EB-2008-0187

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

AND IN THE MATTER OF an application by Hydro One Networks Inc. for an order or orders approving just and reasonable rates and other charges for electricity distribution to be effective May 1, 2009.

Submissions of the Power Workers' Union

Overview

1. This hearing provides the first opportunity for the Ontario Energy Board (the "Board" or "OEB") to consider the concrete application of its 3rd Generation Incentive Regulation Mechanism ("3rd GIRM") to Hydro One Networks Inc. ("HO" or "Hydro One"), a major and sophisticated electricity distributor with substantial, diverse, and ongoing capital spending needs and programs. In particular, the Board will have to consider for the first time the appropriate framework for applying the 3rd GIRM's incremental capital module ("ICM") to Hydro One's distribution business.[1]

2. The Power Workers' Union ("PWU") submits that the application of the 3rd GIRM, and particularly the ICM, must strike a balance between the needs of major utilities like Hydro One to make and plan for rational capital investments, and the need for appropriate scrutiny of proposed capital spending. In general, 3rd GIRM is intended to be a "mechanistic and formulaic adjustment to rates between cost-of-service applications".[2] At the same time, it must provide sufficient flexibility

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[1] Transcript, vol. 2, p. 120, l. 2-4.
[2] Transcript, vol. 1, p. 1, l. 10-11.

that distributors with fluctuating capital spending needs are able to make it work for them. Too rigid an approach will simply result in distributors being forced to file cost-of-service ("COS") applications every year.

3. Hydro One has provided evidence in this hearing that its capital spending needs for 2009 (at $461 million) are significantly greater than the amount of capital spending that would be supported by the 3rd GIRM model without an ICM ($250 million).[3] This is largely because Hydro One is at a point in its asset life cycle when significantly greater capital investments must be made than in prior years, in order to replace end-of-life assets, to plan rationally, and to ensure service quality and reliability.[4] HO's current capital spending needs significantly outstrip depreciation, and are not otherwise captured in the 3rd GIRM price cap mechanism, which reflects lower historical capital spending. The PWU submits that this is precisely the situation when the ICM ought to be available to address the imbalance.

4. It is appropriate to examine carefully Hydro One's proposed capital spending, to ensure that it reflects investments that are reasonably necessary and in the public interest. Hydro One has filed evidence comparable to the evidence it would file in support of capital spending in a COS application, and has subjected that evidence to testing through cross-examination. If the Board is satisfied that this evidence supports the capital program, then the ICM should be allowed. However, the PWU submits that the ICM should not be arbitrarily limited as suggested by some intervenors.

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[3] Transcript, vol. 1, p. 41, l, 13-21.
[4] Transcript, vol. 1, p. 46, l. 9-14.

1 SCOPE OF REVIEW

5. The PWU submits that while the review of the incremental capital investments that meet the threshold test should be comprehensive (as per the Board's filing guidelines),[5] such review ought not to require the Board to consider evidence that does not relate to the incremental capital investments i.e. costs implicit in existing rates that are under the price cap. Nor should the Board second-guess the application of the 3rd GIRM model in areas where it might not generate actual numbers, as suggested (at least implicitly) by some intervenors in cross-examination.[6] To do so would be to undermine the goal of 3rd GIRM, to be mechanistic and formulaic as far as is reasonably possible.

2 THE BOARD'S INTENT FOR THE INCREMENTAL CAPITAL MODULE

6. The Board indicated in the September 17, 2008 Board Report that ICM should not be seen as an ongoing, automatic component of 3rd GIRM.[7] The Board characterized its intent as follows:

> **… The intent is not to have an IR regime under which distributors would habitually have their CAPEX reviewed to determine whether their rates are adequate to support the required funding. Rather, the capital module is intended to be reserved for unusual circumstances that are not captured as a Z-factor and where the distributor has no other options for meeting its capital requirements within the context of its financial capacities underpinned by existing rates.**[8]

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[5] September 17, 2008 *Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors* ("September 17, 2008 Board Report") [Exhibit K1.14].
[6] See e.g. Transcript, March 27, p. 25-27 (re actual PILS impact compared to number generated by IRM model).
[7] September 17, 2008 Board Report, p. 30, para. 3.
[8] September 17, 2008 Board Report, p. 31, para. 1.

7. The Board further noted in the September 17, 2008 Board Report that the rate relief provided by the Board must be for “new capital” sought in excess of the materiality threshold determined using Board-provided supplementary filing modules. [9]

8. The Board has therefore indicated that to meet the intent of the capital module the following factors should be present:

    a. There are unusual circumstances;

    b. The utility has no other options for meeting the capital requirements within the context of its financial capacities underpinned by existing rates; and

    c. The requested rate relief must be in respect of new capital in excess of the materiality threshold.

9. In referring to “unusual circumstances”, the Board did not describe this as a “test”, but rather set out these considerations in the context of a description of the rationale behind the ICM. Indeed, the Board does not include such wording in its description of the process to be followed:

    > **A review of an application will test whether the applicant has passed the materiality threshold, and, if it does, will scrutinize the need for the requested incremental capital relief. Such scrutiny will entail reviewing the distributor’s assumptions and planning and examining alternative options, and its overall CAPEX plan.[10]**

10. The PWU submits that the Board’s reference to “unusual circumstances” was simply intended to signify that the ICM is not meant to be available to distributors automatically, as of right, and in the ordinary course. In any event, each of the above factors is present in this case.

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[9] September 17, 2008 Board Report, p. 31, para. 3.
[10] September 17, 2008 Board Report, p. 31, para. 2.

a) Unusual Circumstances

11. In response to Board Staff Interrogatory #2[11] which asks HO to explain how its application is consistent with the Board's statement that the capital module is intended for unusual circumstances, HO responded that:

> **Perhaps a more appropriate way to view this issue of capital treatment under 3GIRM is to recognize the fact that Hydro One and possibly other electricity distributors, are operating in an environment where future capital expenditures are trending considerably higher than historical capital expenditures**.[12]

12. When asked by the PWU whether it is the funding gap that occurs when capital expenditures outstrip depreciation that HO characterizes as the unusual circumstance, HO's witness, Dr. Poray responded that that is correct.

> **MR. LOKAN: …**
>
> **I take it, then, that Hydro One's position is that the raison d'etre of the ICM is to address that funding gap that occurs when capital expenditures outstrip depreciation?**
>
> **DR. PORAY: That is correct.**
>
> **MR. LOKAN: And that that is what you would characterize as the unusual circumstances?**
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> **DR. PORAY: That is correct, because, in essence, the net effect of the capital expenditures outstripping depreciation is because of the work that has to be done as a result of the combination of circumstances that the company finds itself in.**[13]

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[11] Board Staff Interrogatory #2, Exhibit I, Tab 1, Schedule 3.
[12] Exhibit I, Tab 1, Schedule 3, page 2, response (a), para. 3.
[13] Transcript, vol. 2, p. 91, l. 9-20.

13. The PWU asked HO whether Dr. Kaufman's comment in his May 6th presentation during the Board's consultation on 3rd GIRM below was consistent with HO's responses to the interrogatories on its approach to the ICM.[14]

> **…if, going forward, projected capital investment is substantially different than the history of what is reflected in the X-factor, then there could be an issue and a capital module could be designed to address the disparity.**[15]

14. Dr. Poray agreed, adding that "in essence" HO's historical growth in capital is not representative of future growth in capital:

> **DR. PORAY: Well, in essence, what we're saying is that the historical growth in capital is not representative of future growth in capital.**[16]

15. The PWU also referred to Exhibit K2.1, an exhibit prepared by the PWU that shows HO distribution's Total Annual Capital Expenditures for 2002-2009, Total Annual Depreciation + Amortization Expenses for 2002-2008, and Total Net Fixed Assets for 2003-2008. Dr. Poray was asked to relate the pattern in Figure 1 to Dr. Kaufmann's comments and HO's responses to Board Staff's Interrogatories #2 and #3.[17]

16. Dr. Poray agreed that Exhibit K2.1 indicates that capital expenditures are growing faster than depreciation over a several year period, and added that it illustrates the unusual circumstances that HO are faced with. Dr. Poray added that the exhibit illustrates the point that HO makes in its response to Board Staff's interrogatories #2 and #3.[18]

> **MR. LOKAN: …**
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> **Again, can you relate this pattern to the comments of Dr. Kaufmann and the responses to the interrogatories?**

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[14] Transcript, vol. 2, p. 92, l. 8-23.
[15] Exhibit K1.13, p. 25, para. 1.
[16] Transcript, vol. 2, p. 92, l. 28 and p. 93, l. 1-2.
[17] Exhibit I, Tab 1, Schedules 2 and 3.
[18] Exhibit I, Tab 1, Schedules 2 and 3.

DR. PORAY: Yes. We understand or we believe certainly that the capital expenditures over the period that are indicated here are consistent with what we've always termed as unusual circumstances, in terms of what utilities are faced with and certainly Hydro One.[19]

17. The PWU therefore submits that while the capital investments proposed for 2009 are not unusual in nature for a distributor, it is the increasing volume of capital investments that HO is required to make in order to meet its distribution obligations that is unusual. This constitutes the "unusual circumstances", consistent with the circumstances that Dr. Kaufman, Board staff expert consultant, who provided expert advice to the 3rd GIRM Working Group ("Working Group"), identified as warranting a capital module.

b) <u>No Other Options for Meeting Capital Requirements Through Existing Rates</u>

18. HO has provided evidence that shows that HO has no other options for meeting the capital requirements within the context of its financial capacities underpinned by existing rates. HO's Exhibit K1.15 illustrates that after accounting for $188 million in depreciation expense, $42 million price cap adjustment, $20 million related to growth and $38 million for the dead band, there is a $174 million capital investment funding gap.

19. Like HO, the PWU was a member of the Working Group, and recalls that it is this unusual circumstance that results in a funding gap (illustrated by HO in Exhibit K1.15) for which the utilities represented on the 3rd GIRM Working Group sought a capital module. This was articulated by Dr. Poray in addressing K1.15 as follows:

DR. PORAY: The net gain in the rate base in 2009 is approximately $270 million. So the key message we can take from this slide is that the

[19] Transcript Volume 2, Page 94, Lines 14-20.

rate base does, in fact, change or increases in 2009, or another way of saying it is that the rate base is not static during the IRM period.

The Board recognized, during the consultation on 3rd generation IRM model development, that unusual circumstances, such as I have just illustrated, may cause utilities to incur additional costs during the IR term that might not be funded by the price cap index adjustment, and I refer you here to the Board report on 3rd generation IRM dated July 14th, 2008.

It is for this reason that the Board included the capital adjustment module as part of the 3rd generation IRM for utilities to apply for when they find themselves in these unusual circumstances.[20]

20. Picking up on the discussions of the Working Group, Board staff proposed including an ICM as a component of 3rd GIRM. The Board noted as follows in the July 14, 2008 Board Report:

At the May 6, 2008 stakeholder meeting, staff proposed the introduction of an incremental capital module as a flexible and practical means of accommodating reasonable spikes in incremental capital investment needs during 3rd Generation IR. In brief, staff proposed that the module should only be invoked by a distributor intra-term and that any Board-approved amounts and rate base treatment should be fully resolved through comprehensive rebasing.[21]

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[20] Transcript, vol. 1, p. 36, l. 12-27.
[21] July 14, 2008 Board Report [Exhibit K.1.13], p. 25, para. 2.

21. While one smaller utility on the Working Group identified the need to build an additional transformer station over the course of the 3rd GIRM term as an "unusual circumstance", HO and the Coalition of Large Distributors described unusual increases in the volume of capital work required over the term as the kind of "unusual circumstance" that would require consideration of a capital module in 3rd GIRM from their perspective. Indeed, for a distributor with large-scale and complex operations such as HO, an unusual volume of required capital work is more likely to lead to the need for an ICM than any one particular project, which might be a more typical circumstance for a smaller utility. The PWU submits that this diversity of needs between distributors should be captured in the Board's approach to the ICM.[22]

c) <u>New Capital Investments</u>

22. In its interrogatory responses and in direct evidence HO established that the $461 million 2009 capital investments are all new investments:

> **… The total capital expenditures forecast for the 2009 rate year need to be considered as a separate and standalone block of expenditures different from 2008 capital expenditures because these planned expenditures reflect the capital facilities that will go into service in 2009. In other words the capital expenditures in 2009 are over and above the 2008 capital expenditures and not merely incremental to 2008 levels. Therefore, one cannot isolate a few projects which could be viewed as being "incremental" to the 2008 capital plan. It is the total capital expenditures in the rate year that need to be factored in the capital related costs that are incurred and need to be recovered through rates.**[23]
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> **DR. PORAY: Hydro One's 2008 distribution revenue requirement does not contain any costs related to 2009 capital work. Hence, Hydro One's 2008 distribution rates do not recover any costs relate to 2009 capital work.**[24]

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[22] The Board noted in the September 17 Board Report, p.32 para. 4, that it "sees merit in an incremental capital module that considers the diversity among distributors", and that it had not "observed any objections to this approach".
[23] Exhibit I, Tab 1, Schedule 3, p. 3, l. 2-10.
[24] Transcript, vol. 1, p. 34, l. 19-22.

> **DR. PORAY: ..., the 2009 capital expenditures are completely new capital expenditures over and above the 2008 expenditures that will be placed in service in 2009.**[25]

23. The PWU agrees with HO that all capital expenditures proposed for 2009 are new capital expenditures over and above the 2008 capital expenditures. That is, all the proposed 2009 capital investments are distinct from and incremental to the 2008 capital investments that were added to rate base in 2008. Except for one year's worth of depreciation, the 2008 capital investments remain in the rate base in 2009. The PWU therefore submits that HO has correctly entered the total proposed 2009 capital expenditure of $460,800,000 as the "Capital Addition" ("O") used to derive the Incremental Capital CAPEX of $174 million in the Incremental Capital Threshold Test, as per the OEB 3 GIRM Supplementary Filing Module G2.1.[26] As HO indicates in an interrogatory response:

> **… Hydro One considers the incremental capital threshold to be the demarcation between capital facilities that are in base year (approved) rate base and the incremental capital facilities that will be placed in-service that are not covered by current rates.**[27]

24. As illustrated in Exhibit K1.15, $174 million of the $461 million is the amount of incremental capital expenditure that is unfunded in the absence of an ICM, after taking into account the ICM dead band. The incremental 2009 revenue requirement associated with the $174 incremental capital expenditure, as derived by HO in Exhibit B2-1-2, Appendix F, Page 8, is correctly stated as $21,326 million as per the Board's OEB 3GIRM Supplementary Filing Module G4.1.

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[25] Transcript, vol. 1, p. 45, l. 23-26.
[26] Exhibit B2-1-2, Appendix D, p. 6.
[27] Exhibit I, Tab 1, Schedule 2, Response (a), para. 1.

25. With the above evidence, the PWU submits that HO's application for a capital module meets the Board's intent given: the unusual circumstances faced by HO that require a capital module; that HO has no other options for meeting the capital requirements within the context of its financial capacities underpinned by existing rates; and that the incremental capital for which HO seeks rate relief is the new capital sought in excess of the materiality threshold.

3 ELIGIBILITY CRITERIA

26. The Board set out the eligibility criteria for applicants to recover amounts through rates to fund incremental capital in the July 14, 2008 Board Report:[28]

Table 5: Incremental Capital Investment Eligibility Criteria

Criteria	Description
Materiality	The amounts must exceed the Board-defined materiality threshold and clearly have a significant influence on the operation of the distributor; otherwise they should be dealt with at rebasing.
Need	Amounts should be directly related to the claimed driver, which must be clearly non-discretionary. The amounts must be clearly outside of the base upon which rates were derived.
Prudence	The amounts to be incurred must be prudent. This means that the distributor's decision to incur the amounts must represent the most cost-effective option (not necessarily least initial cost) for ratepayers.

27. The PWU submits that HO has provided evidence that demonstrates that its proposed 2009 capital investments meet the above eligibility criteria in its pre-filed evidence,[29] in its interrogatory responses and in cross-examination.

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[28] July 14, 2008 Board Report p. 33, Table 5.
[29] Exhibit B1, Tab 3, Schedule 1 and Exhibit B2, Tab 1, Schedule 2.

28. HO has responded to interrogatories and cross examination all in the context of an ICM that is part of the 3rd GIRM framework. Such a context should limit the review to the 2009 capital expenditures and should not amount to a full COS review. This is consistent with the Board's statement in the September 17, 2008 Board Report on the nature of a proceeding on the incremental capital for which rate relief is sought:

> **… The proceeding to consider an eligible distributor's application for rate relief would examine the reasonableness of the distributor's increased spending plan.**[30]

29. In the context of the review of the ICM, HO has provided evidence to justify the need for the proposed 2009 capital investments, and evidence on the process that determines the appropriate 2009 capital program spending levels. To review costs outside of the 2009 capital expenditures would extend the review to costs that are implicit in the rates under the price cap component of the 3rd GIRM. Doing so would be contrary to the Board's objective of a price cap that would provide a mechanistic and formulaic adjustment to rates between COS applications. In addition, the PWU submits that examining costs implicit in existing rates that are under the price cap component of the 3rd GIRM would create uncertainty in the distribution sector that would result in the loss of confidence in the Board's incentive regulation. In turn the lack of confidence could jeopardize the 3rd GIRM's incentive for rational efficiency gains, and instead could lead to irrational cost cutting.

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[30] September 17, 2008 Board Report, p. 31, para. 3.

4 CONSEQUENCES OF NOT PROCEEDING WITH PROPOSED 2009 CAPITAL INVESTMENTS

30. The PWU cross-examined HO on what the consequences would be if the Board took a different view from HO on how the ICM should work, as suggested by some intervenors, and HO did not proceed with capital investments that were not supported by rate treatment. HO responded that its sustainment of aging assets and end-of-life assets would not proceed as it should and that the connection of distributed generation would be delayed.

> **MR. LOKAN: Right. Let's just imagine for a minute that you didn't go ahead with the work that was not supported by rate treatment. What would the consequences of that be?**
>
> **DR. PORAY: Well, the consequences would be that our sustainment of the aging assets and end-of-life assets would not proceed as it should be proceeding. The connection of distributed generation would be delayed. So perhaps that would be some of the bigger impacts.**[31]

31. The PWU asked HO whether it would then find itself in a situation where it would have to organize spending so that there were big lumps of spending in COS years and smaller spending in between those years. HO responded that would be a reasonable expectation if the capital module is not implemented in the way HO has interpreted it.

> **DR. PORAY: If the capital adjustment module doesn't work as we believe it works and how we have interpreted it to work in accordance with the guidelines, then, yes, that would be a reasonable expectation.**[32]

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[31] Transcript, vol. 2, p. 95, l. 19-27.
[32] Transcript, vol. 2, p. 96, l. 4-7.

32. HO also agreed with the PWU that this kind of spending pattern doesn't make sense from a planning perspective because projects are frequently multi-year projects, and stated that it would be contrary to the way HO has been doing planning and carrying out work:

> **MR. LOKAN: I take it you would agree with me that that doesn't make any sense from a planning point of view, in that you are frequently dealing with multi-year projects?**
>
> **DR. PORAY: That is correct. And it is certainly contrary to the way we've been doing planning and carrying out [of] work at Hydro One.**[33]

33. The PWU also cross-examined HO on the minimum spending level concept. HO's evidence was that investment above the minimum level is more cost-effective and better addresses risk.

> **MR. LOKAN: In this context, you commented a little earlier - - before the break - - about the minimum spend concept.**
>
> **And the minimum spend sounded like a threshold where, within a five-year period you would see there being a probability of an adverse event occurring; is that correct?**
>
> **MR. VAN DESEN: Yes, that's correct.**
>
> **MR. LOKAN: But even short of that , that is spending above the minimum, is it fair to say that it would be - - you've identified it as being more cost-effective overall and better at addressing these risks if you are able to spend the full amount claimed?**
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> **MR. VAN DESEN: Yes, that's correct.**[34]

34. An example of the consequence of inadequate funding in a specific program was provided by HO in pre-filed evidence on wood pole replacement, and highlighted in cross-examination.[35]

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[33] Transcript, vol. 2, p. 96, l. 8-14.
[34] Transcript, vol. 2, p. 97, l. 14-26.
[35] Transcript, vol. 2, p. 97, l. 1-7.

Reduced funding of the pole replacement program will increase reliability and safety risk and will prevent Hydro One Distribution from fully meeting due diligence obligations to remove known defective assets that present hazard to workers and the public.[36]

MR. LOKAN: Okay. And you've commented at the bottom of page 16 of the application that if you were in a world of reduced funding for pole replacement, there would be increased reliability and safety risks, you'd be prevented from meeting due diligence obligations and present a hazard to workers and the public; is that correct?

MR. JUHN: Yes, it is.

MR. LOKAN: So that would be an example of, if you were – – if the rate design world through he 3GIRM were such that this was unsupported spending and the response was not to spend, you would have those additional risks?

MR. JUHN: Yes, we would. In addition to some of the planning risks that you identified from year over year.[37]

35. The PWU submits that the intervenors who oppose the application have not contradicted or undermined HO's evidence that the proposed capital expenditures are necessary to maintain ongoing service reliability, quality and safety, and to meet its due diligence obligations. Nor have they challenged HO's evidence that its proposed capital spending is a result of rigorous risk-based planning processes and asset condition assessment process, through which HO has identified the required level of capital investment required for 2009.

36. The PWU submits that denial of HO's application for the ICM as put forth by HO, in whole or in part, could jeopardize HO's ongoing service reliability, quality and safety efforts, and could compromise HO's ability to meet its due diligence obligations. In addition, the requirement for the unfunded capital investments will not go away and could end up costing more in the future.

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[36] Exhibit B1, Tab 3, Schedule 3, p. 16, l. 24-27.
[37] Transcript, vol. 2, p. 97, l. 1-13.

5 CONCLUSION

37. The PWU submits that the Board should approve HO's application for its ICM based on proposed capital investments of $461 required for 2009, as identified through HO's rigorous risk-based planning process:

> **This process yielded a capital program of $461 million in 2009 that is required to maintain the operation of the Hydro One distribution infrastructure at a level that is commensurate with requirements imposed by Hydro One's distributor licence, the various Board code requirements, applicable industry standards and customer expectations of service, quality and reliability.**[38]

38. HO's application meets the Board's intent as set out above, and HO has demonstrated that all of its 2009 capital investments meet the Board's eligibility criteria. The application should therefore be allowed.

ALL OF WHICH IS RESPECTFULLY SUBMITTED.

Date: April 6, 2009

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[38] Transcript, vol. 1, p. 44, l. 21-27.