



EB-2010-0042

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

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. for an order or orders approving the clearance or disposition of amounts recorded in certain deferral or variance accounts.

BEFORE: Paul Sommerville
Presiding Member

Paula Conboy
Member

DECISION AND ORDER

STOCK-BASED COMPENSATION EXPENSES IN THE 2009 EARNINGS SHARING CALCULATION

Enbridge Gas Distribution Inc. (“Enbridge” or the “Company”) filed an application dated April 16, 2010 (the “Application”) with the Ontario Energy Board (the “Board”) under section 36 of the *Ontario Energy Board Act, S.O. 1998, c.15*, Schedule B (the “Act”) for an order approving the disposition of balances in certain deferral or variance accounts. The Board assigned file number EB-2010-0042 to the Application and issued a Notice of Application & Procedural Order No. 1 on May 6, 2010.

A Settlement Conference was held on June 21, 2010. The Board issued its Decision and Procedural Order No. 2 on July 8, 2010 in which the Board accepted the Settlement Agreement filed in the proceeding. The Settlement Agreement resolved all of the issues except one. The unresolved issue related to the amount of Enbridge's 2009 stock-based compensation costs included within its operating and maintenance expenses used to determine the utility earnings for earnings sharing purposes ("SBC Issue"). The Board framed the SBC Issue as follows:

Is the amount included for stock-based compensation expenses in Enbridge's 2009 Earnings Sharing calculations appropriate?

To address the SBC Issue, the Board scheduled a written hearing process including the filing of evidence, interrogatories, argument, submissions and reply argument.

Background

In 2009, Enbridge included \$4.3 million for costs related to stock-based compensation ("SBC") in its operating and maintenance expense used in the calculation of utility earnings for earnings sharing purposes. These costs were allocated to Enbridge by its parent Enbridge Inc. ("EI") according to the Board-sanctioned Regulatory Cost Allocation Methodology ("RCAM").

Stock-based compensation ("SBC") is an employee bonus and incentive arrangement related to the price of a company's stock. It is intended to reward the employee for services, over and above the employee's base salary. Certain senior officers and employees of Enbridge are granted a stock-based compensation program from EI that contains within it three separate plans: Incentive Stock Options ("ISO"), Restricted Stock Units ("RSU") and Performance Stock Units ("PSU"). SBC is intended to provide both a performance incentive and a retention incentive for participating employees.

The following is a brief description of each plan and the accounting approach currently used by Enbridge to recognize both the timing and the amount of the expense.

Incentive Stock Options: The ISOs provide employees with the the right to purchase common shares of the parent company Enbridge Inc. ("EI") at a specified price during a specific period of time. The purchase price (or strike price) of EI's options are set at the

market price of EI's shares on the date the options are granted. These options vest in equal annual installments over a four-year period and expire ten years after the grant date. Enbridge expenses the fair value at the date of grant of ISOs evenly over each year of the vesting period of four years.

Restricted Stock Units: The RSU plan grants notional units as if one unit was one EI common share. RSU holders receive cash per outstanding unit equal to EI's weighted average share price at the time of maturity, 35 months from the date of the grant. The outstanding units accumulate notional dividends during their validity. RSU grants are expensed over the 35 month duration of their validity. Changes in EI's stock price are typically recognized for RSU expensing calculations.

Performance Stock Units: The PSU plan grants notional units as if one unit was one EI common share. PSU holders receive cash awards following a three-year performance cycle. Awards are calculated for each outstanding unit at the end of the performance period using the EI weighted average share price and a performance multiplier. PSU grants are expensed over the three-year duration of their validity using a formulaic based approach, which makes reference to the EI stock performance relative to a pre-determined peer group.

The School Energy Coalition ("SEC") made submissions on the SBC Issue. The Vulnerable Energy Consumers Coalition ("VECC") was the other party to provide a submission. VECC's submission supports all of the main elements of SEC's submission. In addition, VECC raised the matters of earnings sharing impacts and the prudence of the SBC costs, which are increasing during the Company's incentive regulation plan period. The Building Owners and Managers Association of the Greater Toronto Area, Consumers Council of Canada, Canadian Manufacturers & Exporters and Energy Probe filed letters in support of SEC and VECC. As a matter of convenience the Board refers mainly to the elements of SEC's proposal in this Decision and Order.

SEC argued that the Board should review the accounting for the SBC plan components and establish an alternate regulatory accounting treatment for the ISOs and RSUs. For PSUs, SEC argued that they should be disallowed from ratepayer recovery entirely. The basis for SEC's suggested accounting treatment appears to be related mostly to the tax treatment given to SBC by the Canadian taxation authorities. The taxation treatment differs from the treatment required under Canadian Generally Accepted Accounting

Principles (“GAAP”), the accounting guidance currently adopted by the Company. SEC’s proposed regulatory accounting treatment is to delay the timing of the recognition of the SBC expense associated with ISOs and RSUs until the date of exercise of the option or payment of the award, as applicable. The methodology proposed by SEC impacts the SBC expense amount, and consequentially the earnings sharing amount for 2009.

If the Board were to adopt SEC’s proposal, no amount of the \$4.3 million stock-based compensation expense would be included in the 2009 earnings sharing calculation.

The Canadian Institute of Chartered Accountants (“CICA”) Handbook provides specific guidance on the timing of expense recognition for entities with a stock-based awards program. The GAAP accounting treatment, as followed by Enbridge, allocates the SBC costs over the vesting period in which the employee’s services are rendered. The CICA addresses the matter of SBCs in its handbook under Section 3870.

The CICA Handbook, at section 3870, paragraph 49 provides as follows:

49. The compensation cost for a stock-based award to employees should be recognized over the period in which the related employee services are rendered, by a charge to compensation cost if the award is for future service. If the service period is not defined as an earlier or shorter period, the service period should be presumed to be the period from the grant date to the date that the award is vested and its exercisability does not depend on continued employee service. If an award is for past services, the related compensation cost should be recognized in the period in which it is granted. Where the award consists of equity instruments, the offsetting entry is to shareholders' equity.¹

As historical context to the issue, on September 27, 2007 Enbridge filed a Supplementary Settlement Proposal with the Board concerning the RCAM cost allocation methodology as part of Phase I of the 2007 cost of service rates proceeding under Board file EB-2006-0034. The level of costs produced by the RCAM methodology was accepted for inclusion within the utility O&M expenses. The agreement was approved by the Board; however, two items remained outstanding. One item related to the recoverability of the costs of SBC embedded within the RCAM methodology and the other was the recoverability of the costs of raising equity capital.

¹ Paragraph 49, Section 3870 of the CICA Handbook. Enbridge referenced this paragraph as Paragraph 48 of Section 3870 of the CICA Handbook; however the reference should instead be Paragraph 49.

Both items were reviewed and decided by the Board in its May 20, 2008 Decision with Reasons in the EB-2006-0034 Phase II proceeding. With respect to SBC costs, the Board determined that the RCAM-allocated costs related to SBC were appropriate for ratepayer recovery.

BOARD FINDINGS

The Board addresses each of the three plan types and set out its findings in relation to each plan below.

Incentive Stock Options

Central to the SEC argument is that the ISO expense should be calculated and recognized for regulatory purposes at the time of the exercise of the option, in contrast to an amortization of the expense over a number of years. SEC makes reference to the *Income Tax Act* in which SBC is treated differently than the accounting guidance provided by the CICA. SEC pointed out that the *Income Tax Act* requires recognition of stock options for taxation purposes as compensation at the time the option is exercised. GAAP requires amortization of the SBC over a number of years, in relation to the period in which the employee's services are rendered. In SEC's view the federal tax legislators got it "right" while the accounting rules did not. SEC submits that the treatment for tax purposes is a more conceptually sound approach, and therefore the Board should develop a regulatory accounting treatment for the SBC along these lines.

SEC identified some matters for consideration by the Board in support of its position. In addition to the tax treatment, SEC observed that its approach may offer a more appropriate matching of costs to the employee benefit and that it is appropriate to defer recovery until the SBC amount is known with more certainty.

The Board is not persuaded that the tax treatment approach warrants the change in regulatory accounting suggested by SEC. Both Enbridge and SEC acknowledge that GAAP and tax treatments often differ in particular situations. In this situation, the existence of differing treatments for tax and GAAP by itself is not of sufficient concern to the Board to prompt it to change the methodology.

The expense for the ISO is matched to the points in time at each of the four years when the right to the ISO vests. Enbridge expenses the value of ISO grants evenly over the four years of the vesting period. The expenses are therefore recognized over the period in which the employee services are rendered, as the CICA Handbook provides. The Board observes that the matching referred to by SEC is derived from the tax legislation applicable to corporate taxation or incurrence of expense by the corporation for tax purposes and, as such, is of limited assistance to the Board in considering this matter. The Board concludes that the GAAP accounting treatment as provided by the CICA Handbook, which uses the vesting time period as the basis of matching, is a rational, systematic and appropriate manner to match the costs of the ISO grant to time periods.

With regard to the question of the uncertainty of the amounts, the Board agrees with SEC that the amount of expense is known with absolute certainty only when the vested options are exercised. However, the Board does not consider the level of uncertainty that comes with recognition over a period of time is an issue that would support altering the accounting treatment of the ISO expense.

SEC has not suggested that the treatment adopted by the Company for SBCs is not in conformance to GAAP. The Board notes that the Company has received an unqualified or “clean” audit opinion from its external auditors.

The Board does not generally depart from the guidance of GAAP and finds no reason to do so in the case of ISOs.

The Board therefore finds that there is no need to alter the ISO amount included in the calculation of earnings to be shared for 2009.

Restricted Stock Units

SEC argued that the RSU amounts are primarily a retention incentive and should be treated as a deferred bonus, in which no liability exists until the date of payment and should be considered regulatory expenses only when they are paid.

The Board acknowledges that the RSU is similar to a deferred cash award. However, the amount of the award is related to EI share performance over a period of 35 months. The Board is not persuaded that the underlying concept of RSUs is fundamentally

different than the ISOs. Both plans are conceptually stock-related and this is reflected in the inclusive language of the CICA Handbook when it refers to “stock-based awards”.

For the same reasons as outlined above with respect to the ISO, the Board finds that the treatment accorded to RSUs by the Company is reasonable. The Board believes it entirely appropriate to match the amount of the cost to the intervening months during which the award is earned rather than reserving recognition until the cash award date. The amortization approach provides a suitable basis for accruing the cost over the time periods giving rise to those costs. Given the appropriateness of the approach, the Board finds that the amounts for RSUs as filed by Enbridge are appropriate as expenses for the 2009 earnings sharing calculation.

Performance Stock Units

SEC submitted that the PSUs should be disallowed for rate recovery because they are structured solely to target earnings maximization in the parent company and not the utility or its ratepayers. Enbridge countered that the gas utility is a significant contributor to EI's operations, so success by Enbridge will translate into success at EI. Enbridge also submitted that ratepayers benefit from the fact that PSUs are part of a compensation package that is designed to ensure the retention of experienced and expert managers at the utility.

The Board addressed the matter of ratepayer recovery when it approved Enbridge's SBC costs for rate recovery in its Decision on May 20, 2008 in the Board's Decision EB-2006-0034 Phase II. In that Decision the Board noted that stock options are an important element of executive compensation. Although the Board did not specifically address the features of the PSU plan itself, it was supportive of the concept of stock-based compensation as being appropriate costs to be recovered from ratepayers. At this time, it is the Board's view that the PSUs are appropriately included as SBC costs in the calculation of earnings sharing.

As for the timing and pattern of recognition of the cost of PSUs, the Board supports the treatment put forward by the Company for the same reasons provided for ISOs and RSUs.

The Board notes that at the present time, Enbridge is at the mid-term of its 5-year Incentive Regulation plan ("IR Plan"). The base rates established for the IR Plan notionally include SBC amounts through the RCAM. The accounting treatment has passed the external auditor's examination. The costs have been included within the RCAM corporate cost allocations and the SBC expenses have been accepted for inclusion in the earnings sharing calculation for the 2008 fiscal year. The Board does not find sufficient merit in the arguments brought forward by SEC to introduce a revision to the basis upon which the IR Plan has already been engaged. Given the current status of the IR Plan, any party faces a relatively high standard to persuade the Board that changing accounting methodologies mid-term is the right and just thing to do. SEC has not met this standard.

For all of these reasons, the Board concludes that the accounting for SBCs undertaken by Enbridge is an appropriate basis for ratepayer recovery and inclusion in the 2009 earnings sharing calculation.

Looking forward to the next generation of incentive rate-making, the Board observes that there may be some merit in a more thorough exploration of how the PSU plan and the incentives associated with it serve the interests of the ratepayers at the utility. While unwilling to consider the matter further in the midst of the current IR Plan, the Board considers that it may be appropriate to review the PSUs to ensure the appropriate balance is struck between ratepayer's interests and shareholder's interests. Should parties wish to explore this matter they may do so at the time of Enbridge's next cost of service rebasing application.

In conclusion, and for the aforementioned reasons, the Board will order no adjustment to the amount of the SBC expenses included in the earnings sharing calculations for 2009.

In terms of implementation, the Board notes that the Settlement Agreement contemplates that the subject deferral and variance accounts should be cleared in conjunction with the upcoming January 1, 2011 QRAM application. The Board also notes that Enbridge has agreed to file a Draft Rate Order with respect to the clearances.

The Board will make the following provision for submissions on cost awards relating to this proceeding.

THE BOARD ORDERS THAT:

1. Parties eligible for a cost award shall submit their cost claims by November 22, 2010. A copy of the cost claim must be filed with the Board and a copy is to be served on Enbridge. Cost claims must be prepared in accordance with the Board's *Practice Direction on Cost Awards*.
2. Enbridge will have until November 26, 2010 to object to any aspect of the costs claimed. A copy of the objection must be filed with the Board and one copy must be served on the party against whose claim the objection is being made.
3. Any party whose cost claim was objected to will have until December 1, 2010 to make a reply submission as to why their cost claim should be allowed. One copy of the submission must be filed with the Board and one copy is to be served on Enbridge.

All filings to the Board must quote file number EB-2010-0042 and consist of two paper copies and one electronic copy in searchable / unrestricted PDF format filed through the Board's web portal at www.errr.oeb.gov.on.ca. Filings must clearly state the sender's name, postal address and telephone number and, if available, a fax number and e-mail address. Please use the document naming conventions and document submission standards outlined in the RESS Document Guideline found on the "e-Filing Services" webpage of the Board's website at www.oeb.gov.on.ca. If the web portal is not available you may email your document to BoardSec@oeb.gov.on.ca.

DATED at Toronto, November 10, 2010

ONTARIO ENERGY BOARD

Original signed by

Kirsten Walli
Board Secretary