By electronic filing and by e-mail

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BORDEN LADNER GERVAIS

April 8, 2009

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
27th floor
Toronto ON M4P 1E4

Dear Ms Walli,

Hydro One Networks Inc. ("Hydro One")
2009/2010 Distribution Rates
Board File No.: EB-2008-0187
Our File No.: 339583-000034

Please find attached the Redacted Argument of Canadian Manufacturers & Exporters ("CME") in this proceeding. Paper copies will be sent to the Board as required.

Redactions have been made on pages 3, 7, 20, 21, 22, 23, 24 and 26.

We confirm that a copy of CME's Confidential Unredacted Argument has been sent to parties who have executed the required Confidentiality Undertaking. Paper copies of this Confidential Unredacted Argument are also being forwarded to the Board in a sealed envelope.

Please call me if you have any questions.

Yours very truly,

Peter C.P. Thompson, Q.C.

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enclosures
c. Glen MacDonald (Hydro One)
Interested Parties
Paul Clipsham (CME)

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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.

REDACTED
ARGUMENT OF
CANADIAN MANUFACTURERS & EXPORTERS ("CME")

April 8, 2009

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I. Introduction and Overview

1. The Board is being asked to approve a 2009 Distribution Rates for Hydro One which are, on average, about 4.28% greater than its current rates.[1]

2. The Application is based on a Price Cap Incentive Regulation Plan ("IRP") having a duration of one (1) year. If approved, rates under the proposal will be in effect from May 1, 2009, to April 30, 2010. The proposed one (1) year IRP will fall between two (2) Cost of Service Applications, being the twelve (12) month test period ending December 31, 2009, and the twenty-four (24) month test period ending December 31, 2011.

3. The Application incorrectly presumes that the proposed one (1) year IRP is governed by the provisions of the 3rd Generation Incentive Regulation Mechanism ("3GIRM") established by the Board in its July 14, 2008 and September 17, 2008 Reports.[2] The Board's 3GIRM applies to IR Plans having a fixed term of three (3) years. The three (3) year fixed term requirement of the Board's 3GIRM is mandatory.[3] Hydro One's proposed one (1) year Price Cap IRP does not comply with this mandatory requirement. Hydro One's proposed Price Cap IRP lies outside the ambit of Board's 3GIRM and the Incremental Capital Module ("ICM") specified therein.

4. Hydro One's proposed one (1) year Price Cap IRP must be evaluated for reasonableness as a Company-specific stand-alone proposal. While the evaluation criteria the Board has established in its 3GIRM Reports, for plans

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[1] Transcript Volume 1, page 43, line 2; page 64, line 17; page 96, line 18; page 136, lines 5 to 12

[2] Exhibit B, Tab 1, Schedule 1, page 1, lines 5 to 15 and Exhibits K1.13 and K1.14

[3] Exhibit K1.13 page 5 where the Board states *":The Board has determined that the planned term for 3rd Generation IR* <u>*will be*</u> *fixed at 3 years … ."* (emphasis added) See also Transcript Volume 1, page 65, line 1 to page 66, line 8

having a fixed term of three (3) years, provide some guidance for assessing the appropriateness of Hydro One's one (1) year IRP proposal, those criteria are not necessarily determinative of the issue.

5. Hydro One's one (1) year Price Cap proposal, including the proposed ICM feature thereof, should be evaluated for reasonableness in the context of the reality that it is not a multi-year IRP. In essence, the proposal is a one (1) year IRP interruption in a Cost of Service regulation continuum. There is material difference between a one (1) year IRP, preceded and followed by a series of single year or multi-year Cost of Service applications, and multi-year IRPs, preceded and followed by Cost of Service Re-Basing applications founded on test year periods of one (1) year in duration.

6. The components of the requested 4.28% Distribution Rate increase are as follows:

(a)	Price Cap	1.18%
(b)	Smart Meter Adder	1.0%
(c)	Proposed Incremental Capital Module	2.1%
	Total	4.28% [4]

7. Arguments we made in Hydro One's 2009 and 2010 Transmission Rates Case in support of the proposition that, in the midst of a severe recession, rate affordability considerations should be accorded the highest priority, apply, as well, in this case.

[4] See footnote 1

8. In recessionary times, any distribution rate increases produce a shock which many electricity consumers may be unable to absorb. In recessionary times, any rate increase has the potential of triggering an electricity consumer "death spiral". A 4.28% increase in distribution rates in conjunction with the series of Hydro One transmission and distribution rate increases which have been imposed on them in recent years and the further increases in transmission and distribution rates Hydro One is planning to impose for the years 2009 to 2011 inclusive, may be intolerable for some electricity consumers.

9. The evidence in this case[5] indicates that the transmission and distribution rate increases Hydro One is planning for the years 2009 to 2011 inclusive are as follows:

Year over Year	Transmission	Distribution
2009 over 2008	6.4%	4.0%
2010 over 2009	12.1%	**[REDACTED]**
2011 over 2010	10.7%	**[REDACTED]**
Totals	**29.2%**	**[REDACTED]**

10. Successive transmission and distribution rate increases of this magnitude, in combination with the ever-increasing costs being passed on to electricity consumers through the "Global Adjustment", impair the already tarnished attractiveness of Ontario as a place for manufacturers to continue to conduct their businesses. Recession-related spending constraints are required of Hydro One and the other utilities the Board regulates to help prevent any further shrinkage of the energy dependent manufacturing sector in Ontario.

5 Exhibit KX1.6 at pages 3 and 4, as well as at Schedule C, pages 14 and 32; and Exhibit A, Tab 2, Schedule 1, page 2, line 19

11. Absent recognition by the Board of the need for utilities to reflect appropriate spending constraints in their budgets, then, over the longer term, Ontario is unlikely to remain as a place where energy dependent manufacturers will continue to conduct their businesses. If the Board does not set some limits on the ever-increasing spending plans of Hydro One, then energy dependent manufacturers in Ontario are likely to find themselves "out of their markets". If this scenario emerges, then Ontario's unattractiveness to energy dependent manufacturers will prevail until such time as the Ontario Government begins to off-set the ever-increasing prices of electricity by waiving some or all of the revenues it currently recovers from electricity consumers through their payments on account of stranded debt and through the profit and Payment-in-Lieu of Taxes ("PILs") components of their regulated rates.

12. We recognize that the Board is not empowered to provide electricity consumers with relief from the material portion of their bills that relates to stranded debt payments, profit, and PILs. However, the Board is empowered to determine rates for Hydro One which prevent it from obtaining ICM relief which is not needed to prevent an erosion of Hydro One's ROE materially below the Board approved ROE.

13. The regulatory rationale for requiring recession-related budgeting constraints includes the obligation of regulators, as surrogates for competition, to emulate a competitive market outcome, as well as the obligation of utilities to minimize rate shock. Hydro One acknowledged the obligation to minimize rate shock in its

Argument-in-Chief in its 2009 and 2010 Transmission Rates Case.[6] As well, the statutory objective, which requires the Board to protect the interests of electricity consumers,[7] is a matter of increased importance when electricity consumers find themselves in the midst of a severe recession.

14. In recessionary times, competitive market participants constrain capital and operating spending to the maximum extent possible. Infrastructure spending is largely funded by Governments and not by competitive market participants and their customers. In recessionary times, utilities should behave similarly.

15. We submit that Hydro One has an obligation to constrain its spending and requested rate increases to the maximum extent possible without impairing the provision of safe and reliable service to its existing customers. Rate affordability considerations should take priority in recessionary times.

16. Unfortunately, the evidence in this proceeding indicates that affordability considerations are not a priority for those who manage Hydro One. The evidence in this proceeding reveals that the 4.28% which this Board is asked to approve is more than four (4) times the 1% Distribution Rate increase for 2009 which Hydro One's management recommended to its Board of Directors and the Directors approved on November 13, 2008.[8]

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6 EB-2008-0272 Transcript Volume 7, page 3, lines 17 to 21

7 *Ontario Energy Board Act, 1998,* Section 1

8 Exhibit KX1.6 at page 14 where it is stated that *"a distribution rate adjustment of approximately 1% is assumed for May 1, 2009 based on the 3rd GIRM"*. At page 13 of the same Exhibit, it is stated *"we have not included a capital adjustment as we are continuing to assess and analyze the OEB Adjustment Model and its applicability to our capital program."* See also Transcript Volume 1, page 66, line 9 to page 77, line 16, and Exhibit K1.12 at page 4, line 4 to page 20, line 13. The actions taken by Hydro One Management after its November 13, 2008, Board of Directors meeting to quadruple the distribution rate increase request completely discredit Hydro One's contention that it ascribes a high priority to rate affordability considerations as suggested in Exhibit K1.12 and again by counsel for Hydro One in Argument-in-Chief at Transcript Volume 2 at page 121, lines 10 and 11 where counsel stated *"Hydro One is sensitive to the needs and concerns of its customers … ."*

17. The absence of any written material demonstrating that Hydro One's Board of Directors has subsequently considered and approved the quadrupling of the 1% Distribution Rate increase they approved on November 13, 2008,[9] in and of itself, should cause the Board to consider the 4.28% Distribution Rate increase with considerable skepticism. Why should the Ontario Energy Board approve rate increases more than four (4) times the 1% Distribution Rate increase Hydro One's Directors authorized on November 13, 2008, when the quadrupling of the requested rate increase has never been formally presented to and approved by those Directors?

18. For reasons which follow, we submit that the proposed Price Cap increase in rates for 2009 of 1.18% is reasonable and should be approved.

19. A Distribution Rate increase of about 1% is attributable to the Smart Meter Adder.[10] We understand that the Smart Meter Adder "modular" approach, which Hydro One applies in its January 30, 2009 evidence update, complies with the Board's December 18, 2008 Decision with Reasons in EB-2007-0681.[11] We also understand that the Smart Meter Adder approach, followed by Hydro One, is consistent with the regulatory approach the Board applies to the Smart Meter additions made by the other electricity distributors it regulates. In these circumstances, we support the distribution rate increase of 1% attributable to the Smart Meters component of Hydro One's 2009 Capital Budget.

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9 Transcript Volume 1, page 148, line 9 to page 151, line 20, and Transcript Volume 2, page 11, line 15 to page 18, line 27; page 43, lines 16 to 20

10 Transcript Volume 1, page 96, line 18

11 EB-2007-0681 Decision with Reasons at pages 16 to 21

20. In the context of Hydro One's request for Incremental Capital Module ("ICM") relief, it needs to be recognized and emphasized that the ROE associated with the Smart Meter Adder of about $4,482,308[12] was not included in the presentation made to Hydro One's Board of Directors on November 13, 2008, in which the Company-wide 2009 forecast ROE is **[REDACTED]**. We calculate that the Smart Meter Adder ROE of about $4.482M increases Hydro One's corporate ROE by about **[REDACTED]** basis points[13] to a forecast level of about **[REDACTED]**, some **[REDACTED]** basis points above the 2009 Board approved ROE of about 8.00%. For reasons explained later in this Argument, we submit that Hydro One's corporate forecast of 2009 ROE of about **[REDACTED]**, including Smart Meter Adder ROE, is very material to the Board's consideration of whether Hydro One is eligible for ICM relief with respect to any portion of its 2009 Capital Budget, excluding 2009 capital expenditures related to Smart Meters.

21. Having regard to the analysis which follows, we submit and urge the Board to find that Hydro One has failed to demonstrate its eligibility for extraordinary relief under the auspices of any ICM the Board might approve for use in conjunction with an IRP having a duration of only one (1) year.

[12] Exhibit B2.1.3, Appendix B, page 4. The amount is calculated for 2009 using a ROE of 8.57% which we question. Since the Smart Meter Adder is supposed to be trued-up for actual 2009 amounts, we submit that the ROE and Short-Term Debt ("STD") components of the Adder should be calculated at the updated ROE and STD rates which reflect the March 2009 consensus forecast. In its 2009 and 2010 Transmission Rates Application, Hydro One has committed to use the ROE and STD rates derived from these forecasts. Calculating Smart Meter ROE at 8% produces an amount which is about $300,000 less than the amount derived using the Board approved ROE for 2008. Similarly, the 2009 STD costs for the Smart Meter Adder at 1.33% and not at the 2008 rate of 4.47% produces an amount which is some $164,000 less than that calculated by Hydro One. The Smart Meter Adder rate increase for 2009 appears to us to be excessive by some $464,000, plus the PILs calculation related to about $300,000 of equity return.

[13] The evidence at page 2 of Exhibit KX1.6 indicates that **[REDACTED]** of net income produces a corporate ROE of **[REDACTED]** basis points. From this information, we calculate that equity return of about **[REDACTED]** equates to about **[REDACTED]** basis points which we have rounded to **[REDACTED]**.

22. Accordingly, we submit that, on average, the 2009 Distribution Rates which the Board approves for Hydro One should be no more than 2.18% greater than its existing rates.

II. Guiding Principles for Evaluating Incentive Regulation Plans ("IRPs")

23. Before discussing the criteria that should be considered when assessing the reasonableness of the components of the one (1) year IRP Hydro One asks the Board to approve, it is useful to step back and consider the underlying rationale for IRPs generally.

24. The Board has repeatedly stated[14] that every IRP should satisfy the following criteria:

    (a) Establish incentives for sustainable gains in productivity and efficiency;

    (b) Ensure appropriate quality of service for customers, and

    (c) Create an environment conducive to investment.

25. The Board has stated that a properly designed IRP will ensure downward pressure on rates by encouraging improved levels of efficiency to the benefit of utility customers and its shareholders.[15]

26. As well, the Board has repeatedly expressed the view that Plan durations greater than one (1) year are needed to prompt the achievement of sustainable productivity and efficiency benefits.[16]

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[14] Statements to this effect can be found in the Board's *Natural Gas Forum ("NGF") Report* dated March 30, 2005, at page 14 to 22, as well as in recent Board Decision approving five (5) year Incentive Regulation Plans ("IRPs") for Enbridge Gas Distribution Inc. ("EGD") and Union Gas Limited ("Union").

[15] *NGF Report* at page 22

[16] *NGF Report* at pages 28 and 29; Exhibit K1.13 at page 7

27. The duration of IRPs previously approved or established by the Board are greater than one (1) year. The targeted O&M Performance-Based Regulation ("PBR") Mechanism established by the Board for EGD on or about April 22, 1999,[17] had a Board determined duration of three (3) years. Similarly, Union's PBR Mechanism approved by the Board in its RP-1999-0017 Decision with Reasons dated July 21, 2001, had a Board determined duration of three (3) years. The Board's 1st Generation, 2nd Generation and 3rd Generation IRMs for electricity distributors call for terms greater than one (1) year.

28. The foregoing guiding principles are germane to an assessment of the reasonableness of the parameters of the one (1) year IRP Hydro One proposes.

29. Hydro One's proposal one (1) year IRP includes a proposed ICM patterned on the ICM the Board approved for use in 3GIRM Plans having a fixed duration of three (3) years. We submit that a one (1) year Price Cap IRP with an ICM will do nothing to prompt sustainable productivity and efficiency improvements. A one (1) year Price Cap IRP without an ICM could prompt some spending constraints but they are unlikely to be sustainable because Cost of Service Re-Basing will occur within the ensuing twelve (12) months.

30. A one (1) year Price Cap IRP with an accompanying ICM does nothing to prompt rate stability and does not relieve regulatory burden since the justification for including an ICM in a one (1) year IRP and the features of the design of such an ICM, if it is allowed, are matters which the Board has not yet considered and

17 EBRO 497-01, Decision with Reasons dated April 22, 1999

determined. As explained in more detail later,[18] the Board's 3GIRM, including its ICM, do not apply to Hydro One's proposed one (1) year IRP. The Board's 3GIRM only applies to utilities which are operating under the auspices of the fixed three (3) year plan term which the Board mandates in its 3GIRM Reports.

31. Later in this Argument,[19] we outline the reasons why an ICM should not be included as a feature of a one (1) year Price Cap IRP. Including an ICM as a feature of a one (1) year IRP is incompatible with the incentive objectives which should govern the design of any IRP.

32. Even if it is determined that an ICM is an appropriate parameter for a proposed Price Cap IRP having a duration of only one (1) year, then evidence with respect to need, materiality and prudence must be presented and analyzed. All of this creates, rather than eliminates, a regulatory burden.

33. Before considering whether or not an ICM is an appropriate component of an IRP having a duration of only one (1) year, it is important to recognize and emphasize the general principle that Price Cap rate increases include coverage for capital expenditures made during the term of a particular IRP. This feature of Price Cap IRPs was emphasized by the experts during the lengthy consultative process which culminated with the Board's 3GIRM Reports.

34. The consultants who assisted Board Staff and intervenors with matters addressed in the Board's 3GIRM Reports also assisted Board Staff and intervenors in the proceedings leading to the Board's approval of multi-year IRPs

[18] See paragraphs 39 and 40 of this Argument.
[19] See paragraphs 41 and 42 of this Argument.

for Union Gas Limited ("Union") and Enbridge Gas Distribution Inc. ("EGD"). Union operates under the auspices of a Board approved five (5) year Price Cap IRP. All of its capital expenditures are covered by the Price Cap. There is no ICM in Union's multi-year IRP. Union has just recently reported in 2008 equity returns, being the first year of its operation under the Board approved IRP, of more than 300 basis points above the Board approved ROE.[20]

35. Similarly, EGD operates under the auspices of a Board approved five (5) year IRP. Under EGD's revenue-per-customer cap, there is very little incremental capital expenditure protection. EGD has also just recently reported its 2008 earnings which are well in excess of the Board approved ROE for 2008.[21]

36. These facts convincingly demonstrate that utilities operating under the auspices of an IRP without an ICM can manage their capital and operating expenditures to achieve equity returns well in excess of the Board approved ROE. These examples provide persuasive support for the general principle that, without ICM relief, Price Cap rate increases in and of themselves can provide far more coverage than is needed to accommodate the carrying costs associated with capital expenditures made during the term of a particular IRP.

37. In the context of this general rule, we submit that there is a heavy onus on an IRP proponent to justify the addition of an ICM as a IRP parameter. The weight of this onus to displace the general rule should increase as the proposed duration of the IRP declines, with the result that the onus is extremely

[20] See Union 2008 Earnings Sharing and Incentive Regulation Review Application – EB-2009-0101 dated April 2, 2009.

[21] See EGD 2008 Earnings Sharing Mechanism and Other Deferral and Variance Accounts Clearance Review Application dated March 18, 2009 EB-2009-0055

burdensome and perhaps insurmountable when the proposed duration of the IRP, to which an ICM is proposed to be added, is only one (1) year. Stated another way, the longer the duration of the proposed IRP, the easier it is to justify the addition of an ICM. It is easier to justify the addition of an ICM to IRPs having a duration of three (3) years or longer, than it is to justify the addition of an ICM to an IRP having a duration of only one (1) year.

38. In this proceeding, Hydro One has led no evidence to demonstrate why a proposed IRP having a duration of only one (1) year should include an ICM. It has led no evidence to displace the general rule that the Price Cap IRPs provide coverage for capital expenditures made during the term of the Plan. Hydro One simply assumes that an ICM, patterned after the ICM the Board approved in its 3GIRM Reports for three (3) year IRPs is appropriate for a one (1) year IRP.[22] We submit that this is an incorrect, inappropriate and unreasonable assumption. It is incompatible with Price Cap theory and the principles which govern the design of IRPs.

III. Evaluation of Hydro One's Proposed One (1) Year IRP Including an ICM

A. <u>The Board's 3GIRM Does Not Apply</u>

39. We reiterate that the Board's 3GIRM applies to utilities which commit to the fixed three (3) year plan term which the Board mandates in its Reports. Hydro One's proposed one (1) year IRM Plan does not satisfy this mandatory pre-requisite.

[22] Argument of counsel for Hydro One at Transcript Volume 2, pages 120 to 129 reflects this approach. It presumes that the Board's 3GIRM Reports apply to IRPs having a duration of only one (1) year, which is clearly incorrect.

Accordingly, Hydro One's proposal must be evaluated as a stand-alone utility-specific Price Cap Plan having a duration of one (1) year only.

40. This is not to suggest that the concepts which the Board applied in establishing its 3GIRM are not to be applied when considering Hydro One's proposal. Those concepts can and should be considered when evaluating the appropriateness of the parameters of Hydro One's proposal. However, there is, as we have already noted, a material difference between a one (1) year IRP, preceded and followed by a series of single or multi-year Cost of Service Applications, and multi-year IRPs preceded and followed by Cost of Service Re-Basing Applications having a test period of one (1) year. A one year IRP will do little, if anything, to achieve any of the objectives of incentive regulation.

B. <u>Inappropriateness of an ICM Within a One (1) Year Price Cap IRP</u>

41. The inclusion of an ICM in a proposed IRP of one (1) year's duration, preceded and followed by both single and multi-year test period Cost of Service applications, does nothing to prompt productivity and efficiency gains which benefit ratepayers. For IRPs having a duration of one (1) year, the general rule that the Price Cap amount covers costs associated with capital expenditures should prevail.

42. We have difficulty envisaging how any extraordinary and unusual capital spending circumstances that might emerge during the term of a one (1) year IRP are going to cause material harm to the "financial capacities" underpinned by Hydro One's existing rates, when the cost consequences of any extraordinary

and unexpected capital spending will be addressed within twelve (12) months of the commencement date of the one (1) year IRP.

43. Stated another way, we question whether any capital expenditures during the course of a one (1) year IRP can have a "significant influence on the operation of the distributor" [23] when the influence of such expenditures will be cured within months of the date the expenditures become used and useful.

44. Accordingly, we question whether there can be any justification for establishing an ICM for use in conjunction with an IRP limited in duration to one (1) year.

45. As well, for reasons which follow, we submit that Hydro One is clearly ineligible for ICM relief under the eligibility criteria the Board established in its 3GIRM Reports. If Hydro One is ineligible under the Board's 3GIRM Reports eligibility criteria, then it is certainly ineligible for any ICM relief under its proposed IRP which has a duration of only one (1) year. In these circumstances, we find it to be somewhat speculative to be making any submissions on the factors that the Board should consider in the event that it is going to permit an ICM to be used in conjunction with an IRP limited in duration to one (1) year.

46. However, if an ICM for an IRP of a duration of only one (1) year is going to be permitted, then the factors to be considered when determining eligibility and the amount, if any, of the incremental capital that will be eligible for coverage should certainly be as stringent as, and arguably more stringent than, the eligibility criteria and the incremental capital measurement criteria which the Board established in its 3GIRM for IRPs having a fixed duration of three (3) years.

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[23] See Exhibit K1.13 at page 33, Table 5

47. If the parameters for an ICM in IRP having a duration of only one (1) year are the same as those the Board has established for three (3) year plans under 3GIRM, as Hydro One suggests, then there is a material potential for utility "gaming" at a time when base year Costs of Capital materially exceed current Board approved Costs of Capital. Permitting out of period base year Costs of Capital, which are materially higher than current Board approved Costs of Capital, to be used to determine recoverable costs associated with incremental capital expenditures in a one (1) year IRP unreasonably benefits utility owners and harms ratepayers.

48. As well, utilities could "game" a one (1) year IRP by budgeting capital expenditures well in excess of their total depreciation allowance plus the deadband; ask for and obtain ICM relief calculated using base year Costs of Capital which are too high; and then proceed to manage their capital and operating expenditures to earn equity returns in excess of the Board approved ROE for that particular year, secure in the knowledge that at the end of the IRM period, there will be Cost of Service Re-Basing where budgeted capital not spent can be re-budgeted in the Cost of Service Application. This potential for "gaming" an IRP having a duration of only one (1) year is in and of itself a reason to refuse to approve an ICM for use in conjunction with a one (1) year IRP.

49. If the potential for "gaming" can be eliminated, then we would expect the parameters of an ICM module for use in conjunction with a one (1) year IRP to include rules governing the following:

(a) The reasonableness of the total capital budget amount;

(b) The reasonableness of the threshold calculation, including the deadband;

(c) The amount available for ICM relief; and

(d) A calculation of recoverable costs associated with the portion of capital determined to be incremental.

50. For example, the rules for determining what qualifies as "incremental capital" might be confined to spending related to incremental programs and not linked, in any way, to total depreciation expense plus a deadband amount. We understand that counsel for other intervenors will be making some suggestions with respect to the extent to which incremental capital relief in an IRP having a duration of only one (1) year should be defined.

51. Alternatively, in a one (1) year IRP, the parameters of the threshold calculation could be materially more stringent than they are under 3GIRM. For example, the deadband could be much larger than it is under three (3) year plans in order to eliminate the gaming potential to which we have already referred.

52. The rules for determining the recoverable costs associated with any capital expenditures in a one (1) year IRP preceded and followed by Cost of Service test periods, should be based on Cost of Service rules applicable to the determination of test year revenue requirement related to capital expenditures. These rules include the mid-year rule and/or the monthly averages rule, and the rules calling for the in-service date forecasts, as well as the use of test period costs of capital. We submit that there is no justification for the Costs of Capital charged to Hydro One's ratepayers in 2009 with respect to distribution expenditures to be 8.57% for equity capital and for transmission rates to be 8.01% for equity capital.

53. We understand that counsel for other intervenors will be questioning the amounts Hydro One has used in its calculation of any incremental capital which might be eligible for ICM treatment in a one (1) year IRP. We rely upon and adopt those submissions. Suffice it to say that the approximate $20M in revenue requirement Hydro One asks the Board to approve in conjunction with its proposed ICM for a one (1) year IRP is grossly unreasonable, even if it was able to demonstrate a need for ICM relief.

54. We submit that any ICM relief granted in conjunction with a one (1) year IRP should be no more than the revenue requirement relief ratepayers realize when the Board excludes capital expenditures from a Cost of Service test period of having a duration of one (1) year. On the basis of Hydro One's responses to interrogatories in the Transmission Rates Case, a reduction in budgeted capital expenditures of $94M produced a related revenue requirement reduction of about $5.5M.[24] This is the maximum amount Hydro One should receive by way of ICM relief for an ICM amount of $94M in conjunction with a IRP having a duration of only one (1) year.

55. If the Board agrees with our submissions that Hydro One has failed to demonstrate eligibility for ICM relief, then it will be unnecessary for the Board to decide these issues pertaining to the inappropriateness of an ICM within a one (1) year Price Cap Plan, and the design parameters of any ICM to be included in a IRP having a duration of only one (1) year.

[24] Transcript Volume 1, page 86, line 7 to page 97, line 2

C. Hydro One's Ineligibility for ICM Relief Under the Board's 3GIRM Even if it does Apply

56. Throughout the entire consultation process which eventually led to the Board's 3GIRM Reports of July 14 and September 17, 2008, it was recognized that the Price Cap increases in rates cover capital expenditures made during the term of the Plan unless an extraordinary or unusual situation occurs which will threaten the financial capacities of the utility unless relief incremental to the Price Cap increases is granted. Before any utility, committed to a three (3) year fixed term IRP, can qualify for ICM relief, it must adduce comprehensive and convincing evidence to establish that, without ICM relief, its ability to earn the Board approved ROE will be in jeopardy.

57. We submit that eligibility for ICM relief within the Board's 3GIRM for those utilities which commit to the mandatory three (3) year fixed term requirement is not established simply by demonstrating that capital expenditures in any year during the IRM term are likely to exceed total utility depreciation plus a deadband amount.[25] The Board's 3GIRM Reports indicate that eligibility considerations of need, materiality and prudence must be established by comprehensive and convincing evidence separate and apart from the formulaic calculation of the ICM in a three (3) year fixed term IRP. The formulaic calculation is not a "pass-through".

58. Prevention of an erosion of Board approved ROE is the underlying rationale for an ICM. This is evident from the Board's paraphrase of distributor submissions

[25] The eligibility criteria in Exhibits K1.13 at page 33 and K1.14 at page 30 called for comprehensive evidence to demonstrate a threat to the ability of the utility to operate within the financial capabilities of its existing rates.

with respect to the ICM issue in its initial 3GIRM Report dated July 14, 2008, at page 27 of the Report, the Board paraphrased the submissions as follows:

> *"While these distributors were supportive of moving forward with a comprehensive price cap for 3rd Generation IR and were not advocating that distributors be held "whole" during the term for all capital expenditures, some distributors did advocate that distributors <u>have a reasonable expectation of achieving their approved returns</u> without being unduly penalized by having to significantly reduce their OM&A and/or capital programs."* (emphasis added)

59. The eligibility criteria which the Board established pertaining to need, materiality and prudence[26] are to be applied in the context of the conceptual rationale for the ICM component of the Board's 3GIRM which is to protect against erosion of the Board approved ROE. The question to be asked and answered is whether there is any comprehensive and convincing evidence to demonstrate that Hydro One needs ICM relief in 2009 in order to have a reasonable opportunity of earning a 8.01% ROE. If the evidence adduced by Hydro One in this proceeding is insufficient to satisfy the requirements for ICM eligibility for plans of three (3) years duration, then that evidence cannot possibly satisfy the higher burden of establishing need in the case of an IR plan of only one (1) year duration.

60. Eligibility is not automatic, merely because proposed capital expenditures exceed the total utility depreciation expense plus a pre-determined deadband as Hydro One argues.[27] The ICM is not a formulaic mechanism which automatically fills a funding gap as Hydro One contends.[28] We submit that the Board clearly rejected this notion in its September 17, 2008 3GIRM Report at page 30 when it stated as follows:

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26 Exhibit K1.13, page 30 to 33
27 Transcript Volume 2, page 120
28 Transcript Volume 2, page 121

> "***Board Policy and Rationale***
>
> *The Board notes that there are clearly differences in perception as to the purpose of the incremental capital module. Ratepayer groups perceive the capital module as a mechanism aimed solely at addressing extraordinary or special CAPEX needs by distributors. The distributors, on the other hand, perceive the module as a special feature of the 3rd Generation IR architecture which would enable them to adjust rates on an on-going, as-needed basis to accommodate increases in rate base.*
>
> *In the Board's view, the distributors' view is not aligned with the comprehensive price cap form of IR which has been espoused by the Board in its July 14, 2008 Report. … Rather, the capital module is intended to be reserved <u>for unusual circumstances</u> that are not captured as a Z-factor and where the distributor has <u>no other options for meeting its capital requirements within the context of its financial capacities underpinned by existing rates</u>."* (emphasis added)

61. The fact that the Rate Base amount, after applying the ICM module defined in the Board's 3GIRM reports, is about the same or marginally less than the Rate Base amount that would exist under Cost of Service does nothing to establish either need, materiality or prudence.[29] The recent cases of Union and EGD demonstrate convincingly that it is the ability to manage all capital and operating expenditures under the auspices of an IRP which provides the "financial capacities" of Price Cap adjusted rates.

62. Similarly, a bald and unsubstantiated assertion in Argument[30] that the amount being recovered under the Price Cap and proposed ICM is less than the amount recoverable under Cost of Service does not establish eligibility. This is particularly so in this case where such assertions are incompatible with the budget presented to Hydro One's Directors in November showing that, without

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[29] Transcript Volume 2, page 125, lines 21 to 23; Transcript Volume 2, page 9, line 10 to page 10, line 12

[30] Transcript Volume 2, page 121, lines 4 to 9 where counsel for Hydro One stated *"I submit that it goes without saying that the revenue requirement in rates being requested by Hydro One by using 3GIRM are less than the revenue requirement in rates that would result from a Cost of Service application if, for no other reason than the fact that a Cost of Service application includes OM&A rather than capital items only."* This statement ignores the reality that the price cap increase of 1.18% can produce for Hydro One more OM&A coverage than it has budgeted for 2009. This must be one of the reasons for the Company being able to budget an **[REDACTED]** ROE for 2009 under an assumption of a 1% distribution rate increase.

ICM, the ROE for 2009 for the corporation as a whole would be **[REDACTED].** With the Smart Meter Adder profit, this forecast ROE increases to about **[REDACTED]** which is some **[REDACTED]** basis points above the Board's currently approved ROE. The budget presented to Hydro One's Board of Directors indicates that, without claiming ICM relief, the ROE is expected to be more than what would be recoverable under Cost of Service.

63. To establish need, materiality and prudence, the onus is on the utility to convincingly demonstrate that the additional recoveries which the ICM permits are needed to prevent an erosion of Board approved ROE. Stated another way, if incremental revenue requirement attributable to the ICM operates to enhance a utility's profits above the Board approved ROE, then the pre-requisites of need, materiality and prudence are not satisfied. If incremental revenue recovered under the auspices of an ICM operates to enhance profits above the Board approved ROE, then approval of an ICM claim will effectively be providing the utility with a windfall benefit.[31]

64. Utilities operating under the auspices of three (3) year IRPs are ineligible for ICM relief within 3GIRM if the evidence indicates that its ROE is likely to exceed Board approved levels without ICM relief. Similarly, a utility operating under the auspices of a three (3) year IPR is ineligible for ICM relief if the evidence shows that the granting of such relief will likely enhance utility profits to levels over and above the Board's currently approved ROE. We reiterate that ICM relief was

[31] Transcript Volume 2, page 125 where counsel for Hydro One made submissions with respect to the subject of windfall benefit.

never intended to be available to produce material increases in profit over and above the Board approved ROE.

65. One need go no further than the budget for 2009 approved by Hydro One's Board of Directors on November 13, 2008, to conclude that Hydro One cannot satisfy the evidentiary burden of convincingly establishing a threatened erosion of profits below the Board approved ROE. The budget which Hydro One's Directors considered and approved established that without ICM relief, Hydro One's ROE in 2009 will be about **[REDACTED]**.[32] Clearly, Hydro One does not need ICM relief in 2009 to prevent its ROE from falling materially below 8.01%.[33]

66. Hydro One management has told its Board of Directors that, with a 2009 Price Cap rate increase in the order of 1%, the distribution rates will be more than sufficient to meet the Company's capital and operating spending needs and produce a ROE of **[REDACTED]**. Any grant of ICM relief in such circumstances would be inappropriate and unreasonable.

67. The evidence in this case, and in particular, the presentations made by Hydro One Management to the Company's Board of Directors, demonstrates beyond doubt that Hydro One is not seeking ICM relief to prevent an erosion of its profits below the Board approved rate for 2009 of about 8%. The equity return associated with the ICM relief Hydro One claims is $5,653,487, or about

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32 Exhibit KX1.6, pages 2 and 15

33 In its 2009 and 2010 Transmission Rates Case, Hydro One has undertaken to update the cost of equity and short-term debt to reflect the results of the consensus forecast as of March 31, 2009, so that the Board approved ROE for 2009 could be slightly different than 8.01%.

[REDACTED] basis points of ROE for the Company as a whole.[34] This incremental ROE, in combination with the ROE associated with the Smart Meter Adder of about **[REDACTED]** basis points, will raise Hydro One's 2009 corporate ROE forecast by about **[REDACTED]** basis points from **[REDACTED]** to about **[REDACTED]**.

68. In conjunction with the Smart Meter Adder, Hydro One's ICM proposal is intended to materially increase its 2009 profits well above the Board approved ROE for 2009 of about 8%. The proposal is not advanced to protect Hydro One's shareholder from ROE erosion below the Board approved ROE for 2009 but to materially enhance shareholder returns at a time when consumers find themselves in the midst of a severe recession.

69. We submit that the following facts[35] support these conclusions:

(a) Hydro One's August 2008 presentation to its Board of Directors indicated that there would be a 1% distribution rate increase in 2009. This presentation was made after the Board had issued its 3G IRM July 14, 2008 Report but before the ICM Supplement thereto was issued in mid-September 2008;

(b) The filing on November 7, 2008, by Hydro One's Management of the Company's initial 3GIRM Application with the Ontario Energy Board as a

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34 Exhibit B2-1-2, Appendix F, page 8 Return on Rate Base – equity line which translates into about **[REDACTED]** basis points of ROE, based on the information in Exhibit KX1.6 indicating that **[REDACTED]** of net income produces **[REDACTED]** basis points of ROE return for the Company as a whole.

35 Exhibits KX1.8, KX1.7, and KX1.6 are the documents presented to and approved by Hydro One's Directors in August and November 2008. Exhibits K1.11 and K1.12 are evidence excerpts pertaining to the cross-examination of Hydro One witnesses on these documents in the Transmission Rates Case. Hydro One's November 7, 2008 "Placeholder" filing is the November 7, 2008 version of Exhibit B, Tab 3, Schedule 1; Exhibit B1, Tab 3, Schedule 1, Exhibit B2, Tab 1, Schedule 2 and Appendices A to F thereof. Further material pertaining to these facts is cited in footnotes 7 and 8.

"placeholder" only. In that Application, Hydro One claimed an incremental capital module of $316M and $35M of incremental revenue requirement related thereto. The distribution rate increase indicated in the November 7, 2008 Application was 4%, rather than the 1% increase reflected in the plan approved by the Board of Directors in August;

(c) About one week later, on November 13, 2008, Hydro One Management presented the proposed 2009 Budget to its Board of Directors. The distribution system budget the Directors were asked to approve was based on a 1% distribution rate increase. The 1% proposed distribution rate increase presented to the Company's Directors was materially less than the 4% reflected in the Application previously filed by Management with the OEB;

(d) The total capital budget presented to the Directors in November for the Company as a whole was $1,670M, of which about $659M related to distribution. This capital budget included the capital to be spent on Smart Meters;

(e) The evidence indicates that a 1% distribution rate increase, in conjunction with a distribution capital budget in excess of $659M, would, in combination with the transmission rate increases Hydro One was seeking, produce a ROE for Hydro One in 2009 of **[REDACTED]**;

(f) The net earnings and ROE components of the presentation to Hydro One's Board of Directors on November 13, 2008, reflected the transmission Cost of Service Application for 2009 based on a 8.57% ROE.

A reduction in ROE will operate to bring transmission earnings down but it will not affect the component of earnings from distribution reflected in the Report to the Board of Directors which was based upon an application of a price cap to existing 2008 Rates;

(g) Hydro One's Directors approved the November presentation and a 2009 distribution budget calling for a 1% rate increase. There is no evidence to establish that the Hydro One Directors either considered or approved the November 7, 2008 "Placeholder" Application filed with the OEB. There is no documentary evidence to show that the more than 4% distribution rate increase that Hydro One Management now asks the Ontario Energy Board to approve for 2009 has ever been considered or approved by the Company's Board of Directors;

(h) In the updated January 30, 2009 Application and supporting evidence, Hydro One severed the initial $316M incremental capital module referenced in its November 7, 2008 filing into a Smart Meters component of about $166M and an ICM component of about $174M. The total incremental capital covered by the updated Application is now about $340M, including Smart Meters capital expenditures, and $24M more than the $316M incremental capital module filed as a "Placeholder" on November 7, 2008. The updated filing, in effect, seeks to recover more than the "Placeholder" and neither the "Placeholder" nor the updated filing have been considered or approved by Hydro One's Board of Directors who are supposedly acutely sensitized to the challenges any distribution rate increases provide for electricity consumers;

(i) As already noted, the ROE associated with the ICM Hydro One asks the Board to approve is **[REDACTED]** which adds about **[REDACTED]** basis points to the corporate ROE and in combination with the **[REDACTED]** basis points of ROE attributable to the Smart Meter Adder, increases the corporate ROE presented to Hydro One's Board of Directors on November 13, 2008, of **[REDACTED]** to **[REDACTED]**.

70. In these circumstances, granting ICM relief would only enhance the level of Hydro One's profits already forecast for 2009 at levels well above the Board's currently allowed ROE for 2009 of about 8%. Even if Hydro One was operating in 2009 under the auspices of a three (3) year IRP, the evidence in this case completely fails to demonstrate the pre-requisite need to be eligible for ICM relief. Contrary to the submissions of counsel for Hydro One, the documentary evidence from Hydro One overwhelmingly impugns the evidence from Hydro One's witnesses asserting that it is eligible ICM relief under the Board's 3GIRM Reports.

D. <u>Conclusion re: Hydro One's ICM Proposal</u>

71. By way of summary, we submit that Hydro One's request for ICM relief which increases existing distribution rates by 2.1% should be rejected in its entirety because:

(a) ICM, within the Board's 3GIRM Reports, is inaccessible to utilities which do not commit to the three (3) year IRM term the Board's Reports have mandated;

(b) The potential for utility "gaming" should prompt the Board to refrain from adding an ICM to an IRP having a duration of only one (1) year;

(c) Hydro One's ICM proposal for 2009 is incompatible with the Budget its Board of Directors approved on November 13, 2008, and the Ontario Energy Board should be reluctant to entertain profit enhancing rate increase proposals which have neither been specifically considered nor approved by Hydro One's Board of Directors, particularly when Management makes such proposals in the midst of a severe recession;

(d) Hydro One is ineligible for relief under the ICM within the Board's 3GIRM because there is no evidence whatsoever to demonstrate that ICM relief is needed to prevent Hydro One's utility ROE from falling materially below the Board approved ROE for 2009 of about 8%; and

(e) ICM relief was never intended to enable a utility to materially enhance profits above the Board ROE and requests for such relief are entirely incompatible with spending and rate increase constraints required during a severe recession.

IV. OEB's Response to Hydro One's 2009 Distribution Rates Application

A. Price Cap Rate Increase of 1.18%

72. The Price Cap increase of 1.18%, which Hydro One requests should be approved.

B. Smart Meter Adder

73. We support the Smart Meter Adder distribution rate increase of 1% for the reasons already described in this Argument.

C. ICM Rate Increase of 2.1%

74. Hydro One's request for ICM relief which increases existing rates by 2.1% should be rejected for all of the reasons articulated in this Argument.

V. Customer Impacts

75. Many customers will be challenged to absorb any increases in Hydro One's 2009 Distribution Rates. We submit that, in combination with Hydro One's inability to demonstrate that ICM relief is needed to prevent utility ROE from falling materially below the Board approved ROE for 2009 of about 8%, consumer affordability considerations should prompt the Board to approve 2009 Distribution Rates for Hydro One which are, on average, no more than 2.18% greater than existing rates.

VI. Costs

76. CME respectfully requests that it be awarded 100% of its reasonably incurred costs of participating in these proceedings.

77. As in other proceedings before the Board, counsel for CME worked closely with other intervenors in preparing for the hearing. Prior to the commencement of the oral hearing, CME counsel provided the Board and interested parties, including Hydro One, with a list of topics of concern to ratepayer representatives. Counsel for CME coordinated conference calls with ratepayer representatives prior to the oral hearing and subsequently to facilitate coalescence, to the extent possible, around issues of common interest.

78. We submit that CME's participation in these proceedings has been responsible and justifies an award of 100% of its reasonably incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 8th day of April, 2009.

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