E.B.O. 179-14
E.B.O. 179-15

IN THE MATTER OF the Ontario Energy Board Act, R.S.O. 1990, c. O.13;

AND IN THE MATTER OF an Application by The Consumers' Gas Company Ltd. for an order or orders approving rates to be charged for the sale, distribution, transmission and storage of gas for its 1999 fiscal year;

AND IN THE MATTER OF an Application by The Consumers' Gas Company Ltd. for all necessary approvals of transactions related to the transfer of certain customer information systems to an affiliate;

AND IN THE MATTER OF an Application by The Consumers' Gas Company Ltd. for all necessary approvals of transactions related to the transfer of certain businesses and activities to one or more affiliates;

AND IN THE MATTER OF an Application by The Consumers' Gas Company Ltd. for approval of an incentive mechanism in relation to the Operation and Maintenance Expense component of its cost of service, effective during the 2000 through 2002 fiscal years, and an incentive mechanism in relation to Demand Side Management.

BEFORE: H.G. Morrison
Presiding Member

P. Vlahos
Member

DECISION WITH REASONS

March 31, 1999

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APPENDICES

Appendix A - Portion of the Settlement Agreement

1. INTRODUCTION

1.1 THE APPLICATION AND PROCEEDING

1.1.1 The Consumers' Gas Company Ltd. ("Enbridge Consumers Gas" or "the Company") filed an Application with the Ontario Energy Board ("the Board") dated January 8, 1998 ("the Application"), for relief on a number of matters. The details of the application are contained in the Board's Decision with Reasons in E.B.R.O. 497, issued August 30, 1998. The present Proceeding addresses approvals requested by the Company for transactions between itself and an affiliate and for specific regulatory treatment of certain programs.

1.1.2 The procedural framework for this Proceeding was set out in Procedural Order No. 5 issued in October 1998. As a result of this Order, one Proceeding was constituted for the Company's proposed targeted Performance Based Regulation or PBR (E.B.R.O. 497-01) and another for the matters described in this Decision (E.B.O. 179-14 and E.B.O. 179-15).

1.1.3 Procedural Order No. 5 provided for the oral hearing into this matter to commence on December 16, 1998; Procedural Order No. 6 set dates for a technical conference, a settlement conference and the exchange of interrogatories. The Board was advised on December 15, 1998 by the Minister of Energy, Science and Technology that the Government had approved new Undertakings of the Company to be effective March 31, 1999 ("the 1998 Undertakings" or "the new Undertakings"). The 1998 Undertakings superseded the 1994 Undertakings and will be in effect at the time the proposed transactions would take place. While the 1994 Undertakings had required the Board's approval for affiliate transactions and diversification activities of the type proposed, the new Undertakings removed that requirement. Board approval is therefore no longer required for the transfer of ancillary activities to an affiliate, but Board approval is required to retain such activities within the regulated utility.

1.1.4 At the outset of the hearing of the Application on December 16, 1998, the Board requested the Company and intervenors to make submissions on the effect the new Undertakings would have on the Company's Application. Having heard the submissions, the Board requested the Company to consider whether or not it wished to reframe its application in light of the new Undertakings. The Company provided a reframed application on December 18, 1998. This reframed application, as clarified by the Company in its Argument-in-Chief, is set out in detail in the next Chapter.

1.1.5 Having received the reframed application, the Board requested submissions from the Applicant and parties as to the appropriate timetable for continuing the Proceeding and, having received those submissions, the Board issued Procedural Order No. 7 on December 23, 1998. This Procedural Order established a revised issues list and ordered that the oral hearing commence on January 11, 1999. The oral hearing required seven hearing days, concluding on January 25, 1999. The argument phase was completed on March 8, 1999.

1.1.6 Copies of all the evidence, exhibits and argument filed in the Proceeding, together with a verbatim transcript of the hearing, are available for review at the Board's offices. While the Board has considered all of the evidence and submissions presented in this hearing, the Board has chosen to cite these only to the extent necessary to clarify specific issues on which it has made findings.

1.2 THE SETTLEMENT PROPOSAL

1.2.1 A Settlement Conference for E.B.O. 179-14 and E.B.O. 179-15 was held by the parties commencing November 16, 1998 and resulted in the settlement of only one of the issues, the one related to energy use and demand-side management programs. The settlement of this issue, as set out in the Settlement Proposal is described in Appendix A. The final result of the Settlement Proposal was presented to the Board on December 1, 1998. The settlement was accepted by the Board subject to updates, changes necessary as a result of the Board's Decision on unsettled matters, or as a result of unforeseen events.

1.3 PARTIES TO THE PROCEEDING

1.3.1 Thirty-five parties intervened. Below is a list of parties, including the Company, and their representatives who participated actively in the oral hearing by cross-examining or filing argument.

The Consumers' Gas Company Ltd. ("Enbridge Consumers Gas")	Jerry Farrell Fred Cass
Alliance Gas Management Inc. ("Alliance Gas")	Brian Dingwall

Alliance of Manufacturers and Exporters, Canada ("AMEC")	Beth Symes C. Street
Association of Municipalities of Ontario ("AMO")/ECNG Inc. ("ECNG")	Peter Scully
Coalition for Efficient Energy Distribution ("CEED")	George Vegh Elizabeth DeMarco
Consumers Association of Canada ("CAC")	Robert Warren
Energy Probe Foundation ("Energy Probe")	Mark Mattson
Green Energy Coalition ("GEC")	David Poch
The Heating, Ventilation and Air Conditioning Contractors Coalition Inc. ("HVAC")	Ian Mondrow
Industrial Gas Users Association ("IGUA")	Peter Thompson Bryan Carroll
Ontario Association of Physical Plant Administrators ("OAPPA")	Michael Morrison

Ontario Association of School Board Officials/Metropolitan Toronto Separate School Board (“the Schools”)	Thomas Brett
Ontario Coalition Against Poverty ("OCAP")	Michael Janigan Philippa Lawson
Pollution Probe Foundation ("Pollution Probe")	Murray Klippenstein
Union Energy Inc. (“Union Energy”)	Donald Rogers
Canadian Association of Energy Service Companies (“CAESCO”)	Thomas Brett
Coalition of Eastern Natural Gas Aggregators and Sellers (“CENGAS”)	Richard Perdue

1.3.2 In addition, the Board received three letters requesting observer status from other organizations and individuals, and two letters of comment expressing concerns regarding the Company's request to increase rates.

1.3.3 The Enbridge Consumers Gas’ employees who appeared as witnesses are shown below.

L.A.E. Beattie	Vice-President, Energy Supply and Storage

R.A. Bourke	Manager, Regulatory Accounting
D. Charleson	Manager, Accounting Systems
G. J. Hills	Vice-President, Regulatory and Legal
J.A. Holder	Vice President, Market Development
W. Lomax	Manager, Financial Studies
R. Rackus	General Manager, Central Region
W. B. Taylor	Director, Financial and Economic Studies

1.3.4 In addition, the Company called the following witnesses:

K. McShane	Vice-President and senior consultant of Foster Associates Inc.

1.3.5 HVAC called the following witnesses:

R. Grochmal	Owner, Atlas Air Conditioning Company and Chair - HVAC Coalition
M. Luymes	Manager, Heating, Refrigeration and Air Conditioning Contractors of Canada (“HRAC”), a division of the Heating Refrigeration and Air Conditioning Institute of Canada (“HRAI”)

P. Messenger	President and Owner of Messenger Mechanical Inc. under the trademark of A1 Air Conditioning and Heating

1.3.6 CAC, IGUA, OCAP and HVAC called the following witness:

Dr. J. Bauer	Associate Professor in the Department of Telecommunication, Michigan State University and a Research Associate in the Institute of Public Utilities.

2. THE COMPANY'S PROPOSAL AND PARTIES' VIEWS

2.1 THE ORIGINAL APPLICATION

2.1.1 In its original Application dated January 8, 1998, the Applicant proposed to separate and remove (or unbundle) the following from the existing operations of the regulated utility:

- its Merchandise Sales Program (or Merchandise Business Unit);
- its Heating Parts Replacement Plan or HIP; and
- approximately one half of the service operations currently provided to customers by the regulated utility under its Customer Maintenance Programs and Customer Appliance Repair and Diagnostic Service.

2.1.2 These ancillary services, together with the non-utility Merchandise Finance Program ("MFP") were proposed to be transferred to Consumersfirst Ltd. ("Consumersfirst"), a non-subsidiary affiliate of the Company, on October 1, 1999. The Company's proposal would result in Consumersfirst operating the transferred businesses outside of regulation. The Company proposed that its Natural Gas Vehicle Program ("NGV") and its rental program remain within the regulated utility, although it proposed to wind-down its rental program gradually.

2.1.3 As part of its Application, the Company requested the establishment of an Unbundling Business Activities Deferral Account to record costs incurred in the 1998 and 1999 fiscal years in relation to the transfers proposed. In addition, the Company requested approval of the Board for the ratemaking implications of its proposals relating to the rental program, including approval for the recovery from ratepayers of unrecorded deferred income taxes in relation to the program. This original Application was framed under the 1994 Undertakings.

2.2 THE REFRAMED APPLICATION

2.2.1 As noted in Chapter 1, the Board was advised that the 1998 Undertakings would supersede the 1994 Undertakings. While the 1994 Undertakings had required the Board's approval for affiliate transactions and diversification activities of the type proposed, the new Undertakings removed that requirement, replacing it with the following:

> *Consumers shall not, except through an affiliate or affiliates, carry on any business activity other than the transmission, distribution or storage of gas, without the prior approval of the Board.* (Article 2.1)

2.2.2 The reframed Application, under the new Undertakings, as clarified during the hearing, was described by the Applicant in its Argument-in-Chief as follows:

The Company requests that the Board grant the following under Article 2.1 of the 1998 Undertakings:

- *prior approval for the Company to carry on the business activity known as the Rental Program, in a wind-down mode, on and after October 1, 1999*

until the wind-down is completed, including the Rental Service Agreement with Consumersfirst Ltd. during the initial five years; and

- *prior approval for the Company to carry on the business activity known as the ABC-T Program, in its current format, on and after October 1, 1999 and until the Board determines that the program should be discontinued.*

The Company also requests that the Board approve the following for rate-making purposes:

- *an Unbundling Business Activities Deferral Account in order to record and recover reasonably incurred costs, in the 1998, 1999, and 2000 fiscal years, in relation to the transfer, by the Company to Consumersfirst Ltd., of the assets that comprise, and of copies of the information software that is necessary to operate, the following businesses and activities: merchandise sales, heating parts replacement plan (also known as "HIP"), and certain service activities;*

- *the proposed regulatory treatment of the Rental Program in a wind-down mode, including the following:*
  - *the classification of the program as a core utility activity; and*
  - *the recovery from ratepayers, in due course on a taxes payable or "flow through" basis, of the Company's unrecorded deferred income tax liability in relation to the program as at September 30, 1999 (approximately $168.2 million), to the extent that such liability cannot be recovered from customers of the program; and*

- *the proposed Unbundled Budget for use in connection with the targeted Performance Based Regulation (PBR) plan that is before the Board in the E.B.R.O. 497-01 proceeding.*

2.2.3 The retention of other programs, including NGV, within the utility from March 31,1999 until the end of the fiscal year was requested by letter to the Board dated December 17, 1998. These requests have been approved by the Board in a letter dated March 24, 1999.

2.3 TRANSFERRED OUT PROGRAMS

2.3.1 The Company plans to transfer assets with a net book value of approximately $166.8 million to its affiliate, Consumersfirst, of which $140.7 million are receivables associated with the MFP, and the remaining $26.1 million consists of assets relating to the other programs. To ensure no tax payments are triggered by the transaction, the Company and Consumersfirst would elect under the *Income Tax Act* to transfer the assets, which have been assessed by KPMG as having a fair market value of $168.5 million, at book value. In return for the transfer of the assets, the Company would receive $166.8 million in cash and $1.7 million in preferred shares issued by Consumersfirst. These shares are expected to be redeemed for $1.7 million in cash immediately following the asset transfer.

2.3.2 The Company proposes to continue a management services agreement with Consumersfirst, the fully allocated cost of which is forecast to be $2.4 million annually following the transfer. The Company filed a set of Standards of Business Practice to apply to these activities. These Standards have been preempted subsequently by the Board's draft *Affiliate Relationships Code for Gas Utilities*.

2.3.3 Given that no Board approval is required for these transfers under the new Undertakings, it was not necessary to examine the valuations in detail. Any ratemaking implications will be subject to review in the next main rates case. As noted later in this Decision the Board accepts for removal from the cost of service the amounts identified, as adjusted to reflect the actual amounts at the date of transfer.

2.4 RETENTION OF THE ABC-T PROGRAM

2.4.1 The Company is requesting approval under the new Undertakings to continue the ABC-T Program as an ancillary program within the Utility on the basis of fully allocated costs. The evidence is that this optional billing and collection service provided by the Company to agents, marketers, and brokers is needed in the developing competitive retail natural gas commodity market, and that other alternatives are not yet available. It is the Company's expectation that "the fate of the program would be revisited in another regulatory proceeding before the program would disappear".

2.5 PROPOSED TREATMENT OF THE RENTAL PROGRAM

2.5.1 The Company's rental program currently serves approximately 1.2 million homes and businesses in the Company's franchise area. The Company proposed to wind-down this program, installing no new rental units after October 1, 1999, and replacing no existing rental units at the end of their useful lives. The Company proposed that the rental program would, during the wind-down, cease to be considered an ancillary program and become part of the core utility for regulatory purposes.

Rationale and Proposed Regulatory Treatment

2.5.2 The rental program was operated on a marginal cost basis until the Board's finding in E.B.R.O. 495 required fully allocated costing of the Company's ancillary programs. The Company's proposal to treat this program as part of the core utility would subsume the costs of the program into the utility's cost of service.

2.5.3 In its evidence in E.B.R.O. 497 the Company described the new competitive environment relating to rentals and the difficulties facing the rental program as competitors expand into the business of providing water heaters for sale, and promoting electric water heaters. Essentially, in that Proceeding, the Company requested an extension of the time during which it could operate its rental program on a marginal cost basis. Having not had its request granted, the Company wishes to withdraw from the rental business, and proposes the wind-down as a way to manage the transition.

2.5.4 It was the Company's view that, given the historic benefits it identified with the rental program, its anticipated lack of flexibility to manage revenues and mitigate the impact of premature equipment removals, the loss of economies of scale during the wind-down, and the aim of fostering competition, the rental investment should be treated as any other utility investment through the wind-down. The program would not, under the Company's proposal, be subject to fully allocated costs for regulatory purposes. Until the competitive infrastructure is in place to assure adequate service levels for rental customers, the Company proposes to enter into a five year service agreement with Consumersfirst; at the end of the term of this agreement, the Company states that Consumersfirst would have to compete for the utility business.

2.5.5 It is the Company's view that its wind-down strategy balances the interest of the shareholder in protection of its investment with the interests of customers in increased choice through an orderly transition to competitive markets. Existing customers may remain on the utility rental program until their equipment needs to be replaced, and will be made aware of alternative supply sources. The shareholder would, under the Company's proposal, recover the full costs of winding down the program.

2.6 DEFERRED TAXES

2.6.1 As a result of the Company's use of a "flow through" method of recording taxes relating not only to its regulated utility income but also to the income from the Rental Program, there would be unrecorded deferred taxes in the amount of $168.2 million attributable to rental assets as at the end of fiscal 1999. The Company proposed that ratepayers be responsible for the payment of these deferred taxes. In support of this proposal, the Company cites an analysis of the regulatory treatment of returns on ancillary programs over the past 10 years that indicated a resulting $151 million, on a current dollar basis, benefit to ratepayers over those years, $127.5 million of which is attributable to the rental program. Over the past 20 years, the Company estimated that the rental program had been responsible for approximately $172.5 million in current dollar benefits to ratepayers resulting from the regulatory treatment applied to earnings from it.

2.6.2 As a result of a recent Supreme Court Decision, Revenue Canada has changed the tax treatment of certain expenses associated with rental equipment. Because of this change, the Company was credited with $42 million of tax overpayment. This amount contributed to the total of $168.2 million deferred tax liability noted above. The Company proposed to credit the $42 million to the ratepayers conditional upon the Board accepting the Company's proposed wind-down and deferred tax treatment.

2.7 CONSUMERSFIRST SERVICE AGREEMENT

2.7.1 As noted above, the Company proposes to enter into a five year rental service agreement with Consumersfirst for the latter to provide service to existing rental products primarily consisting of rental water heaters. It is the Company's evidence that its affiliate is the only contractor capable of providing service comparable to that presently provided. At the end of the five year period, other contractors who can demonstrate the capability will be considered to provide this service. The Company contended that this agreement, as opposed to servicing through third parties, will prevent premature stranding of rental assets, because the two companies are commonly owned. The Company also argued that the contract will enable a smooth transition to a competitive market.

2.7.2 Based on a negotiated cost per unit serviced, the Company forecast that it will pay Consumersfirst $17.7 million in fiscal year 2000 to provide the rental equipment service. The Company stated that in its negotiations with Consumersfirst it undertook to ensure that the cost of the agreement would be equivalent to the cost of a Company-managed option using 100% contractor workforce. The Company's evidence indicated that the cost of the rental service agreement on a marginal cost basis is comparable to the cost of a Company-managed alternative.

2.8 STRANDED ASSETS

2.8.1 Assets no longer required for the operation of the core utility once the unbundling process is complete and therefore no longer "used and useful" were estimated at $400,000 after mitigation efforts by the Company. These assets comprise the net cost of telecommunication equipment and infrastructure costs associated with office space reductions. The Company proposed that the stranded costs from these assets be recoverable from ratepayers through depreciation.

2.9 TRANSITION COSTS

2.9.1 The Company identified one-time transition costs of approximately $18.4 million in O&M expenses, and approximately $0.9 million in capital costs. The following table indicates the sources of these costs:

Item	O&M ($000's)	Capital ($000's)
Customer Communications	900	
System Modifications, Data Extraction	5,000	
Human Resources/Employee Support	4,000	
Office Relocation/Facility Restoration	3,600	900
Consulting & Regulatory Costs	2,100	
Transition Planning	2,800	
	18,400	900
From Prefiled Evidence E.B.R.O. 497-01, E.B.O. 179-14 and 15 Table B/5.3/2		

2.9.2 Costs related to system modifications are claimed to be necessary to ensure appropriate confidentiality of data and continued effective information technology for the core utility. Human resources costs include employee education, relocation, and severance, and the separation of pension and benefit plans for transferred employees. Office relocation and facility restoration expenses involve distributing the utility workforce into facilities owned by the utility, and vacating the leased facilities presently used by the larger bundled operation. Consulting and regulatory costs include costs to obtain independent valuations, tax, legal and accounting opinions and rulings, and the regulatory costs associated with this Application. Transition planning

costs are for incremental staff and external consultants to develop and implement transition initiatives.

2.9.3 The Company recommended that, given that the costs associated with unbundling are estimated, a deferral account be set up to capture incremental one-time transition costs so that actual costs related to the planning and implementation of the unbundling proposal become part of the cost of service to be recovered in rates over a three year period from fiscal 2000 to fiscal 2002, inclusive.

2.10 THE UNBUNDLED BUDGET

2.10.1 The Unbundled Budget as presented by the Company is the budget that would have been required for fiscal 1999 had the proposed unbundling of ancillary and service activities been effective on October 1, 1998, representing "the revenue requirement...to operate a core utility, on a stand alone basis (including the Rental Service Agreement), and to provide limited shared services". The Company submitted that the Unbundled Budget demonstrates that the core utility "can deliver annually, on an ongoing basis, some $18.4 million in benefits, or savings, when measured against the revenue requirement of an integrated utility based on the Board-approved budget for fiscal 1999".

2.10.2 It is the Company's position that these savings require not only the removal of the direct costs of the activities proposed to be unbundled, but the incurrence of other management initiatives and efforts which will result in the transition costs noted above.

2.11 PARTIES' VIEWS

2.11.1 The parties, with few exceptions, opposed the Company's proposals in whole or in part. Some noted that the onus was on the Applicant to satisfy the Board that the specific relief it was seeking should be granted, and that the Board could simply turn down the proposal entirely, if that onus was not met. The relief sought was characterized variously as "regulatory overreach", "excessive", and self-serving. Concerns were expressed that the Company was relitigating matters which the Board had clearly determined in previous proceedings, that there were no efficiency gains resulting from its restructuring, and that its proposed contract with its affiliate would distort markets and hinder competition. A number of parties pointed out that the shareholder had chosen to pursue ancillary programs for its own purposes, and must therefore accept the risks of a changing marketplace. Many argued that past benefits were overstated, and some submitted that past outcomes should not, in any case, necessarily determine the fate of the present Application.

2.11.2 There was general support, with one exception, of the Company's proposal to retain ABC-T Service.

2.11.3 With respect to the new Undertakings, parties suggested various tests that might be applied in determining whether business activities other than distribution, transmission and storage of gas should be permitted within the Company, and urged the Board to consider the context of the new legislation, its general purposes, the Board objectives set out in the legislation, the description of the purposes of the new Undertakings and their specific wording, and the general direction of change in the energy industry. Based on Dr. Bauer's testimony, parties urged the Board, at a minimum, to hold ratepayers harmless and apply the test of economic efficiency as a criterion in assessing the Company's requests.

2.11.4 Many parties noted that the Company had provided little in the way of evaluation of alternatives to its proposals. With respect to the deferred taxes, some parties questioned the jurisdiction of the Board to pass through into rates taxes relating to assets of ancillary programs. No party agreed that the "regulatory compact", as articulated by the Company's witness, Ms. McShane, guaranteed recovery of deferred taxes by the shareholder as suggested by the Company. One party suggested that the Board may have been "mistaken" in its past decisions relating to the treatment of taxes, but that it could redeem itself through the proper determination of the present application.

2.11.5 With respect to the proposed services contract with Consumersfirst, there were general concerns that the contract in essence amounted to a transfer of the rental program to the affiliate at no cost, and that in fact the Company would be paying its affiliate to acquire a profitable business as the Company wound down its participation. Evidence provided by witnesses on behalf of HVAC addressed concerns relating to fairness to others in the service industry, and protection of ratepayers from subsidizing an affiliate's entry into the market. Parties recommended that the Board consider these in evaluating the proposal.

2.11.6 A number of parties noted the complexity and difficulty of the issues in the Application. Although there was almost universal agreement that the Company's course should not be agreed to, parties did not generally provide alternative courses for the Board's consideration.

2.11.7 In reply, the Company urged the Board to take a narrower approach to its mandate in relation to competition than that argued for by some parties, noting that the new legislation speaks of the Board's role in facilitating competition in "the sale of natural gas" and in "the generation and sale of electricity". On the other hand, the Company dismissed as "astonishing" any suggestion that the Board does not have the

jurisdiction to require ratepayers to pay the deferred tax liabilities. The Company urged the Board to adopt a "just and reasonable" standard in determining the extent to which ratepayers' and shareholders' interests should be protected, a standard it submited would be completely consistent with its proposals with respect to the treatment of the ancillary programs, and the deferred taxes.

3. BOARD FINDINGS

3.1 GENERAL

3.1.1 The Company wishes to retain the rental program within the core utility, wind it down, recover the resulting deferred tax liability from the ratepayers (to the extent that it cannot be recovered from the rental customers) and utilize an exclusive five year service agreement with its affiliate to provide service of the rental assets. The Company also requests approval to retain its ABC-T program within the utility. Additional approvals are sought relating to the costs of transferring other activities out of the utility and the resulting "unbundled budget" for use in connection with a proposed PBR Application that is under consideration by this Board in a related proceeding.

3.1.2 Thus summarized, the Company's proposals seem straightforward. As many intervenors have indicated, however, the matters under consideration in this Application are not only complex, but interwoven in complicated ways. In addition, the consequences are potentially momentous, in both policy and financial terms. It is necessary to carefully balance the interests of ratepayers, shareholders, and users of the programs in question, to consider the changing legislative, regulatory and market contexts, and to take into account previous Board findings and directives.

3.1.3 During the hearing the Board requested clarification from the Company of its expectations should the Board deny part or all of the relief requested. In its Argument-in-Chief, the Company responded, asking for "detailed guidance as to the Board's expectations...[to] enable the Company [if necessary] to design an alternative that would meet the Board's expectations and...facilitate the regulatory process." In setting out its findings in the following pages, the Board has been mindful of the effort that has gone into this Application by all involved, and of the need for regulatory efficiency to utilize that effort to move forward. While some intervenors have urged the Board to "just say no", this course appears to the Board to be wasteful. The Board has therefore attempted to craft a solution to address its concerns with the Application as proposed, and to provide the Company with sufficient information and guidance to allow it to make effective decisions about the way in which it will proceed. The Board has also, of course, addressed the separate requests for approval for transactions other than those relating to the rental program and the resulting deferred tax liability.

3.2 THE RENTAL PROGRAM

Retention Within the "Core Utility"

3.2.1 As noted earlier, the 1998 Undertakings changed the nature of the approvals required by this Board in relation to the Company's activities. The relevant paragraph of the Undertakings reads as follows:

> *Consumers shall not, except through an affiliate or affiliates, carry on any business activity other than the transmission, distribution or storage of gas, without the prior approval of the Board.*

3.2.2 The Board has no difficulty in accepting that the rental program is a "business activity" within the meaning of this paragraph, and the Company does not contend, nor does the Board accept, that the program is part of "the transmission, distribution or storage of gas". Had this been the Company's interpretation, it would not have seen the necessity for approval to retain the rental program.

3.2.3 The Board has reviewed the various positions of the Company and intervenors as to the Board's jurisdiction and role under the *Energy Competition Act*, the direction of policy change envisioned by the new legislation, and the extent to which the gas and electricity sectors must be treated identically or symmetrically. The provisions of the legislation relating to the two sectors are not the same, and while the Board accepts the need for a consistent regulatory approach, it is required under the new Undertakings to make determinations which have no equivalent in relation to the electricity utilities. These decisions must be informed by regulatory history and the Board's sense of the regulatory future. In this particular case, the Board finds that under certain circumstances the carrying on of the business activity of equipment rentals by the Company would be appropriate.

3.2.4 The Board is not prepared, however, to approve a proposal to run the rental program as part of the "core utility". The essence of such a proposal is that no separate costing of the program, and hence no assessment of its profitability is possible. Not only would the costs of the program not be assessed on a fully allocated basis, as the Board has previously directed, but there would be no way of assessing them at all. The extent of any cross subsidization by the ratepayers would be unknown, and there would be little incentive for the Company to operate the program as efficiently as possible. The Board notes as well that any stranded assets which might develop in the program would become a ratepayer responsibility.

3.2.5 The Board's finding with respect to retention of the rental program in the core utility is supported by its view of current regulatory policy, which encourages the development of a "pure utility", stripped of non-monopoly services. The Board recognizes that the issue of the rental programs within the electrical utilities is still under consideration. In the event that such programs are to remain in electrical utilities, the Board will need to apply consistent principles to their regulation. While it may not be necessary to follow the same timetable in the gas industry as may be envisioned for the electric utilities, the general principles with respect to costing of such programs should be the same. Retaining the Company's rental program in the core utility does not allow appropriate costing principles to prevail.

3.2.6 The Board would accept the program, for the time being, on a non-utility basis within the Company, with elimination of the program's costs on a fully allocated basis.

<u>The Proposal to Wind Down the Program</u>

3.2.7 The Company has stated that it does not wish to continue the rental program as a going concern, partly because it is unprofitable to do so under fully allocated costs. While the Company provided, in a transcript undertaking response, a "high-level summary" of its analysis of options leading it to conclude that its proposal was optimum, the Board was not provided with detailed information on options and their consequences. It is clear that "a key component" of the wind-down proposal is the proposed five year service agreement with Consumersfirst. It is also clear that in the Company's view the deferred tax implications of the wind-down proposal were preferable to those that would result from other options.

3.2.8 Whatever the Company's motivation in proposing the wind-down of the rental program, the Board is not convinced that it is either necessary, or the best solution in the circumstances. There is no convincing evidence on the record that competition is rapidly eroding the program's remarkably high market penetration. While according to the Company the program was not forecast to return the allowed rate of return for fiscal 1999, this was partly due to the Company's reclassification of certain diagnostic charges which resulted in additional direct costs of $3.1 million for the program, and additional allocated costs of $6.8 million. Reversal of the changes in accounting for diagnostic charges would have resulted in a forecast combined rate of return of 8.7% for the Company's four ancillary programs, most of which is attributable to the rental program. Even when the program does not yield the returns realized by the utility as a whole, it is not losing money, on any cost allocation basis.

3.2.9 The most important consequence of the fate of the rental program is the timing by which the deferred taxes associated with it must be either recorded or paid. The Board discusses this consequence below. While it is not appropriate for the Board to tell the Company what it should do with the rental program, the Board's proposed treatment of the deferred taxes will determine the parameters within which the Company must decide the fate of the program. If the Company does not wish to continue the program as a non-utility program, it does not need Board approval to transfer it to an affiliate or to sell it to a third party.

3.3 DEFERRED TAX LIABILITY

3.3.1 As noted earlier, approximately $168 million in deferred taxes are associated with the rental program, including a tax credit of some $42 million arising from the recent reversal of Revenue Canada's treatment of expenses associated with the installation of rental assets. In the Board's view, whoever is responsible for the payment of the deferred taxes should be entitled to this credit.

3.3.2 The Company has contended that the deferred tax liability is a ratepayer responsibility, arguing that ratepayers have benefitted from the deferral of the taxes through lower rates, and that there has been a cumulative shortfall in earnings flowing to the shareholder over the years as a result of the lower actual returns from the program. Intervenors have presented various reasons why the liability should not fall on ratepayers.

3.3.3 The Company relies heavily on earlier Board decisions and the "regulatory compact" for its contention that the deferred taxes should be recovered in rates. According to the Company, the Board's decisions and the consequential regulatory precedents imply, without question, a commitment ("the Commitment") that these taxes would be recovered in rates when they are due and payable in the future. The trade-off for this Commitment is that gas rates have been minimized for the many years leading up to the time when the future tax liability arrives.

3.3.4 A review of the history of the Board's considerations of the Company's tax methodology will be helpful in assessing the Company's argument in this respect.

History

3.3.5 The flow through or "taxes payable" method of recording taxes is an exception to the standards of the Canadian Institute of Chartered Accountants ("CICA") as expressed in the following excerpt from the current CICA Handbook:

...the taxes payable basis would be appropriate ... provided that there is a reasonable expectation that all taxes payable in future years will be:
(a) included in the approved rate or formula for reimbursement and
(b) recoverable from the customer at that time.

3.3.6 The CICA Handbook, in setting out this exception to the usual rule that "the deferral method of income tax allocation should be used", notes that the exception would apply in very limited circumstances, and uses as an example of those circumstances "a company in the regulated utility field under the jurisdiction of an authority, which allows as an element of cost in setting rates only the amount of taxes currently payable".

3.3.7 The Company has used the flow through basis of recording its taxes for many years. The Board has reviewed the history of the treatment of taxes, as set out in the cases relied upon by the Company, and notes the following:

- In 1961, when the Company asked the Board to approve an amount in rates for deferred taxes relating to "plant expansion and replacement", the Board declined, citing uncertainty as to when or whether the Company would have to actually pay the taxes in question.
- The Company based a 1975 request for "interim rate relief" to collect deferred taxes in part on the improvement that would result in its "cash flow and financing ability", and cited risks which arose from postponing recovery of taxes.
- One of the reasons recovery of deferred taxes in rates was denied by the Board in the past was that adding to rates for the purpose requested was inconsistent with Government price restraint policies in place at the time to deal with high rates of inflation.
- More than ten years ago Board staff argued for the exclusion of the rental program from the utility operation; at the time, the deferred tax situation was not raised, although evidence filed in the present application suggests that a total unrecorded deferred tax liability of almost $250 million existed at that time, a significant portion of which would have related to rental assets.

- In the past five years, the regulatory treatment of the ancillary programs has been examined in each main rates case; the Board ordered the implementation of fully allocated costing for these programs in 1997.

3.3.8 In E.B.R.O. 497, the Company presented evidence that, on the fully allocated costing basis directed by the Board the previous year, the ancillary programs were forecast to produce a revenue deficiency of $21.3 million dollars. The Company requested that the Board not impute any revenues to the programs in the test year, essentially requesting relief from the application of full costing for the test year. Detailed probing during the hearing revealed that much of the forecast deficiency in these programs could be traced to the introduction by the Company of a separate charge for diagnostic services, and a charging to the ancillary programs of direct and allocable costs related to these services. When these costs were excluded, the forecast revenue deficiency for the programs was reduced to $3.7 million.

3.3.9 The Board expressed its concern in the E.B.R.O. 497 Decision that the costs relating to diagnostic services had not been identified previously in the fully allocated costs study which had been presented to the Board in E.B.R.O. 495. The result of this failure was that the true revenue deficiency of the programs in fiscal 1998 was not recognized, and the Company had, in effect, a transition period in which fully allocated costing did not apply to the programs. The Board declined to provide any additional transition period, and directed that full costing continue to be applied. In addition, the Board expressed its concern as to "what *other* costs properly belonging to either ancillary or non-utility activities are still missing in the Company's cost allocation". It now appears that the unrecorded deferred taxes relating to the ancillary programs were another such cost, and a large one.

The Commitment

3.3.10 The Board does not accept the Company's argument that its past decisions imply the Commitment claimed for the following reasons:

- Many of the Board's decisions addressed whether deferred taxes should be collected in rates of the year in question. No distinction was made between the utility in general and its ancillary programs, although it is noteworthy that aspects of the Company's business, such as exploration and development, were treated differently. These decisions were based on circumstances at the time in question, such as the existence of high inflation, the status of the Company's cash flow and financing capabilities, and the extent to which the Board was persuaded that the Company's future was at risk from competition with other forms of energy or a future shortage of natural gas.
- Some of the decisions dealt with the extent to which a return should be allowed on the deferred taxes, not on a change to the tax methodology itself.
- The Company relies in the present Application on the Board's conclusion in 1976. In that Decision, the Board's statement that "...it is not reasonable to expect that the Applicant would be unable to obtain regulatory approval for the collection of deferred taxes in rates when they become payable, or that competition with other forms of energy would prevent the collection in rates due to a loss of customers" was in response to a Company argument that a future shortage of gas or competition with other energy forms might affect the Company's ability to recover the taxes following the crossover point.
- Where the decision requested was for a change in principle from flow through tax accounting to normalized accounting, the Board relied on its earlier decisions, and did not address the principle.

- The "regulatory compact" does not operate in such a way as to prevent the Board from considering new circumstances and changing its approach in response to them.
- The Company argues that the rental program has always been treated as part of the utility. The Board has never set rental rates, and has always required separate reporting for the ancillary programs. Taxes paid on income from the programs were expected to be part of the expenses directly assigned to the programs. While rates were set on the basis of a forecast rate of return from the rental program which took into account the taxes payable, it is not entirely clear to the Board that the CICA guideline applied to the program at all. Certainly once full costing of the rental program was required, it is difficult to see how the CICA guideline applied. The point was never raised before the Board.
- Even if one accepts that earlier Board decisions did not differentiate between taxes relating to ancillary programs and taxes relating to the utility, it is remarkable that the Company did not alert the Board to the deferred tax problem when the question of the costing of the ancillary programs was under consideration. The Company was undoubtedly aware of the unrecorded deferred tax liability related to these programs. It appears to the Board that its existence was an essential piece of information that should have been available to the Board in its review of the regulatory treatment of these programs. Consideration of a different costing treatment for the rental program commenced as early as 1995 (E.B.R.O. 490). Indeed, in E.B.R.O. 497, the Board expressed its concern "as to what other costs properly belonging to either ancillary or non-utility activities are still missing in the Company's cost allocation". It is notable that the amount of the liability related to the rental program has increased by approximately $50 million dollars since 1995, a period in which there has been considerable discussion of the characterization of costs relating to this program.

3.3.11 Considering all of the above, it is the Board's view that the deferred taxes associated with the rental program should be the responsibility of the shareholder. In the circumstances, the Board does not need to decide whether it has the jurisdiction to pass these costs directly through to the ratepayer in rates. As noted above, the $42 million credit for tax overpayment should, therefore, be credited to the shareholder.

Ratepayer Savings

3.3.12 It is instructive to consider who would have paid the taxes related to the rental program had they not been deferred. The Company's evidence is that rental rates were set by the market, and were not therefore dependent on the program costs. If one accepts that evidence, it follows that the renters would not have paid any more or less had the taxes not been deferred.

3.3.13 The Board cannot accept the Company's premise that rental rates were in fact set by the market as the Company states. The rental business, while competing to some extent with similar programs run by the electricity utilities, was in some senses a "monopoly business", with an approximately 95% market share in the Company's franchise area. Unfortunately, there is no evidence to suggest what differential existed between rental prices as set by the Company and those that would have been determined by the market. To the extent that prices were set to cover costs of the program, renters would have been responsible for paying the taxes, and would have benefitted from their deferral. The Board can only assume that there was some benefit; it cannot be quantified.

3.3.14 In order to analyze who else would benefit from the deferral, or, in other words, who else would have paid the taxes had they not been deferred, it is useful to accept for the purposes of the analysis that rental prices were set by the market, and thereby exclude possible benefits to renters from the analysis for the moment.

3.3.15 For most of the life of the rental program, its costs have been determined on a marginal basis. If one assumes that the taxes on the income of the rental program were charged to the program *as a direct charge*, and that the tax shelter related to the rental assets was applied directly to those taxes, the treatment of the taxes would have been the same under either marginal or fully allocated costing, since direct charges are attributed to the program under either regime. The deferral of the taxes would have, in any given year, lowered the cost of the program. Who benefitted from that lower cost?

3.3.16 To answer this question, it is necessary to note that the setting of utility rates on a forecast basis has the following results:

- if the forecast rate of return for the rental program was higher than the overall allowed rate of return, utility rates would have been set to reflect the higher return from the program, and ratepayers would have benefitted;
- to the extent that the actual rate of return for the program was higher than that forecast, shareholders would have benefitted; and
- to the extent that the actual rate of return was lower than that forecast, the risk being symmetrical, the shareholder would have absorbed the shortfall.

3.3.17 The Company has provided forecast and actual returns over the last ten years. From these, the following can be established:

- On a forecast basis, between 1989 and 1998 there was a total sufficiency from the program of $50 million.
- There are also some benefits to ratepayers from the reduction of fixed costs through incremental gas sales attributable to the rental program and the improvement in system load factor. Although these benefits would also have arisen if the rental program were owned and operated by a third party, it seems unlikely that the high market penetration the program achieved would have occurred had the utility not operated the program. In addition, it should be noted that rental customers are also ratepayers; almost 95% of ratepayers are also renters. To the extent that renters, who are also ratepayers, have not paid higher rental rates to cover costs of the program, they have benefitted.

3.3.18 It is not, in the Board's view, fair to revisit earlier regulatory treatment which allowed the program to operate on a marginal cost basis and calculate for this period a 'subsidy' to the rental program from the general body of ratepayers. The regulatory regime was what it was. However, even if such consideration were justified, the evidence reveals such 'subsidy' is only a portion of the $50 million sufficiency noted above.

3.3.19 It therefore appears to the Board that utility ratepayers have benefitted from the rental program over the years, and that the shareholder has absorbed some costs. While finding that ratepayers should not be responsible for the deferred tax liability, *per se*, related to the rental program, the Board believes that there should be some recognition of the benefits they have received in the past. The Board therefore would accept the provision of a notional utility account in the amount of $50 million, after tax, to allow the shareholder to use the value of these past ratepayer benefits to pay a portion of the deferred taxes associated with the rental program as they become due. It is up to the Company to determine the future of the program, but whatever that

choice, the notional account can be drawn down to pay deferred taxes up to $50 million.

3.3.20 There are a number of options which the Company may consider with respect to the rental program, each with its own consequences for the rate at which the deferred taxes will come due. The options include:

- The Company may choose to continue to operate the program as a non-utility program for the time being. As the taxes become due, they will be accounted for as costs for potential elimination as non-utility expenses, as they are not common costs. It is possible that the deferred tax liability would need to be recorded immediately, even though payment is not immediately required.
- The Company may choose to wind-down the program as a non-utility program. In this case, the necessity to pay the deferred taxes will be accelerated.
- The Company may choose to transfer the assets to an affiliate or sell the program to a third party. In these circumstances, any proceeds from the sale or transfer would be available to address the related tax consequences. To the extent that the Company proposes to utilize any or all of the notional account as well, the Board's approval of the ratemaking consequences would be required. The Company should be aware that, under this option, consideration of 'rate shock' may dictate the degree of amortization of the amount to be reflected in rates going forward.

3.3.21 In any of these cases, the Company may draw on the notional account to pay deferred taxes as they become due. If the Company decides to continue the program, it will have an incentive to run it as efficiently as possible, since it must account for it on a fully costed basis. In any year, the amount used from the account would be recognized in rates, subject to considerations of 'rate shock' as noted above.

3.4 CONSUMERSFIRST CONTRACT

3.4.1 The Company has described its proposed contract with Consumersfirst as a “key component of the Company’s proposal to wind-down its Rental Program....” Given the Board’s findings above, the Company may decide on a different course for the program, and change its approach to service provision. The Board has determined that the program must operate, if it is to be retained by the Company, on the basis of fully allocated costs. Included in these costs will be whatever charges are paid through contracts for service. If the Company is to contract with its affiliate, it will be required to adhere to the *Affiliate Relationships Code for Gas Utilities* , which is intended to address not only the possibility of cross subsidies, but also potential unfair competition by the affiliate with others in similar markets.

3.5 RETENTION OF ABC-T SERVICE PROGRAM

3.5.1 The Board confirmed the status of the ABC-T service as an ancillary program in E.B.R.O. 495, and accepts that it is a “business activity” within the meaning of the 1998 Undertakings. Under fully allocated costing, costs of the program will not be borne by ratepayers. The Board is prepared to accept the retention of the ABC-T Service Program, noting that the Company may decide in the future that the program is no longer economic, and would then be at liberty to cease to operate it. However, for consistency with the Board’s findings in relation to the rental program and for regulatory efficiency, the ABC-T Service Program is accepted as non-utility rather than ancillary. Therefore, the Board’s review in future will be limited to the costs removed and would not include matters of pricing or profitability.

3.6 TRANSITION COSTS

3.6.1 Of the $18.4 million O&M and $900,000 capital costs that the Company has identified as transition costs in relation to its application, some are directly related to the transfer of assets to Consumersfirst for which the Board's approval was sought in the original application, some arise from the wind-down of the rental program and the remainder relate to the realization of future savings through the reduction of 173 employee positions. No breakdown of these amounts was provided.

3.6.2 Disposition to the ratepayer of the portion of transition costs relating to the transferred programs would reduce the net transfer value of the transferred assets to below their book value; in the result, ratepayers would not be held harmless by the transfer.

3.6.3 Based on the Board's findings above, the transition costs associated with both the wind-down of the rental program and the reduction in employee positions will be subject to further uncertainty. Until such time as the Company takes action with respect to the alternatives available to it, the Board sees no need for the requested deferral account.

3.7 THE UNBUNDLED BUDGET

3.7.1 The Unbundled Budget presented by the Company was proposed as a basis for the Performance Based Regulation plan that is before the Board in E.B.R.O. 497-01. The Board is prepared to accept the adjustments to the cost of service identified for programs to be transferred to Consumersfirst at the end of this fiscal year, subject to the Company providing the actual amounts for ratemaking purposes. Depending upon the choice(s) the Company makes in response to the Board's findings in the present application, a different Unbundled Budget will result. Other aspects of the

base budget for any PBR plan which the Board may approve will be dealt with in the E.B.R.O. 497-01 Decision.

3.7.2 The Board could not determine the extent to which the stranded assets identified by the Company are associated with the proposed treatment of the rental program. To the extent that any such costs are associated with businesses transferred out, they should not be reflected in the cost of service going forward.

3.8 ENERGY USE AND DEMAND-SIDE MANAGEMENT

3.8.1 As noted above, this issue was completely settled in the Settlement Conference. The Settlement Agreement set out certain commitments by the Company to address energy conservation and demand-side management concerns upon approval of its Application. It is the Board's expectation that any proposal brought forward by the Company in response to this Decision will take into account the terms of that Agreement.

4. COST AWARDS

4.1 COST AWARDS

4.1.1 The following parties applied for an award of costs: AMEC, CAC, CEED, Energy Probe, HVAC, IGUA, OAPPA, OCAP, Pollution Probe and the Schools.

4.1.2 In order to expedite the issuance of this Decision, the Board will address cost claims in a supplementary decision which will be issued in due course.

DATED AT Toronto March 31, 1999.

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H. G. Morrison
Presiding Member

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P. Vlahos
Member

A Portion of E.B.O. 179-14 and 179-15 Settlement Agreement from Exhibit B, Section 8.0 Pages 8 and 9 dated December 1, 1998.

D.3 Impact on Energy Use and Utility DSM Programs (Complete Settlement)

The following parties participated in the discussion of this issue: the Company, AMEC, CAESCO, CAC, CEED, Energy Probe, GEC, HVAC, IGUA, Schools, OCAP, and Pollution Probe.

There is an agreement to settle this issue on the following basis:

- The Company recognizes that its restructuring proposals in the EBO 179-14/15 application will have an impact on the way in which it designs and delivers DSM programs, particularly in the residential sector. Since the inception of DSM in 1995, many of the residential programs and a significant portion of the total results have been associated with the Rental Program.

- In its EBO 177-17 Decision with Reasons, the Board noted its concern that if the cost effectiveness of DSM programs is not maintained, ratepayers will be detrimentally affected. The Company will monitor the impact of completing its restructuring proposals and, as required, take appropriate steps to mitigate any detrimental effects.

- The Company will expand its program approaches and its delivery channels, in a restructured environment, to included a wider array of industry and trade allies. The Company will also broaden its monitoring and evaluation processes in order to track the impact of its programs on a broader market basis. In addition, the Company will file a comprehensive monitoring and evaluation plan with each DSM Plan, which will be developed with input from the DSM consultative process.

- The Company will also take an active role in advocating an increase, to or beyond the level that the Company has achieved in its Rental Program in recent years, in the Ontario Government's minimum standard for the efficiency of gas-fired water heaters.

The following parties agree with the settlement: the Company, AMEC, CAESCO, CAC, Energy Probe, GEC, IGUA, Schools, OCAP and Pollution Probe.

The following parties take no position on the issue: CEED and HVAC.