DECISION

IN THE MATTER of a Review of Enbridge Gas New Brunswick LP's 2010 Financial Results, 2010 Natural Gas Sales and 2012 Proposed Budget

January 30, 2012

NEW BRUNSWICK ENERGY AND UTILITIES BOARD

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NEW BRUNSWICK ENERGY AND UTILITIES BOARD:

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Public Intervenor	René Basque
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INTRODUCTION

The New Brunswick Energy and Utilities Board (Board) conducts an annual review of Enbridge Gas New Brunswick Limited Partnership's (EGNB) Regulatory Financial Statements (Review) and has done so since 2000. This decision relates to EGNB's Regulatory Financial Statements for the year ending December 31, 2010. An important result of the Review is to approve the amount, if any, that will be added to the regulatory deferral account.

The Board considered three other matters concurrently with this Review namely: the application of the test for the end of the Development Period, the Board's review of EGNB's natural gas purchases and sales in 2010 and the Board's consideration of EGNB's prospective Revenue Requirement for 2012.

This Review followed a similar process to the one developed for the 2009 review. The Regulatory Financial Statements were filed on March 15, 2011. Revised statements were filed on July 28 and October 25. It was the revised October 25 statements which were under consideration in this Review.

A procedure conference was held on September 13, 2011, at which time the Board established a schedule for the filing of evidence, for submitting interrogatories and a hearing date. With respect to the EGNB evidence, interrogatories were posed by both by the Public Intervenor and Board staff. The Public Intervenor retained an expert to prepare a report and interrogatories were also posed relating to this evidence. Motions days were scheduled to deal with any preliminary issues and in case any party was dissatisfied with the response to an interrogatory. No motions were filed by any party to this proceeding. The process provided ample opportunity for all parties to present all necessary evidence and to explore all relevant topics.

An Act to Amend the Gas Distribution Act 1999 (Bill 18) was introduced in the Legislative Assembly a few days before the hearing of this matter and has since received Royal Assent. The parties noted the introduction of this legislation but did not seek an adjournment to the hearing.

The legislative amendments do not affect the Board's review of the 2010 results, whether the test for the end of the Development Period has been met or the consideration of the 2010 gas sales. While the amendments found in Bill 18 and any related regulations may impact upon EGNB's 2012 Revenue Requirement, the Board will be able to consider any such impact during the review of the 2012 Regulatory

Financial Statements after the year-end. In light of these factors the Board considers it appropriate to proceed with the consideration of all the matters before it.

REVIEW OF 2010 REGULATORY FINANCIAL STATEMENTS

During the course of this Review the Board examined in detail both the revenue and the expenses recorded in the Regulatory Financial Statements for the 2010 fiscal year.

Revenue

Revenue from Gas Distribution

EGNB's revenue from gas distribution for 2010 was $39.5 million, which is $11.8 million less than budgeted. Revenue is a reflection of the distribution rates charged to customers multiplied by the volume of throughput.

With respect to rates, EGNB submits that for 2010, the rates charged to customers were lower than expected.

In the current market based system, distribution rates are neither entirely predictable nor wholly within EGNB's control. On October 28, 2009 EGNB applied for increased rates to be effective as of January 1, 2010. The rates applied for were granted following a hearing, but did not take effect until well into the year. In the case of the Contract Large General Service Light Fuel Oil (LFO) class, only half of the increase was allowed during 2010, with the remainder of the increase delayed until July 2011.

As a result the Board finds that the lower than projected rates in 2010 were due to matters beyond the control of EGNB and should not be considered a forecasting error.

With respect to throughput, EGNB states that it was lower than expected in 2010 primarily due to fewer than projected attachments and warmer than average weather. EGNB attached considerably fewer customers than they had budgeted for. As a result, throughput and revenue was significantly less than anticipated.

EGNB's overly optimistic projections of throughput have been a regular subject of discussion at annual reviews for several years. It is noted, however, that during this hearing Mr. Charleson, General Manger of EGNB, indicated that throughput for 2011 was running much closer to projections. He testified at page 54 of the transcript: "I would say 2011 is looking very good. We are probably within a couple of percentage points of being on on our throughput forecast".

In forecasting throughput, it is also important that EGNB make some allowance for those customers leaving the distribution system. From the evidence that has been filed in this matter it is not clear if EGNB takes this factor into account. In the event EGNB does not account for this in its forecasts, it is directed to do so in the future.

Weather normalization is another issue related to throughput that was examined. EGNB filed evidence outlining its weather normalized throughput in response to an interrogatory, but the subject was not pursued vigorously at the hearing, perhaps on the understanding that the Board would not be acting on any throughput shortfalls until the 2011 review. In future years, should EGNB wish to focus on weather as an explanation for variations from the throughput forecast, pre-filed evidence on the subject must be presented which explains the weather normalization process and the underlying data and assumptions used in the calculations.

In a decision arising out of the 2009 review, the Board determined at page 13 that, starting in 2011, "EGNB must be responsible for its throughput forecasts." As was indicated at that time, the issue of throughput will be an important one in future financial reviews, especially as EGNB moves towards a cost based system. A "spending per throughput target" was established for 2011. Since no such target was established for 2010, the forecasting of throughput will not be taken into account when determining the appropriate amount for the deferral account in 2010. This will not be the case in future years.

The Board approves the portion of the income statement relating to gas distribution revenue as presented.

Revenue from Installation Services

In the decision related to the 2008 review, the Board expressed its concern that all costs related to installation services be properly identified and charged to installation services revenue. This concern was repeated in the 2009 review, at which time EGNB was directed to include the results of installation services on a full cost basis in all Regulatory Financial Statements.

In the revised October 25 Financial Statements EGNB attached a document identifying the results of installation services on a full cost basis, but did not charge those costs to installation services and made no corresponding adjustment to the revenue on the statement of income to reflect this. The full cost analysis showed a loss on installation services of $634,000.

EGNB argues that it performs installation services to support the growth of the gas distribution system in New Brunswick and that accordingly it would not be appropriate for EGNB to have to absorb any losses arising from this work. As part of their evidence, EGNB provided a 2003 letter that they had sent to the Board, outlining their expectation that the results of installation services would be integrated with the results of the distribution activity. EGNB states that it has operated on this basis since 2003.

While EGNB may have had this expectation in 2003, the Board has stated in its review of both the 2008 and 2009 financial results that installation services should be accounted for on a full cost basis to prevent further cross-subsidization of installation services by ratepayers.

The Board will not allow the loss associated with installation services in 2010 to be added to the deferral account. EGNB is directed to re-file its regulatory financial statements in accordance with the directions of the Board, accounting for installation service costs on a full cost basis.

Expenses

The Board carefully examined all of EGNB's expenses incurred in 2010 as reflected in the Regulatory Financial Statements.

Operating Expenses:

Operation & Maintenance

Operation & Maintenance expenses (O&M) generally include those expenses covering the day to day operation of the business, including Payment to Affiliates which will be dealt with separately. O&M expenses were a major consideration in the Review. EGNB filed a substantial amount of evidence on this topic and responded to many interrogatories. This was also a focus of cross-examination by Board Counsel.

O&M expenses were not covered in much detail by Robert D. Knecht, the expert witness who testified on behalf of the Public Intervenor. On 2010 expenses, he commented generally, at page 3 of his report that: "…EGNB has little or no chance of being able to fully recover all of its deferred costs". He concluded at page 4 of his report that: "It is therefore less critical and probably not cost-effective to engage in an exhaustive prudence review of EGNB's 2010 financials." In final argument, the Public Intervenor stated that EGNB will not recover the regulatory deferral account and such, did not propose that any 2010 costs be disallowed.

Despite the above, the Public Intervenor did express concerns with increases in certain O&M expenses namely advertising expenses, increased payments to directors and the amounts paid for stock-based compensation. Director's fees were about $50,000 higher in 2010 than 2009. Advertising and promotions costs were about $202,000 above budget in 2010. The Public Intervenor however, had no specific recommendation to the Board as to how they should be adjusted.

Mr. Charleson testified at page 203 of the transcript that the increased expenses in advertising costs and directors fees were directly attributable to “unprecedented attacks that were happening on our business by some of our large customers.”

EGNB remains a small utility with significant challenges in the marketplace. The Board does not consider it unreasonable or imprudent for EGNB to respond to these challenges by drawing upon the knowledge of its directors or by engaging in additional advertising and public relations spending. There are certainly limits beyond which such spending might not be considered prudent, but they were not exceeded in 2010.

With respect to the Public Intervenor’s concerns about stock based compensation, it is to be noted that the significant increases in this expense occurred prior to the year under review. For 2010, a 3% increase was proposed and this proposed increase will be addressed below.

There was one additional issue with respect to 2010 O&M expenses dealt with at this hearing. Prior to 2010, EGNB was capitalizing a significant amount of its O&M expenses to a Development O&M account. In 2010 however, EGNB modified this practice, reducing the capitalized expenses to Development O&M. The Board considers these changes appropriate. The capitalization of O&M expenses for 2012 will be discussed later in this decision.

Payment to Affiliates

EGNB is affiliated with the Enbridge Group of companies and incurs a number of expenses, all of which are recorded in the Regulatory Financial Statements. These expenses take two forms. The first is payment for services rendered by affiliated companies for EGNB through Service Level Agreements (SLA’s). The Board reviewed the payments under the SLA’s extensively in 2009. During this proceeding, the Board reviewed the SLAs for 2010 and finds the cost to be prudent.

The second type of payments to affiliates is the payment by EGNB to Enbridge Inc. for its share of the allocation of corporate head office expenses. These corporate allocations have been a significant focus of the annual review for several years. Since 2004, the amount allowed in the Regulatory Financial Statements has been less than

EGNB's total allocation by Enbridge Inc. Certain charges are excluded on the basis that they would not be incurred if EGNB was a stand-alone business.

In the May 16, 2011 decision, the Board indicated that it would continue to monitor the corporate allocations. The Board orders EGNB to file the following:

1. A detailed description of the current methodology used for calculating those portions of the costs allocated by Enbridge Inc. which are included as expenses in the Regulatory Financial Statements.
2. A list of all costs allocated by Enbridge Inc. together with EGNB's position as to whether each of these costs, or a portion of them, would be incurred were EGNB a stand-alone corporation.
3. EGNB's position with respect to how each cost benefits the ratepayers of EGNB.

The above information is to be filed with the Board with EGNB's responses to the first round of interrogatories in the 2012 review or at such time as the Board directs.

With respect to 2010, EGNB increased certain corporate allocations by 3%. EGNB explained the 3% as necessary to cover inflation. No documentation was produced to support the increase. While inflation in 2010 was less than 3%, Mr. Charleson testified that this percentage was chosen to reflect the fact that many of the allocated costs had a significant labour component and labour costs rose faster than inflation.

The Board is not satisfied that the increase applied by EGNB is either prudent or justified. The Board will not allow the 3% increase to those corporate allocations to which it was applied. EGNB is directed to re-file its Regulatory Financial Statements accordingly.

<u>System Expansion Costs</u>

EGNB uses a portfolio method to measure the prudency of expansion costs. In this system, EGNB sums the incremental costs for all of the expansion during the year and compares those total costs to the annualized revenues expected from the year's expansion. This methodology was examined by the Board in its May 16, 2011 decision at which time it approved a system expansion portfolio (SEP) test to determine the prudency of capital additions.

While some issues were raised in the current proceeding, specifically regarding throughput forecasts and lost customers, the evidence was clear that the SEP test was passed in 2010. Mr. Knecht, in his report, recalculated the test with a downward adjustment to the incremental load and revenues to account for some of the concerns expressed. Even with these downward adjustments, he concluded at page 12 that

"EGNB's 2010 performance passes the SEP test by more than the 2 percent required by the Board."

The Board confirms that spending for system expansion in 2010 was prudent.

Other expenses

EGNB's other expenses are, to a large part, fixed. These include Amortization of Property, Plant and Equipment, Municipal and Other Taxes, Interest on Amounts Due to Associates and Affiliates and Other Interest and Amortization of Deferred Development Costs. The Board has reviewed these items and finds them to be prudent.

Conclusion

The Board must, as part of this proceeding, determine the appropriate amount that is to be added to the deferral account as a result of EGNB's prudent spending. The Board will require EGNB to re-file its 2010 Regulatory Financial Statements with the adjustments to the corporate allocation and installation services set out above. The adjusted 2010 financial statements shall be filed with the Board prior to the filing of the 2011 financial statements.

The Board will confirm that the adjustments comply with this decision and will then issue an addendum confirming the appropriate amount to be added to the deferral account.

DEVELOPMENT PERIOD TEST

The Board clarified the two part test for determining the end of the development period in its May 16, 2011 decision. The first part of the test is retrospective. It considers the year in review and determines if the revenues exceed the full costs. EGNB provided an analysis as an attachment to its financial statements which demonstrated that full costs exceeded revenues by approximately $35 million. Accordingly the first test for the end of the development period is not met.

There is no need to consider the second test. The second test is prospective and need only be considered when the first test has been passed.

EGNB remains in the Development Period. The issue will be reviewed again when the Board conducts its retrospective review of the 2011 Regulatory Financial Statements.

GAS SALES in 2010

At the commencement of the franchise period, EGNB was not permitted to sell natural gas. In 2003 the provincial government introduced regulations that allow EGNB to sell gas to its customers under certain conditions. Annually the Board is required, by the Gas Distributor Marketing Regulation, to review the sale of Standard Service Gas, referred to as Enbridge Utility Gas (EUG) and alternative-offer gas products. The review is meant to ensure that the regulations and any relevant Board orders are complied with.

The Board engaged John Butler of JC Butler Management Ltd. to conduct an independent review of the gas sales. Among Mr. Butler's tasks was to ensure that EGNB complied with Section 6 of the Regulation prohibiting cross-subsidization between gas sales and the gas distribution operations.

Mr. Butler filed a report outlining his findings. In his review Mr. Butler noted no significant concerns. He did raise one possible issue of cross-subsidization between standard offer customers and partner's equity and EGNB responded to this by transferring an adjusting amount to the Purchase Gas Variance Account which resolved this issue.

The Board finds that EGNB complied with all relevant regulations and Board orders for 2010.

2012 REVENUE REQUIREMENT

For most utilities, a prospective revenue requirement is generally examined and approved with any necessary modifications. This is not the case for EGNB, since it is still in its development period. The purpose of the Board's examination of EGNB's 2012 Revenue Requirement, is to provide some guidance on items that will require further explanation or detail during the annual review.

Revenue

EGNB projects total revenue of $57.7 million in 2012 from gas distribution. Revenue from gas distribution is projected by multiplying the forecast throughput by assumed rates.

EGNB's rates are not entirely predictable nor wholly within EGNB's control. The reasons for this have been discussed earlier in this decision. For 2012, the changes to the *Gas Distribution Act 1999* and regulations add an additional layer of uncertainty surrounding the issue of rates. The Board is satisfied that EGNB has made its best effort to predict rates in 2012.

Expenses

Operating Expenses

Capitalization

In the past, EGNB capitalized some of its O&M expenses to the Development O&M account. This practice will be eliminated in 2012. Other O&M expenses were capitalized to property, plant and equipment (PP&E) and this practice will continue.

EGNB makes payments to customers as an incentive to attach to their gas distribution system. In the past, these incentives were capitalized to the Development O&M account. These are currently amortized over 40 years.

EGNB now proposes to capitalize incentives as part of PP&E. The Board acknowledges this change, but expects EGNB to be able to defend all capitalized items in accordance with Generally Accepted Accounting Principles (GAAP). It is noted, for example, that incentives are amortized over a longer period of time than service lines. If EGNB wishes to amortize incentives in future years, the Board will require evidence in support of the appropriateness of the policy.

Spending Target

The Board has established that EGNB will be responsible for its throughput forecasts. In 2012, EGNB forecasts 842 new customers and a total throughput of approximately 6,081,000 Gigajoules (GJ). It will be against this throughput forecast that O&M spending will be measured, in keeping with the "spending per throughput" system established in 2010. This results in an O&M/GJ target of $2.84.

This "spending per throughput" target will be a significant indicator of prudence in assessing the 2012 O&M spending. Should EGNB's per GJ spending be above the target, without sufficient justification for variances in throughput or expenses, the excess may not be considered prudent.

System Expansion Test

The SEP test requires that EGNB's incremental revenue exceed incremental costs by a premium of 2%. Mr. Knecht suggests that the Board could increase this premium and expressed concerns about the forecast of incremental load. The Board will not increase the premium at this time, but will continue to monitor this issue on an ongoing basis.

The Board does have concerns regarding the manner in which EGNB projects throughput for the purposes of the test. In assessing the viability of system expansion, EGNB uses specific forecast figures for each individual customer added in a class. These forecasts were, in 2010, often higher than the average consumption in that class of customers.

The Board considers that for the smaller consumption classes it would be preferable to use a conservative approach and assume for system expansion purposes that the added customers will consume at the class average. The Board directs that EGNB use the class average for consumption for the SGSRE, SGSRO and SGSC classes. EGNB may continue to use customer specific estimates for all other classes. In applying the test, EGNB should use the averages for consumption by class included in its revenue projections.

CONCLUSION

This is the second year in which the Board conducted both a retrospective annual review and a prospective consideration of a revenue requirement. The Board will continue to monitor and modify this process as necessary so to ensure an efficient, timely review of these issues.

Dated at the City of Saint John, New Brunswick this 30th day of January, 2011.

Raymond Gorman, Q.C., Chairman

Cyril Johnston, Vice-Chairman

Edward McLean, Member

Terry Totten, Member