Hydro One Networks Inc.

Transmission Revenue Requirements, 2009, 2010

EB-2008-0272

Board Staff Submissions

March 20, 2009

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1.0 Introduction

Hydro One Network Inc. ("Hydro One", "the Applicant", or "the Company") filed an application on September 30, 2008 for an order or orders approving a transmission revenue requirement of $1,233m in 2009 and $1,341m in 2010, to be implemented on July 1, 2009. Hydro One further requests that the Board amend the Uniform Transmission Rates to allow for recovery of the proposed revenue requirements for 2009 and 2010. If approved, this would equate to an increase in transmission rates of 6.4% in 2009 and a further 12.1% in 2010.[1]

The following parties intervened in the proceeding:

AMPCO
Building Owners and Managers Association
Canadian Manufactures and Exporters
Consumers Council of Canada
Electricity Distributors Association
Energy Probe Research Foundation
Five Nations Energy Inc.
Great Lakes Power Transmission LP
Hydro Ottawa
IESO
Lewis Balogh
London Property Management Association
Ontario Power Generation
Pollution Probe
Power Workers' Union
School Energy Coalition
Shell North America
The Society of Energy Professionals

[1] For a complete summary of the requested relief, see Exhibit A, Tab 2, Schedule 1, pp. 1-3.

Toronto Hydro
Union Gas Limited
Vulnerable Energy Coalition

The Board established and issued a draft Issues List and invited comment. A final Issues List was then issued with Procedural Order no. 4. Although a settlement conference was held there was no agreement reached on any of the issues. All issue were reviewed as part of the oral hearing which commenced on February 19 and concluded on March 6, 2009.

Board staff has not addressed all issues on the Issues List in this submission. Only those issues which in Board staff's opinion require some adjustment to Hydro One's proposed application, or that seek the Board to direct Hydro One in future applications have been addressed here.

2.0 Export Revenues

Issue 2.2: Are Other Revenue (including export revenue) forecasts appropriate?

Export Revenue

Hydro One forecasts export revenues of $12m in 2009 and $12m in 2010. No changes are sought to the export transmission tariff of $1/MWh. In the Board approved settlement agreement in Hydro One's last rate case (EB-2006-0501) the IESO committed to a study of the export transmission tariff involving neighbouring jurisdictions and market participants. The study is to focus on reciprocal arrangements with other jurisdictions for an Export Transmission Service ("ETS") with the intention of eliminating the ETS. That study is to be completed by June 2009.

Undertaking J3.2 provided the revenues Hydro One received for export transmission service over the last three years and total amounts are shown here below.

2006	2007	2008
$13,250,100	$14,131,500	$24,589,600

In its evidence[2] Hydro One refers to the IESO's 2008-2010 Business Plan as basis for its 2009 and 2010 export revenue forecast. The table below is from the IESO's 2008-2010 Business Plan (p.33) and shows the export revenue.

($ millions)	2007 Projected	2008 Budget	2009 Plan	2010 Plan
Outlook Demand Forecast	154.4	154.5	154.9	156.5
Less: Transmission Line Losses[4]	(4.6)	(4.6)	(4.6)	(4.7)
Exports[5]	11.2	10.9	11.2	11.1
Total	**161.0**	**160.8**	**161.5**	**162.9**

Source: IESO 2008-2010 Business Plan p. 33

5 Exports assumptions are based on a three-year rolling average.

Counsel for CME as part of cross-examination[3] questioned Hydro One on its historical export revenues in relation to what was forecast for 2009 and 2010. Counsel pointed out that the actual revenues are higher than the forecast amounts being used by Hydro One. Hydro One indicated however, that to the extent that the export revenues were under-forecast, it would penalize the company[4].

Board staff submits that the actual export revenue received by Hydro One over the past three years supports a higher forecast amount for 2009 and 2010. The average revenue over the past three years is $17,323,733. Although Board staff recognizes that the revenues for 2008 were unusually high and may be anomalous, even prior to 2008 export revenues were higher than the $12M being forecast for 2009 and 2010.

Board staff suggests that the Board consider increasing the export revenue amounts for the test years by 2-3 million dollars. This figure would be more in

[2] Ex. H1/T5/S1/p.2
[3] Transcript volume 3 page 141
[4] Transcript volume 3 page 142

line with the historic averages. The evidence filed by Hydro One does not reveal any convincing rationale for why the export revenues would be lower than the historic norm.

3.0 Staff Compensation

Issue 3.3: Are the compensation levels proposed for 2009 and 2010 appropriate?

Background

Hydro One provided historical and test year payroll information for Hydro One Networks Inc. The projected payroll is $589.2m for 2009 and $619.9m for 2010.[5] These data reflect combined compensation cost for the transmission and distribution businesses. A portion of the compensation cost is included in OM&A and the rest in capital. Hydro One states that due to the nature of its integrated transmission and distribution workforce, separate workforce data and compensation data for the transmission business only is not available.[6]

Compensation levels at Hydro One have been a source of concern for the Board and many intervenors for several years. In the 2006 Hydro One distribution rates case, the Board stated:

> The Board notes that the high compensation issue for Hydro One has a considerable history before this Board, dating back to the Ontario Hydro days.
>
> [...] The Board is particularly concerned about the apparently high labour rates. In this respect, the Board expects Hydro One to identify what steps the company has taken or will take to reduce labour rates.

[5] Exhibit C1, Tab 3, Schedule 2, page 10
[6] Exhibit I, Tab 2, Schedule 11

> Even so, the comparisons between Hydro One's cash compensation with certain other utilities presented by intervenors are of concern. […]
>
> The Board will not make an adjustment to the proposed OM&A costs based on compensation levels at this time but expects the utility to demonstrate in the future that lower compensation costs per employee have been achieved or demonstrate concrete initiatives whereby compensation costs will be brought more in line with other utilities.[7]

In the last Hydro One transmission rates case (EB-2006-0501), the Board commented:

> The Board finds itself in the same position after this hearing as it was after the hearing on Hydro One's 2006 distribution rates – it has lingering concerns about the size and growth of overall compensation costs at Hydro One. Having said that, the Board will accept the forecast compensation costs for 2007 and 2008. The evidence on compensation costs in this proceeding, while less than optimal, is sufficient to enable the Board to make this finding. […]
>
> Some intervenors recommended that the Board should direct Hydro One to prepare a more comprehensive study of its compensation costs and how they compare with the costs of comparable utilities. Hydro One indicated during the hearing that it is carrying out further work now that will be filed as part of its next distribution case.

[7] EB-2005-0020/EB-2005-0378, Decision with Reasons, pp. 14-15.

> The Board looks forward to the filing of a study which provides useful and reliable information concerning Hydro One's compensations costs, and how they compare to those of other regulated transmission and/or distribution utilities in North America. […]
>
> In the study that Hydro One is now preparing, the Board expects it to provide empirical evidence which reveals the relative productivity of its workforce in comparison to other utilities. Deficiencies in the evidence which are not fully justified could be construed against the utility in its next rates case[8].

In the most recent Hydro One distribution cost of service hearing, the Board stated:

> Virtually every intervenor expressed some frustration with respect to the nature of the evidence supporting the company's compensation proposal. This area has been a challenge for the company, intervenors and the Board for some time. It appears as though the company is preparing a more informative benchmarking evidence for the purposes of its transmission application. As noted above with respect to the vegetation management issue, effective benchmarking is absolutely crucial for this Company and the ratepayers' interest going forward. Without such information, which takes into account the interests of both the ratepayers and the Company, it is difficult to judge the adequacy or inadequacy of the company's proposal. Accordingly, most parties deferred their concerns on this

[8] EB-2006-0501, Decision with Reasons, pp. 32-33.

subject matter for consideration in the context of the transmission case where it is hoped a full and fruitful examination of the Company's relative compensation costs can be conducted[9].

Reporting of Compensation

Hydro One does not request approval of its compensation levels specifically; rather it requests approval of its OM&A and capital budgets for the test years. The lack of transmission specific compensation and staffing data is a source of frustration for parties.[10] However, Hydro One does have the capability to estimate labour cost for transmission and further breakdown that transmission labour cost by OM&A and capital[11,12] . These estimates would be helpful in understanding and evaluating the application.

Staff recommends that the Board require Hydro One to provide these estimates, for historic and test years, in the next distribution and transmission rate cases.

The Compensation Cost Benchmarking Study

In response to the Board's direction, Hydro One conducted a compensation benchmarking study by engaging Mercer Canada and Oliver Wyman (the "Mercer Study"). On an overall weighted average basis for the benchmarked positions, the Mercer Study concluded that total compensation levels at Hydro One are approximately 17% above the market median.

As directed by the Board, the Mercer Study also included a productivity component. Four transmission and distribution productivity indicators were measured: compensation per MWh sold, compensation divided by gross asset

[9] EB-2007-0681, Decision with Reasons, p. 15.
[10] Transcript Volume 3, page 150, lines 8-13, page 154-155
[11] Exhibit C1, Tab 5, Schedule 2, Attachment 1, Attachment A, page 1
[12] Exhibit J3.5, page 3, Note 4

value, compensation per km of line, and compensation per square kilometer of service territory. According to the study, Hydro One ranked better than the median on all indicators except one (service territory), which was slightly below median. The Mercer Study concluded: "examining the mix of [productivity] indicators leads to the conclusion that Hydro One requires less workforce compensation to generate various units of output."[13] In its pre-filed evidence, Hydro One stated: "[T]he positive Hydro One productivity results balance Hydro One's total compensation being above the market median. The [Mercer Study] results provide further support for Hydro One's position that its continued productivity accomplishments offset its relative compensation levels.[14]"

Although Hydro One ranked better than median on three of the four measures; only for the compensation per MWh sold measure was Hydro One markedly better than its comparator companies (here it was ranked as the best of the seven companies examined). For both compensation divided by gross asset value and compensation per kilometer of line, the Company ranked fourth out of seven[15].

The value of the compensation per MWh sold indicator as a tool for assessing relative productivity was challenged by counsel for Energy Probe in his cross examination of Hydro One's witness panel. Energy Probe noted that the comparator companies in the productivity benchmarking were largely companies that provided both transmission and distribution functions. The majority of distribution services in Ontario, however, are provided by local distribution companies and not Hydro One. This leads, in Energy Probe's view, to an improper comparison in that Hydro One is not responsible for many of the services (and therefore the associated costs) provided by the comparator companies. Hydro One has in fact conceded that there are some limitations to the productivity analysis. In his argument in chief to the Board, counsel for Hydro

[13] Exhibit A, Tab 16, Schedule 2, Attachment 1, p. 2.
[14] Exhibit C1, tab 3, Schedule 2, p. 16.
[15] Exhibit A, Tab 16, Schedule 2, Attachment 1, p. 31. Hydro One's ranking on the remaining measure, compensation per square kilometre of service territory, was fourth out of six.

One stated: "[Counsel for Energy Probe] pointed out that the utilities in the sample group were not necessarily comparable because some had distribution components and others did not. I think he may have had a valid point there. The applicant acknowledges that the productivity benchmarking study performed by Oliver Wyman has limitations.[16]"

Hydro One's Position

Hydro One pointed to a number of factors which led to compensation levels 17% above the market median: "Factors that can be attributed to Hydro One's position in the compensation market would include legacy collective agreement commitments, a need for competitive salaries and legacy pension and benefit programs."[17] In his argument in chief to the Board, counsel for Hydro One re-iterated and expanded upon these points. He noted that Hydro One is heavily unionized, and that the Company would be unable to keep the system operating if the largest union, the Power Workers' Union ("PWU"), should strike. He stated that the Company had been making efforts to control its labour costs, and had in fact had a strike by the Society of Energy Professionals ("SEP") in 2005. Counsel for Hydro One further noted that the current collective agreements with the PWU and the SEP were negotiated in a much rosier economic climate, and that the annual 3% wage increases provided in those agreements were considered to be normal or even favourable to the Company at the time. Hydro One accepted that the Board is not bound by the Company's contracts with its workers. However, counsel for Hydro One stated: "[I]n my respectful submission, the Board does not have the jurisdiction to refuse to allow a company to recover costs which it incurred to provide service to its ratepayers unless, unless the Board is satisfied that there is compelling evidence to show that the company acted imprudently in entering those contracts."[18]

[16] Transcript Volume 7, p. 17.
[17] Exhibit C1, Tab 3, Schedule 2, p. 14.
[18] Transcript, Volume 7, pp. 12-14.

Submission

It is the submission of Board staff that Hydro One has not sufficiently justified its overall level of staff compensation, and the Board should consider a reduction to the revenue requirement to account for this.

As noted above, compensation levels at Hydro One have been a source of frustration for the Board and intervenors alike for many years. In the past, it appears to staff that the Board has somewhat reluctantly approved the proposed amounts on the basis that it did not have solid grounds to find the costs unreasonable. The Board did, however, direct the Company to produce a compensation and productivity benchmarking study in order to obtain a clearer picture of the Company's compensation levels. The Board indicated that "effective benchmarking is absolutely crucial for this Company and the ratepayers' interest going forward."[19]

The Mercer Study shows that Hydro One's overall compensation levels for the positions examined are 17% above market median. For some individual positions, total compensation levels were more than 40% above market median[20]. Although Hydro One pointed to some limitations in the compensation element of the study, it did not challenge the study's conclusions.

Hydro One's explanations for its relatively high compensation levels include the impact of legacy collective agreements, the fact that the Company is heavily unionized, the impact of a large number of retirements, and the relative productivity of its work force as demonstrated by the Mercer Study.

With regard to the productivity analysis in the Mercer Study, Board staff shares the concerns expressed by Energy Probe regarding the value of the

[19] EB-2007-0681, Decision with Reasons, p. 15.
[20] Three PWU positions had overall compensation levels more than 40% above market median: Regional Maintainer – lines (43%), Service Dispatcher (42%), and Stock Keeper (42%). Exhibit A, Tab 16, Schedule 2, Attachment 1, p. 19.

compensation per MWh sold indicator. In particular, failing to account for the fact that much of Ontario's distribution service is provided by local LDCs and not Hydro One, whereas many of the comparator companies in the study provide all or most of the distribution services themselves, appears to be a serious methodological flaw. In Board staff's view, this flaw makes the results of this particular part of the analysis unconvincing. As noted above, compensation per MWh sold was the only indicator for which Hydro One was materially better than its comparators.

Board staff also has concerns about the explanations for the relatively high compensation levels themselves. Although the Company's current collective agreements with its unionized staff were originally agreements with Ontario Hydro (i.e. legacy agreements), Hydro One has been a separate entity since April 1, 1999. Its collective agreements have been re-negotiated several times over that time. Although the original Ontario Hydro collective agreements were a starting point to the collective bargaining process, it is Board staff's submission that the importance of the "legacy" factor diminishes with every passing year. The Company concedes that the original agreements are not necessarily a "floor" for subsequent agreements[21]. The Company's witnesses further agreed that the different successor companies had reached different collective agreements with their unionized workers since the break-up of Ontario Hydro[22].

Although Hydro One is indeed heavily unionized, and is faced with an increasing number of retirements in the near term, in this regard they appear to be no different from their compensation comparators in the Mercer Study[23]. These challenges are faced by many businesses in the energy sector. The purpose of a benchmarking study is to compare how similar companies manage these challenges. Although they face similar challenges, the Mercer Study concludes

[21] Transcript Volume 4, pp. 171-172.
[22] Transcript Volume 4, p. 177.
[23] Transcript Volume 4, p. 163.

that Hydro One's comparator companies, on average, have total compensation levels 17% lower than Hydro One.

Hydro One witnesses were asked to address this matter in the hearing:

> Mr. Millar: I will get to the legacy contracts in a moment, but when you say "a need for competitive salaries", isn't that what the Mercer study sets out, the compensation study? Doesn't that tell you more or less what a competitive salary would be?
>
> Mr. McDonell: Perhaps, because that is the peer group from which we are competing for staff, yes.[24]

Board staff accepts that Hydro One is heavily unionized. It is Board staff's submission, however, that a unionized work force does not give a regulated utility authority to recover unreasonable staff compensation costs from ratepayers. In the last Hydro One transmission rate case, the SEP challenged the Board's jurisdiction to provide guidance with respect to compensation costs negotiated as part of the collective bargaining process. The Board rejected the SEP's arguments, and found that it has not only the jurisdiction, but the duty to review a utility's labour costs in order to arrive at a just and reasonable rate:

> In assessing the Society's assertions it is important to note that where there is jurisdiction to regulate there is also an obligation to regulate. A regulatory body such as the Board has a positive obligation to fulfill the mandate bestowed upon it by the Legislature. The Board has a positive obligation pursuant to section 78 to ensure that the rates governing the transmission of electricity are just and reasonable.
>
> […] The Board's obligation to arrive at just and reasonable rates, and to protect the interests of consumers, requires it

[24] Transcript Volume 4, p. 170.

> to assess the reasonableness of all cost categories for which recovery is sought. The Board has a wide discretion to allow, disallow or adjust the components of both rate base and expense.
>
> […]The Board did not and does not prohibit the Utility from paying to its workforce whatever it negotiates within the context of its labour relations environment. What the Board does do is limit the recovery as part of the revenue requirement to that portion of compensation cost which the Board finds to be reasonable.
>
> […]To do otherwise would make the ratepayers captive to whatever private arrangements are agreed to by the Utility and its unions. The Board can only meet its responsibility to protect the interests of consumers if it assesses the reasonableness of the costs which result from such settlements and provides for recovery according to a fair, transparent, and principled regulatory approach.[25]

It is Board staff's submission that the Board has a duty to disallow recovery for compensation costs that it finds to be unreasonable. This would not, of course, mean that Hydro One is not obligated to pay its workers the amounts that were negotiated in the current collective agreements. It would simply mean that this money cannot be recovered from ratepayers.

The best evidence on the record regarding the reasonableness of Hydro One's staff compensation levels is the Mercer Study. Hydro One has not seriously challenged the conclusions of that study with regard to compensation levels. Hydro One's explanations of why it has significantly higher overall compensation

[25] EB-2006-0501, Decision with Reasons, pp. 15-18 (citations omitted).

than its benchmark comparators are either factors they largely share with their comparators and are therefore already accounted for in the Mercer Study (highly unionized work environment, high demand for labour, increasing retirements), or were called into question through cross examination (the productivity analysis in the Mercer Study). The particular increases negotiated in the current collective agreements are not necessarily the issue; the Board must instead consider whether the total compensation it pays to its employees in the test years is unreasonably high. The balance of the evidence clearly suggests that it is.

Board staff therefore submits that there should be a reduction to the revenue requirement to account for these unreasonably high compensation levels. Staff proposes three possible ways to select the appropriate reduction.

In response to Undertaking J3.5, Hydro One indicated that if it were to reduce its overall staff compensation levels by 17% (i.e. the amount they are over the market median according to the Mercer Report), the resulting reduction to the total Hydro One Networks Inc. compensation would be $81.6 million. Based on the Rudden study inputs, 16%, or approximately $13 million, would be associated with transmission business O&MA costs for each of the test years. The first option, therefore, would be to make a reduction to the revenue requirement in the amount of $13 million for each of the test years.

Board staff recognizes, however, that benchmarking studies are not perfectly precise tools, and submits that a reduction by the entire $13 million amount may not be warranted. Board staff also recognizes the difficulties the Company faces in negotiating lower compensation through the collective bargaining process. A second option, therefore, would be to reduce the revenue requirement by some percentage – perhaps half of the amount identified in option 1 – i.e. $6-7 million – for each of the test years.

A third alternative considered by Board staff, would be to base the reduction on the percentage of PWU positions that are not specifically related to the

transmission and distribution of electricity. A review of the Mercer Study indicates that approximately 20% of these positions are not specifically related to the transmission and distribution of electricity. These non-unique positions include fleet mechanic, service dispatcher, drafter and stock keeper. Board staff therefore suggests that an appropriate reduction to the revenue requirement would be 20% of the PWU reduction in compensation related to transmission business OM&A. The suggested reduction through this option would be $2 million[26].

[26] Reference Exhibit A Tab 16 Schedule 1 page 19 and Appendix A
Of the benchmarked PWU positions, the descriptions for fleet mechanic, service dispatcher, drafter II, stock keeper, data entry clerk, production field administrator III, meter reader and general labourer are not directly related to the maintenance and operation of the transmission and distribution system. The number of incumbents is 20% of the total. Assuming this is representative of the PWU population, 20% of the $63M identified in column G of J3.5 is associated with these positions. As noted in footnote 4 of J3.5, 16% is related to transmission OM&A.

4.0 Capital Expenditure and Rate Base

Issue 4.1: Are the proposed 2009 and 2010 Sustaining and Development and Operations capital expenditures appropriate, including consideration of factors such as system reliability and asset condition?

Use of Social Discount Rate in Economic Project Evaluation

Hydro One is using a "real social discount rate" of 4% when conducting economic evaluation on certain Network projects. In response to a Board staff interrogatory[27] Hydro One indicated that reliance on 4% is based on the Ontario Power Authority's ("OPA") Integrated Power System Plan (IPSP) that included pre-filed evidence[28] on that 4% level. Board staff notes that the evidence in the noted IPSP proceeding (EB-2007-0707)[29] indicate that the OPA made a determination that the appropriate Social Discount Rate should be between 3.5% to 4.5% and thus the choice of the 4%; and on page 7, lines 7-11, the OPA states in part that :

> *due to wide range of authoritative estimates, it is prudent to examine the degree to which the economic preference for the recommended projects would be affected by SDRs of lower or higher value than the reference 4 % real rate*.

Board staff agrees with Hydro One that in general it is appropriate to use a real social discount rate for assessing economic net benefits of "Network" projects

[27] Interrogatory Response to Board Staff (IR # 60), (Exh I/Tab 1/Sch 60), response to questions (i), (ii) and (iii)
[28] Exh I/Tab 1/Sch 60/ response to i), [Pre-filed Evidence [Ontario Power Authority's (OPA) Integrated Power System Plan (IPSP)], proceeding EB-2007-0707, Exh D/Tab 3/Sch 1/ Attachment 1/pp. 4-7
[29] Exh I/Tab 1/Sch 60/ response to i), [Pre-filed Evidence Ontario Power Authority's (OPA) Integrated Power System Plan (IPSP)], proceeding EB-2007-0707, Exh D/Tab 3/Sch 1/ Attachment 1/Section 3.4/pp. 6-7

where the evaluation involves future energy savings expressed in real terms i.e., un-escalated.

Board staff notes however, that the IPSP review has not been concluded by the Board and therefore the use of a 4% has not been approved as part of that proceeding.

Hydro One has not updated the value of the 4% social discount rate since its use in the 2006 proceeding, EB-2006-0501[30]. Board staff also notes the 4% was used by the OPA for the economic evaluation of the Bruce-Milton Reinforcement Project in proceeding EB-2007-0050[31].

In response to an interrogatory concerning the basis for the 4% social discount rate, the Applicant filed an Ontario Ministry of Finance paper[32] titled "The Social Discount Rate for Ontario Government Projects" (January 2007), by Peter Spiro. An updated version of the paper was also filed (March, 2008). Board staff notes that these two papers have similar recommendation and conclusions as follows:

- The recommended Social Discount Rate is 5% (in both versions - the January, 2007 and the March, 2008);
- In the January 2007 version, the paper's conclusion states, in part, on page 8 in Attachment 1 of that reference:
  "*The market cost of capital that determines the social discount rate can change substantially. It is appropriate to review the value of the social discount rate at least once a year by examining changes in the financial market indicators of the cost of capital****"***.
- The updated study (March, 2008 by the same author on page 10 in Attachment 2 of the same reference the paper's conclusion states in part:

[30] Hydro One Networks Inc. for 2007 and 2008 Electricity Transmission Revenue Requirements, evidence in support of Project D17, Claireville – Cherrywood Re unbundling of 500 kV circuits
[31] Hydro One Network Inc.'s application for the Bruce-Milton Reinforcement Project
[32] Pre-filed Evidence [Ontario Power Authority's (OPA) Integrated Power System Plan (IPSP)], proceeding EB-2007-0707, Exh I/Tab 31/Sch 85/ Attachment 1 and 2 of this paper

> ***"****The supply and demand conditions in the economy that determine the social discount rate can change substantially over time. It is appropriate to review the value of the social discount rate by examining changes in the financial market indicators of the return on capital****."*** (Emphasis added)

Submission

Board staff suggests that the social discount rate should reflect the economic conditions in the province of Ontario which can be reviewed and recalculated on a regular basis by the Board for use in certain Network projects by licensed transmitters. Board staff suggests it may not be necessarily appropriate in the future for Hydro One to rely on a 4% social discount rate for evaluating Network Projects. Hydro One's rationale, essentially, is that this was the discount rate used by the OPA in the IPSP proceeding. As noted above, however, the IPSP proceeding has not concluded, and the Board has made no finding regarding the appropriateness of a 4% discount rate. The OPA also recognized that different authorities recommended different discount rates, and in that light it chose to employ a sensitivity analysis using different discount rates. Hydro One did not do any sensitivity analysis.

Board staff further submits that it is important that Hydro One have a set methodology for calculating the discount rate. In keeping with the recommendations of the two papers by Peter Spiro, the social discount rate should be reviewed and updated frequently.

Board staff submits that Hydro One should file evidence in its next rate case which demonstrates a sound methodology for establishing an appropriate social discount rate.

Capital Expenditures

The application has Hydro One proposing capital expenditure in 2009 of $994.0m (an increase of 34% over 2008 actual expenditures) and $1074m in 2010 (a further increase of 14% over proposed 2009 and an increase of some 52% over actual 2008 expenditures).

Board staff presented a table (Exhibit K1.6) indicating that the actual achievement of capital expenditures has historically lagged behind what had been proposed by the Company and approved by the Board, although there has recently been an increased level of achievement. The table below, derived from Exhibit K1.6, shows the levels of actual expenditure versus approved expenditure in the first and second halves of 2008, as reported in the updates for 2008, and in the hearing.

Hydro One Capital Expenditures
EB-2008-0272

YEAR	Capital Expenditures approved/proposed (D1-3-24)	Capital Expenditure Achieved D1-3-1p6/ as reported	Expenditure Achievement
2007	$711.6m	$559.5m	79%
2008	$774.4m (+9%)	Jan-Jun:$ 260.2m July-Dec: $444m Jan-Dec 2009:$704.2m (+26%)	Jan-Jun 2008: 67.2% July-Dec 2008: 114.7% Jan-Dec 91.5%
2009	$944.0m (+22%)	To achieve expenditure requires 34% increase over previous year (704.2->944)	
2010	$1074.1m (+14%)	Requires additional 14% increase over proposed 2009 expenditures	

The transcript of the hearing[33] reveals that $444m of capital spending was completed in the last 6 months of 2008, and it can therefore be calculated that just $260.2m was completed in the first 6 months. This represents a very dramatic increase in spending – a 70% increase in the second half over the first half of the year. The annualized achievement level in the first 6 months was 67% compared to 114.7% in the second half of the year, for an average achievement of 91.5% of planned expenditure over the year.

Although the Applicant's levels of capital spending increased markedly in the second half of 2008, its overall ability to spend its approved budget over the past several years has not been good. It should also be noted that the 67% approved versus actual spending achievement in the first six months of 2008 was below the 79% approved versus actual spending achievement of the previous year 2007, so it is not clear that there is an overall trend towards greater expenditure achievement. Therefore it is reasonable to question whether the increased levels of spending in the latter half of 2008 are likely to continue. The overall expenditure level for the whole of 2008 may be a more reasonable estimate of likely achievement in future years.

In its pre-filed evidence, Hydro One described its work execution program that would allow it to complete its aggressive capital spending program. The work execution program contained no new methods or radically different techniques introduced in the second six months of 2008 which were not being done in the first six months of the year.

Concerns about not allowing sufficient capital expenditure

The Board's assessment of the Applicant's ability to achieve its proposed capital expenditure will determine whether or not there is over-collection from the

[33] Volume 6 page 187, lines 9 to 11

ratepayers in the short term. Just as it is important that development activity not be constrained, it is also important to the economy that payments in excess of what is needed for the electricity resource should not be collected ahead of the time when they are due. In the 2007 year there was over-collection of 21% in the year, and in 2008 there was over-collection of 9% in the year, representing amounts which were not available for consumer spending or for industry to invest.

It should be remembered that none of this amount relates to activity which might follow from the Green Energy and Green Economy Act which is currently before the Legislature, and therefore would not restrict that in any way[34]. The applicant has indicated that it will be making an application before the Board within a year for requirements which flow from the Green Energy and Green economy Act[35].

Submission

Board staff suggests there is considerable uncertainty surrounding Hydro One's ability to achieve the capital expenditure levels for 2009 and 2010. The budgets for both years are aggressive. Board staff recommends that the Board consider establishment of a variance account which would allow review of the actual achievement and disposition of any over recovery should it occur as part of Hydro One's next rate filing.

[34] Transcripts volume 1 pp 4-5
[35] Transcripts, volume 1, page 7, lines 18 -21

5.0 DEFERRAL/VARIANCE ACCOUNTS

Issue 5.1: Are the proposed amounts and disposition for each of the deferral and variance accounts appropriate?

Issue 5.2: Is the proposed continuation of the deferral/variance accounts appropriate?

Disposition of Accounts

At Exhibit F1/Tab1/Sch1, Hydro One requested the disposition of $18.3 million (balance at June 30, 2009) in regulatory assets. This is a negative balance, i.e., the $18 million is a credit to customers. This total is made up of 3 accounts:

Tax Rate Changes	Account 1592	-$13.9 million
OEB Cost Assessment Differential	Account 1508	-$ 4.2 million
Pension Cost Differential	Account 2405	-$ 0.2 million

Simple interest is applied to the monthly opening principal balance in these accounts according to Board prescribed interest rates.

In response to Board Staff IR#79, Hydro One indicated that the authority for all three accounts is found in the EB-2006-0501 decision when the Settlement Agreement was accepted by the Board. (Page 18, EB-2006-0501 Settlement Agreement)

Board staff also asked (IR#82) specific questions regarding the practice of forecasting principle transactions for a deferral account and Hydro One cited the RP-2005-0020/EB-2005-0378 distribution rates decision of the Board where balances with forecast principle transactions were approved by the Board.

In IR#83 Board staff asked why Hydro One was requesting recovery of these amounts over a 4 year period when it was likely they would soon file another

rates application for new rates in January 2011 (implying that a 2 year period would be more appropriate).

Hydro One responded that it was proposing a four year recovery period to maintain consistency with recovery periods approved for other Regulatory Accounts for its Electricity Transmission and Distribution businesses, such as the 2007-2008 Transmission Rate Proceeding (EB-2006-0501), the 2006 Distribution Rate Proceeding (RP-2005-0020/ EB-2005-0378) and the 2004 Regulatory Assets Review Proceeding (RP-2004-0117/0118). Hydro One also maintained that a four year recovery helps to smooth the customer impact.

Board staff submits that Hydro One's deferral and variance accounts proposed for disposition appear to be properly constituted. However, Board staff submits that a two year recovery period is preferable to the proposed 4 year period as it would then synchronize with the next anticipated change in transmission rates.

Issue 5.3: Are the proposed new Deferral/Variance Accounts appropriate?

New Accounts Continued/Requested

Hydro One requested the continuance of all three accounts mentioned above, but the evidence only mentioned the Pension Cost Deferral Account. In response to Board staff IR # 84 Hydro One confirmed that it is requesting continuance of all three accounts.

In addition, Hydro One also requested two other accounts, with details provided in response to Board Staff IR#86:

i) Transmission System Code and Cost Responsibility Changes Account. Hydro One indicated that this account was one of those approved in the EB-2006-0501 decision when the Settlement Agreement was accepted by the Board. (Page 18, EB-2006-0501 Settlement Agreement). Hydro One did not incur any costs related

to changes in connection procedures, so the account was not opened. The need for this account still exists, and an example provided was the Board's review of the Code's provisions for assigning cost responsibility for enabler lines. The Board's proposal may involve transmitters making investments as part of the Transmitter Designation process, and the mechanism for recovery of such costs is not yet clear.

ii) IPSP and Other Preliminary Planning Costs Account.

This account would cover Hydro One's costs of preliminary work to advance 18 transmission related projects required by the OPA in the IPSP but is yet to be approved. Hydro One maintained that it is prudent to undertake this work to meet the required in-service dates identified by the OPA, but, it faces risks, as the in-service dates are contingent on a yet uncertain IPSP approval. In the event that approval of individual projects in the IPSP may take some time or not be given at all, Hydro One would face a revenue loss. The deferral account is intended to mitigate this risk.

In justifying the need for this account, Hydro One cited the August 13, 2004, Decision 2004-067, of the Alberta Utilities Commission authorizing (then) EPCOR Distribution Inc. ("EDI") to establish a deferral account for the 2004 test year, to track costs incurred in respect of the Alberta Electric System Operator ("AESO"). This was approved again in Decision 2008-125 (December 3, 2008).

Board staff submits that the Transmission System Code and Cost Responsibility Changes Account are appropriate as it was already approved in a previous proceeding. The IPSP and Other Preliminary Planning Costs Account appears to be justified, however Board staff submits that Hydro One should address, using the evidence record as filed, how this account would meet the four Board criteria for the establishment of a deferral or variance account i.e. causation, materiality, inability of management control and prudence, as defined in the Performance Based Regulation handbook following from the decision RP-1999-0034 of

January 18, 2000.

6.0 Cost Allocation

Issue 6.1: Would it be appropriate to make changes to cost allocation in response to the study submitted on line connection costs for customers directly connected to networks stations?

Delivery Points in Network Stations Exempt from Line Connection Charges

Background

For the purpose of costing and pricing transmission services, the transmission system and its assets are classed into three pools: The Network Pool; The Line Connection Pool[36]; and the Transformation Connection Pool. The charges for transmission services are derived per Delivery Point, typically a transformer station (from above 50 kV to below 50 kV). It should be noted that many transmission customers own more than one Delivery Point.

The following is a summary of the first two transmission rate hearings relating to the issue of exemptions of Delivery Points located inside Network Stations from Line Connection Charges.

First Transmission Rate Hearing (RP-1999-0044)

After consulting with its customers, Hydro One, in the first proceeding dealing with its transmission rates[37] (RP-1999-0044), proposed to address a fairness issue by classifying some of its Network Lines as Dual Function Lines.

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[36] The Line Connection Pool consisted of Radial Transmission Lines and after Board approval of Dual Function Lines in proceeding EB-2006-0501, an allocation of Dual Function (Network) Lines are added to the Line Connection Pool

[37] Decision with Reasons, May 26, 2000 for Transmission Cost Allocation and Rate Design for Hydro One Networks Company Inc., proceeding RP-1999-0044

This proposal meant that if any Network Line had a customer Delivery Point connected to it, it would attract Line Connection charges.

In that Decision, RP-1999-0044, the Board approved that concept even though Hydro One had not performed a cost allocation step to break down the cost of the assets between the two Pools – Network Pool and Line Connection Pool.

The following excerpt from the Board's Decision illustrates its concerns:

> *2.2.19 The evolution of the system created a disparity between those transmission customers who, because of historical and geographic circumstances, are served from the 136 delivery points connected directly to a network station and therefore would not pay line connection charges if they own the line, and customers who are served from the other 660 delivery points who are connected to the network stations via dual function lines and would pay a line connection charge even if they own, or have paid for the line connection portion.*

Second Transmission Rate for the years 2007/2008 (EB-2006-0501)

Hydro One addressed one of the two concerns raised by the Board in proceeding RP-1999-0044 by proposing a methodology to allocate the costs of dual purpose lines between network and line connection. This addressed the issue of the mismatch between the assets allocated to the Line Connection Pool and the level of the charges. What Hydro One did not do is address the second issue of not charging Line Connection charges to the 136 Delivery Points connected directly to a network stations. As part of the Settlement Agreement approved by the Board under EB-2006-0501, Hydro One agreed to conduct an internal study to deal with this issue.

Current Application

Hydro One in its pre-filed evidence[38] in this proceeding (EB-2008-0272) conducted the study as outlined in the Settlement Agreement in proceeding EB-2006-0501. The study corrected the statistics which indicated that there are 45 Delivery Points (previously 136) out of a total of 522 Delivery Points (previously 796) (or 8.6 %) that do not pay Line Connection charges.

The study performed an allocation step[39] whereby an average cost of $1.25 million has been assumed in the study. This study identified bill impacts to transmission customers ranging from -1.4% to 330% on the transmission bill. The study is included as Attachment 1 to that noted Exhibit.

Hydro One Transmission is not recommending any change from the current methodology in Cost Allocation of Transmission assets or the definition of the charge determinants for each rate pool.

The total number of Delivery Points on the system[40] is 522. Delivery Points connected to either "Radial Lines" or "Dual Function (Network) Lines" pay Line Connection Charges, while Delivery Points connected to Network Stations are exempt from paying Line Connection Charges.

In response to the Board's Decision with Reasons dated August 16, 2007[41] which included acceptance of a Settlement Agreement[42], Hydro One submitted a

[38] Exh G1/Tab 3/Schedule 1 & Exh G1/Tab 3/Schedule 1/Attachment 1
[39] Exh G1/Tab 3/Sch 1/Attachment 1/p. 3/lines 24-29
[40] Exh G1/Tab 3/Sch 1/Attachment 1/p. 4/lines 9-12
[41] Decision with Reasons dated August 16, 2007 for Hydro One Networks Inc., 2007 and 2008 Electricity Transmission Revenue Requirements, requirements
[42] Decision with Reasons dated August 16, 2007 for Hydro One Networks Inc., 2007 and 2008 Electricity Transmission Revenue Requirements, Settlement Agreement, Section 1.2, Issue 6.2 "Dual Function (Network) Lines" being fully settled by requiring Hydro One to conduct a Study on Line Connection Charges for Customers Connected to Network Stations

study[43] in this proceeding to examine an alternative to the status quo of not charging Line Connection Charges to Delivery Points connected to Network Stations.

It is important to note that the original purpose for Hydro One's "Dual Line Function" proposal and for the Board's acceptance of the approach, is to avoid the unfairness of the fortuitous situations where a Delivery Point belonging to one customer would attract Line Connection Charges because of its connection to a radial line while a second customer with a Delivery Point connection to a Network Line would not pay Line Connection charges.

Hydro One witnesses, during cross examination by Board counsel[44] referred to Hydro One's response to an interrogatory submitted by the Vulnerable Energy Consumers Coalition (VECC)[45]. The response focused on three aspects related to this cost allocation issue:

> **(1)** The dollar impact related to the shift between the pools is not significant;
>
> **(2)** Hydro One's understanding that the Board has previously ruled that customers owning their own line connection facilities to Network Station should not pay a line connection charge, and it appears inconsistent to make customers that own distribution feeders to a transformer station located within a network station pay a line connection charge;
>
> **(3)** The Study alternative redefines a minimal amount of what are currently Network Pool assets as Line Connection Pool assets. This could be perceived as inconsistent with the principle of cost causality for such minimal use of Line Connection Assets.

[43] Exh G1/Tab 3/Sch 1/p. 4/ Section 3 (Study on Line Connection Charges for Customers Connected to Network Stations) & Exh G1/Tab 3/Sch 1/Attachment 1
[44] Transcript Volume 5, March 2, 2009, pages 92 -94
[45] Exh I/Tab 6/Sch 65/pp.1-2

Board staff agrees that the overall dollar impact related to any shift in cost allocation would be minimal. There are, however, issues of fairness and equity which in Board staff's submission require further examination and these are addressed below.

Line Ownership and Board Direction

Board staff observes that Hydro One's argument related to line ownership is in fact referring to only 1 of 2 situations that the Board was concerned about. In its Decision in the first Rate Hearing[46] , the following paragraph clarifies the Board's concern as it stated that:

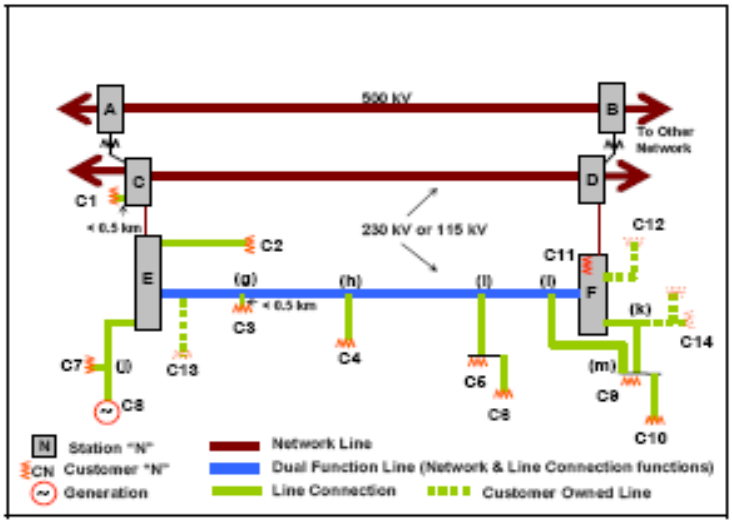
> *2.2.19 The evolution of the system created a disparity between those transmission customers who, because of historical and geographic circumstances, are served from the 136 delivery points connected directly to a network station and therefore would not pay line connection charges if they own the line,* ***and customers who are served from the other 660 delivery points who are connected to the network stations via dual function lines and would pay a line connection charge even if they own, or have paid for the line connection portion****.{emphasis added}*

Board staff points out that the bolded portion of paragraph 2.2.19 clearly refers to the disparity and unfairness which would persist if the exemption from Line Connection charges continues for Delivery Points connected to Network Stations. To illustrate the disparity of treatment, Board staff refers to Figure 1[47] of Hydro One's pre-filed evidence. It shows various configurations for customers connected to the transmission system. In particular both customers C13 and

[46] Decision with Reasons, May 26, 2000, Cost Allocation and Rate Design, RP-1999-0044, paragraph 2.2.19
[47] Exh G1/Tab 3/Sch 1/p.2/Figure 1

Customer C12 own their own Tap lines, where C13 will still pay Line Connection Charges, while C12 will not, even though they both connect to the assets of a single Network pool.

Figure 1



Minimal amount of Assets

Board staff points out that there are many transformer stations (Delivery Points) on Hydro One's transmission system in close proximity to network lines (for cost allocation purposes classed as "Dual Function (Network) Lines").

Board staff is of the view that when the Board accepted the settlement[48] in proceeding EB-2006-0501 in regard to the Dual Function (Network) Lines, in effect the Line Connection Pool has essentially become merely a "Connection Pool". It should be noted that the Line Connection Pool consisted originally of only Radial Transmission Lines, and the asset value reflected that. After the Board's approval of allocating a portion of assets of the "Dual Function (Network) Lines" to the assets of the "Line Connection Pool", in proceeding EB-2006-0501,

[48] Decision with Reasons, August 16, 2007 For Hydro One Networks Inc., 2007 and 2008 Electricity Transmission Revenue Requirements, Section 1.2, Fully Settled Issues including Issue 6.2 (Dual Function Lines)

the value of the assets in the revised "Line Connection Pool" reflected the mix of the two sets of assets. The definition of the "Line Connection" in Transmission System Code[49] informs this aspect as it states that:

> *"line connection" means radial lines that do not, under normal operating conditions, connect network stations and whose sole purpose is to serve one or more persons."*

Board staff is of the view that where Delivery Points are located inside Network Stations, these Network Stations perform Dual Functions similar to the Dual Function Lines in that they perform a Connection Function and a Network Function.

Hydro One's pre-filed evidence[50] indicates that an average cost of $1.25 million per transformer station was used to carry out the allocation study. During the cross examination by Board counsel, the Hydro One witness[51] stated that these costs are rough estimates.

Board staff is of the view that such a study is good for illustrative purposes, but is not of the accuracy normally required when a Board Panel would contemplate ordering any change from the current methodology for cost allocation of transmission assets.

Hydro One's pre-filed evidence[52] showed the impact of implementing the "Scenario" on transmission bills for the year 2009 covering the 45 Delivery Points when their exemption from the Line Connection Charges is removed. The impacts range between 2.6 % and 330% for Directs (Large Consumers) and between 1.9% and 23% for LDCs (Electricity Distributors).

Undertaking J5.3 showed that there are 11 customers owning the 45 Delivery

[49] Transmission System Code, July 25, 2005, paragraph 2.0.39
[50] Exh G1/Tab 3/Sch 1/p. 3/ lines 24-29
[51] Transcript Volume 5, March 2, 2009, pages 88, lines 8-14
[52] Exh G1/Tab 3/Sch 1/Attachment 1/p.8/table 4

Points. Of those 11 customers there are only 2 Large Consumers (Directs), each owning 1 Delivery Point. The transmission bill impact on the first Large Consumer customer is 329% and on the second is 42.5%. The calculation provided in Undertaking J5.3 did not reveal the pattern of electricity use of these two customers. It is very likely that these two customers are shifting their demand to off-peak hours to reduce payments for Transmission Network charges, which in turn explains their high transmission bill impacts.

The 9 distributors that own the 43 remaining Delivery Points experience transmission bill impacts between 22 % and 25.8 %. Of these 43 Delivery Points, 29 Delivery Points are owned by Hydro One Distribution[53] as stated by the Hydro One witness.

Board counsel established that Hydro One did not communicate the results of this study to the other 10 customers who own the remaining 16 Delivery Points[54].

Submission

Board staff submits that in order for the Board to assess the appropriateness of changing the methodology for cost allocation, Hydro One should be directed to revise its study using a detailed asset value assessment for the 45 Delivery Points. Hydro One should also be directed to communicate the results of the revised study to the customers that would be impacted by any changes in allocation.

[53] Transcript, Volume 5, March 2, 2009, page 94, lines 11-16
[54] Transcript, Volume 5, March 2, 2009, page 94, lines 11-21

7.0 Charge Determinants

Issue 7.1: Is the proposal to continue with the status quo charge determinants for Network and Connection service appropriate?

AMPCO charge determinant proposal

Board staff is supportive of increased demand response, where appropriate, and fully understands the benefits it can provide. However, Board staff has some concerns regarding AMPCO's charge determinant proposal.

The primary concern is that the industrial customers that are able to shift consumption may already be shifting consumption to the extent they can to existing price signals and there may be little, if any, incremental demand response under the proposal . If this is the case, it would only result in cost-shifting.

For transmission-connected customers, the percentage of their bill that is comprised by the commodity is between 70% (2006) and 94% (2005). In contrast, the transmission charge only represents about 6%[55]. In addition, Exhibit K6.4 identifies two OPA demand response programs (DR1 and DR3) which are focused on the same purpose -- peak load shedding (k6.4, chart on p. 7). The analysis in the AMPCO evidence was based on 2007 data. DR 1 had just been introduced in 2006 and DR 3 would not be reflected at all as it went live on August 1, 2008. [k6.4, p. 9]

AMPCO's evidence also appears to note that individual industrial customers are already maximizing electrical consumption during off-peak periods and minimizing consumption during on-peak periods.[p.4, lines 6-10] The table on

[55] Transcript volume 6, pp 172-3

page 5[56] shows "Average Industrial Consumption: Summer 2007" and it peaks on Monday to Wednesday from 1 am to 4 am.

Exhibit K6.4 (p. 6) indicates about 35 LDCs have not implemented Peaksaver at all and Exhibit K6.4 (p. 9) identifies that, within LDCs, there is currently only 40–70 MW of demand response potential under the Peaksaver program. At the same time, the OPA DR 1 and DR 3 programs include over 20 industrial customers and 713 MW of peak demand reduction under contract.

Hydro One's application[57] also notes *"until such time as LDCs can pass on the transmission pricing signals to their end-use customers they would be at a disadvantage relative to transmission customers that can respond to the increased time-of-use signals."*
As a result, under the AMPCO proposal, Board staff also has concerns regarding the potential inequities that it would appear to create. For example:

1. between LDCs and directly-connected industrial customers;
2. between industrial customers within LDCs and directly-connected industrials, since LDCs cannot pass on the transmission pricing signals to their end-use customers; and
3. between LDCs that *have* implemented Peaksaver and LDCs that *have not* implemented Peaksaver.

Board staff also shares Hydro One's concerns as per their Closing Argument (page 20-22), particularly:

- While AMPCO has attempted to estimate the transmission cost increase to other customers at $899,206, the proposal contains no rate impact analysis and there needs to be a more thorough assessment of the magnitude of costs being shifted and the potential rate impacts on customers of LDCs.
- Neither the IESO nor the OPA appear to have been formally consulted.

[56] AMPCO Intervenor Evidence Volume L. p.4, lines 6-10
[57] Exhibit H1 Tab 3 Schedule 1, p.3

- No analysis was undertaken to support the definition of the peak period (i.e., selection of five days).
- A change to the Hydro One charge determinant must be applied to the uniform transmission rate which impacts all transmitters (and their customers) and the other transmitters have not been involved in this process.

If the Board feels the AMPCO proposal has some merit, Board staff suggests further study in a process involving all affected parties.

All of which is respectfully submitted.