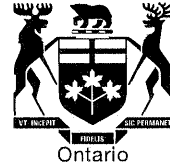
Ontario Energy Board

Commission de l'énergie de l'Ontario




Régie de l'énergie
DOSSIER: R-3752-2011 Phase 2
DÉPOSÉE EN AUDIENCE
Date: 19/Sept/2011
Pièces n°: C-FCEI-0036

**EB-2009-0172**

**IN THE MATTER OF** the *Ontario Energy Board Act 1998*, S.O.1998, c.15, (Schedule B);

**AND IN THE MATTER OF** an Application by Enbridge Gas Distribution Inc. for an Order or Orders approving or fixing just and reasonable rates and other charges for the sale, distribution, transmission and storage of gas commencing January 1, 2010.

**BEFORE:** Gordon Kaiser
Vice Chair and Presiding Member

Paul Sommerville
Member

Cathy Spoel
Member

# DECISION
# RETURN ON EQUITY FOR EARNINGS SHARING and DSM INDUSTRIAL PILOT PROGRAM

This matter comes to the Ontario Energy Board (the "Board") as an element in Enbridge's annual adjustment to its rates pursuant to its incentive rate mechanism. In EB-2007-0615 the Board approved a five-year incentive regulation plan ("IR Plan") for Enbridge Gas Distribution Inc. The parameters of the IR Plan are set out in the Board approved EB-2007-0615 Settlement Agreement ("Settlement Agreement"). As part of the IR Plan, Enbridge is obliged to apply on an annual basis for an update to its rates based on the components of the incentive plan.

The issue that the Board must address in this decision is how the earnings sharing mechanism ("ESM") which forms part of the IR Plan ought to be calculated.

The ESM is a regulatory instrument embedded within the IR Plan that has the effect of distributing higher than anticipated earnings between the shareholder and the ratepayers. The ESM in Enbridge's plan provides for a 50/50 split of excess utility earnings if the earnings in any year exceed a 100 basis point Return on Equity ("ROE") threshold. The agreed-upon formula for the ESM, which appears in the Settlement Agreement, establishes that the baseline of anticipated earnings for each year of the IR Plan is to be rooted in the rate of the ROE.

It is Enbridge's position that the ROE to be used in calculating the ESM should be updated to reflect the Board's recent revision of its cost of capital guideline. In December of 2009, the Board issued a report which changed some elements of the methodology it had used in establishing the ROE component for regulated utilities in Ontario[1]. That report emanated from a consultation process that had begun early in 2009. The primary implication of the Board's revised guideline was that it materially increased the ROE component of utility rates. Enbridge seeks to apply this new ROE methodology to its 2010 ESM calculation.

It is important to note that Enbridge does not seek to apply the Board's revised ROE methodology to its rates *per se* for the remainder of the term of its IR Plan. In fact in its materials it has specifically stated that it has no interest in having the new ROE methodology applied to its rates for the remainder of the IR Plan. Had it desired to do so, it would have to proceed pursuant to section 6.1 of the Settlement Agreement which provides an explicit process for applying for that change. The narrow issue engaged here is limited to the rate of ROE used in the earnings sharing mechanism.

While the issue is narrow, the implications are significant. If Enbridge's proposal is approved by the Board, the amounts retained by the shareholder and not credited to the ratepayer could be significant.

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[1] EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities. December 11, 2009.

Enbridge's proposal is based primarily on its interpretation of section 10.1 of the Settlement Agreement, which is reproduced here:

> (i) if in any calendar year Enbridge's actual utility ROE, calculated on the weather normalized basis, is more than 100 basis points over the amount calculated annually by the application of the Boards ROE Formula in any year of the IR plan, then the resulting amount shall be shared equally (i.e., 50/50) between Enbridge and it's ratepayers;
> (ii) for the purposes of the ESM, Enbridge shall calculate its earnings using the regulatory rules prescribed by the Board from time to time, and shall not make any material changes in accounting practices that have the effect of reducing utility earnings;
> (iii) all revenues that would otherwise be included in a cost of service application shall be included in revenues in the calculation of the earnings calculation and only those expenses (whether operating or capital) that would otherwise be allowable as deductions from earnings in a cost of service application, shall be included in the earnings calculation.

It is Enbridge's position that the phrase appearing in subsection (ii) " ...regulatory rules prescribed by the Board from time to time..." brings the Board's revised ROE methodology into play for the purposes of calculating the earnings sharing amount. It contends that the change in methodology adopted by the Board for its cost of capital guideline in December of 2009 is a "regulatory rule" that is prescribed by the Board.

An obstacle to this position appears in section 2.4 of the Settlement Agreement itself. That section stipulates that except as otherwise provided in the Settlement Agreement, the ROE for the entire term of the IR Plan will be 8.39%. That rate is the ROE value derived from the Board's ROE formula before it was amended by the Board's December 2009 report.

Enbridge argues that section 10.1 is an exception to section 2.4 insofar as it provides for the application of the "regulatory rules prescribed by the Board from time to time" to the ESM calculation. It contends that section 10.1 displaces the general rule that the unamended ROE formula should prevail.

Enbridge also asserts that in its December 2009 cost of capital report, the Board amended the methodology appearing in the guideline so as to give effect to the fair return standard for Ontario utilities. The fair return standard is a concept adopted by both Canadian and American courts that requires as a matter of legal entitlement

sufficient return to rate regulated utilities. Enbridge suggests that in order to be consistent with the Board's approach in the recent ROE proceeding, this panel should adopt the Board's amended formula for the purposes of calculating the earnings sharing mechanism.

The intervenors representing ratepayer interests (Consumers Council of Canada, Industrial Gas Users Association, Vulnerable Energy Consumers Coalition, Schools Energy Coalition and Energy Probe) all disagreed with Enbridge's interpretation. While there are differences in their positions, they can be reasonably summarized as rejecting Enbridge's characterization of the Board's revised ROE methodology as a regulatory rule prescribed by the Board which has the effect of overriding the ROE provision appearing in section 2.4 of the Settlement Agreement. In their view, a plain and fair reading of the Settlement Agreement leads to the conclusion that the calculation of the amount subject to the ESM was to be made using the ROE methodology prevailing at the time the Settlement Agreement was made. In their view, there is no justification for the insertion of the new ROE value, derived from the amended guideline, in this midterm adjustment.

The intervenors are adamant that it was never the intention of the parties to the Settlement Agreement to provide for the adjustment sought by Enbridge. To this end they have gone so far as to bring a motion requesting that the Board examine the negotiations and communications associated with the Settlement Agreement when it was entered into in February 2008. The Board will deal with that motion later in this decision.

In order to prevail, Enbridge must establish that the amended ROE methodology reflected in the December 2009 report represents a regulatory rule that is prescribed by the Board.

First, is the Board's amended ROE methodology a regulatory rule?

To answer this question the Board must examine the language used in the December 2009 report on the cost of capital. In the Board's view it is clear from that report that the amended ROE methodology is not a regulatory rule by any reasonable interpretation. On page 13 of the report, the Board says:

> The final "product" of this process, of course, is a Board policy. This was not a hearing process, and it does not - indeed cannot - set rates. The Board's refreshed cost of capital policies will be considered through rate hearings for the individual utilities at which it is possible that specific evidence may be proffered and tested before the Board. Board panels assigned to these cases will look to the report for guidance in how the cost of capital should be determined. Board panels considering individual rate applications, however, are not bound by the Board's policy, and where justified by specific circumstances, may choose not to apply the policy (or a part of the policy).

This passage establishes that the Board's intention in amending its ROE methodology through its guideline was to provide guidance to Board panels in considering cost of capital issues and expressly to not create a rule or mandatory direction. The revised ROE methodology is a matter to be considered and applied by the Board in the absence of convincing relevant and sufficient evidence to the contrary. That is a considerable remove from the effect of a regulatory rule that must be applied, virtually without exception.

Apart from this functional analysis, it is noteworthy that the Board in its report on the cost of capital issued in December of 2009 did not refer to it's methodology as representing a "rule".

The next question in resolving the issue before us in this case is whether the amended ROE methodology is prescribed by the Board in circumstances analogous to those obtained in this case.

Again the answer must be found in the text of the December 2009 cost of capital report. On page 2 of that report the Board stated:

> The Board will apply the methods set out in this report annually to derive the values for the ROE and the deemed long-term and short-term debt rates <u>for use in cost of service applications</u>. (Emphasis added)

Later, at page 61 of the report the Board stated:

> The policy set out in Chapter 4 of this report will come into effect for the setting of rates beginning in 2010, <u>by way of a cost of service application</u>. (Emphasis added)

These excerpts indicate that it was the Board's intention in its December 2009 report to create an amended methodology for ROE that would apply at the next cost of service application for utilities, beginning in 2010. The amended methodology was not intended to be applied in the midterm of incentive regulation plans, such as the current Enbridge plan. There is a good reason for ensuring that the amended methodology not be used for midterm adjustments insofar as it is only in the context of a cost of service application that there is evidence of all the factors which need to be taken into account when applying the ROE formula. This latter observation was made in the recent Board decision in the case of Hydro One Networks Inc.[2]

> It is the Board's view that it is amply clear in the Board's report that the revised methodology is intended to be implemented in the context of a cost of service application. On page 61 of the report of the Board states:
>
> > The policy set out in Chapter 4 of this report will come into effect for the setting of rates, beginning in 2010, by way of a cost of service application.
>
> In this case, the 2010 cost of service application was, with the sole exception of the consideration of the four proposed construction projects mentioned above, decided fully six months before the Board's cost of capital report was issued. There is therefore no cost of service application to provide a context for the appropriate consideration of the revised cost of capital methodology. The implementation of that methodology is dependent on its consideration within a cost of service application which allows for a full and contemporaneous consideration of all the company's costs in setting just and reasonable rates. In this case that is not possible, unless the applicant decides to file a new cost of service application for 2010 rates. In the course of his remarks, counsel for Hydro One indicated that such an application was not being contemplated by his client. (Emphasis added)

It is clear to the Board that the amended ROE methodology is neither a regulatory rule nor is it a rule which is prescribed by the Board for use in midterm adjustment cases. Enbridge's position is not sustainable and the Board finds that the appropriate ROE value to use in calculating the earnings sharing amount for 2010, and for every year of this incentive regulation plan, is the amount derived from the application of the Board's legacy formula.

[2] Decision and Order of the Ontario Energy Board in the matter of Hydro One Networks Inc. EB-2010-0003, dated April 5, 2010.

Enbridge suggested in the course of its submissions that the dependence of the amended ROE methodology on the fair return standard somehow compelled its use. The Board has two observations on this proposition.

First, in administering this incentive regulation plan the Board is implementing a Settlement Agreement that was arrived at by the parties in 2008. It would be inappropriate, except in the most extraordinary circumstances for the Board to unseat the Settlement Agreement on the basis of external factors in a manner which was not contemplated by the parties. As has been noted, section 6.1 of the Settlement Agreement does provide a process for the application of a revised ROE methodology to Enbridge's rates *per se* upon the application of any party to the Settlement Agreement. No party, including Enbridge, has sought to invoke that process.

Second, although the December 2009 Report identified a need to reset and refine the existing ROE formula used by the Board to determine a utility's cost of capital, the Board did not make a finding that the ROE arising from the application of the existing formula produced a result that did not meet the fair return standard. If the Board had believed that all of the rates predicated on the pre-amended ROE formula did not meet the legal requirements of the fair return standard, it would have had to address that issue directly in its December Report.

Instead, in a manner that confirms that the previous methodology produced conforming rates, the December Report provided that the new methodology would only be applied prospectively, and in cost of service applications where a full review of the operations of the utilities could be undertaken.

It is also important to note that the fair return standard applies for the setting of rates. In this proceeding we are not setting rates. The base rates are adjusted annually in a limited fashion according to the terms of the IR Plan. Any excess earnings above a certain threshold are allocated between ratepayers and shareholders, once again in accordance with the terms of the IR Plan. However the basic exercise before us in this case is to determine the amount of over earnings, not rates *per se*.

In the end we should remember that this is a guideline. While much of the argument in this case is based on a narrow construction of contractual language, in interpreting a guideline the Board must find a solution that makes common sense.

The only common sense conclusion is that the ROE under the December Report cannot apply until the utility has gone through a cost of service proceeding and the required evidentiary basis has been established to make a proper calculation of the ROE within the terms clearly set out in the December Report. The process for transitioning from the old guidelines to the new guidelines is clearly set out. It can only be introduced at the time of a cost of service proceeding. There is no other way to achieve this without violating the essential regulatory scheme of the IR Plan.

We should also remember this is an incentive rate making plan. Parties entered into a five year agreement and are bound to follow the agreement unless exceptional circumstances develop. No one is arguing that the exceptional circumstances or Z factors are at play here. The rationale for an incentive rate making plan is to give the utility an incentive to reduce costs. The plan can and often does result in excess earnings. The utility gets to share in those earnings. That's the incentive. If Enbridge's argument was accepted, the utility would in fact receive a substantial windfall gain that had no connection to any of its actions. To interpret the IR Plan as Enbridge does could cause these types of plans to lose credibility.

As was noted above, a number of intervenors brought a motion requesting that the Board examine the negotiations and communications which surrounded the creation of the Settlement Agreement. In light of the decision the Board has made in this case, it is unnecessary for the Board to make any ruling with respect to that motion, which is now moot.

## INDUSTRIAL PILOT PROGRAM

An issue has been brought to the Board for resolution. The issue relates to a dispute about how to interpret the language used in the Board's September 30, 2009 EB-2009-0154 Decision and Order pertaining to funding for Enbridge's DSM industrial pilot program. In the settlement of Issue 7, the parties asked the following of the Board:

> For the purposes of settling the issues in this proceeding, all parties ask that the Board provide confirmation as to its intention in the EB-2009-0154 Decision regarding the appropriate source of funding for Enbridge's new industrial pilot project.
>
> - EB-2009-0172 Settlement Agreement, page 10.

In its EB-2009-0154 Decision and Order, the Board stated the following:

> The Board approves the inclusion of the new industrial pilot program as proposed by Enbridge. The Board notes that it was not its expectation that the 2010 DSM Plan would include new projects. However, the Board finds that, given the nature of the program, its general acceptance by the intervenor community, and the limitations (set out below) on the use of its outcomes will provide a positive addition to Enbridge's 2010 DSM Plan and the development of knowledge for gas DSM moving forward. The Board confirms that the funding for the program must come from outside of Enbridge's DSM budget, and the outcomes shall not be incorporated into the TRC and SSM calculations.
>
> - EB-2009-0154 Decision and Order, page 7.

The parties have differing views as to what the Board intended to be the appropriate source of funding for the new industrial pilot project.

Enbridge's position is that the Board approved the pilot project "as proposed by Enbridge", and that its Application contemplated that funding for the industrial pilot program would be incremental to the $23.8 million DSM budget for 2010. Enbridge said that the incremental funding would be recovered in rates through an increase to the otherwise determined DSM Y-factor, allocated to the customer classes qualifying for the program.

Other parties have taken the position that the Board approved the pilot project but, in response to concerns of some parties noted in the Board's decision, directed that the costs of the program not be added to the $23.8 million DSM budget for 2010, and thus not be passed through as an increase to the otherwise determined DSM Y-factor, but rather funded from within Enbridge's overall 2010 distribution revenue requirement as otherwise determined.

The Board confirms its original intention that the industrial pilot program funding will not be incremental to Enbridge's DSM $23.8 million budget for 2010. Further, the Board will not approve an increase to the DSM Y-factor for this project. The Board's intention was that the funding was to be sourced from outside of the DSM budget. This is confirmed by the Board's original statement in the EB-2009-0154 Decision and Order that "the funding for the program must come from outside of Enbridge's DSM budget". The Board would have no objection to the program being funded from within Enbridge's existing Board-approved 2010 revenue. If Enbridge wishes to pursue the pilot program, it is free

to do so. However the Board will not approve an incremental ratepayer funded budget for this program.

## COST AWARDS

Parties eligible to claim an award of costs in this proceeding shall submit any claims to the Board with a copy to Enbridge, within fifteen (15) business days of the date of this decision. Enbridge may file an objection to any claim of an award of costs within twenty (20) business days of the date of this decision, with a copy to the claimant. Any claimant whose cost claim was objected to may file a response within twenty-five (25) business days of the date of this decision, with a copy to Enbridge.

**DATED** at Toronto, May 18, 2010

**ONTARIO ENERGY BOARD**

*Original Signed By*

Gordon Kaiser
Vice Chair and Presiding Member

*Original Signed By*

Paul Sommerville
Member

*Original Signed By*

Cathy Spoel
Member