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April 8, 2009

BY EMAIL & COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge St, Suite 2701
Toronto ON M4P 1E4

Dear Ms. Walli:

Board File No. EB-2008-0187
Hydro One Networks Inc. – 2009 Rates Adjustment
Argument of Energy Probe

Pursuant to the direction of the Board in respect of filing submissions, Energy Probe Research Foundation (Energy Probe) is hereby attaching two hard copies of its Argument in the EB-2008-0187 proceeding. An electronic version of this communication will be forwarded in PDF format.

Should you require additional information, please do not hesitate to contact me.

Yours truly,

David S. MacIntosh
Case Manager

cc: Glen MacDonald, Hydro One Networks Inc. (By email)
Michael Engelberg, Hydro One Networks Inc. (By email)
Interested Parties (By email)
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ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an application filed 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.

Final Argument On Behalf Of
Energy Probe Research Foundation

April 8, 2009

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**Final Argument On Behalf Of
Energy Probe Research Foundation**

How these Matters came before the Board

1. On November 7, 2008, Hydro One Networks Inc., filed an Application seeking approval for changes to the rates that Hydro One charges for electricity distribution, to be effective May 1, 2009. For the purposes of addressing the approvals sought, Energy Probe will focus on the distribution business of Hydro One Networks Inc. (the “Applicant” or “Hydro One Dx”). The application was filed under the Board’s guidelines for 3rd Generation Incentive Regulation, which provides for a mechanistic and formulaic adjustment to rates between cost of service applications. In addition to the formulaic adjustment to rates, Hydro One Dx filed for approval for incremental capital investments as provided for under the guidelines.

2. The Board issued a Notice of Application on December 12, 2008. Energy Probe filed a Notice of Intervention on January 5, 2009, as a full time intervenor.

3. On January 30, 2009, Hydro One Dx filed an update to its application as a result of the Board’s December 18, 2008 Decision in the Applicant’s immediate prior distribution application, the Hydro One Dx 2008 Cost of Service Rates EB-2007-0681 proceeding.

4. Procedural Order No. 1 was issued by the Board on February 3, 2009, providing a procedural schedule for the delivery of interrogatories to Hydro One Dx and the response by the Applicant. Energy Probe filed Interrogatories on February 23, 2009. Responses were delivered by the Applicant on March 9, 2009.

5. Procedural Order No. 2 was issued by the Board on March 12, 2009, ordering an Oral Hearing to commence on March 26, 2009. No provision for a Settlement Conference was ordered in this proceeding.

6. On March 17, 2009, Pollution Probe filed a Motion for Full and Adequate Interrogatory Responses in respect of Conservation and Demand Management. Procedural Order No. 3 was issued by the Board on March 19, 2009, made provision for the Motion to be heard orally immediately prior to the Oral Hearing commencing on March 26, 2009.

7. Energy Probe made no submissions during the Motion Hearing. Energy Probe did take an active part in the Oral Hearing.

Argument Overview

8. Energy Probe has conducted itself as an all issues intervenor throughout this proceeding.

9. In its Argument, Energy Probe will not seek to explore all outstanding issues before the Board, but will be examining those issues of concern to Energy Probe where we believe we can be of most assistance to the Board, and has addressed some matters that might not be as thoroughly canvassed by other consumer-oriented groups.

10. Energy Probe was assisted by the opportunity to review a draft argument provided by counsel to the Canadian Manufacturers & Exporters.

Is Hydro One Dx Operating Within a 3rd Generation IR Plan?

11. It is the submission of Energy Probe that prior to turning its mind to the approvals sought by the Applicant, the Board Panel must determine whether or not Hydro One Dx is operating within a 3rd Generation Incentive Regulation Plan (the “IR Plan”). If it is operating within the IR Plan, each approval sought must be determined on its merits. If it is not, none of the approvals sought appear to be applicable to its 2009 rates.

12. What are the determinants of the IR Plan? The *Report of the Board on 3rd Generation Incentive Regulation for Ontario’s Electricity Distributors* (the “Report”), dated July 14, 2008 and issued on July 15, 2008, describes the elements of the incentive regulation plan that it named the 3rd Generation Incentive Regulation for Ontario’s Electricity Distributors.

13. The Report in Section 2.1 refers to three alternate approaches to incentive mechanisms and, at Page 6, in the second paragraph, states:

The Board will retain a comprehensive price cap form of adjustment mechanism for electricity distributors. The price cap, used in the 1st and 2nd generation IR plans, continues to be supported by distributors and other stakeholders and is a simple approach that will, along with the implementation of mandatory service quality requirements, provide balanced incentives for efficiency improvements and the maintenance of adequate service quality over the course of an IR term. The concern of potential financial harm for some distributors in contrast with revenue caps is mitigated by the other elements of the 3rd Generation IR plan described in this report.

14. The Report in Section 2.2 discusses the relative merits of different lengths of incentive regulation periods, even the merits of allowing distributors the choice of term plan which could vary from three to five years. While there was a divergence of opinion among consultation participants, in the end the Board decided the following, as stated in the penultimate paragraph on Page 6:

The Board has determined that the plan term for 3rd Generation IR will be fixed at three years (i.e., rebasing year plus three years). The rates of the distributor are not expected to be subject to rebasing before the end of the plan term other than through an eligible off-ramp.

15. During the Oral Hearing on March 26, 2009, there was a portion of the cross examination of the Hydro One Dx Witness Panel by Mr. Thompson, counsel to the Canadian manufacturers & Exporters (“CME”), and specifically questioning Dr. Andrew Poray, in respect of the Report and the term of IR Plan that the Applicant was pursuing:

MR. THOMPSON: One of the things the Board determined in that report, will you agree with me, is at page 7, is that the plan term for 3GIRM will be - - those are the Board's words -- fixed at three years.

DR. PORAY: That's what the report said.

MR. THOMPSON: Is that correct? Right.
So I would suggest to you that the report applies to a multi-year 3GIRM plan. Would you agree?

DR. PORAY: It does.

MR. THOMPSON: Now, your approach here is to go 3GIRM for 2009. You're asking to have your rates set on the basis of 3GIRM for 2009; am I correct?

DR. PORAY: That's correct.

MR. THOMPSON: But the evidence indicates clearly that you are opting out of 3GIRM at the end of the first year. You are coming in with a cost-of-service application in 2010; is that correct?

DR. PORAY: That's the plan.

MR. THOMPSON: Well, the company -- does the company intend to carry out that plan?

DR. PORAY: We have notified the Board that we will be submitting a two-year cost-of-service for 2010 and 2011.

MR. THOMPSON: So the upshot of all of that, I suggest to you, is that what we're considering in your particular case is not a multi-year IRM plan, but a plan for one year?

DR. PORAY: We have submitted an application to adjust the rates for 2009.

MR. THOMPSON: And you have indicated, quite clearly, you will be rebasing or coming in with cost-of-service for 2010?

DR. PORAY: That's correct.

MR. THOMPSON: So the IRM plan under consideration in this case is for a term of one year and one year only; would you agree?

DR. PORAY: That's what Hydro One is following, yes.

MR. THOMPSON: Thanks.
(Transcript, Volume 1, page 65, line 1)

16. Based upon a plain reading of the Report, the evidence of the Applicant and the testimony Dr. Poray, the Applicant's most able director of regulatory policy and support, it is the submission of Energy Probe that the Applicant is not operating within a 3rd Generation Incentive Regulation Plan.

17. Hydro One Dx may well have filed its Application and Evidence in the EB-2007-0680 2008 Rates Rebasing proceeding with the intention of operating within the boundaries and elements of a 3rd Generation Incentive Regulation Plan, but by the January 30, 2009 evidence update, that was no longer the case.

18. Base on the foregoing, Energy Probe submits that the Board may view the path now being travelled by the Applicant to be entirely outside the IR Plan, or it may be construed as being within a 3rd Generation Incentive Regulation Plan, interrupted.

19. If the Board concludes after reviewing the evidence presented in this proceeding, as Energy Probe has, that the Applicant is not operating within the boundaries and elements of a 3rd Generation Incentive Regulation Plan, as described in the Report, Energy Probe submits that any consideration of an Incremental Capital Module is by definition not applicable within this proceeding.

20. The same reasoning would necessarily apply to the approval sought for the Price Cap increase of 1.18% or the Smart Meter Funding Adder as requested.

Proposed Incremental Capital Module

21. If the Board concludes after reviewing the evidence presented in this proceeding, despite the submissions of Energy Probe, that the Applicant is operating within the boundaries and elements of a 3rd Generation Incentive Regulation Plan, as described in the Report, then within that rubric, Energy Probe does not oppose either the Price Cap increase of 1.18% or the Smart Meter Funding Adder of 1% as requested.

22. The request for an incremental capital rate rider by the Applicant is another matter, one requiring close scrutiny by the Board.

23. Energy Probe wishes to remind the Board that it is not intrinsically opposed to the creation of an Incremental Capital Module within an IR Plan. Mr. Randy Aiken, acting on behalf of the London Property Management Association and Energy Probe, presented the Board with a formulaic approach to calculate an individual threshold for each distributor, as reported in the Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, dated September 17, 2008 (the "Supplementary Report"), within Section 2.3, Incremental Capital Module Materiality Threshold, beginning at Page 22. The Board attached a 20% adder to this formula as a dead band to prevent marginal applications.

24. Energy Probe submits that crossing the Incremental Capital Module Materiality Threshold does not by itself guarantee the Applicant approval of an incremental capital rate rider. There is another important threshold to cross – Unusual Circumstances.

Are There Unusual Circumstances?

25 In the Supplemental Report, Section 2.3, starting on Page 30, beginning with the first paragraph under the heading *Board Policy and Rationale* the Board provides us with its conclusions in respect of the hurdle that electricity distributors must clear, once they have crossed the Materiality Threshold, in order to gain approval for an incremental capital rate rider as sought by the Applicant:

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. The distributors' concept better fits a "targeted OM&A" or "hybrid" form of IR. This alternative IR form was discussed extensively in earlier consultations but was not adopted by the Board. 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. (Italics added)

26. Energy Probe submits that the Board must determine if the circumstances giving rise to the capital deficiencies of the Applicant are truly unusual. To assist it in that determination, the following exchange between Mr. Engelberg, counsel for the Hydro One Dx, and Dr. Poray, Hydro One's director of regulatory policy and support, commencing at the very bottom of Page 45 of the transcript of the Oral Hearing on March 26, 2009, is quoted as follows:

MR. ENGELBERG: Is it Hydro One's position that its use of the Board's capital adjustment module is consistent with the Board's words in the September 17th, 2008 supplemental report, at page 31, regarding "unusual circumstances"? And if your answer to that question is "yes", could you tell us what the unusual circumstances here are?

DR. PORAY: Yes. Hydro One has followed the rules for triggering the capital adjustment module, consistent with the OEB's supplementary report of September 17th, 2008.

Hydro One's distribution is at a stage where its distribution facilities are nearing end of life and require significant investment to maintain the system capability to deliver energy to electricity consumers at a level of reliability and quality of service required by its licence, OEB codes, industry standards and customer expectations.

Furthermore, distributor generation projects are increasing development capital-related costs.

Hydro One's capital expenditures have been rising significantly to meet these requirements. In 2002 our capital expenditure was \$262 million, in 2005 it was \$317 million, and in 2009 it is \$461 million.

So in the past seven years our capital expenditures have increased by approximately 75 percent. Hydro One, therefore, finds itself in unusual circumstances, when viewed in the context of the more prevalent circumstances, where the utility operations are viewed as being in a more steady-state environment, where annual capital spending is approximately the same as annual depreciation.

In summary, Hydro One believes that it has applied for the use of the capital adjustment module entirely as prescribed by the Board's 3rd generation IRM and supplemental reports.
(Transcript, Volume 1, page 45, line 27)

27. How then is the Board to weigh this information? Information which was not drawn out of the Applicant's witnesses by clever cross examination, but rather was presented as direct evidence, as "in chief" as it were, prior to cross of the Hydro One Dx Witness Panel. To quote again from that passage above in order to focus on the cause of these unusual circumstances:

"... distribution facilities are nearing end of life and require significant investment to maintain the system capability to deliver energy to electricity consumers ..."
(Transcript, Volume1, page 46, line 9)

28. The Applicant traces the "unusual circumstances" to their beginning in 2002, with the distribution division's capital expenditures growing steadily higher from then until the present, from 2002 until 2009, with the clear forecast of similar increases in future years. And why does the Applicant believe that these are unusual circumstances? The Applicant tells us it is because the utility operations of other distributors are "viewed as being in a more steady-state environment, where annual capital spending is approximately the same as annual depreciation." (Transcript, Volume1, page 46, line 24)

29. It is the submission of Energy Probe that the comparison of Hydro One Dx's operations to those of other distributors does not meet the test of "unusual circumstances" as contemplated by the Board in the Supplementary Report.

30. As presented in its own direct evidence during the Oral Hearing on March 26, 2009, the circumstances are not unusual for the Applicant itself. These circumstances are part of a continuum stretching from 2002 into the future. Hydro One Dx does not find itself even in new circumstances.

In Conclusion

31. It is the submission of Energy Probe that in the first instance, as explored above under the heading *Is Hydro One Dx Operating Within a 3rd Generation IR Plan?* the Applicant is not operating within the mandated IR Plan and thus is not entitled to the approvals sought in this proceeding.

32. It is the submission of Energy Probe in the second instance, as explored above under the heading *Are There Unusual Circumstances?* the Applicant is not operating in "unusual circumstances", not unusual to itself. In this instance, the Applicant would be entitled to the Price Cap increase of 1.18% and the Smart Meter Funding Adder of 1% as requested. These approvals are not opposed by Energy Probe should the Board determine that the Applicant is operating within the mandated IR Plan.

33. What then is the solution to the capital expenditure circumstances of Hydro One Dx? It is the submission of Energy Probe that Hydro One Dx should not be operating within an incentive mechanism regime. It appears clear that it is not functioning in the steady state environment that is conducive to successful incentive regulation.

34. It is the submission of Energy Probe that the Applicant should continue with its plan to file a cost of service application for 2010 and 2011. It is the further submission of Energy Probe that during the proceeding, the Applicant should seek the Board's approval for continuing in a cost of service regime until it approaches the steady state of operations in which its customers would benefit from an incentive regime.

Costs

35. Energy Probe submits that it participated responsibly in this proceeding. Energy Probe requests the Board award 100% of its reasonably incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

April 8, 2009

Energy Probe Research Foundation