



# **ONTARIO ENERGY BOARD**

## **STAFF SUBMISSION**

### **2009 ELECTRICITY DISTRIBUTION RATES**

#### **Midland Power Utility Corporation**

**EB-2008-0236**

**February 20, 2009**

## **INTRODUCTION**

Midland Power Utility Corporation (“Midland”) is a licensed electricity distributor serving approximately 8,222 customers. Midland filed its 2009 rebasing application (the “Application”) on August 18, 2008. Midland requested approval of its proposed distribution rates and other charges effective May 1, 2009. The Application was based on a future test year cost of service methodology.

The Association of Major Power Consumers in Ontario (“AMPCO”), the School Energy Coalition (“SEC”), and the Vulnerable Energy Consumers’ Coalition (“VECC”), were granted intervenor status.

This submission reflects Board staff’s review of the pre-filed evidence and interrogatory responses made by Midland, and is intended to assist the Board in evaluating Midland’s application and in setting just and reasonable rates.

## **THE APPLICATION**

In the Application, Midland requested a revenue requirement of \$4,472,579 to be recovered in rates effective May 1, 2009.

### **Rate Base**

Midland is requesting approval of \$12.3 million for the 2009 rate base. This amount is a 37% increase (\$3.3 million) from Midland’s 2007 actuals and a 47% increase (\$3.9 million) from its 2006 actuals.

### **Capital Expenditures**

#### **Background**

As shown in Table 1 Midland has proposed 2009 capital expenditures of \$2.7 million. This represents an increase of approximately 8% compared to the 2008 projected level of \$2.6 million, and an increase of approximately 89% over 2007 actual capital expenditures of \$1.5 million.

### Discussion and Submission

Table 1 lists the percentage change of the capital expenditures from the 2007 actual to the 2009 Test year.

**Table 1**

|   | <b>2007 Actual</b> | <b>2008 Bridge</b> | <b>2009 Test</b> |
|---|--------------------|--------------------|------------------|
| <b>Capital Expenditures</b>                   | \$1,451,837        | \$2,550,453        | \$2,746,840      |
| <b>% change as compared to the prior year</b> |                    | 76%                | 8%               |

A majority of the projects are related to replacement of aging infrastructure, old vehicles or improving system reliability. One major initiative includes the replacement of six substations, one per year for the years 2007 to 2010 and two substations to be replaced in 2011. The first four substations slated for replacement are approximately 50 years old. Midland acknowledges this plan to be aggressive but considers this to be a matter impacting safety and reliability. The Fourth Street Substation upgrade at a cost of \$1.2 million will be undertaken in the 2009 Test year.

Rondar Engineering completed an assessment of the substation infrastructure in 2006. According to Midland Rondar has been completing the maintenance on Midland's substations over the past 10 years and is familiar with the transformer condition and breaker relay of the substations. Midland was asked through interrogatories to confirm whether Rondar was involved in the assessment as well as replacement of the substation infrastructure in order to ascertain whether there was any conflict of interest. Midland confirmed in its response that Rondar was involved in the discussion of the overall capital plan but that three independent quotes were obtained for the installation of the Scott Street and Brandon substations.

In response to Board staff interrogatory number 15 asking Midland to identify projects that could be deferred or cancelled, Midland emphasized the importance of all its projects and their impact on system reliability. The only project identified as a candidate for deferral was the Scada software upgrade project. Accordingly, Midland has proposed to defer the project to 2010.

At the same time, Midland has made an adjustment to the estimate of the Bourgeois Lane Transformer Kiosk (Project #2009-01), raising it from the initial estimate of \$53,100 to \$143,000. The substantial increase results from an engineering report that recommended additional installation of a secondary splitter box and a steel vault cover. The two adjustments (deferral of the Scada software upgrade project and an increase in the estimate of the Bourgeois Lane Project) and the capital adjustments to certain projects as a result of a response to VECC interrogatory number 2, have increased the proposed capital expenditures for 2009 by \$121,860 to a total of \$2,820,400. Midland is proposing to reflect this change at the time final rates are determined.

Although Midland has argued that a majority of its projects are critical as they impact system reliability, its reliability indices for the years 2003 to 2007 do not show any deterioration<sup>1</sup>. Also, Midland has not provided any forecast indices or explained how its proposed projects will impact the reliability indices going forward.

Board staff invites parties to comment on whether Midland's proposed capital expenditures for 2009, including an increase of \$121,860 to the original estimate, are appropriate.

## **Payment in Lieu (PILs) of Taxes**

### **1. Income Tax**

#### **Discussion and Submission**

In the pre-filed evidence Midland claimed a total PILs expense of \$204,993. This amount was reduced to \$80,822 as result of Board Staff interrogatories that questioned the inclusion of deemed debt interest in the income tax calculation.

Calculations by Board staff indicate a total PILs expense of \$75,976. The difference in the two amounts (\$80,822 and \$75,976) exists due to the fact that Midland has added the PILs amount to its taxable income in order to determine its income tax rate. In Midland's case, the addition has pushed its income over the \$400,000 threshold, for which a higher tax rate applies.

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<sup>1</sup> Exhibit 2, Tab 3, Schedule 1, Page 2

However, as a result of the 2009 Federal Budget, the amount of small business income eligible for the 11% tax rate has been increased to \$500,000 from \$400,000. This means that even if Midland were to add the PILs amount to its taxable income, the total income tax rate would be 16.5%<sup>2</sup> as it would still be under the \$500,000 threshold.

Board staff submits that the appropriate regulatory income tax rate for Midland is 16.5% based on changes announced in the 2009 Federal Budget. Board staff submits that Midland should reflect this change in the draft Rate Order.

## Cost of Capital

### Background

Midland has provided its proposed Cost of Capital in Exhibit 6. The following table summarizes its proposals in this area:

**Table 2**

| <b>Cost of Capital Parameter</b> | <b>Applicant's Proposal</b>  |
|----------------------------------|--|
| Capital Structure                | Requesting Board approval of a capital structure of 56.67% debt and 43.33% equity. This is to comply with the <i>Report of the Board on Cost of Capital and 2<sup>nd</sup> Generation Incentive Regulation for Ontario's Electricity Distributors</i> , issued December 20, 2006 (the "Board Report"). |
| Short-Term Debt                  | Requesting a 4% short-term debt component with a rate of 4.47% in accordance with the letter from the Board of March 7, 2008 regarding cost of capital updates for 2008 cost of service applications, consistent with the Board's Report   |
| Long-Term Debt                   | Proposing a weighted debt cost rate for 2009 of 4.64%  |
| Return on Equity                 | Proposing a return on equity rate for the 2009 Test year of 8.57% in accordance with the Board's letter of March 7, 2008 regarding cost of capital updates for 2008 cost of service applications consistent with the Board's Report.   |

<sup>2</sup> Federal Rate of 11% + Ontario Income Tax Rate of 5.5% = 16.5%

## **Discussion and Submission**

### **Capital Structure**

Midland states that it has a current (2008) capital structure of 53.33% debt and 46.67% equity and is requesting Board approval of a capital structure of 56.67% debt and 43.33% equity. It is requesting this change primarily to comply with the Board Report which requires all licensed Ontario electricity distributors to move toward a 60% debt and 40% equity ratio.

Board staff notes that Midland's proposal appears to be consistent with the Board Report.

### **Short Term Debt**

Midland has included a 4% short-term debt component as part of its proposed capital structure and is proposing a short-term debt rate for the 2009 Test year of 4.47% in accordance with the letter from the Board of March 7, 2008 regarding cost of capital updates for 2008 cost of service applications, consistent with the Board Report.

The Board will update the short-term debt rate in early 2009 for rates effective May 1, 2009. Midland has not indicated whether it has adopted the short term debt rate without prejudice to any revised rate that may be adopted by the Board in early 2009.

Board staff invites Midland to indicate to the Board whether it has adopted the short term debt rate without prejudice to any revised rate that may be adopted by the Board in early 2009.

### **Long Term Debt**

Midland's current long-term debt note is by way of a promissory note payable to the Corporation of the Town of Midland. The interest rate payable in any given year is the Government of Canada 10-year bond rate posted by the Bank of Canada on December 31<sup>st</sup> of each year. The terms of this note include prepayment at any time without notice or bonus. Midland has filed a copy of the original Promissory Note dated January 23, 2002.

Midland also has a long term debt with a financial institution at a rate of 5.0%.  
Midland's weighted cost of debt of 4.64% has been calculated as follows:

| Description                 | Effective Rate | Debt Balance | 2009 Cost | 2009 Ending Balance |
|-----------------------------|----------------|--------------|-----------|---------------------|
| Note payable to shareholder | 3.99%          | \$1,122,519  | \$ 44,789 | \$1,122,519         |
| Debenture/Loan to Bank      | 5.00%          | \$2,000,000  | \$100,000 | \$2,000,000         |
| TOTAL                       | 4.64%          | \$3,122,519  | \$144,789 | \$3,122,519         |

Midland has indicated that going forward it will incur additional debt as it moves to complete its Smart Meter Implementation Plan.

Board staff submit that Midland's proposed long term cost of debt appears to be compliant with the Board Report.

### **Common Equity**

Midland is proposing a return on equity ("ROE") rate for the 2009 Test year of 8.57%, in accordance with the Board's letter of March 7, 2008 regarding cost of capital updates for 2008 cost of service applications, consistent with the Board's Report. Midland has confirmed that its use of an ROE of 8.57% is without prejudice to any revised ROE that may be adopted by the Board in early 2009.

Midland believes that the requested capital structure and equity return will provide continued access to long-term debt at reasonable rates.

Board staff notes that Midland's proposal appears to be consistent with the Board Report.

### **Line Losses**

#### ***Background***

Midland is an embedded distributor of Hydro One. Midland has proposed to maintain its distribution loss factor ("DLF") and total loss factor ("TLF") at the 2007

approved levels of 3.01% and 6.51% respectively. Midland provided DLF and TLF averages with its proposal.<sup>3</sup>

Midland noted in its application and reiterated in its interrogatory responses that, in 2006, one of Midland’s metering points read by Hydro One was malfunctioning. Midland noted that the meter may have been inaccurate for 2005 as well.

Midland’s DLF and TLF varied over the 5-yr period from 2003 to 2007, and is shown in table 3 below:

**Table 3**

|              | 5 year average (2003-2007) | 4 year average | 4 year average (excluding 2006) | 2007 approved | 2009 proposed |
|--------------|----------------------------|----------------|---------------------------------|---------------|---------------|
| Embedded DLF | 1.0318                     | 1.0313         | 1.0294                          | 1.0301        | 1.0301        |
| TLF          | 1.0669                     | 1.0664         | 1.0644                          | 1.0651        | 1.0651        |

Midland noted that it is experiencing an increase in residential load, which can increase losses, and the variability of those losses. Midland also indicated that the balance in variance account 1588 is increasing, and that this should be considered an indication that the current loss factor should increase. However, Midland indicated that it would not request an increase to its loss factor until additional historical data is available.

Midland provided a modified Schedule 10-5 in response to Board staff interrogatory number 13. Staff has reproduced the TLF values from that response in the Table 4 below.

**Table 4 – Modified Schedule 10-5 Total Loss Factors**

|                  | 2005   | 2006   | 2007   | 3 year average |
|------------------|--------|--------|--------|----------------|
| DLF <sup>4</sup> | 1.0211 | 1.0413 | 1.0346 | 1.0323         |
| TLF              | 1.0558 | 1.0767 | 1.0697 | 1.0674         |

<sup>3</sup> Values reproduced at Board staff IR #10

<sup>4</sup> Does not include upstream losses (Hydro One SFLF=1.0340)

### ***Discussion and submission***

Board staff notes that Midland's determination of DLF and TLF is based on an apparent analysis of 4 and 5 year averages. Board staff notes that the proposed loss factor is greater than the averages calculated; both are shown in Table 3.

Board staff notes that Midland's actual DLF and TLF values for 2007, as seen in Table 4, were greater than the values approved for 2007. Staff submits that Midland's proposed loss factors for 2009, while higher than the averages provided in Table 3, are a better reflection of losses within Midland's system.

With respect to Midland's comments regarding variance account 1588 resulting from the loss factor, Board staff submits that loss factors should be set based on past and expected losses in the distribution system. The Board has its own processes for disposing of the balances in variance accounts.

Board staff submits that Midland's proposed DLF of 1.0301 and proposed TLF of 1.0651 are consistent with other partially embedded distributors of similar size and profile.

## **Cost Allocation and Rate Design**

### **Low Voltage Costs**

#### ***Background***

In its original filing, Midland requested Low Voltage ("LV") costs of \$339,515. These LV charges did not take into account consideration of Hydro One's proposed rate changes.<sup>5</sup>

Midland's proposal is to allocate LV costs to the customer classes on the basis of retail transmission connection revenue collected from each class. The proposed LV costs by class are then divided by the projected volumetric charges.

#### ***Discussion and Submission***

Staff notes that two events have occurred subsequent to the second round of interrogatories that affect the cost forecast. The final Hydro One LV rates were approved on January 28, 2009, and are lower than the interim rates. Second,

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<sup>5</sup> Exhibit 5, Tab 1, Schedule 2

Hydro One has applied for new rates to take effect May 1, 2009 (EB-2008-0187). Staff submits that Midland should assume that the latter rates will determine its costs in 2009 and that Midland should provide an update to its LV cost forecast in its reply submission.

Staff submits that as a future test year cost of service application, Midland is properly assigning LV charges based on 2009 figures.

## **Retail Transmission Service Rates**

### ***Background***

In its original application, Midland indicated it had not prepared updated retail transmission costs, and would await a Board order directing it to update these rates.<sup>6</sup>

Midland indicated in response to Board staff interrogatory number 5 that its proposed 2009 retail transmission service (“RTS”) rates did not take into account the Board’s guidelines on RTS rates, issued October 22, 2008. The response to Board staff interrogatory number 5 includes a new calculation to more accurately reflect the costs of these services from Hydro One.

Midland’s proposed RTS rates take into account changes to Hydro One’s Uniform Transmission Rates (wholesale) that came into effect January 1, 2009. In response to Board staff interrogatory 5c, Midland included further changes to mitigate large variances, shown as of October 31, 2008, in the associated network and connection variance accounts noted below:

|  |               |
|--|---------------|
| Account 1584 – Retail Transmission Network Charge    | \$387,291     |
| Account 1586 – Retail Transmission Connection Charge | (\$1,534,690) |

Midland provided a variance analysis indicating how the rates would mitigate growth in these balances.

Midland’s proposed RTS rates match the change in the wholesale rates.

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<sup>6</sup> Exhibit 4, Tab 2, Schedule 12

As part of the response to Board staff interrogatory number 5, Midland indicated that its analysis determined that if the Transmission Connection and Network charges are not adjusted, the Deferral and Variance account balances will continue to grow. Midland noted that it had considered this in its original application, and provided a further update to take into consideration the growing balances.

### **Discussion and Submission**

The Board's guidelines on RTS rates states, "The pattern over time of the amounts being recorded in these accounts can guide the distributor as to what adjustments may be needed to maintain the balance of the deferral accounts at a reasonable level."<sup>7</sup>

The balances in account 1584 and account 1586 reflect historic disparities in the Network and Connection rates respectively. The amounts are the balances as of December 31, 2007 plus interest to April 30, 2009.

Staff submits that the response provided by Midland at Board staff interrogatory number 5 takes into account the update to Hydro One's Uniform Transmission Rates, and the trend analysis provided by Midland addresses the concern regarding the growing balances in account 1584 and account 1586. Staff submits that the RTS rates developed by Midland are designed to collect the associated revenues appropriately.

### **Revenue to Cost Ratios**

#### ***Background***

The revenue to cost ratios for each class from the informational filing appear in column 3 in Table 5 below.<sup>8</sup>

Midland's application involves a re-balancing of class revenues to better reflect the results of the cost allocation model. The proposed revenue to cost ("R/C") ratios are shown in the second column.

For convenience, the Board's Cost Allocation Report target range for each class is shown in column 2, which are based on the Board Report.<sup>9</sup>

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<sup>7</sup> Page 3, second paragraph

<sup>8</sup> Table reproduced from Response to Board staff interrogatory number 3

**Table 5 – Response to Board Staff Interrogatory number 3**

| Customer Class       | CA Report <sup>10</sup> Range | CA Info. Filing | 2009 Rate Application, as requested | 2010 IRM | 2011 IRM |
|----------------------|-------------------------------|-----------------|-------------------------------------|----------|----------|
| Residential          | 85-115                        | 118.18          | 107                                 |          |          |
| GS < 50              | 80-120                        | 97.96           | 98                                  |          |          |
| GS > 50 kW – regular | 80-120                        | 83.67           | 98                                  |          |          |
| Street Lighting      | 70-120                        | 23.46           | 49                                  | 60       | 70       |
| Sentinel Lighting    | 70-120                        | 28.21           | 49                                  | 60       | 70       |
| USL                  | 80-120                        | 117.38          | 100                                 |          |          |

**Discussion and Submission**

Board staff notes that the proposed ratios are within the Board’s range for all classes except Street Lighting and Sentinel Lighting, and that the changes proposed are in-line with the Board’s policy, insofar as they move the ratios closer to unity in all instances.

The proposed R/C ratio for Street Lighting is at the midpoint between the status quo and the lower boundary of the Board’s policy range. A number of recent decisions have found this ratio to be acceptable in this type of situation. Many of those decisions have gone on to require that the revenue re-balancing continue in subsequent years, culminating in a ratio that would be in the policy range before the expected next cost of service application.

In response to Board staff interrogatory number 5(b) Midland provided assurance that it will reach the lower boundary of the policy range by 2011 for Street and

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<sup>9</sup> *Application of Cost Allocation for Electricity Distributors*, EB-2007-0667

<sup>10</sup> Report of the Board, *Application of Cost Allocation for Electricity Distributors*, November 28, 2007

Sentinel Lighting. In many recent decisions, LDCs have been required to meet the lower boundary of the target range in the year subsequent to the approved rate year. In the case of Midland, this would constitute a minimum of a 70% R/C ratio for both Street and Sentinel Lighting by the 2010 rate year. Staff submits that Midland should be required to reach 70%, the lower boundary for revenue-to-cost ratio, for Street and Sentinel Lighting in the 2010 rate year, rather than the 2011 rate year as Midland has proposed.

## Deferral and Variance Accounts

### Accounts specifically requested for disposition by Midland

#### *Background*

Midland is requesting clearance of the accounts shown in the Table 6 below.<sup>11</sup> The balances for disposition as of April 30, 2009 have since been updated as per the revised continuity schedule.<sup>12</sup> The balances provided below include December 31, 2007 balances with interest forecasted up to April 30, 2009:

**Table 6 – Deferral and Variance Accounts  
Requested for disposition by Midland**

| Account Number | Account Description     | Balance |
|----------------|-------------------------|---------|
| 1508           | Other Regulatory Assets | 89,068  |
| 1550           | LV Variance Account     | 122,180 |
|                | Total                   | 211,248 |

In response to Board staff supplemental interrogatory number 4, Midland indicated it would transfer amounts from account 1508, sub-account – Other – Transition Costs, to account 1590. On February 19, 2009, Midland filed an updated continuity schedule to reflect the changes in account 1508 and 1590, and an updated table of proposed riders.

<sup>11</sup> Exhibit 5, Tab 1, Schedule 1

<sup>12</sup> Response to Board staff interrogatory number 6a, Attachment 1. Updated February 19, 2009.

Midland’s proposal is to collect these amounts from rate payers over two years beginning May 1, 2009 via rate riders. It is proposed that the two year rate rider be a variable rate rider.

**Discussion and Submission**

Board staff submits that the Board should consider allowing Midland’s request to clear these accounts. Staff has further comments on other accounts which may be considered for disposition.

**Accounts not requested for disposition by Midland**

**Background**

A list of all deferral and variance accounts, which includes accounts specifically requested for disposition, is reproduced from the revised continuity schedule filed by Midland.<sup>13</sup> There are a number of accounts which staff submits the Board may wish to consider for disposition (Table 7) and a number of accounts which staff submits should not be considered for disposition (Table 8).

**Table 7 – Deferral and Variance Accounts  
To be considered for disposition**

| Account Number | Account Description   | Balance     |
|----------------|---|-------------|
| 1508           | Other Regulatory Assets – Sub-Account – OEB Cost Assessments  | 15,791      |
| 1508           | Other Regulatory Assets – Sub-Account – Pension Contributions | 73,277      |
| 1518           | Retail Cost Variance Account – Retail                         | (8,739)     |
| 1550           | Low Voltage Variance Account                                  | 122,180     |
| 1580           | RSVA – Wholesale Market Service Charge                        | (395,943)   |
| 1582           | RSVA – One-time Wholesale Market Service                      | 15,930      |
| 1584           | RSVA – Retail Transmission Network Charge                     | 280,233     |
| 1586           | RSVA – Retail Transmission Connection Charge                  | (1,029,880) |
| 1588           | RSVA – Power (including Global Adjustment)                    | 672,930     |
|                |   |             |
|                | Total   | (254,221)   |

<sup>13</sup> Response to Board staff interrogatory number 6a, Attachment 1. Updated February 19, 2009

**Table 8 – Deferral and Variance Accounts  
Not to be considered for disposition**

| Account Number | Account Description                         | Balance   |
|----------------|---|-----------|
| 1555           | Smart Meter Capital and Recovery Offset     | (16,280)  |
| 1562           | Deferred Payments in Lieu of Taxes ("PILs") | (450,634) |
| 1563           | Deferred PILs Contra Account                | 450,634   |
| 1590           | Recovery of Regulatory Asset Balances       | 349,985   |
|                |   |           |
|                | Total                                       | 333,705   |

***Discussion and Submission***

**To be considered for disposition (Table 7)**

Staff notes that the credit balance submitted for these accounts (RSVA, RCVA, low voltage, and certain non-RSVA variance accounts) is approximately 7% of the proposed revenue requirement for 2009.<sup>14</sup> Staff submits that the Board may wish to consider disposing of these balances at this time rather than waiting for the separate initiative that the Board will undertake for the review of the commodity account 1588 (RSVA-Power) and other related RSVA and RCVA accounts. The rules or guidelines with respect to that process are not yet known. Although it has been the Board’s practice not to dispose of RSVA and RCVA accounts until such time as the initiative noted above is established, the Board may wish to consider disposition at this time as it has done in previous applications where certain LDCs were carrying large balances.<sup>15</sup>

These accounts, which include the accounts already requested for disposition by Midland, total a credit balance of \$254,221.

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<sup>14</sup> Midland originally requested to dispose only accounts 1508 and 1550, and over a period of two years. Given a similar two year recovery, the resulting amount as a portion of revenue requirement becomes approximately 4% of revenue requirement per annum.

<sup>15</sup> Decision for Hydro 2000 – EB-2007-0704, page 10

Staff submits that Midland should submit an updated table of proposed rate riders reflecting the accounts included in Table 7 to be considered for disposition.<sup>16</sup>

**Not to be considered for disposition (Table 8)**

These accounts, which may be reviewed by separate independent Board processes, have a total debit balance of \$333,705 Board staff submits that these accounts should not be disposed of in this proceeding.

- All of which is respectfully Submitted -

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<sup>16</sup> Similar to the table provided in the August 15, 2008 filing at Exhibit 5/Tab 1/Schedule 3.