMS the revenue requirement savings of the Envision service have to be captured as well. Another problem, alluded to in our discussion of the O&M budget, is that Enbridge expects productivity benefits from WAMS, but has not included any of them in the operating forecasts.

5.7.6 The total of amounts added to revenue requirement for the WAMS project are $31.6 million over the period 2014-2018[129]. Against that has to be offset three types of revenue requirement reductions:

(a) The amount that is included in 2013 rates as the O&M component of the Accenture fees ($1.25 million[130]), times five years, less the amounts that will have to be paid to Accenture during the changeover in 2014 and 2015 ($890,000 in each year[131]). The net savings are about $4.5 million.

(b) The capital amount that is included in 2013 mains accounts is $11.246 million, and that goes down to $8.0 million in each of 2014 and 2015, and then to zero

[128] I.B18.EGDI.SEC.97 and Tr.6:87.
[129] I.B18.EGDI.SEC.97, App. A.
[130] If the 90% capital component is $11.246 million (J10.1), the total is $12.5 million, and the O&M component is $1.25 million.
[131] If the 90% capital component is $8 million (J10.1), the total is $8. 9 million, and the O&M component is $890,000.

for each of 2016, 2017, and 2018. The total capital savings are $40.2 million. The revenue requirement impacts of that amount, phased in as expected over five years, are about $7.0 million. In addition, the total rate base at the end of the five years would be lower by at least $35 million, for a further impact going forward.

(c) Productivity savings associated with WAMS, which clearly should accrue to the ratepayers if the cost is being borne by the ratepayers during IRM. Enbridge does not have an estimate of these savings, but they could easily make up the $20 million balance of the incremental costs.

5.7.7 Another way of looking at it is that the WAMS project incurs $67 million of capital costs and $12 million of O&M costs[132] in the IRM period, to replace $40 million in capital costs and $4.5 million in O&M costs[133] in the IRM period, and generate productivity improvements to cover the balance.

5.7.8 SEC is concerned that, if Enbridge is required to report the entire impact of WAMS as part of its Y factor claim, it could be complex and contentious.

5.7.9 The alternative is for the Board to treat this as a productivity initiative that Enbridge will be implementing during IRM. Enbridge will pay for it with their own money, but will also reap the benefits. It would appear to SEC that this will at least be a wash, and more likely be a net benefit to Enbridge.

5.7.10 ***CIS Customer Care.*** This has been approved in EB-2011-0226, and should continue unchanged.

5.7.11 ***DSM.*** The Board should continue the past practice of considering DSM budgets and related issues in a separate proceeding, and adjusting rates through a Y factor.

5.7.12 ***Pensions.*** The Board has approved the PTUVA, which was a negotiated solution to a difficult problem for utilities like Enbridge[134]. SEC supports the continuation of this mechanism.

5.7.13 ***Others.*** SEC has no comment on Gas in Storage, which it is leaving to others to analyze.

5.7.14 SEC has not identified any other costs or cost drivers that should be included as Y factors in the Enbridge plan.

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[132] I.B18.EGDI.SEC.97, App. A
[133] J10.1, p.2.
[134] EB-2011-0354 Settlement Agreement.

5.8 *Z Factors*

5.8.1 Enbridge has proposed a change to the wording of the Z factor provision, but a retention of the $1.5 million threshold.

5.8.2 SEC has had an opportunity to review a draft of the Final Argument of Energy Probe on this issue, and agrees completely with their analysis. SEC submits that the wording of the Z factor provision should not be changed, and the threshold should be increased to a more reasonable $4 million.

5.8.3 SEC also agrees with Energy Probe's two additional points. First, Z factor treatment should not be available where there are over-earnings available to pay the additional cost. Second, the 50/50 tax sharing from the previous plan can now be eliminated.

5.9 *Cost of Capital*

5.9.1 SEC agrees with the submissions of Board Staff and others that the cost of capital for Enbridge should be fixed at the level included in 2013 rates, i.e. 8.93%. This is consistent with all of the Board's other IRM plans.

5.9.2 We note that the Union Approved IRM Plan contains an express provision allowing Union and all other parties to take any positions they choose in any generic proceeding on the cost of capital, but with the understanding that any changes to ROE arising out of that generic proceeding should only apply to Union, either for rates or for earnings-sharing, on rebasing[135]. SEC believes it is appropriate for the Board to stipulate the same rule in this case, applicable to Enbridge and the parties in this proceeding.

5.10 *Reporting Requirements*

5.10.1 Board Staff include, in their Submissions[136], a discussion of the benefits of an Annual Stakeholder Meeting. SEC adopts that discussion and conclusion.

[135] K1.4, p. 26
[136] Board Staff Submissions, p. 70.

6 PRODUCTIVITY ISSUES

6.1 *Introduction*

6.1.1 The Applicant has claimed that they have embedded productivity in their forecasts for the 2014-2018 period. We have dealt with that claim previously in these submissions.

6.1.2 As SEC has proposed the used of the Empirical Method to set the Applicant's rates, we have also proposed a productivity factor, which has also been discussed previously.

6.1.3 That leaves three productivity-related issues to be addressed: ESM, SEIM, and reporting. We will comment on the first two. Other parties may deal with the third.

6.2 *ESM (Earnings Sharing Mechanism)*

6.2.1 SEC has long been on record as opposing ESMs, because they dilute the incentive to the utility to drive cost reductions during IRM. However, we accept that the Board has adopted an ESM standard for all IRM plans, and that there should be an ESM in this situation as well.

6.2.2 SEC believes that, if the Applicant's rates are set using the Empirical Method, an ESM similar to that approved by the Board for Union Gas would be suitable for Enbridge as well.

6.2.3 Conversely, if the Board determines that it will set rates based on the Forecast Method, as proposed by Enbridge (or some variation of that), in our submission there is a serious risk of over-forecasting. To partially ameliorate that risk, SEC would support an adjusted ESM along the lines proposed by Energy Probe in their Final Argument. However, we would agree with Board Staff that the threshold ROE for ESM purposes should still be the amount fixed in rates, which should be 8.93%.

6.3 *SEIM (Sustainable Efficiency Incentive Mechanism)*

6.3.1 SEC has had an opportunity to review the Submissions of Board Staff, and a draft of the Final Argument of Energy Probe, on this issue. For the reasons they have set out, and many others, SEC believes that this proposal should not be implemented.

6.3.2 SEC notes that Enbridge themselves appear to be struggling with this proposal. They have amended it substantially already, and in presenting it to the Board they were often at a loss to explain how it would achieve its intended goals. Although we do not doubt that their intentions are good on this, their actual proposal has not, in our view, achieved anything close to a reasonable and implementable framework.

6.3.3 Like Board Staff, SEC does not feel comfortable proposing an alternative to the SEIM at this time. The concept of some type of efficiency carryover mechanism is probably something the Board should pursue, not just for Enbridge but for all regulated entities on a form of IRM. This is probably best done in a generic policy process, rather than in the midst of a rate case.

6.3.4 If the Board does wish to provide something of this nature to Enbridge at this time, SEC suggests that the Board simply advise that, when Enbridge comes in for rebasing, it may be eligible for an additional incentive of up to $X million ($5 million, perhaps) to the extent that it can demonstrate at that time that its costs going forward have been reduced by initiatives implemented during IRM. The actual amount, and method of calculation, of the additional incentive would be decided by the Board panel at that time, taking into consideration not only the amount, nature and certainty of the future savings, but also the savings already enjoyed during IRM, and the level of increase or decrease in revenue requirement being proposed by the company on rebasing.

7 SITE RESTORATION COSTS

7.1 ***Introduction***

7.1.1 When utility assets reach the end of their useful lives, they have to be removed. There are basically four ways to account for the costs of so doing:

(a) *Assume the removal costs are part of the cost of putting in the new asset to replace the old one*. For example, if old cast iron pipe is being replaced with plastic pipe, the cost of removing the cast iron pipe to make way for the plastic pipe is part of the capital cost of installing the plastic pipe.

(b) *Assume that removal costs are a current expense associated with operating the utility.* This would be true, for example, when, in a road-widening project, old pipe has to be removed, but new pipe is installed somewhere else. It can also be used where an asset is being replaced, rather than capitalizing the removal cost into the cost of the new asset.

(c) *Assume that the future cost of removing an asset is part of the initial cost of the asset.* The net present value of that future cost is added to the actual installed cost of the asset, and the aggregate is depreciated over the life of the asset. The extra depreciation, plus the accretion in value of that "fund" over time, provides sufficient money to cover the cost of removal at the end of the asset's life.

(d) *Assume that a reserve has to be established for the future cost, but instead of adding the future cost to initial cost, depreciate in excess of the booked cost of the asset to generate that reserve.* This is the method used by Enbridge.

7.1.2 Enbridge seeks the Board's approval to continue to use the fourth method. That is not a method found in USGAAP.

7.1.3 SEC disagrees with the Enbridge proposal. The fourth method has resulted in over-collection of depreciation from ratepayers totaling $903.9 million, none of which is needed by the utility today, and none of which will be needed by the utility in the foreseeable future. Further, since no external fund is set up, the reserve does nothing to protect future ratepayers from bearing these costs.

7.1.4 In our view, and as detailed below, the Board should order use of the second method for removal costs (i.e. current cost accounting), consistent with the practice of some other Ontario utilities and with US GAAP, to which Enbridge is subject. During the Enbridge IRM period, the Board should initiate a review of the accounting for future decommissioning costs, including these costs, informed by the review currently going

on at the National Energy Board on related issues.

7.2 ***Factual Background***

7.2.1 Existing assets have costs associated with the end of their useful life. There are basically three scenarios:

(a) *Assets are removed at the end of their life, or where damaged or obsolete, and replaced with new assets performing the same function at the same location.* For example, cast iron mains are removed and replaced in the same trenches with plastic mains.

(b) *Assets are removed as above, but replaced with new assets performing the same function at a different location.* For example, plastic pipe at the side of a road that is being widened is replaced with new plastic pipe in a new trench twenty feet away, beside the now wider road.

(c) *Assets are removed as above, but not replaced.* For example, services that go to an industrial customer are removed, and the land is re-purposed as a public park. No new service is installed. This is normally called abandonment.

7.2.2 In every case, the utility knows when they install an asset that there will be some kind of removal cost for that asset in the future. The circumstances of the future removal are generally not known, so neither the amount of the removal costs, nor the timing, can be predicted. Removal and replacement at the same location may cost the least, but it also may be a long time in the future. By contrast, removal and replacement at a new location will likely cost more, and it often arises before the asset has reached the end of its life. Removal without replacement is probably the most expensive, because of the need to return to a greenfield state, but its timing is likely the least predictable and most remote.

7.2.3 The Board has previously approved the use of a technique called Net Negative Salvage to account for the future costs of removal of an asset.

7.2.4 Basically, Net Negative Salvage starts with the general depreciation principle that the amount of depreciation for an asset is the initial cost, less the salvage value, divided by the number of years of expected service. The purpose is to divide the value "used up" over the accounting periods it is used. The value "used up" is the cost of the asset, less the amount obtained when the asset is scrapped or sold. That is the net cost to the company, and so is divided amongst the years the asset will be used.

7.2.5 In the classic case, the salvage value is a positive number. When the company no longer uses an asset, some amount can still be obtained from it, either as scrap metal or used goods. A vehicle can be sold as used, or for parts. Copper plumbing fixtures can

be sold for the value of the copper.

7.2.6 In the case of a gas utility, however, the primary assets – mains, for example – have little scrap value, but there is a cost of removal. The "salvage value" is therefore, on this approach, a negative number, representing a net cost at the end of life. This is not the original intention of salvage value, of course, but it is consistent with the underlying concept of costs and benefits at the end of an asset's life.

7.2.7 Applying the same concept, the original cost of the asset, minus the negative salvage value (the double negatives resulting in addition), is the total cost to be depreciated. For example, if a main costs $1000 to install, and $500 to remove at end of life 50 years later, the total cost is $1500 for depreciation purposes, charged to expense $30 per year for 50 years. Without the removal cost, the cost would be $1000, and $20 per year would be charged to expense. The difference is excess depreciation, designed to cover the future cost when it arises.

7.2.8 There are four basic problems with this simple explanation:

(a) A future expense many years from now does not have the same present cost as would be the case if it had to be expended today, yet somehow the extra depreciation has to cover the cost at that future date. This raises issues of discounting and accretion.

(b) There are many assets coming into service each year, which could make the process of accounting for net negative salvage complex and administratively burdensome unless a simplification of some sort is used, such as grouping.

(c) Unless the excess depreciation is actually set aside as a segregated fund of some kind, the money collected is not actually available for the future costs as they are incurred.

(d) As long as a utility is growing, the depreciation associated with net negative salvage will always exceed the actual site removal costs incurred in the year, and whenever there is inflation, the amount of that excess will increase annually.

7.2.9 In Canada there are two methods used to calculated Net Negative Salvage or SRC, and both are intended to address the first two problems set out above: the Traditional Method, and Constant Dollar Net Salvage (CDNS).

7.2.10 In both cases, the intent is to estimate the future costs of site restoration, using current estimates of cost plus inflation assumptions, and then discount those future costs back to today's date to get the net present value.

7.2.11 Gannett Fleming provided detailed evidence as to the difference between the two methods, but summarized the difference by saying that the traditional method assumes a future pattern of inflation similar to the past, whereas the CDNS method relies on inflation forecasts. Given that inflation is not expected to reach the heights that it did at some times during the last two decades, the CDNS method produces a more reasonable future forecast[137].

7.2.12 On the view SEC has of the Enbridge proposal, it is not necessary to determine if the Traditional Method or the CDNS method should be preferred. However, to the extent that it becomes relevant, we agree that the CDNS method – if it uses the appropriate assumptions – is the better method, for the reasons cited by Gannett Fleming.

7.2.13 Enbridge has been using the Traditional Method, and as a result has a regulatory liability of $903.9 million as of December 31, 2013[138] for site restoration costs (SRC).

7.2.14 Gannett Fleming (GF) did a depreciation study for Enbridge as of December 31, 2010. When that study was completed, Enbridge asked GF to evaluate the provision they were including for SRC. GF did that review, and concluded that Enbridge should reduce the amount of depreciation being charged for SRC annually, and further that the accumulated SRC regulatory liability was too high relative to future SRC spending actually expected to occur.

7.2.15 As part of their review, GF recommended that Enbridge move from the Traditional Method to the CDNS Method, using a discount rate of the long Canada AAA bond rate. The effect of adopting the GF proposal would be to decrease the annual SRC-related depreciation by about $30 million a year[139], for an indefinite period. However, SRC-related depreciation would continue to exceed actual SRC incurred each year, again indefinitely.

7.2.16 Enbridge has asked for the Board's approval to adopt the GF recommendation for future depreciation expense. It has also asked for approval to repay a portion of the current regulatory liability to ratepayers over the next five years.

[137] Tr.9:53.
[138] I.E40.EGDI.Staff.77.
[139] I.E40.EGDI.Staff.77.

7.2.17 The effect of the Enbridge proposal is seen in the following table[140]:

Future Removal or Site Restoration Reserves or Liability

EGDI Utility Only	*Line*		*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*
Beginning of year liability	1		0.0	691.6	753.0	815.0	859.0	903.9	862.0	828.0	806.2	791.7
Period-to-date adjustment	2		640.0									
Recovery through depreciation	3	+	74.8	79.4	82.4	87.4	63.2	42.1	44.9	51.1	53.5	55.7
Actual site restoration and removal costs	4	-	-22.4	-18.7	-34.2	-27.7	-18.3	-15.9	-15.8	-14.9	-14.9	-14.9
Actual removal costs vs. estimated salvage requirement	5	+/-	-0.9	0.7	13.8 Note 1	-15.6 Note 2						
Return to ratepayers	6	-						-68.1	-63.1	-58.1	-53.1	-17.4
Net change in year	7	3+4+5+6	51.5	61.4	62.0	44.0	44.9	-41.9	-34.0	-21.8	-14.5	23.4
End of year liability	8	1+2+7	691.6	753.0	815.0	859.0	903.9	862.0	828.0	806.2	791.7	815.1

Note 1 Variance was mainly driven by costs incurred from retirement of cast iron mains exceeding estimated salvage per Gannett Fleming's model.

Note 2 Variance was mainly driven by costs incurred from retirement of bare steel mains being lower than estimated salvage per Gannett Fleming's model.

7.2.18 Adopting the GF recommendation for future depreciation expense reduces the average depreciation per year from $81.0 million (2009 through 2012) to $49.5 million (2014-2018). This reduces costs charged to customers by $68.7 million over the five years relative to the depreciation included in 2013 rates[141], plus additional impacts associated with cost of capital and taxes, discussed later.

7.2.19 The other impact is the growth in the fund. For the prior period, and despite the impact of cast iron and bare steel replacements, now essentially completed[142], the fund was increasing by an average of $55.3 million per year (excess of depreciation over annual spending). In the upcoming period, under the Enbridge proposal the fund will only increase by an average of $34.2 million per year, a total of $170.9 million over five years. This is more than offset by a refund to ratepayers of $259.8 million over the same five years, leaving the balance of the regulatory liability $88.9 million lower at the end of 2018.

7.2.20 As was discussed in the hearing, the result is that the balance at the end of 2018 would still be the same as the 2011 balance, and likely hundreds of millions of dollars higher than the amount needed in the reserve under the GF model.

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[140] I.E40.EGDI.Staff.77.
[141] $63.2 million in 2013, times five, less $247.3 proposed in Staff 77 for 2014-2018.
[142] Tr.7:134.

7.3 ***Issues to be Addressed***

7.3.1 SEC recognizes that this is a complex set of issues with a very material impact on rates, no matter how they are resolved. In our view, the Board should approach this by dealing with the following three sub-issues in order:

(a) Which of the three methods of accounting for site restoration costs (as described in para. 5.1.1 above) is appropriate for Enbridge at its current state and with its expected future prospects?

(b) If the appropriate method is different from the current method, what is the best approach to transition from the current method to the new method?

(c) If the existing reserve/liability should, as a result of a change in methodology or for any other reason, be reduced or eliminated, what is the best approach to accomplish that without having material adverse impacts on the ratepayers?

7.3.2 With respect to the first sub-issue, there is no evidence before the Board referring to the possibility of treating removal costs as part of the capital cost of the new asset, and in any case there are situations, like road widening, when that would not apply. SEC therefore submits that it is not open to the Board, on the record before it, to choose this option, and we only included it for completeness. That leaves the discounted future cost approach, the current expense approach, and net negative salvage, all of which are known to the Board.

7.3.3 For the reserve-based approaches, there are two versions:

(a) The approach mandated by USGAAP, when certain conditions are met, sets up asset retirement obligations and costs. This is familiar to the Board because it is a material part of the revenue requirement of Ontario Power Generation.

(b) The approach advocated by Gannett Fleming, and previously accepted by this Board for Enbridge, is the net negative salvage method.

7.3.4 Conceptually, the ARO and negative salvage approaches seek to accomplish the same thing, and in similar ways. Thus, it is submitted that looking at the ARO rules is instructive to the Board in considering the Enbridge proposal.

7.3.5 To that end, the balance of this section of our Final Argument looks first at the ARO rules, to identify aspects that might be useful in considering the Enbridge situation. Then we consider the Enbridge approach, and the alternative approach of treating removal costs as current operating costs, without a reserve or fund. Finally, we look at the second and third questions in light of our recommendation on the first question.

7.4 ***Asset Retirement Obligations and Costs***

7.4.1 ***Applicable Accounting Rules.*** Enbridge reports under USGAAP, pursuant to an order of this Board. Under USGAAP, there is a specific set of rules[143] for asset retirement obligations (AROs), but there is no set of rules dealing with future site restoration costs that do not qualify as AROs. In fact, USGAAP prohibits claiming a future cost as a current cost.

7.4.2 Enbridge in fact admits that, in normal circumstances, site restoration costs must be treated as current expenses as incurred. In their 2013 Annual Report, Enbridge describes the USGAAP accounting rule as follows[144]:

> *"In the absence of rate regulation, costs incurred for removal and site restoration would be charged to earnings."*

7.4.3 The key exception to the basic rule is, as implied above, that where the regulator of a regulated entity requires the entity to set up a reserve for future costs, that can be recognized as a regulatory liability, and the provision for it recognized as a current cost[145], rather than a cost when actually incurred in the future.

7.4.4 It is therefore clear that, under USGAAP, Enbridge can only establish a reserve for site restoration costs, and collect money from ratepayers each year to fund that reserve, based on an order of this Board. Unless the ARO rules apply (and they don't in this case), there is no accounting rule or principle requiring the collection of funds from ratepayers for site restoration costs, in the manner proposed by Enbridge or in any other way. If these funds are to be collected, it is only because the Board so determines.

7.4.5 We note that, questioned about this in cross-examination, Enbridge and its advisors admit that there is no accounting rule requiring them to collect net negative salvage, or otherwise provide for this obligation[146].

7.4.6 We also note that, in this respect, US GAAP and IFRS are different. Under US GAAP, site restoration costs of Enbridge are not considered AROs, because Enbridge is not under a legal obligation to incur those costs[147]. By contrast, under IFRS site restoration costs would be considered AROs (called in IFRS decommissioning costs) if there was a legal or constructive obligation to incur those costs[148]. An obligation is considered a constructive one if the company, through common practice, regulatory

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[143] K9.3.
[144] J1.1/Attachment 1, p. 16.
[145] Tr.9:37.
[146] Tr.9:67.
[147] Tr.9:42.
[148] IAS 37.

requirements, or similar reasons, is expected to incur those costs when the appropriate time arises. That is the case with Enbridge, which means that, if Enbridge had switched to IFRS as originally planned, it would have to comply with the ARO rules, which in IFRS are very similar to those under US GAAP.

7.4.7 Although under US GAAP AROs are not applicable to Enbridge, the structure of AROs is instructive, because what Enbridge is seeking to do with its proposal has a similar purpose.

7.4.8 In the hearing, SEC counsel went through the ARO rules with Mr. Kennedy[149]. In summary, they are as follows:

(a) First, you must determine if you have a legal obligation to restore the site and remediate at the time an asset is taken out of service. If you don't, the ARO/ARC rules do not apply.

(b) Assuming the rules do apply, at the time an asset is placed into service, an Asset Retirement Cost (ARC) is added to the cost of the asset when it is included in rate base. In effect, an incremental asset is created.

(c) To calculate the ARC, you identify the current cost of remediating that asset, if it were at the end of its useful life today.

(d) You then inflate that cost forward to the time that you believe the site will have to be restored and/or the asset decommissioned "using an appropriate rate of inflation".

(e) You then discount that future cost back to today. Under the US GAAP rules, that is done using the credit-adjusted risk-free rate of the utility.

(f) Each year, the asset retirement asset is accreted to reflect the time value of money, and it is also increased by the amounts collected for that purpose.

(g) The amount that is added to the cost of the assets is balanced by an equal amount which is the obligation to restore the site in the future. That is called the Asset Retirement Obligation. That is also adjusted annually in lock step with the Asset Retirement Cost.

(h) The amount of the ARO/ARC can be set aside in segregated funds, but a segregated fund is not a requirement.

7.4.9 What is most interesting about this set of rules is that it is almost identical to what

[149] Tr. 9:39 et seq..

Enbridge is doing with three exceptions.

7.4.10 First, under the net negative salvage approach used by Enbridge (either the traditional method or CDNS), no initial asset is created, and no future obligation is created[150]. There is a regulatory liability, because money has been collected that relates neither to existing assets, or current costs, but is held to pay for future costs. That is not, however, an obligation to anyone. It is simply a recognition that the accumulated amounts collected are not available to Enbridge to use for other things.

7.4.11 Second, Enbridge uses 2.38% discount rate, rather than the required credit-adjusted risk-free rate, which is probably closer to 5%. This is discussed in more detail below.

7.4.12 Third, and perhaps most important, Enbridge does not believe it has a legal obligation to restore its sites, or if it does it believes that due to the very long time frames until remediation, the net present value would be nominal[151].

7.5 ***The Enbridge Proposal***

7.5.1 ***General.*** The Applicant has, through their advisor Gannett Fleming, recalculated the amount it thinks it needs to have in reserve for future site restoration costs. There are two key issues associated with that:

(a) Inflation and discount rate assumptions used.

(b) The timing of the comparison between the recalculated number, and the existing reserve, to get the amount of the excess.

7.5.2 ***Calculation of Future Site Restoration Costs and Annual Provision.*** For any given asset, there are essentially four components to the calculation of the provision for site restoration[152]:

(a) How much does it cost to remove the asset and restore the site?

(b) What is the time in the future that those costs will have to be incurred?

(c) How, and at what rate, should the costs be inflated from today to that future date to get to the future cost that will be incurred?

(d) At what rate should that future cost be discounted to get to the amount that should be put in reserve today to pay it?

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[150] Tr.9:72.
[151] Tr.9:43.
[152] See Tr.9:50-1, where five are listed. The last is the period of depreciation, which as the discussion ensued turned out to be identical to (b).

7.5.3 We note that these are the same four components that need to be determined to establish the annual amount to cover asset retirement obligations. They are also the same four components that are used in calculating the value of future pension obligations.

7.5.4 With respect to the cost of removal and site restoration, there was some discussion in the hearing about whether changes to the Applicant's system should result in a review of those costs. For example, in the past those costs had to deal with removal and site restoration for cast iron and bare steel mains, which have now been replaced entirely in the Enbridge system. If the costs for removal and site restoration for plastic or coated steel mains are different, then the assumption should be changed.

7.5.5 Enbridge's evidence is that it has not changed the current cost component of the calculation, because they believe that the costs associated with plastic and coated steel are similar to the costs associated with cast iron and bare steel. We understand that some intervenors may discuss this issue in their submissions.

7.5.6 SEC can only say, based on the evidence that we have seen, that it does not appear at all clear that costs based on cast iron and bare steel are applicable to a system that is now all plastic and coated steel[153]. However, for the purpose of our analysis here, we have assumed that Enbridge is correct on this point. If Enbridge is incorrect, then the amount in reserve is overstated by an even greater amount.

7.5.7 On the timing of the future expenditure, Enbridge uses the remaining useful life of the asset[154]. In Enbridge's approach to this issue, it is irrelevant whether an asset is removed and replaced, or moved, or abandoned altogether. In each case, the costs to do so are the removal and site restoration costs. Most of Enbridge's assets will, when they come out of service, be replaced. There is no current expectation that any significant percentage of them will be abandoned entirely[155].

7.5.8 Gannett Fleming, in their analysis, has used an inflation rate of 2%[156]. This is a reasonable long term inflation rate, given the consistent government policy in Canada to manage inflation to a 2% target level.

7.5.9 The Enbridge calculations use a discount rate of 2.38%[157], which was the current rate for long Canada bonds as of October 2012[158]. No explanation has been given, that we

[153] And Mr. Kennedy appears to agree: Tr.9:51.
[154] Tr.9:52-3.
[155] Tr.9:48.
[156] D2-1-1, p. II-10.
[157] D2-1-1, p. II-13.
[158] Bank of Canada Website. "Selected Government of Canada Benchmark Bond Yields – Long Term". We were unable to find a reference in the Enbridge evidence, including the Gannett Fleming study, to the date of the discount rate used, although at Tr,9:126, Mr. Kennedy appears to imply that it was December 31, 2010, which clearly was not

have found, for the selection of that particular effective date for the discount rate.

7.5.10 Mr. Kennedy said that he felt the long Canada rate was an appropriate rate. The only support for that rate provided was that it is the rate mandated by Canadian GAAP for asset retirement obligations[159]. No cross-reference has been given, but in any case Enbridge is no longer subject to Canadian GAAP.

7.5.11 Even if GF had used the right date to select that rate[160], there are at least three reasons why that rate is not appropriate:

(a) Under USGAAP, the discount rate to be used for asset retirement obligations is the credit-adjusted risk free rate[161], which is essentially the weighted average debt rate of Enbridge. Therefore, applying Gannett Fleming's own approach, but the correct accounting standard, the discount rate would be significantly higher.

(b) The discount rate for the purposes of net present valuing a fund or reserve is a proxy for the expected investment returns or accretion on the fund or reserve. No reasonable person would assume that Enbridge, if it was investing these funds, would earn only 2.38%.

(c) Pension funds have a similar structure, and also must make a discount rate assumption. The discount rate for the Enbridge pension funds, as recommended by their advisors Mercer, was 4.3% as of December 31, 2012[162]. As of December 31, 2010, the date this reserve was being valued, that pension discount rate was 5.7%.

7.5.12 It appears to SEC that, even if the proposed treatment of SRC by Enbridge is correct from a policy point of view (and we disagree with that), it is calculated incorrectly. Board Staff asked for a calculation at 4.95% discount rate, which is probably a good approximation of Enbridge's weighted average cost of debt, but in any case is a good indicator of the magnitude of changing the discount rate.

7.5.13 The result of that recalculation, which is still as of December 31, 2010, is that the amount to be refunded in the period 2014 - 2018 increases to $503.1 million, compared to the $259.8 million proposed by Enbridge[163]. The difference is $243.3

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correct. The rate on December 31, 2010, the effective date of the recalculation of the SRC reserve, was 3.54% (from the same source). We note that Board Staff, in their Submissions, appear to be under the same mistaken impression that 2.38% is a 2010 rate.

[159] D2-1-1, p. II-13.

[160] If you present value a cost to a particular date, the only reasonable discount rate is one effective on the date the NPV is supposed to be effective.

[161] K9.3, p. 10 and Tr.9:54.

[162] D1-16-1, App. 2, p. 15.

[163] J9.2 and Staff 77.

million of excess funds in the hands of the Applicant. In addition, using that more reasonable discount rate, the total of the annual provisions for SRC is $73.8 million, which is even less than the $76.4 million of actual site restoration costs in the Applicant's forecast. Further, that $73.8 million is $173.5 million less than the $247.3 million that the Applicant has proposed to include in rates for the same period[164].

7.5.14 In aggregate, the correction of the discount rate by itself, and without more, increases the amount in the hands of ratepayers by $416.8 million over those five years. Further, when the effect of the discount rate correction is adjusted for tax and rate base impacts, the amount to be returned to ratepayers is doubled[165].

7.5.15 The magnitude of this error cannot be overstated. Getting the discount rate right reduces the amount required in reserve as of December 31, 2018, on Gannett Fleming's methodology and with no other changes, from $815.1 million if the Enbridge proposal is accepted, to $398.2 million, and reduces the amount to be collected annually thereafter to essentially the amount being spent. Since the refunds are tax deductible, and despite the increasing rate base that results, rates would be substantially reduced.

7.5.16 SEC therefore concludes that, if the Applicant's proposal is accepted, it must be adjusted to use an appropriate discount rate, thus reducing the annual SRC cost in rates, and increasing the amount that needs to be refunded.

7.5.17 ***Calculation of "Excess Reserve".*** Having calculated the amount that should be held in reserve, the next step is to compare that to the actual amount in reserve, in order to get any excess or shortfall. Again, this is similar to the process used to determine if a pension fund (or an OPEBs reserve) is fully funded.

7.5.18 Gannett Fleming did their study in 2013, but they selected December 31, 2010 as the date at which to calculate the appropriate reserve, and compare it to the actual reserve in place. They did that calculation and, as a result, adjusted the depreciation rate to cover site restoration costs, but applied that new depreciation rate only from January 1, 2014 going forward[166].

7.5.19 Asked about the intervening three years, 2011-2013, Mr. Kennedy referred to it as "regulatory lag", and said "That lag is, quite frankly, quite common in doing depreciation studies[167]. He went on to suggest that those years would be corrected in the next depreciation study, which would be filed in the 2019 rebasing application.

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[164] Op.cit.
[165] See the SEC proposal, below, which has roughly the same overall impact, i.e. +$800 million over 5 years combining both refund and base year adjustment.
[166] Tr.9:81.
[167] Tr. 9:81.

7.5.20 There followed a lengthy discussion[168] about the impact of using 2010 vs. 2013, and whether that impact could be calculated. While the Board ultimately determined that the witness would not be required to calculate that impact because it was requested too late in the day to be useful to the Board[169], two interesting things came out of that whole discussion:

(a) Mr. Kennedy, on behalf of Gannett Fleming, repeatedly agreed that the amount to be refunded would likely be higher if it were calculated as of December 31, 2013[170]; and

(b) Enbridge counsel proposed in his submissions that we use the back-of-the envelope number SEC calculated for the impact but the witness could not confirm, a $106.7 million increase in refund, in our final argument[171].

7.5.21 As it turns out, on SEC's view of the appropriate response by the Board to the Enbridge proposal, the effective date of the comparison is irrelevant. SEC is proposing that the entire fund be refunded to ratepayers.

7.5.22 However, in the event that the Board determines it will continue to allow this reserve to be retained, in our submission Enbridge should be required to have a proper calculation done, up to December 31, 2013. The amount to be refunded, based on whatever discount rate the Board determines to be reasonable, should be calculated as of that date for refunds in the 2014-2018 period.

7.5.23 It is, in our submission, not reasonable that Enbridge should be allowed to retain an additional $100 million or more that it knows should go back to the ratepayers in the form of a refund of $135 million or more (including the tax and rate base impacts).

7.6 ***Site Restoration Costs as an Operating Cost***

7.6.1 Enbridge has presented its case on SRC as if the use of the net negative salvage approach, whether using the traditional method or the CDNS method, is the default. Unless supplanted, that is what the Board should be doing.

7.6.2 SEC believes that is incorrect. Voluntarily, but with the Board's approval, Enbridge has adopted US GAAP. Under US GAAP, some costs similar to SRC are treated as Asset Retirement Obligations in certain circumstances. However, Enbridge is not in that situation, as discussed earlier. What remains is the US GAAP accounting rule, i.e. unless the Board makes an inconsistent determination, Enbridge must expense removal

[168] Tr.9:81-94.
[169] Tr.9:149.
[170] See Tr. 9:82 and Tr.9:94.
[171] Tr. 9:105.

and site restoration costs on a current basis, as incurred[172].

7.6.3 The Board's normal practice is to follow the accounting rules, unless there is a regulatory reason to depart from them. For example, IFRS has, until recently, prohibited regulatory assets and liabilities, but the Board determined that they were necessary for good regulatory practice, and so retained them even if regulated utilities switch to IFRS (in MIFRS).

7.6.4 Adopting a different rule from the normal accounting rule is the exception, rather than the rule, for two good reasons.

7.6.5 The first reason is based on principle: accounting standards are adopted after detailed and sophisticated review by specialists, and so in normal circumstances they will represent fair and reasonable rules for presenting assets, liabilities, revenues and costs. The Board has no need to reinvent the wheel, if the wheel has already been built, and built well, by wheel specialists.

7.6.6 The second reason is more pragmatic: the Board, regulated entities and ratepayers would all prefer if utilities were not required to keep two sets of books, particularly where they would diverge substantially. Not only is it costly, but the ability to rely on books developed to financial accounting standards greatly assists the Board in having a solid foundation for its decisions.

7.6.7 Therefore, SEC submits that the question is not whether some other accounting approach supplants net negative salvage. Now that US GAAP has been adopted and approved, the question should be whether there is a good regulatory reason for the Board to overrule the normal accounting rule for removal and site restoration costs, and instead impose its own rule (for example, net negative salvage).

7.6.8 SEC submits that the Board should not overrule US GAAP for these costs.

7.6.9 ***Intergenerational Equity.*** Implicit in the Enbridge proposal, of course, is that it is necessary to collect site restoration costs now because they will have to be expended in the future. One problem with that is that, as long as Enbridge continues to grow, there is no reasonable likelihood that the amount to be drawn down from the reserve will, on average, exceed the amount being collected each year.

7.6.10 We had a discussion about this with Mr. Kennedy, and he insisted[173] that at some point in the future Enbridge will have a crossover point, where its drawdowns would start to exceed its annual SRC depreciation. However, he also admitted that wouldn't happen until the Company's growth flat-lined, and that could be a very long time in the future. Pressed on this, Mr. Culbert came to his rescue, suggesting the invention of a new

[172] See earlier discussion and citations.
[173] Tr.9:101.

form of energy (by lawyers, no less)[174].

7.6.11 The importance of this is contained in Mr. Kennedy's admission "There is no expectation that this company is going to flatline in terms of growth"[175]. If there is no current expectation that Enbridge is ever going to flatline, then there is no reasonable likelihood that this SRC reserve will ever actually be used, at least not for a very long time. That of course, begs the question why it is being collected at all. If Enbridge is never going to need the money for its intended purpose, why are they holding on to it?[176]

7.6.12 A similar issue arises with respect to income taxes. Because (at least in part) capital cost allowance for income tax purposes tends to allow deductions in excess of accounting depreciation in the early years, taxes are divided into current taxes and deferred taxes. The amount that is actually included in rates is the current amount, even though the total of both amounts is included in the calculation of income for accounting purposes. As of December 31, 2013, the Applicant treated its $209 million of uncollected deferred taxes as a regulatory asset, recoverable from ratepayers in the future as those taxes are payable[177].

7.6.13 The reason taxes are dealt with on a "taxes-payable" basis rather than on a full accrual basis is that, as long as the utility is growing, the deferred taxes balance is unlikely to go down. While from time to time there will be an adjustment, based on the nature of the capital spending in any year (since CCA rates are different for different assets, so the tax shield varies from year to year), in the long term there is little likelihood that any amount of the deferred taxes will need to be paid as long as the company continues to grow.

7.6.14 The same reasoning is applicable to site restoration costs. There may indeed be a point in the future where there is a crossover, but it is expected to be a long way in the future. Until that future crossover point is at least visible in the distance, collection of net negative salvage, and continued building of this now very substantial fund, does not appear to be good ratemaking at all.

7.6.15 ***Having Funds Available for Future Costs.*** The other issue that potentially arises with respect to treating SRC as a current expense is that then there will be no fund available to pay these costs in the future.

7.6.16 This was discussed in the hearing on more than one occasion, because in fact there is

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[174] Tr. 9:101.
[175] Tr.9:101.
[176] Mr. Culbert, talking about the time in the future that sites might have to actually be restored, said "We believe this will be an ongoing business for an infinite amount of time. We are replacing assets. We are expanding." Tr.9:48.
[177] J1.1, Attachment p. 15.

no fund now to pay these costs in the future. Enbridge collects the money, but the money is not put into a segregated fund. Instead, it is commingled with the Applicant's funds and used as a type of working capital[178]. From the point of view of protecting the ratepayers, it is just an entry on the balance sheet.

7.6.17 It may well be the case that some types of decommissioning or similar costs should be the subject of a segregated fund, so that there is real protection. This is, in fact, the subject of the National Energy Board proceeding that we discuss below in section 7.9. However, as the NEB has already determined for their purposes in that proceeding, most of the categories of costs to which the Enbridge SRC proposal applies do not need that kind of protection. They are more effectively dealt with on a current cost basis.

7.6.18 ***Conclusion.*** SEC therefore concludes, consistent with US GAAP[179], that the appropriate treatment of the site restoration costs dealt with in the Enbridge proposal is by treating them as current operating expenses. Thus, they would be treated as an expense, and recovered in rates as incurred.

7.6.19 The corollary to that is that the entire amount of the reserve currently in place is unnecessary, and should be refunded to ratepayers.

7.7 ***Method of Transitioning to New Approach***

7.7.1 If the Board adopts SEC's proposal to terminate the use of excess depreciation to create and augment an SRC reserve, there are two steps required:

(a) The amount to be collected in rates each year should be changed from the depreciation amount calculated by Gannett Fleming, to the actual amount included in the Enbridge budgets. This has impacts on depreciation, tax and cost of capital.

(b) The reserve, which as of the end of 2013 was $903.9 million, has to be refunded to the ratepayers over a reasonable period of time. This also has substantial tax and cost of capital impacts, and also has the potential to create rate shock if not done in a careful manner.

7.7.2 With respect to the first of the two steps, the appropriate method of achieving that is dependent on the method used to set rates. If the Board adopts SEC's proposal to set rates on a formula basis, then the easiest way of moving from the depreciation basis to the current cost basis is through a base year adjustment. If the Board decided instead to set rates on a cost of service basis, as proposed by Enbridge, then a calculation of the adjustment for each year would have to be made.

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[178] Tr.9:78.
[179] And consistent with the NEB. See Section 7.9 below.

7.7.3 As SEC is proposing rates using the Empirical Method, in our view the use of a rate base adjustment is the best way to move to current cost accounting for this item. The calculation would, in our submission, be as follows:

(a) Start with the 2013 inclusion in rates of $63.2 million for SRC related depreciation[180].

(b) Deduct from that the amount budgeted for actual SRC in 2013, $18.3 million, to get a net of $44.9 million. This is the net amount that was collected in rates, but not spent.

(c) The entire $44.9 million is added to taxable income for tax purposes, and taxed, so from a rate-making point of view it has to be grossed-up to get the gross amount that was collected in rates, before rate base impacts. That grossed-up tax amount would be $16.2 million.

(d) The amount of $44.9 million also reduced closing rate base in 2013, reducing average rate base by $22.5 million. The impact of increasing rate base by that amount would be about $1.9 million, including cost of debt, ROE, and grossed-up taxes.

(e) The amount included in rates for 2013 was therefore $63.2+$16.2-$1.9 million, for a total of $77.5 million. This is the total that has to be backed out, and replaced with the actual costs going forward.

(f) The expected expenditures on SRC going forward are represented in the 2014 figure of $15.9 million[181]. That must be deducted from the $77.5 million to get the base year adjustment applicable to SRC, $61.6 million.

7.7.4 It is therefore submitted that, before an IRM formula is applied to Enbridge's 2013 revenue requirement per customer, or rates, the overall 2013 revenue requirement must be reduced by $61.6 million to reflect current accounting for SRC (in addition to any other base year adjustments the Board determines should be made). The result of this would be to include in revenue requirement the actual costs of SRC, $15.9 million, instead of the SRC based depreciation previously included in 2013 revenue requirement.

[180] I.E40.EGDI.Staff.77.
[181] It is inappropriate to use the $18.3 in 2013, because it is not representative of spending during the IRM period. In any case, the only way in which the $18.3 million was used in setting 2013 rates was in its deductibility in calculating the tax gross-up and rate base implications. We have used it for the same purpose here.

7.8 *Method of Refunding Excess Reserve*

7.8.1 ***Amount to be Refunded.*** Once the Board determines that the entire amount of the reserve should be returned to ratepayers, the question of the "regulatory lag" arising out of the timing of the Gannett Fleming recalculation is no longer an issue. The amount in the reserve applicable to Enbridge Gas Distribution's regulated Ontario operations is $903.9 million, so that is the amount, before tax and rate base calculations, that needs to be refunded to ratepayers.

7.8.2 ***Period of Refund.*** In normal circumstances, if a utility has almost a billion dollars of the ratepayers' money, even if as the result of an honest mistake, as here, the natural reaction is to want it repaid as soon as possible.

7.8.3 The problem with that is the rate roller-coaster that could result if the refund happens too quickly. The amount to be refunded is almost a full years' distribution revenues. While many customers would love to have their full distribution bill returned to them for a year, right away, they will not necessarily be thrilled when they have to start paying the bill again a year from now. There is, in fact, going to be a rate impact no matter how you structure this, given the magnitude of the dollars involved. However, it should be done in a manner that minimizes the suddenness of that impact.

7.8.4 The ameliorating factor that makes it easier to stretch this out, and avoid rate shock, is that Enbridge is effectively paying, at the rate of their weighted average cost of capital, for the use of this money. Because the reserve is an offset to rate base for regulatory purposes, the cost to Enbridge is the lost interest and ROE recovery on those funds. While that overall rate is probably somewhat less than what Enbridge Inc. can earn from investing those funds, the ratepayers cannot say they are not being compensated for the utility holding on to their money.

7.8.5 Given those factors, SEC proposes that the Board order repayment of the reserve balance over ten years. In order to ensure that there is rate smoothing, we are proposing below that those repayments be front-loaded in a pattern that minimizes impacts at the end of the repayment period.

7.8.6 We also note that, if a ten year period, with smoothing, is adopted by the Board, it will have the serendipitous result that the balance still remaining unrefunded at the end of the IRM period will be approximately the same as the balance that would be in reserve if the Board only corrected the discount rate, as discussed earlier. Thus, if the Board decides to order a generic process to review this category of costs, as discussed below, or if in its next rebasing Enbridge wants to make a proposal to reinstate net negative salvage, or some other approach to collection of future SRC, nothing would have to be reversed or "re-collected" from the ratepayers. The reserve would be at the right starting point, or higher, in any case.

7.8.7 Therefore, SEC recommends refund over a ten year period.

7.8.8 ***Rate Base and Cost of Capital Impacts.*** The refund of this reserve has rate base impacts, because right now rate base is reduced by $903.9 million as a result of excess accumulated depreciation. As each refund is made, rate base is increased. In each year, closing rate base will be increased by the amount of all refunds during the year, and half of that would be the increase in average rate base during the year.

7.8.9 There is no depreciation affect as a result of this increase in rate base, of course, because the adjustment is to accumulated depreciation, a balance sheet item. However, there are cost of capital and related tax impacts:

(a) Interest cost would have to be increased by the amount of the notional increase in debt, at the marginal cost of debt included in the 2013 revenue requirement, and at the debt thickness approved in that proceeding. There is no tax impact of the interest cost, as it would be tax deductible.

(b) Return on equity would have to be increased by the amount of the notional increase in equity, at the approved ROE included in the 2013 revenue requirement, and at the equity thickness approved in that proceeding.

(c) The ROE would be taxable, of course, and that tax provision would have to be grossed-up to get a rate equivalent figure.

7.8.10 The total of the cost of capital and tax impacts, at 2013 rates, is about 7.77% of the cumulative increase in the average rate base through refunds, including the impact of the tax gross-up. For example, if the refund in year one is $115 million (before any tax gross-up, see below), the rate base increases by $57.5 million, and the cost of capital and grossed-up tax on that additional rate base is just under $4.5 million. In the second year, the rate base would increase by $115 million plus half of the year two refunds, and so on.

7.8.11 The cost of capital and tax issues arising from increasing rate base are deductions to the amounts that should be returned to the ratepayers. They will increase each year during the refund period. Based on the refund pattern proposed by SEC, those impacts will reduce the refunds over ten years by a total of $384 million[182].

7.8.12 ***Tax Impacts.*** In addition to the rate base impacts, there are direct tax impacts associated with the refund of these amounts. The refunds, although not expenses for accounting purposes (as they draw down a reserve), are deductible for tax purposes. Thus, Enbridge's tax bill will be reduced by the tax on those amounts. To convert that tax reduction to a rate amount, it has to be grossed-up.

[182] The detailed calculations are in Schedule 3 to this Final Argument.

7.8.13 For example, if the principal amount of the refund in 2014, before any rate base related adjustments, is $115 million, that is an additional tax deduction for Enbridge, and they will save about $30.5 million in tax. That $30.5 million is then grossed-up in the normal way, to get about $41.5 million, which is added to the $115 million to get a total gross refund of $156.5 million. (The rate base impacts then have to be deducted from that.)

7.8.14 The reason the grossed-up taxes have to be refunded to the ratepayers is that it is a mirror image of what happens when the funds were collected. When the $903.9 million was collected over time, that amount had to be included in Enbridge's income each year, and there was no offsetting deduction. The tax calculation each year therefore included that in taxable income, and the grossed-up impact of that was included in rates. Now, as the money is being refunded, the grossed-up impact of the deductibility of those amounts must also be for account of the ratepayers.

7.8.15 The aggregate impact of the tax deductibility of these amounts is to increase the amounts refunded to ratepayers, over the full ten years, by about $326 million[183].

7.8.16 The total net impact of the cost of capital and tax deductibility impacts is a reduction in the total refunds of $58 million ($384-$326 million).

7.8.17 ***Rate Impacts and Smoothing.*** In order to ensure that the refund of this sizeable amount of money, even over ten years, doesn't have material rate impacts, SEC proposes that the repayments be set on a trajectory that:

(a) Has higher refunds in the earlier years, declining at a manageable level due to declining principal amounts plus increasing rate base impacts; and

(b) Targets a payment in the last year that limits the SRC-related rate increase in year 11 to a manageable amount.

7.8.18 Schedule 3 to this Final Argument sets out a proposed pattern of refunds that accomplishes those goals. We have provided a live version of Schedule 3 to the Board and the parties, so that anyone can model different refund patterns to come up with different sets of rate impacts[184].

7.8.19 ***Overall Proposal.*** SEC therefore proposes the refund of $903.9 million to ratepayers over ten years, on the refund pattern set out in Schedule 3, in order to complete a full transition to current cost accounting for site restoration costs.

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[183] See Schedule 3 attached.
[184] The term "decline factor" on the model allows the Board or others to adjust the rate of change of the refunds in a single cell, but other patterns can be modeled as well.

7.9 ***Generic Review***

7.9.1 SEC has had an opportunity to consider the proposal from CME and others that the Board initiate a generic review of site restoration costs. In our view, this proposal has merit, and could be implemented in parallel with our proposal to refund the balance of the fund over ten years.

7.9.2 ***NEB Process.*** Part of the issue being addressed by Enbridge with net negative salvage is being considered by a process at the National Energy Board dealing with abandonment costs[185].

7.9.3 The NEB process is considering the collection, in current rates, of amounts to be placed in a segregated fund to pay for the cost of abandonment of pipelines at some future date. The purpose is to a) ensure that landowners don't get stuck paying for pipeline cleanup, and b) maintaining intergenerational equity.

7.9.4 We note that the NEB process is only dealing with a subset of the Enbridge situation. The NEB 2008 framework decision in this matter has the following three definitions, which are instructive:

> *"Abandon: To permanently cease operation such that the cessation results in the discontinuance of service.*
>
> *Retirement: An accounting term for when an asset, whether it is replaced or not, is otherwise removed from pipeline service.*
>
> *Terminal Negative Salvage: The costs incurred in the abandonment of pipeline facilities less any value realized from the disposition of such Facilities."*[186]

7.9.5 Some parties to that process have argued that the NEB should allow collection and use of these funds in essentially the same manner as Enbridge does today, i.e. for both complete abandonment, and for removal and replacement of assets. The NEB has rejected this position:

> *"Pouce Coupé initially submitted that access to accumulated funds should also be permitted for decommissioning of facilities. Others argued that access should be restricted to covering abandonment, and abandonment process activities (such as pre-planning).* ***The Panel notes that both deactivation and decommissioning contemplate continuation of system service.*** *Provided service continues, revenue will be generated from the collection of tolls, from which funds should be available to cover these*

[185] RH-2-2008, Land Management Initiative Stream 3.
[186] RH-2-2008, NEB Section 15 Report, April 2009, p. 8-9

> *costs. Consequently,* ***the Panel recommends that access to the funds should generally not be permitted for decommissioning or deactivation of facilities,*** *unless the Board authorizes the access on the facts of a particular case before it."*[187] *[emphasis added]*

7.9.6 What this demonstrates, in our view, is that the concept of collecting for future decommissioning costs is a live issue in Canada, with a current process going on at the NEB to consider it. Indeed, Enbridge is a party to that NEB proceeding, so it is surprising that it was not brought to the attention of this Board in this case.

7.9.7 ***Removal vs. Abandonment.*** It is clear that the site restoration costs that are the subject of Enbridge's $903.9 million reserve are mainly removal costs, not abandonment costs. The Applicant's witnesses were clear that they see their business as continuing indefinitely into the future[188]. Any true abandonment costs would be so far into the future that a provision for those costs today would be nominal.

7.9.8 ***Abandonment Costs.*** With respect to pipelines, the NEB has established a set of principles that will guide proposals for collection and management of abandonment funds. Those principles include:

(a) Abandonment costs should be collected as an asset is used, so that those who benefit from the service pay the cost, and the landowners are not saddled with it when the service is discontinued.

(b) Amounts collected should be set aside in a segregated fund, and should be invested in a prudent manner so that the fund ultimately is sufficient to cover the future costs. The fund should not be accessible by the company for anything else.

(c) Amounts to be collected should be calculated by determining the future abandonment costs, including inflation, and discounted using a reasonable discount rate representing accretion of the fund over time.

(d) Collections should not be included in depreciation rates, but should be separately identified as a "separate element of cost of service".

(e) Amounts should be recalculated every five years based on fund performance and revised abandonment cost estimates.

7.9.9 What is most striking about the NEB's principles is how close they are to the requirements in USGAAP for ARC/ARO treatment, although with the addition of a mandatory segregated fund. Like ARC/ARO, they also bear a more than passing

[187] Ibid. p. 42.
[188] Tr.9:48.

resemblance to pension fund accounting.

7.9.10 SEC agrees with the principles outlined by the NEB with respect to abandonment costs, but notes that this would apply to only a small portion of the site restoration costs proposed to be covered in Enbridge's net negative salvage treatment.

7.9.11 ***Removal Costs.*** As noted above, the NEB does not consider site restoration costs in a non-abandonment situation – i.e. the service is continuing – except to say that current rates should cover those costs. As we have noted earlier in this Final Argument, this is consistent with the accounting method used by some electricity distributors for similar costs, and with US GAAP, to which Enbridge is subject.

7.9.12 If, as we interpret it, the NEB has mandated that removal/replacement costs be treated as current expenses, we agree with them on that score as well.

7.9.13 ***Generic Proceeding.*** A generic proceeding to deal with the rate recovery of future removal and abandonment costs, which in our view should include gas distributors, electricity distributors, and electricity transmitters, would include at least the following:

(a) How to distinguish between costs to remove and replace, versus costs of abandonment.

(b) How to account for removal costs (e.g. current cost accounting) vs. abandonment costs (e.g. ARC/ARO).

(c) What assumptions should be made about the timing of permanent abandonment of an asset, or how should those assumptions be developed?

(d) What inflation and accretion assumptions should be used?

(e) What form of segregated fund is appropriate (if any)?

(f) How should reserve funds for abandonment be collected to ensure intergenerational equity?

(g) How, and how often, should the amount to be collected be adjusted for actual inflation and/or investment return experience?

(h) What process should be used for utilities to access any segregated funds?

7.9.14 Of course, this implies a certain amount of overlap with the NEB process, still going on. In our view, that is unavoidable. Major pipelines are not the same as distribution systems, whether gas or electric, so it is not certain that the NEB's conclusions would

be applicable to Ontario regulated utilities. Further, it is not the Board's practice to accept the conclusions of another regulator without a thorough review of its own. Nonetheless, the existence of the NEB process will provide the Board with a wealth of information, and so will inform the Board's own process.

7.9.15 In our submission, the proposal to establish a generic process has merit, and should be seriously considered by the Board.

7.9.16 ***Interim Period***. As we understand the generic review proposal, in the period until that review is completed, two things would happen:

(a) There would be a "pause", much like that proposed by Board Staff in their submissions, in the collection of the SRC component of depreciation. The only amounts collected in rates would be a provision for the current amounts being spent on SRC each year.

(b) The portion of the current reserve that is already known to be excess would in any event be refunded to ratepayers over the next five year period, as it is clearly not needed.

7.9.17 ***Synergy with SEC Proposal.*** SEC notes that our proposal and the CME proposal can be implemented at the same time.

7.9.18 In the case of both proposals, as well as the Board Staff submission, the amount to be included in rates in 2014-2018 is the $15.9 million per year of current site restoration costs[189].

7.9.19 In the SEC and the CME proposals, the balance in the reserve at the end of 2018 is just under $400 million.

7.9.20 SEC believes that, whether or not the Board decides to proceed with a generic review, it should require Enbridge to reduce its annual collections, and start refunding the excess reserve, right away. At the end of 2018, the balance in the reserve should in any case be just under $400 million. At that point, the Board in Enbridge's rebasing application can determine if the refunds should cease, or continue, or otherwise be modified.

7.10 ***Board Staff Proposal***

7.10.1 Before summarizing our position, it may be of assistance to the Board to deal briefly with the proposal by Board Staff to deal with SRC. That proposal starts off well, but

[189] We have proposed that be accomplished by a base year adjustment of $61.6 million, which has the effect of removing the $63.2 million, plus tax and rate base impacts, totaling $77.5 million, included in rates in 2013, replacing it with the annual budget of $15.9 million.

fails due to an incorrect assumption about the role of the Applicant's financial auditors.

7.10.2 Board Staff recognizes that there is an issue here, and proposes as a solution the "pause" method for dealing with it going forward. That is, the amounts to be charged to ratepayers each year should be the actual SRC expenditures each year. This is financially identical to SEC's proposal, although conceptually quite different.

7.10.3 Board Staff also takes the position that no refund is required. Their reasoning is encapsulated in the following quote from their Submissions:

> *"Enbridge has disclosed in its 2013 audited financial statements a liability for SRC of $905 million. The forecast amount in IRR Staff #77 is $903.9. Board staff submits that based on the evidence, $900 million is the most reasonable amount available on which to base any conclusions about the quantum of SRC required by Enbridge at the end of 2013. Enbridge's management, lawyers and auditors have signed off on this number."*[190]

7.10.4 With respect, this demonstrates a complete misunderstanding of the nature of the amount on the audited financial statements. This assumes that the $903.9 million included in the balance sheet number is the assessment by the auditors and management (and the lawyers?!) of the fair value of the future liability to restore sites. It is nothing of the sort.

7.10.5 The amount on the balance sheet is the excess amount of depreciation that has actually been collected from ratepayers to that point in time. It is the amount held in reserve, not the present value of the future liability.

7.10.6 The reason Board Staff got confused appears to be that the amount is called a "regulatory liability" on the balance sheet. The term "regulatory liability" in this context refers to an amount collected from ratepayers, not to be treated as current revenues, but to be treated as an amount held for future spending, or return to the ratepayers. It is a liability because the company doesn't get to keep it. It has to spend it, or refund it.

7.10.7 Aside from the fundamental nature of this kind of liability, we also know that this could not be an audited present value of the future SRC liability, because at the time the 2013 audited financial statements were prepared, the Applicant already had an expert valuation showing that the amount in reserve was higher than the present value of the liability[191], had accepted that valuation, and had proposed a refund to this Board. In the face of that valuation and proposal, neither management nor the auditors could have said that the $903.9 million was the present value of the SRC liability. At the

[190] Staff Submissions, p. 66.
[191] That is, the June 2013 Gannett Fleming Report filed in this proceeding.

very least, if they were purporting to say the number had that characteristic, the existing of an inconsistent valuation and decision would have to be noted in the financials, but it is not[192].

7.10.8 Unfortunately, once Board Staff makes that fundamental error in their analysis, the rest of their submissions on SRC are not helpful. If you assume that a past number is correct, when the evidence says, unequivocally, that it is not, then the entire foundation of your position is destroyed.

7.10.9 That is the case here. Board Staff`s proposal to have no refund is contrary to the evidence in every respect. Indeed, their argument that a different discount is indicated suggests the need for a much bigger refund, as we have discussed earlier[193]. Further, their argument for a pause, while leading to the correct financial result, is based on the incorrect notion that the starting point at the end of 2013 is correct.

7.11 ***SEC Recommendations***

7.11.1 ***Choice of Accounting Method.*** The Board should, commencing in 2014, require that Enbridge treat site restoration costs as current operating costs for regulatory purposes, consistent with US GAAP.

7.11.2 ***Transition to New Method.*** To adjust revenue requirement from the old method to the new, and assuming a formula-based approach to setting rates for 2014-2018, the Board should implement a reduction to 2013 revenue requirement for base year purposes of $61.6 million. That figure is the net difference between the $63.2 million of SRC based depreciation included in 2013 revenue requirements, plus the tax and rate base impacts of that depreciation, for a total of $77.5 million, less the normal amount of actual SRC costs annually, $15.9 million.

7.11.3 In the event that the Board determines that it should use cost of service to set the Applicant's rates for 2014-2018, then the same calculation should be made, but for each of the five years.

7.11.4 ***Refund of Reserve.*** The $903.9 million reserve, net of tax and rate base impacts, should be refunded to ratepayers over ten years, with higher principal payments in the earlier years to accomplish rate smoothing and avoid rate shock at the end.

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[192] J1.1, p. 15. The note to the financials is unchanged from previous years, precisely because the amount being disclosed is the amount of the reserve, i.e. the regulatory liability, not a legal liability or contingency.
[193] Their statement, at p. 62 of their submissions – "Board staff submits that had a higher discount rate been used at the outset the revised calculations would not produce a theoretical over-collection in the net present value calculations now." – is just obviously incorrect. A higher discount rate generates a lower net present value, which when compared to the higher amount of the reserve at the end of any year would have produced a higher refund number.

7.11.5 Schedule 3 to this Final Argument sets out a proposed refund pattern, including tax and rate base impacts, and related rate impacts.

7.11.6 ***Sanity Check.*** The SEC proposal set out in this Final Argument would reduce the annual amount charged to rates in the years 2014-2018 by an average of $34.2 million per year over five years, from an aggregate of $247.3 million[194] to an aggregate of $79.5 million (i.e. actual removal and site restoration costs for 2014, times 5). The total reduction over the period is $167.8 million, to which would be added the net of the tax and rate base impacts of about $140 million.

7.11.7 This is simplified by the use of the base year adjustment, which produces a net reduction of $61.6 million per year, or a total of $308.0 million over five years including depreciation, tax impacts, and cost of capital impacts. The amount effectively included in rates ends up being $15.9 million per year.

7.11.8 The SEC proposal also provides for refunds to ratepayers over 2014-2018, the first five years of the ten year refund period. At the end of that five year period, the amount still remaining in the reserve, and not yet refunded, would be $389.4 million[195].

7.11.9 As noted above, the balance still remaining is about the same as the amount that would be remaining if all the Board did is correct the erroneous discount rate in the Enbridge methodology. At a more appropriate discount rate, Enbridge's weighted cost of debt, 4.95%, the balance at the end of 2018 using the Enbridge methodology is $398.2 million[196].

7.11.10 The results of the recalculation are set out below[197]:

[194] I.E40.EGDI.Staff.77.
[195] See Schedule 3 attached to this Final Argument.
[196] Consistent with the US GAAP ARO rules. See earlier discussion.
[197] J9.2.

Future Removal or Site Restoration Reserves or Liability

EGDI Utility Only	*Line*		*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*
Beginning of year liability	1		0.0	691.6	753.0	815.0	859.0	903.9	768.5	643.8	531.8	430.1
Period-to-date adjustment	2		640.0									
Recovery through depreciation	3	+	74.8	79.4	82.4	87.4	63.2	12.4	13.3	15.4	16.1	16.6
Actual site restoration and removal costs	4	-	-22.4	-18.7	-34.2	-27.7	-18.3	-15.9	-15.8	-14.9	-14.9	-14.9
Actual removal costs vs. estimated salvage requirement	5	+/-	-0.9	0.7	13.8	-15.6						
					Note 1	Note 2						
								-	-	-	-	
Return to ratepayers	6	-						131.9	122.2	112.5	102.9	-33.6
								-	-	-	-	
Net change in year	7	3+4+5+6	51.5	61.4	62.0	44.0	44.9	135.4	124.7	112.0	101.7	-31.9
End of year liability	8	1+2+7	691.6	753.0	815.0	859.0	903.9	768.5	643.8	531.8	430.1	398.2

Note 1 Variance was mainly driven by costs incurred from retirement of cast iron mains exceeding estimated salvage per Gannett Fleming's model.

Note 2 Variance was mainly driven by costs incurred from retirement of bare steel mains being lower than estimated salvage per Gannett Fleming's model.

7.11.11 What is noteworthy is that, if the Board just changes the discount rate, but otherwise approves the Enbridge proposal as filed:

(a) The amount collected from ratepayers over 2014-2018 would be reduced to $73.8 million. The SEC proposal is that the amount collected from ratepayers over the same period should be $79.5 million, i.e. the actual costs budgeted to be spent in 2014, times 5.

(b) The balance remaining in the reserve on December 31, 2018 is $398.2 million. Under the SEC proposal, the balance remaining in the reserve on that date is $389.4 million[198].

7.11.12 There are two reasons why these similarities are important. First, they show that the "radical" change being proposed by SEC is in fact, functionally equivalent over the five years to just getting the discount rate right in the method the Applicant is proposing. Second, and as discussed earlier, the status at the end of 2018, when Enbridge returns to rebase again, is essentially the same, whether current expensing is used, or whether the CDNS method with the right discount rate is used.

7.11.13 It is therefore submitted that the SEC proposal passes the sanity check. It adopts the

[198] Schedule A attached.

simplest approach to the problem – follow the basic US GAAP accounting rule, rather than overrule it – yet still leaves everyone in a position that, if the issue has to be debated again five years hence, or in an intervening generic proceeding, nothing is lost.

8 DEFERRAL AND VARIANCE ACCOUNTS

8.1 *Ontario Hearing Costs Variance Account*

8.1.1 We adopt the submissions of Board Staff, and agree with them that this account should be terminated as of January 1, 2014.

8.2 *Site Restoration Costs*

8.2.1 On the proposal we have made for SRC, a variance account is not required.

9 SUMMARY OF SEC RECOMMENDATIONS

9.1 *Introduction*

9.1.1 The Applicant is seeking more than $6 billion in rates over the five years 2014 through 2018[199]. Rather than continue with its current IRM structure, or adopt something similar to Union Gas, or propose an IRM along the same lines as electricity distributors, the Applicant has asked that the Board set its rates for five years based on a five year forecast of its costs, unsupported by any empirical corroboration. SEC believes this is a step backward, and should not be accepted by the Board.

9.1.2 SEC`s Final Argument therefore makes the following proposals for setting rates in the upcoming five years.

9.2 *Method of Setting Rates*

9.2.1 SEC submits that the Board should set rates for Enbridge based on the Empirical Method. This is the method used by most other entities regulated by the Board, and has the key advantage that it establishes reasonable levels of revenue requirement using objective data on which the Board can rely. In our submission, it produces a more reliable level of rates than the alternative proposed by the Applicant, i.e. rates based on questionable forecasts of future costs without any way for the Board to determine their reasonableness.

9.2.2 Using the Empirical Method, SEC submits that the Board should establish the following components:

(a) ***Base Year Adjustments.*** The base year (2013) Board-approved revenue requirement should be reduced by $31.2 million, representing the overearnings on a regulatory basis reported by the Applicant for 2013, grossed-up for tax.

(b) ***Inflation Factor:*** GDPIPPI, the same inflation factor used for the previous IRM period, and adopted by Union Gas in the 2014-2018 period.

(c) ***Productivity Factor.*** 60% of inflation, the same as the factor adopted by Union Gas for the same period. Enbridge over-earned in every year for the period 2008-2012, the last IRM, with a productivity factor that was 55% of inflation at the end of that period.

[199] SEC 64 and K1.3. This excludes the impact of the SRC issue, discussed separately.

(d) ***Y Factors.*** SEC believes the following Y factors are appropriate:

(i) ***Major Capital Projects.*** This would include GTA and Ottawa Reinforcements, and any other major capital projects that arise during the IRM period. The Union Gas decision includes a detailed method of defining such projects. Excluded should be the WAMS project, which should be treated as an efficiency project that pays for itself within the IRM period.

(ii) ***Pension and OPEBs.*** Through the PTUVA account, this was established as a flow-through in EB-2011-0354, and SEC believes that treatment should continue.

(iii) ***DSM.*** The annual DSM budget is established in a separate proceeding, and is a flow-through to annual revenue requirement.

(iv) ***CIS and Customer Care.*** The flow-through of the annual costs for these items was approved in EB-2011-0354, and should in our submission continue.

No further Y factors (except Gas in Storage, on which we have no submissions) are required during the 2014-2018 period.

(e) ***Z Factors.*** SEC does not support the changes to the Z Factor language proposed by the Applicant, but agrees with others that the threshold should be increased to $4 million.

(f) ***Earnings Sharing Mechanism (ESM)***. SEC proposes that Enbridge have the same ESM as is already included in the Union Approved IRM Plan.

(g) ***Sustainable Efficiency Incentive Mechanism (SEIM)***. SEC supports the use of well-designed efficiency carryover mechanisms, but agrees with others that the Enbridge proposal is too badly flawed to be implemented, even with modifications.

9.3 ***Site Restoration Costs***

9.3.1 SEC recommends that the Board terminate the collection of site restoration costs from ratepayers as part of depreciation expense, instead expensing such costs on a current basis as incurred, consistent with US GAAP. Further, the Board should order the return of the accumulated fund, about $903.9 million[200], to ratepayers.

[200] Staff 77.

9.3.2 This has two components:

(a) ***Adjust Depreciation Expense, Operating Costs, Cost of Capital, and Related Taxes.*** This adjustment should be done through an additional base year adjustment totaling $61.6 million[201].

(b) ***Refund of Existing Fund.*** The Applicant has accumulated a fund totaling $903.9 million dollars[202], which SEC submits should be refunded to ratepayers over a ten year period. The calculation of the annual refund has three components:

(i) The annual refund of principal in the fund, which in aggregate should total $903.9 million over that period. In order to ensure that the impact on ratepayers is smoothed, SEC proposes a declining refund, starting at $115.0 million, and ending in year 10 at $69.2 million.

(ii) The cost of capital on the accumulated increase in rate base associated with the refund of accumulated depreciation each year, plus the tax impacts of the ROE component of that cost of capital. This is a reduction in the rate rider of $383.6 million over ten years, starting at $4.5 million, and ending in year 10 at $67.5 million.

(iii) The tax savings arising annually due to the fact that the refunds reduce taxable income each year. This results in an addition to the rate rider of $325.9 million over ten years, starting at $30.5 million, and ending in year 10 at $18.3 million.

SEC proposes that the annual rate rider ordered by the Board be as set forth in Schedule A attached to this Final Argument. The rate rider proposed would smooth the impacts on ratepayers over the ten year period, starting at $152.0 million in 2014, and ending in year 10 at $26.6 million. The net effect on distribution bills is an immediate decrease of 14.2%, annual increases of 1% to 2% thereafter due to the smoothing, and less than 3% impact when the rate rider ends and the full increase to rate base is recognized in year 11. The total amount returned to ratepayers over 10 years is $846.2 million.

9.4 ***Deferral and Variance Accounts***

9.4.1 SEC submits that the Ontario Hearing Costs Variance Account should be terminated as of January 1, 2014.

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[201] Full details of this calculation are in para.7.7.3 of this Final Argument.
[202] I.E40.EGDI.Staff.77..

10 OTHER MATTERS

10.1 *Costs*

10.1.1 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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Jay Shepherd
Counsel for the School Energy Coalition

SCHEDULE 1

Application of Approved Union Gas 2014-2018 IRM Plan to Enbridge

(excludes all SRC impacts/changes)

($ millions)

	a	b	2014 c	2015 d	2016 e	2017 f	2018 g	Totals h
	Revenues at Existing Rates before							
1	*Customer Growth*		$1,021	$1,021	$1,021	$1,021	$1,021	$5,105
2	*Customer Growth (on non-Y factors)*	1.70%	$14	$28	$42	$57	$72	$213
3	*Revenue at Existing Rates*		$1,035	$1,049	$1,063	$1,078	$1,093	$5,318
4	*Prior Years' Escalation Factor*		$0	$7	$13	$20	$28	
5	*Gross Revenue before Y factors*		$1,035	$1,056	$1,077	$1,098	$1,120	
	Remove Base Year Y Factors							
6	*Customer Care*		$110	$110	$110	$110	$110	$550
7	*DSM*		$31	$31	$31	$31	$31	$155
	Pension Costs		$43	$43	$43	$43	$43	$214
8	*Gas in Storage*		$20	$20	$20	$20	$20	$100
9	*Total Y Factors Removed*		$204	$204	$204	$204	$204	$1,019
10	*Revenue to be Escalated*		$831	$852	$873	$895	$917	
11	*I-X Escalator (inflation at 2.0%)*	0.80%	$7	$7	$7	$7	$7	
12	*Escalated Revenue*		$838	$859	$880	$902	$924	$4,402
13	*Increase from Base due to Escalator*		$7	$13	$20	$28	$35	$103
	Add Back Y Factor Annual Values							
14	*Customer Care*		$114	$119	$124	$129	$134	$620
15	*DSM*		$32	$33	$33	$34	$35	$167
	Pension Costs		$37	$34	$31	$31	$31	$164
16	*Gas in Storage*		$20	$20	$21	$21	$21	$103
17	*GTA and Ottawa Projects*		$5	$12	$64	$63	$63	$207
18	*Total Y Factors Added*		$208	$218	$273	$278	$284	$1,261
19	*Total Revenue at Escalated Rates*		$1,046	$1,076	$1,153	$1,180	$1,208	$5,663
20	*Increase in Revenues from Base*		$25	$55	$132	$159	$187	$558
21	*Aggregate Percentage*		2.44%	5.43%	12.92%	15.54%	18.31%	
22	*Annual Increase over previous year*		2.44%	2.92%	7.10%	2.32%	2.39%	
23	*Increase in Rates from Base*		$11	$27	$90	$102	$115	$345
24	*Annual Increase over previous year*		1.07%	1.55%	5.69%	1.04%	1.12%	
25	*Cumulative Average Rate Increase*			2.63%	8.47%	9.60%	10.83%	

Comparison to Enbridge as Filed

(excludes all SRC impacts/changes)

26	*Enbridge As Filed*		$1,011	$1,058	$1,171	$1,227	$1,287	$5,753
27	*Depr. Chg. For Site Restoration*		$30	$32	$36	$38	$39	$174
28	*Carrying cost imp. from SRC*		-$2	-$8	-$14	-$22	-$27	-$73
29	*Income tax imp. from SRC*		$35	$32	$31	$28	$15	$141
30	*Pension Decrease from 2013*		$0	$0	$0	$0	$0	$0
31	*Enbridge Comparable As Filed*		$1,073	$1,114	$1,223	$1,271	$1,314	$5,994
32	*Increase in Revenues from Base*		$52	$93	$202	$250	$293	$889
33	*Aggregate Percentage*		5.06%	9.11%	19.77%	24.49%	28.67%	
34	*Annual Increase over previous year*		5.06%	3.85%	9.78%	3.93%	3.36%	
35	*Increase in Rates from Base*		$38	$65	$160	$193	$221	$676
36	*Annual Increase over previous year*		3.65%	2.50%	8.38%	2.71%	2.16%	
37	*Cumulative Average Rate Increase*			6.24%	15.15%	18.26%	20.82%	
38	*Difference in Revenues*		**$27**	**$38**	**$70**	**$91**	**$106**	**$331**
39	*Incremental Annual Rate Increase*		**2.59%**	**0.95%**	**2.69%**	**1.66%**	**1.05%**	

SCHEDULE 2

Union Gas Typical Commercial Bill

Month		Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Totals
Volume	**35000**	**6290**	**6024**	**4301**	**2479**	**1489**	**1181**	**1111**	**1036**	**1188**	**1559**	**3133**	**5209**	**35000**
Heat Factor		18.0%	17.2%	12.3%	7.1%	4.3%	3.4%	3.2%	3.0%	3.4%	4.5%	9.0%	14.9%	
Fixed	**$21.00**	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$252.00
100	**0.037937**	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$3.79	$45.52
150	**0.035811**	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$5.37	$64.46
Over	**0.030844**	$186.30	$178.10	$124.94	$68.75	$38.21	$28.71	$26.55	$24.24	$28.94	$40.38	$88.91	$152.96	$987.01
Storage	**0.007493**	$47.13	$45.14	$32.23	$18.57	$11.16	$8.85	$8.32	$7.76	$8.90	$11.68	$23.47	$39.03	$262.26
Total		$263.60	$253.41	$187.33	$117.49	$79.53	$67.72	$65.04	$62.17	$68.00	$82.23	$142.55	$222.16	$1,611.25

Enbridge Typical Commercial Bill

Month		Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec	Totals
Volume	**35000**	**6290**	**6024**	**4301**	**2479**	**1489**	**1181**	**1111**	**1036**	**1188**	**1559**	**3133**	**5209**	**35000**
Heat Factor		18.0%	17.2%	12.3%	7.1%	4.3%	3.4%	3.2%	3.0%	3.4%	4.5%	9.0%	14.9%	
Fixed	**$70.00**	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$70.00	$840.00
500	**0.070241**	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$35.12	$421.45
1050	**0.053696**	$56.38	$56.38	$56.38	$56.38	$53.09	$36.56	$32.80	$28.77	$36.95	$56.38	$56.38	$56.38	$582.85
4500	**0.042112**	$189.50	$188.42	$115.84	$39.12	$0.00	$0.00	$0.00	$0.00	$0.00	$0.39	$66.65	$154.10	$754.03
Over	**0.034667**	$8.33	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$8.33
Load Bal.	**0.011496**	$72.31	$69.26	$49.44	$28.50	$17.12	$13.58	$12.77	$11.91	$13.66	$17.93	$36.01	$59.89	$402.36
Total		$431.65	$419.18	$326.78	$229.12	$175.33	$155.25	$150.70	$145.80	$155.73	$179.82	$264.17	$375.48	$3,009.00

86.75%

Union Gas Typical Residential Bill

Month		**Jan**	**Feb**	**Mar**	**Apr**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**Totals**
Volume		**2500**	**449**	**430**	**307**	**177**	**106**	**84**	**79**	**74**	**85**	**111**	**224**	**372**	**2500**
Heat Factor			18.0%	17.2%	12.3%	7.1%	4.3%	3.4%	3.2%	3.0%	3.4%	4.5%	9.0%	14.9%	
Fixed		**$21.00**	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$21.00	$252.00
	100	**0.037937**	$3.79	$3.79	$3.79	$3.79	$3.79	$3.20	$3.01	$2.81	$3.22	$3.79	$3.79	$3.79	$42.59
	150	**0.035811**	$5.37	$5.37	$5.37	$2.76	$0.23	$0.00	$0.00	$0.00	$0.00	$0.41	$4.43	$5.37	$29.31
Over		**0.030844**	$6.15	$5.56	$1.76	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$3.77	$17.24
Storage		**0.007493**	$3.37	$3.22	$2.30	$1.33	$0.80	$0.63	$0.59	$0.55	$0.64	$0.83	$1.68	$2.79	$18.73
Total			$39.68	$38.95	$34.23	$28.88	$25.82	$24.83	$24.60	$24.36	$24.86	$26.04	$30.90	$36.72	$359.87

Enbridge Typical Residential Bill

			18.0%	17.2%	12.3%	7.1%	4.3%	3.4%	3.2%	3.0%	3.4%	4.5%	9.0%	14.9%	
Month		**Jan**	**Feb**	**Mar**	**Apr**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**Totals**	
Volume		**2500**	**449**	**430**	**307**	**177**	**106**	**84**	**79**	**74**	**85**	**111**	**224**	**372**	**2500**
Fixed		**$20.00**	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$20.00	$240.00
	30	**0.069838**	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$2.10	$25.14
	55	**0.065339**	$3.59	$3.59	$3.59	$3.59	$3.59	$3.55	$3.22	$2.87	$3.58	$3.59	$3.59	$3.59	$41.98
	85	**0.061814**	$5.25	$5.25	$5.25	$5.25	$1.32	$0.00	$0.00	$0.00	$0.00	$1.63	$5.25	$5.25	$34.47
Over		**0.059188**	$16.53	$15.41	$8.12	$0.42	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$3.18	$11.96	$55.62
Load Bal.		**0.011496**	$5.17	$4.95	$3.53	$2.04	$1.22	$0.97	$0.91	$0.85	$0.98	$1.28	$2.57	$4.28	$28.74
Total			$52.64	$51.30	$42.60	$33.40	$28.23	$26.62	$26.23	$25.82	$26.66	$28.60	$36.70	$47.18	$425.96

18.37%

SCHEDULE 3

Refund of Accumulated SRC Fund

Date	End of Year Fund Balance	Principal	Tax Saving	Grossed-Up Tax Saving	Rate Base Increase (1/2 year rule)	Accum. Rate Base Increase	Cost of Capital	Gross-up for Taxes	Net Rate Rider	Net Impact on Rates
2013	$903,900,000									
2014	$788,900,000	$115,000,000	$30,475,000	$41,462,585	$57,500,000	$57,500,000	$3,800,750	$666,470	$151,995,365	-14.32%
2015	$680,208,774	$108,691,226	$28,803,175	$39,187,993	$54,345,613	$169,345,613	$11,193,745	$1,962,847	$134,722,627	1.84%
2016	$577,480,229	$102,728,545	$27,223,064	$37,038,183	$51,364,272	$275,055,499	$18,181,168	$3,188,107	$118,397,453	1.70%
2017	$480,387,259	$97,092,970	$25,729,637	$35,006,309	$48,546,485	$374,966,256	$24,785,270	$4,346,150	$102,967,859	1.56%
2018	$388,620,703	$91,766,556	$24,318,137	$33,085,901	$45,883,278	$469,396,019	$31,027,077	$5,440,664	$88,384,716	1.44%
2019	$301,888,360	$86,732,343	$22,984,071	$31,270,845	$43,366,172	$558,645,468	$36,926,465	$6,475,134	$74,601,589	1.32%
2020	$219,914,058	$81,974,302	$21,723,190	$29,555,361	$40,987,151	$642,998,791	$42,502,220	$7,452,855	$61,574,588	1.22%
2021	$142,436,776	$77,477,282	$20,531,480	$27,933,986	$38,738,641	$722,724,583	$47,772,095	$8,376,938	$49,262,235	1.12%
2022	$69,209,813	$73,226,963	$19,405,145	$26,401,558	$36,613,482	$798,076,706	$52,752,870	$9,250,328	$37,625,323	1.03%
2023	$0	$69,209,812	$18,340,600	$24,953,198	$34,604,906	$869,295,094	$57,460,406	$10,075,804	$26,626,800	0.94%
Totals		$903,900,000	$239,533,500	$325,895,918		$903,900,000	$326,402,066	$57,235,296	$846,158,556	-2.15%

Tax Rate	26.50%
Cost of Capital	6.61%
ROE	8.93%
ROE Gross-up	1.16%
Assumed Growth	1.70%
Decline Factor	94.51%