

NOVA SCOTIA UTILITY AND REVIEW BOARD

IN THE MATTER OF THE GAS DISTRIBUTION ACT

- and -

IN THE MATTER OF AN APPLICATION by **HERITAGE GAS LIMITED** for the approval of amendments to its Schedule of Rates, Tolls and Charges

BEFORE: Peter W. Gurnham, Q.C., Chair
Kulvinder S. Dhillon, P.Eng., Member
Murray E. Doehler, CA, P.Eng., Member

APPLICANT: **HERITAGE GAS LIMITED**
John C. MacPherson, Q.C.

INTERVENORS: **CONSUMER ADVOCATE**
William L. Mahody, LL.B.

NOVA SCOTIA DEPARTMENT OF ENERGY
Mark Rieksts, LL.B.

NOVA SCOTIA POWER INC.
Nicole Godbout, LL.B.

BOARD COUNSEL: S. Bruce Outhouse, Q.C.

HEARING DATE: November 15, 2010

**CLOSING
SUBMISSIONS:** November 26, 2010

**REBUTTAL
SUBMISSIONS:** December 1, 2010

DECISION DATE: **December 16, 2010**

DECISION: **The Board approves a 6.8% increase in all rate classes for the test period effective January 1, 2011 and ending December 31, 2011.**

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I BACKGROUND

[1] Since Heritage Gas Limited (“Heritage” or the “Company”) accepted a franchise on June 30, 2003, the Board has approved, on four separate occasions, new distribution rates for Heritage. Most recently, the Board approved an application (GTA-08) 2009 NSUARB 15 (2008 Rate Decision), which had set rates effective February 12, 2009 to December 31, 2011.

[2] During the course of a review of Heritage’s plans to expand the distribution system to Bedford and surrounding areas, the Board, because of concerns about the size and operation of the Revenue Deficiency Account (“RDA”), convened an oral hearing on June 4, 2010. In 2004 the Board approved the creation of the RDA which recognized that Heritage was not able to set rates in the early years which were adequate to recover its full cost of service measured by the traditional rate base rate of return approach. The RDA allows Heritage to charge less than the actual cost of service and recover those costs in future years.

[3] In a decision reported at 2010 NSUARB 127 dated June 11, 2010, the Board directed Heritage to cease the practice, which the Board found to be inappropriate, whereby Heritage had been consciously increasing test year expenditures, without a corresponding increase in revenues, thereby adding to the RDA. Further, the Board directed that if Heritage needed to increase its operating, maintenance and administration expenses (“OMA”) the Company should apply for rate relief.

[4] This application (GTA-10) (“Application”) was filed with the Board on August 25, 2010 for a 7.0% increase in rates for all rate classes to be effective January 1, 2011, to offset increases in OMA beyond those forecasted for 2011 in GTA-08.

[5] A hearing into the matter was held on November 15, 2010. Heritage’s panel included Jim Bracken, President; and Chris Smith, Vice-President, Finance and Business Services.

[6] The two intervenors who were active in the hearing were Nova Scotia Department of Energy (“NSDOE”) and the Consumer Advocate (“CA”). Both cross-examined the panel and the CA filed a final submission. The CA also called, as an expert witness, Paul Chernick. Nova Scotia Power Inc. was a formal intervenor but did not participate in the hearing process.

[7] During the course of the hearing and subsequent review of the submissions, the Board has concluded that there are three issues to be decided:

- Is the forecast of 2011 OMA appropriate?
- Should the forecast 2011 delivery revenue be a consideration in setting rates?
- How should any rate increase be allocated among rate classes?

II OMA 2011 FORECAST

[8] In the 2006 rate decision, 2006 NSUARB 142, GTA-06, the Board ordered that elements of OMA be capitalized as set out below:

Department	2009	2010	2011
Executive	0%	0%	0%
Marketing	100%	100%	100%
Engineering	100%	100%	100%
Construction	100%	100%	100%
Operations	0%	0%	0%
Human Resources	0%	0%	0%
Finance & Administration	0%	0%	0%
Regulatory & Public Affairs	100%	100%	100%
Overhead	0%	0%	0%

[Exhibit H-1, p.10-1]

[9] In the Application, Heritage provided a table showing the current 2011 forecast compared to the GTA-08 2011 forecast of OMA:

<u>Expense Category</u>	<u>GTA-08</u>		<u>Adjusted GTA08 Forecast</u>	<u>GTA-10</u>		<u>GTA-10 over GTA-08 Over/(Under)</u>
	<u>2011 Forecast</u>	<u>Reclassification</u>		<u>2011 Forecast</u>		
Salaries and wages	\$ 4,457,363	\$ 21,040	\$ 4,478,403	\$ 5,390,069	\$ 911,666	
Contractor Costs	36,414	-	36,414	50,700	14,286	
Transportation and related	241,414	101,190	342,604	369,115	26,511	
Moving	36,414	-	36,414	40,000	3,586	
Marketing	343,332	-	343,332	390,000	46,668	
Professional and consulting	193,652	-	193,652	365,000	171,348	
Operating expenses	924,606	-	924,606	1,379,000	454,394	
Office expenses	413,241	(122,230)	291,011	305,086	14,075	
Total	\$ 6,646,436	-	\$ 6,646,436	\$ 8,288,970	\$ 1,642,534	
Amount capitalized	3,655,540	-	3,655,540	4,205,409	549,869	
Net OMA	\$ 2,990,896	\$ -	\$ 2,990,896	\$ 4,083,561	\$ 1,092,665	

[Exhibit H-1, p.10-2]

[10] In response to questioning by the CA, Heritage provided a further breakdown of the GTA-10 2011 forecast:

Expense Category	GTA-10		
	2011 Forecast	Capitalized	Net OMA
Salaries and wages	\$ 5,390,069	\$ 2,736,047	\$ 2,654,022
Contractor Costs	50,700	50,700	-
Transportation and related	369,115	189,921	179,194
Moving	40,000	-	40,000
Marketing	390,000	390,000	-
Professional and consulting	365,000	134,546	230,454
Operating expenses	1,379,000	476,270	902,730
Office expenses	305,086	227,925	77,161
Total	\$ 8,288,970	\$ 4,205,409	\$ 4,083,561

[Undertaking No. 1]

[11] In summary, the above tables show that the net OMA, that is the total OMA less the amount capitalized, is now forecast to be \$4,083,561 in 2011, which is \$1,092,665 more than forecasted in GTA-08.

[12] Heritage stated:

... The recovery of this increase in the cost of service requires a 7.0% increase in rates for service to all rate classes (refer to Section 16). This increase is incremental to the GTA-08 approved rate increases that are effective January 1, 2011.

[Exhibit H-1, p. 2-1]

[13] In its opening statement Heritage set the context for the Application:

The requested rate increase is solely to deal with the projected increases in OM&A. We are requesting this rate increase at this time in response to the Board's statement in June 11th, 2010 Decision.

In that Decision, the Board made it clear that increases in OM&A expenses are not to be accumulated in the RDA. The Board's Decision indicated that if Heritage needs to increase such expenses and if revenues are not expected to increase to cover them, then Heritage must request approval of a rate increase.

[Transcript p. 8]

[14] In the Application, section 10, Heritage provided a detailed review of the changes in its operation which have and will contribute to the OMA being higher than forecasted in GTA-08. The changes include additional salaries and wages for 13 new positions equating to 12 full time equivalent employees, transportation and related expenses, moving expenses, marketing expenses, professional and consulting expenses, office expenses and other operating costs.

[15] Four of the new staff positions are yet to be filled. The CA questioned the timing:

MR. MAHODY: Turning, Mr. Smith, to those expense categories, salaries and benefits, your application indicates that there were four additional positions that, at the time that the application was filed, were unfilled. Have I got that correct?

MR. SMITH: Yes.

MR. MAHODY: Okay. Has there been any update or change in that situation?

MR. SMITH: No, there hasn't. We've put all hirings on hold.

MR. MAHODY: Okay. And if they haven't been filled by this point on November 15 in the year before the anticipated test year, is it reasonable to conclude that they'll be filled by January 1st, 2011?

MR. SMITH: It's not likely they'll be filled by January 1st, 2011, no.

MR. MAHODY: And if they're not filled by January 1st, 2011, your anticipated revenue requirement would be less than what you have applied for.

MR. SMITH: Not necessarily because if the -- what we would do is try to hire some short-term resources to help, particularly in the area of finance and business services, which is an area which would be three of the positions.

We would have the potential to recruit short-term resources that would perhaps be more expensive in the short term, but -- as we move towards the permanent hiring of employees to help us in the long term.

MR. MAHODY: And at present, has the company prepared any estimates relating to those costs associated with filling, on a temporary basis, of those positions?

MR. SMITH: No.

[Transcript, pp. 37-38]

[16] The CA also cross-examined the panel on moving expenses and marketing expenses. In its closing submission, the CA said:

The CA would recommend that the Board closely monitor the above-noted expenses to determine whether the anticipated costs are actually incurred. It may be appropriate to consider a credit to the RDA account to the extent that the above-noted expenses are not actually incurred.

[CA Closing Submission, p.2]

[17] In its closing submission, Heritage noted that:

... the evidence filed by the consultant retained by the Consumer Advocate, Mr. Chernick, does not criticize the prudence or necessity of the projected increases in OMA.

Mr. Chernick, in his evidence, stated (transcript, p. 231):

MR. MacPHERSON:

One final area I'd like to address, Mr. Chernick. In your pre-filed testimony there is nothing in that evidence which raises any objections to the expenditures that have resulted in an increased OM&A for 2011. Am I correct?

MR. CHERNICK: That's correct.

[Heritage Closing Submission, p. 3]

Findings

[18] While there was considerable discussion of the increased 2011 OMA forecast, including a detailed role-by-role review of new positions, there was no evidence presented to suggest the forecast should be altered.

[19] The Board appreciates that an OMA forecast will always have a level of uncertainty and actual costs could be higher or lower; however, in the Board's view, Heritage's present forecast for 2011 OMA is reasonable and the Board sees no reason to direct Heritage to modify it.

[20] The Board agrees with the CA that the costs should be monitored and directs Heritage to report forecast versus actual OMA costs as part of its ongoing financial reporting to the Board.

III CONSIDERATION OF 2011 DELIVERY REVENUE

[21] In the Application, Heritage states:

Delivery revenue generated from customer attachments that are forecast to occur in 2011 were not included in the calculation used in determining the required rate increase.

[Exhibit H-1, p. 3-2]

[22] In an IR, the CA asked why the revenue from 2011 customer attachments was not included, to which Heritage responded:

As part of the June 11, 2010 Decision (NG-HG-FIN-2010) which led to the 2010 Application, the Board determined that if increases in OMA were not recovered through increases in billed revenue then Heritage Gas was instructed to apply for rate relief as opposed to allowing the OMA increase to be included in the RDA balance. Heritage Gas' objective in preparing its Application was to ensure that the assumptions utilized would not result in an increase in the RDA related to the increase in OMA.

If revenues in 2011 are less than forecast the RDA balance will increase and will need to be recovered in future rates.

As referenced on page 3-3 of its Application the Company estimated new customer attachments for the remainder of 2010 based on its assessment of customers' readiness for conversion and the timing of ultimate attachment to the Heritage Gas system. Actual attachments may vary from the estimate due to things such as delays in permitting, delays in or failures of customers signing agreements and paying deposits, and delays in work required by third party contractors to install equipment. As a result, delivery revenue in 2011 may vary depending on customer attachments over the remainder of 2010 and the timing of customer activations in 2011. The delivery revenue expected in 2011 from 2011 activations is only \$0.6 million; the forecast annualized delivery revenue from late 2010 forecast attachments is \$3.0 million. If 20% of these 2010 expected attachments do not materialize, the shortfall in customer attachments in the September - December 2010 period would be offset by the contribution of customer attachments in 2011.

[Heritage Response to CA IR-9]

[23] In CA IR-10, Heritage was asked to recalculate the requested rate increase assuming the projected revenue from 2011 customer attachments was included. Heritage's response included a table which indicated the increase would be reduced from 7.0% to 6.8%.

[24] This issue was explored in cross-examination by the CA:

MR. MAHODY: ...:And in this IR, the Consumer Advocate has asked the company to recalculate its request for rate increase to reflect customer additions in 2011. And on the next page is the company's response.

And so to be clear, Mr. Bracken, you don't disagree that if you were to factor in the 2011 revenue that your requested increase would move to 6.8 percent. You agree with that. You're just disagreeing whether or not it should occur in any event.

MR. BRACKEN: That's right.

MR. MAHODY: The OM&A expenses which you seek in this application, Mr. Bracken, relate to the anticipated revenue in 2011. Correct?

MR. BRACKEN: That's right.

MR. MAHODY: And to the degree to which you're not including 2011 revenue because you're unsure whether or not it's going to be achieved, have you applied any type of similar negative factor to the expenses which you're going to require?

MR. BRACKEN: Not specifically.

MR. MAHODY: So you're trying to seek all of the expenses but not include all of the revenue.

MR. BRACKEN: Well, the expenses do have some variability and some forecasting risk to them as well.

MR. MAHODY: But again, you're seeking recovery of 100 percent of your anticipated increases, but not 100 percent of your anticipated revenue.

MR. BRACKEN: That's right.

[Transcript, pp. 85-86]

[25] The Board requested further clarification:

MR. DHILLON: Okay. The other one I have is that in answer to, I think, Mr. Mahody's question about why the surplus or why the new revenues in 2011 are not included in the calculation of the rates for 2011, and the answer I think Mr. Bracken gave us, that there are certain base customers which may be at risk in 2010 and to overcome that you

haven't included the new revenues in 2011 in calculating the rates for 2011. And in Mr. Outhouse's question you say you're pretty confident that you will achieve 2010 targets which is in this report. So I'm not sure which one is true.

MR. BRACKEN: Well, they're both true. When we filed this we had less certainty around that than we do today, but I am confident that we will hit our revenue projections that we've got in here for 2010.

MR. DHILLON: So the 2010 base is reasonably sure from your point of view?

MR. BRACKEN: I wouldn't call it certain but based on all of the work we're doing between now and the end of December, barring some weather problems or further delays from customers and installation contractors, it's looking good.

[Transcript, pp.175-176]

...

Could you just explain to me again your answer as to why you don't think it's appropriate to make the adjustment from 7 percent to 6.8 percent based on anticipated 2011 sales?

MR. BRACKEN: It's largely a conservatism.

THE CHAIR: Sorry?

MR. BRACKEN: It's largely conservatism. As I mentioned, we still had risk, particularly when we filed this, and even today we have some risk of finishing the year with as many customer additions as we've got in here and whether they're all in the same categories and have the same revenue effects in 2011. And the 2011 effects of customers added in the year, because they come so late in the year, have a relatively small impact on the revenue calculation for that year.

THE CHAIR: But to have apples and apples, don't you have to have -- don't you have to assume revenue from the number of customers you're going to have in a test year?

MR. BRACKEN: Well, this is just for purposes of calculating the 7 percent. Our forecast is that we would have some customers being added in the year.

THE CHAIR: I realize that, but shouldn't we be attempting to determine what your actual revenues are going to be based on the customers you expect to have in the test year if we're going to give you increased revenues for the test year?

MR. BRACKEN: I agree. It's just a matter of what you include in the estimates for ---

THE CHAIR: But you're not including anything.

MR. BRACKEN: Not -- that's right. We're not including anything for the '11 adds.

THE CHAIR: So are we then comparing apples and apples if we're not doing that?

MR. BRACKEN: Well, again, it's just a matter of assuming how much of that you think will be revenue in the year.

THE CHAIR: Okay.

[Transcript, pp.189-191]

Findings

[26] The Board is not persuaded that it is appropriate to exclude delivery revenue from customer attachments forecast to occur in 2011. Heritage argued that there is risk associated with the forecast attachments and they should not be considered.

[27] In the Board's view there is also risk associated with the OMA forecast. For example, as noted above, Heritage does not expect some new staff resources to commence work at the beginning of the year. Indeed, it could be up to 3 months into the year before all proposed FTEs are placed. Heritage indicated that additional contractors could be employed to fill the gap. This could have an effect on the OMA.

[28] The Board finds that to properly set test year rates it is appropriate to take into account assumed test year revenues in addition to test year expenses. Therefore, for a balanced treatment of the calculation of the proposed rate increase, both costs and revenues in the test year will be included. Heritage's calculations show that, with year 2011 new customer revenues included, the requested increase would be reduced from 7.0% to 6.8%.

[29] The Board finds that an increase of 6.8% is appropriate.

IV ALLOCATION AMONG RATE CLASSES

[30] In the Application, Heritage requested a uniform percentage increase to all charges in all rate classes. Heritage did not provide any analysis of cost causation or any other means of allocating the rate increase differently among the various rate classes. In its opening statement, Heritage said:

The rate increase is proposed to be the same for each rate class – that is 7% across the board. The 7% increase for all rate classes is not based on a cost of service study or other rate design principles. Heritage Gas last prepared a cost of service study in 2008. It was filed and used as the basis for rate increases approved by the Board for three consecutive years. We are planning to have a new cost of service study for filing in our next main rate proceeding, along with a number of other studies which are likely to impact cost of service. In the absence of a cost of service study and the consideration of other rate design principles, a straight across-the-board rate increase is appropriate. The uniform 7% is neutral to any cost allocation or rate design considerations. It neither increases nor decreases the allocation of costs to one rate category over another.

[Exhibit H-8 pp. 1-2]

[31] The CA expressed concern with the lack of a more sophisticated analysis:

The CA clearly appreciates the dilemma faced by the Board in this application. A cost of service utility comes forward proposing an increased revenue requirement absent any attempt to apply cost of service or cost causation principles.

The dilemma faced by the Board is mitigated to the extent that Heritage is obligated to return in 2011 with a heavily documented rate case which will allow a thorough investigation and determination of fair rates.

The proposed 7% across the board increase by Heritage fails to adequately reflect the varying experiences of its customer classes. Whatever increase is allowed will be layered onto the previously approved rates for 2011. To the degree that an across the board rate increase layers on rates set pursuant to an antiquated COSS, any class inequities will be accentuated.

[CA closing submission, p. 3]

[32] The CA's consultant, Mr. Chernick, was uncomfortable with Company's simplistic approach, but agreed that other approaches might be no better:

MR. OUTHOUSE: And I guess you haven't given a number, and my question to you is -- and I guess Mr. MacPherson asked it perhaps in a slightly different way -- if the Board

was going to go that route, how would it make an intelligent allocation? How could it allocate these costs other [than] going position by position and trying to make some assessment of whether -- and I'm talking now to the new positions, make some assessment of whether they were focused on Rate Class 1 as opposed to the other three rate classes?

MR. CHERNICK: Well, what the company has asked the Board to do in this proceeding is to do something arbitrary and simple, which is an equal percentage across-the-board increase.

You could do something else that was equally arbitrary and equally simple that would put more of the increase on the larger customers, such as making an equal cent per gigajoule charge, or you could say we're going to -- if the increase is 6.8 percent we'll increase Schedule 1 by 3.4 percent and the other schedules by whatever is necessary to make up the difference.

You could look at a number of simple approaches that would lean in that direction, and it would be arbitrary but then so is an equal percentage across the board.

[Transcript, pp 235 - 236]

[33] In direct testimony, Mr. Chernick suggested the increase be weighted more heavily to Rate Classes 2, 3 and 4:

Q: How does Heritage propose to allocate the increased revenue requirements among the rate classes?

A: Heritage proposes to increase revenues from each rate schedule by the same percentage, specifically 7% (CA-IR-20).

Q: Is that a reasonable approach?

A: No. Heritage has not analysed the cost causation for the additional OM&A expenses (ERI-IR-1)[sic].

Part of the increase in Heritage's OM&A expenses appears to be related to Heritage's increased efforts to market gas to large customers and design and install new connections. Since Heritage is not encouraging smaller customers to connect (as I describe in more detail in Section V below), these marketing efforts are not likely to benefit small customers in the next several years, until and unless Heritage finds a way to draw down its revenue deficiency account. Hence, any OM&A allowed in this case should be allocated more heavily to Schedules 2, 3, and 4 than to Schedule 1.

[Exhibit H-5 pp. 5,6]

[34] However, in cross-examination, Mr. Chernick conceded that given the unusual circumstances, a simple approach is probably preferable:

MR. CHERNICK: Well, the intrinsic merit is that it's very simple.

MR. OUTHOUSE: Yes.

MR. CHERNICK: And it avoids making a lot of detailed decisions about individual items that are hard to decide about, and given the amount of money involved and the fact that the rates are only going to be placed for one year, probably isn't worth anybody's effort to try and pull it all apart and put it back together again.

...

MR. OUTHOUSE: But you acknowledge that given the amount involved and the fact that the rates are going to be in place for one year, it may be a good reason, as you say, not to pull it -- try and pull it all apart at this stage?

MR. CHERNICK: Right. So you'd want to do something simple.

[Transcript p. 237-238]

Findings

[35] The Company's current rates have as their basis a cost of service study ("COSS") which was conducted in support of GTA-08. Although it is probable that some variables in that study have changed, the Board is satisfied that no better information is available on which to base its Decision.

[36] In the absence of a current COSS, the Board agrees that the allocation of the rate increase should be simple and transparent.

[37] The Board believes that tweaking the way the increase is allocated across rate classes would involve effort that would be disproportionate to any potential benefit, particularly where the Board does not have an up-to-date COSS.

[38] Heritage stated it will be making a complete rate application by midyear 2011 which will include the necessary detailed studies to support a revised schedule of rates, including a complete analysis of the allocation of costs.

[39] The Board finds that Heritage's proposed allocation of the rate increase across rate classes is reasonable and appropriate for this Application.

V OTHER MATTERS

[40] During the course of the hearing, several other matters were raised that are related to the Company's ongoing and upcoming regulatory activities:

- Status of the preparation of reports and studies which Heritage was directed to provide prior to, or as part of, its GTA-11 application;
- Return on rate base, capital structure and cost of debt;
- Variances in OMA that flow to the RDA;
- Deferral of costs of regulatory proceedings;
- Service line costs;
- Economic feasibility tests;
- Gas Cost Variance Account – customer education;
- International Financial Reporting Standards.

[41] These issues, while important in their own right, did not need to be determined in this hearing. Nonetheless, the Board understands that parties wish to ensure that these issues continue to receive an appropriate amount of focus and anticipates that some, if not most of them, will be examined in greater depth during the GTA-11 proceeding.

VI COMPLIANCE FILING

[42] Heritage is directed to file a compliance filing with rates as amended in this Decision for final approval by the Board as soon as possible.

VII SUMMARY OF FINDINGS

a) Approval of rates

[43] The Board approves a 6.8% increase in all rate classes for the test period effective January 1, 2011 and ending December 31, 2011.

b) Reporting to the Board

[44] Starting with its 2011 financial reporting to the Board, Heritage shall include a comparison of GTA-10 forecast versus actual OMA costs for the reporting period.

DATED at Halifax, Nova Scotia, this 16th day of December, 2010.

Peter W. Gurnham

Kulvinder S. Dhillon

Murray E. Doehler