Ontario Energy Board Staff Initial Position Paper

On an Application by Enbridge Gas Distribution Inc. and Union Gas Limited to Amalgamate and Request Approval of a Rate-setting Mechanism

EB-2017-0306/EB-2017-0307

Do you plan on supporting approval of the merger?

As a general matter, **staff supports the request to amalgamate**. The evidence to date appears to indicate that the amalgamation will benefit ratepayers by leading to synergies and sustainable efficiencies. However, OEB staff has a number of concerns which are described in further detail below. OEB staff does not necessarily support the amalgamation on all of the applicants' proposed terms.

Do you support the 10-year deferred rebasing period?

OEB staff is prepared to support a 10-year deferred rebasing period provided that it is accompanied by a robust protection mechanism for ratepayers. In OEB staff's view the current proposal from the applicants is not sufficient to justify the 10 year deferral selection. The protection mechanism could be an appropriate earnings sharing mechanism and other measures that provide more and/or earlier benefits to ratepayers. Such customized approaches have been used in the past, including the framework for Union Gas that provided an upfront productivity commitment of $4.5 million for the 2014-2018 IRM period. This was in addition to an ESM that was more favourable to ratepayers than that proposed in this application[1].

Are there elements of the proposed rate setting framework that you oppose?

The applicants have requested a Price Cap Index (PCI) during the deferred rebasing period. The annual rate change would use a price cap index, where PCI growth is driven by an inflation factor, less a productivity factor of zero and no stretch factor.

The proposed framework also includes certain Y factor adjustments that are passed through to customers without any annual escalation. These include pass-through gas

[1] In the 2014-2018 IRM framework, the ESM of Union Gas was as follows: If in any calendar year Union's actual utility return on equity is more than 100 basis points over the 2013 Board-approved ROE of 8.93%, then excess earnings between 100 basis points and 200 basis points will be shared 50/50 between Union and its customers. If the ROE was more than 200 basis points over the 2013 Board-approved ROE of 8.93%, then such earnings in excess of 200 basis points will be shared 90/10 between customers and Union (i.e., 90% in favour of ratepayers), EB-2013-0202 Settlement Agreement, Page 25, July 31, 2013.

commodity and upstream transportation costs, demand side management cost changes, normalized average consumption/average use, and Cap-and-Trade costs.

Consistent with the OEB-established policy on the Incremental Capital Module (ICM), the applicants have proposed that, during the deferred rebasing period, they could apply for rate adjustments to recover costs associated with qualifying incremental capital investment beyond what is normally funded through approved rates.

The OEB's Price Cap formula includes a Z factor mechanism to address material changes in costs associated with unforeseen events outside of the control of management. The applicants propose using a materiality threshold of $1.0 million for Amalco during the deferred rebasing period. This is consistent with the threshold for electric distributors with revenue requirements in excess of $200 million.[2]

OEB staff is not opposed to the use of a Price Cap Index mechanism. However, it does not currently agree with some of the elements of the applicants' proposed Price Cap Index.

Inflation Factor

The applicants propose to use the quarterly Gross Domestic Product Implicit Price Index Final Domestic Demand (GDP IPI FDD) Canada index as the inflation factor. The OEB currently uses the GDP-IPI FDD as a non-labour (materials and capital equipment) indicator for electricity.

OEB staff is not opposed to the use of the inflation factor proposed by the applicants but would **prefer a two-factor IPI that uses labour and non-labour inflation**, and which are weighted by their contribution to costs. Adoption of a two-factor IPI would ensure more consistency between the natural gas and electricity sectors.

Productivity and Stretch Factor

In line with the OEB staff report prepared by Pacific Economics Group, OEB staff expects to recommend **a base productivity growth of 0.0% and a stretch factor of 0.30%. This would provide a PCI of I – 0.3%.** The applicants have submitted a study by NERA that recommends a productivity factor of 0.0% and no stretch factor. Since the applicants have not provided benchmarking evidence, a 0.3% stretch factor for normal/typical cost efficiency performance is appropriate and in line with other rate regulated utilities in Ontario.

Y-Factors

The applicants have proposed a set of Y factors that are similar to Union's 2014-2018 IRM framework. OEB staff has no concerns with the use of most Y factors with the exception to

[2] Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors (page 36, July 14, 2008) sets a materiality threshold of $1 million for a distributor with a distribution revenue requirement of more than $200 million.

true up Normalized Average Consumption (NAC) to account for the decline in average use.

OEB staff is of the opinion that Amalco could assume some weather risk associated with average use. OEB staff may argue that **Amalco could assume the risk of any change in average use and that the NAC deferral account should be discontinued.** Alternatively, OEB staff may suggest continuation of the NAC deferral account which will function asymmetrically in favour of ratepayers during the deferred rebasing period. In other words, Amalco would not be able to recover revenues as a result of decline in average use up to a certain amount in any given year during the Price Cap IR. OEB staff are prepared to explore mechanisms that may need to be adjusted or put in place to facilitate the above options, such as re-establishing an LRAM for general service rate classes.

Incremental Capital Module

OEB staff's view is that, under a Price Cap IR plan, an ICM should be available to the applicants. OEB staff also notes that the Rate Handbook provides for the ICM to deal with necessary incremental capital funding for rate-regulated utilities under Price Cap plans in both electricity and natural gas.

OEB staff is not at this time supportive of the applicants' proposal to deviate from existing ICM policy and **use the current OEB-issued ROE and the long-term debt to calculate the revenue requirement for any qualifying ICM capital project.** This is inconsistent with OEB policy that requires the use of the factors approved in the last cost of service rate case.

OEB staff is also of the view that consideration and **approval of any ICM proposals in Leave-to-Construct (LtC) applications is not consistent with the intent of the policy which requires the costs and funding for ICM proposals to be confirmed in a rate application.** OEB staff notes that the level of capex forecasted to be funded by the proposed price cap and growth adjusted rates, and the proposed capital budget for the year may not be available at the time of the LtC application. All rates-related matters including determination of the amount of incremental capex and revenue requirement for the project should be determined in the annual price cap rate adjustment application.

Materiality Threshold for Z-factor

The Applicants propose using a materiality threshold of $1.0 million for Amalco during the deferred rebasing period. A utility that has a rate base of $10 billion and annual revenues of over $2 billion should be able to manage a risk of over $1.0 million. Z factors are currently in place for both utilities (Enbridge Gas - $1.5 million and Union Gas - $4 million) under their current rate setting plans. Both utilities are at the end of their respective rate-setting plans and have been able to manage within their respective thresholds. **OEB staff therefore may argue that the Z-factor threshold for Amalco should be around $5.0 million** (approximate combined current threshold of Enbridge Gas and Union Gas). OEB staff acknowledges that the current threshold for electricity distributors is $1.0 million, but this threshold was first established in 2008[3].

If you plan to support the merger what, if any, conditions of approval will you propose?

Storage

Union Gas Cost Based Storage

Enbridge Gas has insufficient storage to meet the needs of its in-franchise customers. However, Union Gas has excess storage and a portion of its storage is not rate-regulated. The NGEIR Decision (EB-2015-0551) determined that Union Gas must allocate 100 PJ of storage to meet the needs of in-franchise customers at cost-based rates. Currently, Union Gas sells storage to Enbridge Gas at market based rates. Union Gas' in-franchise customers typically use around 93 PJs annually with the balance being sold as short-term storage. The net revenues from short-term storage and load balancing transactions are shared 90:10 to the benefit of Union Gas' ratepayers.

OEB staff will explore in cross-examination whether it would make sense to allocate the excess over Union Gas' legacy in-franchise requirements up to a 100 PJ to meet the needs of all Amalco's in-franchise customers, and what impact such an arrangement may have on Union Gas' rate zones.

Blind RFP Process for the Purchase of Unregulated Storage Services for Enbridge Zone Customers

Post amalgamation, the legacy Enbridge Gas will continue to receive storage services from Union Gas at market-based rates. Amalco will continue to purchase market-based storage services and could potentially be purchasing storage at market rates from itself (Union Gas storage pools) for serving its in-franchise customers. In order to ensure an unbiased storage procurement process, Amalco has indicated that it will conduct a blind request for proposals through an independent third party for storage capacity[4].

OEB staff may argue that, in addition, **Amalco should be required to provide information to the OEB about the bids, possibly under the OEB's *Natural Gas Reporting and Record Keeping Requirements***.

[3] Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, Page 36, July 14, 2008
[4] Response to OGVG IR#4