EB-2008-0187

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch.B, as amended;

AND IN THE MATTER OF an Application by Hydro One Networks Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates for the delivery and distribution of electricity commencing May 1, 2009.

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

April 8, 2009

SHIBLEY RIGHTON LLP
250 University Avenue, Suite 700
Toronto, Ontario M5H 3E5

Jay Shepherd
Tel: 416.214.5224
Fax: 416.214.5424
Email: jay.shepherd@shibleyrighton.com

Counsel for the School Energy Coalition

TABLE OF CONTENTS

1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 On November 7, 2008 Hydro One Networks Inc. filed an application for new distribution rates commencing May 1, 2009. While the application was formally filed on that date, the Applicant treated that filing as a "placeholder" [Tr.1:73], and the "real application" was in fact filed on January 30, 2009 [Tr.1:63]. It is to this latter document that we refer when we use the term "Application".

1.1.2 The Application follows the policies relating to the 3rd Generation Incentive Regulation Mechanism, as set out in the Report of the Board dated July 14, 2008 (the "3rd Generation Report") and the Supplemental Report of the Board dated September 17, 2008 (the "Supplementary Report"). Both Hydro One and the School Energy Coalition were active participants in the consultation process leading up to those two Board reports.

1.1.3 The Application is the first instance of a distributor applying for the Incremental Capital Module ("ICM"), which was approved in principle in the 3rd Generation Report, and then specified in considerable detail in the Supplementary Report. Aside from the ICM, the Application appears to follow the 3rd Generation IRM rules without material exceptions.

1.1.4 In this our Final Argument in this matter, we will confine our submissions to the ICM applied for by the Applicant. Because of the importance of this decision to all other stakeholders, we have attempted in these submissions to be particularly thorough in dealing with the issues raised by this first ICM rate relief application.

1.1.5 In order to ensure that our entire Final Argument can remain on the public record, we have ensured that, where we have referred to in camera or confidential parts of the evidence or the proceeding, we have removed all references to forward-looking profit, revenue, or return information that is not already on the public record. No part of this Final Argument contains confidential information.

1.2 *Components of the ICM Analysis*

1.2.1 This Final Argument is organized following the structure for ICM established by the Board in the Supplementary Report**.** After considering the overall policy considerations of the ICM – specifically the purpose of the ICM, and the evidentiary burden on the Applicant – we review step by step whether the Applicant has met the requirements, and , if so, what relief should be afforded them.

1.2.2 In our submission, the Board has established a three-step process for considering an

ICM application, as follows:

(a) ***Has the Applicant met the materiality threshold?*** This is a mechanistic and formulaic calculation, designed to determine with precision whether the Applicant is allowed to apply for the ICM.

(b) ***If the Applicant has met the materiality threshold, has the Applicant satisfied the substantive requirements for relief?*** There would appear to us to be fourteen such requirements, listed in Appendix B of the Supplementary Report at pages VI and VII, and on page 31 of the Supplementary Report. This is the bulk of the inquiry, and none of these requirements are in any way mechanistic or formulaic. The Board has, in our submission, recognized that different utilities will have different capital spending situations, and has established a set of criteria that allow it to assess whether in a given situation relief is appropriate.

(c) ***If the Applicant has met the substantive requirements, what is the appropriate relief to be provided by the Board?*** In this regard, the Board has been permissive in the Supplementary Report ("the Board **may provide** rate relief" – page 31, emphasis added), but has also provided some guidance in this, by establishing a maximum, being the revenue requirement impact of the expenditures that exceed the materiality threshold and meet the substantive requirements. It has also specifically dealt with the application of the half year rule in this context [page 31].

1.3 *Summary of SEC Argument*

1.3.1 It is SEC's submission that the Applicant has not met the requirements set out by the Board to be granted rate relief under the Incremental Capital Module. The Applicant's failure comes under three heads. First, the Applicant's evidence as filed demonstrates that rate relief under the ICM is inappropriate, given the purpose the Board has established for the introduction of the ICM into the 3rd Generation IRM process. Second, even on the Applicant's view of the purpose of the ICM, the evidence filed does not meet the burden of demonstrating to this Board that $461 million of capital spending should be given the Board's approval. Third, even if all of the spending has been justified, and the Applicant comes within the purpose of the ICM, on a fair analysis the Applicant does not actually need any rate relief.

1.3.2 We would therefore answer the questions implicit in the IRM process established by the Board as follows:

(a) ***Materiality Threshold.*** The materiality threshold has been met, although the excess over the materiality threshold is substantially less than the Applicant has proposed.

(b) ***Evidentiary Burden.*** The Applicant has misunderstood its evidentiary burden in an

application for ICM rate relief, and thus has failed to provide sufficient evidence in support of its claim.

(c) ***Substantive Requirements.*** The Applicant has not met the substantive requirements set forth in the Supplementary Report, including at least the following, each of which in and of itself is sufficient to ground denial of this Application:

(i) ***The Applicant has not demonstrated that it needs rate relief.*** Indeed, the only evidence before the Board dealing with whether rate relief is needed is the presentation to the Hydro One Board of Directors in November, in which management told its BoD that it could achieve its Board-approved ROE for 2009 with a 1% rate increase under IRM. Nothing has changed since that time, and there is no inconsistent evidence before this Board.

(ii) ***The Applicant has failed to establish through evidence that there are unusual circumstances.*** Hydro One admits that this is a "business as usual" capital plan, but argues that it has an unusual amount of assets at the end of their life. However, it has filed no supporting evidence of a capital spending cycle, or asset ages relative to any benchmark, that would justify this assertion.

(iii) ***The Applicant has not demonstrated that the incremental spending is non-discretionary, prudent, and cost-effective.*** The Applicant claims to have a document – its detailed justification of its capital plan to its executive management team – that would demonstrate the satisfaction of these requirement, but despite repeated requests has declined to file it. In our submission, the Board should make the logical, adverse inference from this that the detailed justification would not support compliance with the Board's requirements.

(iv) ***The Applicant has not properly identified and offset from its rate relief claim other known sources of funds that cover the revenue requirement impact of the incremental capital spending.*** Those offsets exceed the amount of the claim, so that the net remaining claim should in any case be zero.

(d) ***Amount of Rate Relief.*** In the alternative, if the Board determines that the Applicant has met the substantive requirements, then the relief that is appropriate has been overstated, and the appropriate amount of relief would in fact be zero, as the adjustments that are required exceed the amount originally claimed.

1.4 *The Precedent Being Established*

1.4.1 We are intensely conscious, as we are sure the Board is, of the potential precedential impact of its decision in this matter. The Applicant is as well, as they pointed out at

the very beginning of their direct evidence "It is also the first time that the Board's capital adjustment module is being used" [Tr.1:33]. There followed a lengthy discussion of the theory behind the ICM, and the reasons it is needed by utilities, some of which is discussed in the next section of this Final Argument.

1.4.2 In our submission, two things are going on here.

1.4.3 First, Hydro One is asking the Board to approve $461 million of capital spending, a relatively modest 10% increase from last year, but by any account a substantial amount of money. As a result of that approval, if given, Hydro One is proposing that they be allowed to increase rates, not by 2.28%, as would normally be the case [Tr.1:136], but by 4.38%, an additional $21.3 million collected from the ratepayers.

1.4.4 Second, this Board is considering for the first time the extent to which, and the ease with which, LDCs can use the ICM to increase rates beyond the increases otherwise provided for in the 3rd Generation IRM. Based on the comments set out in the Board's decision in this matter, LDCs will reach conclusions about:

(a) The practical purpose and limits of the ICM, and in particular whether it is intended to be an exceptional remedy reserved for special cases, or a routine method by which distributors with high levels of capital spending can get approval for extra rate increases.

(b) The evidentiary requirements of ICM, and in particular whether ICM can be used as a handy shortcut to higher rate increases, with less time and trouble than cost of service proceedings, or whether the Board will instead carry out a rigorous review of these applications.

(c) The Board's interpretation of the individual substantive requirements, such as need, revenue requirement impact, other sources of funds, etc.

(d) In general, whether it is a good idea to apply for the ICM. In this context, the Board is already aware that, at historical spending levels, at least 20 distributors would be eligible to apply for the ICM [Supplementary Report, page 30], and presumably that number is substantially larger if LDCs know that getting above the threshold in any given year means a relatively routine grant of an additional rate increase. There is no incentive for capital spending restraint in those circumstances.

1.4.5 It is submitted that a tightly disciplined, exception-driven approach to the ICM is essential if 3rd Generation IRM is to operate successfully. As we note in Section 2 of this Final Argument, in our view this is exactly what the Board intended when the ICM was instituted.

1.4.6 For these reasons, we believe it is essential that the Board reject this Application in its entirety, for the reasons stated in this Final Argument. This case is not just about the $21.3 million claimed by Hydro One this year. It is about the hundreds of millions of dollars that will be claimed by LDCs throughout the province if the Board establishes a purpose and/or evidentiary burden that is too favourable for the utilities. Provision of any relief to Hydro One in this Application would, in our view, not only be inconsistent with the purpose of the IRM framework as it applies to this Applicant, but on a broader level would seriously undermine the Board's 3rd Generation IRM.

1.4.7 ***The Countervailing Danger*****.** The PWU, in their cross-examination and again in their Final Argument, raise the spectre of the dangerous regulatory results that could arise if this ICM rate relief is not granted. The following was the exchange with Dr. Poray dealing with the consequences of denial of this Application:

> "*MR. LOKAN: Is it fair to say that you would be in a world where you would have to try and organize spending so that there were big lumps in cost-of-service years and then smaller capital spending in in-between years?*
> *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.*
> *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 work at Hydro One." [Tr. 2:95-6]*

1.4.8 We confess, the statement by a senior executive of a major utility that, yes, they would game the regulatory system to maximize their rates, takes one's breath away a bit. While we believe that a little bit of regulatory gaming goes on all the time, it appears to us that, for the most part, utilities try to run their businesses in the most conscientious manner they can using proper operational and planning principles. What Dr. Poray appears to be saying, that Hydro One would act contrary to those principles to gain regulatory benefit in a significant matter such as this, is not appropriate.

1.4.9 The reason we bring this up is not to attack Dr. Poray. We believe that, if he read this part of the transcript, and this Final Argument, he would be equally shocked at being quoted as favouring jettisoning proper planning principles. He cannot, in our view, have intended that.

1.4.10 No, the reason we bring this up is to point out that the PWU's straw man – "If you deny this application, you will be incenting utilities to act badly" – is simply not credible.

1.4.11 The real countervailing danger that was implied many times in this proceeding is that

utilities will be forced to revert to cost of service to cover their capital spending plans. As the Board has already seen in the last few years, that danger is theoretical, not real. It was a "sky is falling" prediction during the consultations for 2nd Generation IRM, which did not have a capital module. What happened? Essentially, the three biggest utilities came in for cost of service more often than the Board's standard schedule. Virtually everyone else followed the Board's schedule, and survived nicely.

1.4.12 In fact, in the case of this Applicant, they already plan to apply for cost of service for 2010, even if they get the relief sought in this Application, and then again in 2011. It would appear that they may never go through a year in which they accept the Board's standard IRM formula without any "enhancements". They didn't like it during the consultations, and they still don't like it. So, the danger that denying them the ICM rate relief would mean more applications for cost of service is illusory at best. They will be before the Board on a cost of service basis most years anyway.

1.4.13 ***Statement from the Chair.*** We note that the Chair of the Board published a letter to stakeholders on April 3, 2009 (the "Statement") dealing with capital spending pressures on electricity transmitters and distributors in the province. In it, he talks about those various pressures, and expresses a concern that traditional ratemaking approaches may not provide sufficient regulatory certainty for distributors and transmitters to invest in a timely manner. He announces that the Board will carry out a review of how capital spending is recovered from ratepayers, to determine if the implementation of any new regulatory tools may be appropriate.

1.4.14 It, of course, goes without saying that the personal views of the Chair in the Statement cannot as a matter of law influence this Board panel in their decision on this Application, and we know that we do not need to make any submissions on that point. This Board panel already understands that legal imperative.

1.4.15 However, the Statement also implicitly raises a question: to what extent, if any, should this Board panel's interpretation of the ICM be used to address the pressures and issues raised in the Statement, if this Board panel believes those pressures and issues to exist and to apply in this case?

1.4.16 In our submission, the answer is that they cannot and should not. The ICM was developed by this Board after thorough consultation, including the advice of experts in the field. It had a particular purpose when developed. The Chair is proposing to deal with a new set of pressures and issues, and, as set forth in the Statement, will initiate an appropriate consultation to consider how to address those pressures and issues.

1.4.17 This Board panel should, in our view, use the ICM for the purpose for which it was designed, and not pre-empt the new initiative of the Chair by seeking to use the ICM to address the matters contained in the Statement.

2 OVERRIDING POLICY CONSIDERATIONS

2.1 *Purpose and Scope of the Incremental Capital Module*

2.1.1 There appear to be two overriding policy considerations applicable to the capital module claim. First, do the Applicant and its 2009 capital plan fall within the underlying purpose and intent of the ICM established by the Board? Second, what evidentiary burden is placed on the Applicant to support its claim?

2.1.2 The purpose of the incremental capital module was hotly debated in the consultation on the 3rd Generation IRM. [In the following discussion, we have not made extensive use of citations. Two of the three panel members here were actively involved in this previous debate, and the concepts were addressed at length in this proceeding as well.]

2.1.3 In the consultation, distributors, led by Hydro One, sought a mechanism that allowed them to separate their capital spending from the other components of their revenue requirement, and get an additional rate increase whenever capital spending exceeded depreciation. In their view, the ICM should correct what they saw as a fundamental flaw in the IRM structure, in that it did not properly cover capital spending needs, which position was continued in this proceeding [e.g. Tr.1:78, Ex. I/1/2, and a consistent theme throughout]. A good summary of this position is given by Dr. Poray, as follows:

> *"DR. PORAY: I think it has always been Hydro One's view, throughout this proceeding, in the 3rd Generation IRM, that again* ***the price cap index is insufficient to cover the capital work that has to go on year over year****" [Tr.1:85][emphasis added]*

2.1.4 Ratepayers, supported by Board staff, sought a mechanism which respected the diversity of distributors, and allowed those with special ("unusual") capital spending needs to come to the Board for relief without a full cost of service application. The ratepayers believed that the standard IRM model covered the capital spending of most distributors, and this was supported by the experts retained by the Board.

2.1.5 It must be understood in this context that the ratepayers have always opposed "cherry-picking", the idea that individual cost increases could be looked at in a vacuum, and rate increases granted without considering the other aspects of cost of service. Many regulators, including the Board, have in general also opposed rate regulation based on cherry-picking. They recognize that increases in costs in one area often have impacts in other areas, so unless they see the whole picture, they are not likely to end up with rates that are "just and reasonable".

2.1.6 Notwithstanding this valid principle, it is a practical reality in Ontario that there are

many small utilities, and for them a cost of service application is a daunting task, stretching both their financial and people resources to the limit. Yet, from time to time those utilities have a year in which their capital spending requirements far outstrip their normal spending pattern. For that year, in which their people are already stretched in planning that major project or projects, undertaking a cost of service application as well might be simply unrealistic.

2.1.7 The Board considered the two points of view – routine capital adjustments (distributors) vs. exceptional capital adjustments only (ratepayers), and made no bones about rejecting the distributors' position and coming down on the side of the narrower approach. The Board had established a comprehensive IRM, said the Board, and that was not consistent with routine capital adjustments. The distributors' view, the Board added, is more consistent with a targetted IRM, limited to OM&A. The Board did not select that model, and thus routine capital adjustments did not make sense.

2.1.8 Hydro One has taken the position, in this Application, that they qualify for ICM rate relief because they spend more than the threshold [e.g. Tr.1:36,81, many other references]. With respect, if the Board's intent was to give rate increases based on high capital spending, that would have just been built into the basic IRM model, and that would be the end of it. The Board did not select that option. The Board, instead, selected the option that said: If your situation is exceptional, and your spending exceeds a certain threshold, we'll let you make your case that additional rate relief is appropriate, and we'll decide on a case by case basis. Here are some guidelines to help you understand our thinking.

2.1.9 Then the Board provided a set of filing requirements that explain the nature of the remedy. Those guidelines send the same, consistent message: Tell us what's special about your spending this year.

2.1.10 In our submission, the entire Supplementary Report makes clear that the ICM is not intended to be available to everyone, all the time. It was implemented to recognize that not all distributors are the same, and some may need special treatment when their capital spending needs hit an unusual period. IRM should handle the vast majority of cases, but there will be some unusual circumstances in which IRM doesn't work, and COS is not the optimal solution. The ICM is designed for those circumstances.

2.1.11 What are those circumstances? There was a lot of discussion about this in the consultation, including the paradigm of the small utility and the transformer station (often raised in the discussions). But that wasn't the only example. Another was the natural investment cycle. Some utilities said that high capital spending in the 1960s implied a cyclical need for high capital spending now. Others talked about government policy driven spending, like smart meters, to the extent that it was not covered by special OEB rules (as smart meters are). Unless a special rule is implemented for the Green Energy Act, that might well come under that heading. Not

all distributors will have a material impact, but those that do may need relief.

2.1.12 The point here is that in every case there is a cause for the spending that is not "business as usual". Whether it is a single large project (a transformer station, a CIS), or a demonstrable spending cycle (with supporting evidence that it has gone up, and it will come down as well), or the unique impact of a government program on the distributor (the Green Energy Act, a regional development initiative), the cause of the incremental spending has to be unusual.

2.1.13 It is instructive to contrast this with the IRM format the Board has approved for the two large gas utilities. Neither of those IRM structures, although established during the period when 3rd Generation IRM was being debated, include a capital module. Why is that? In our submission, it is because these are two very large gas distributors, and if there is something big enough and unusual enough that they can't handle it within their IRM regime, they have the resources to seek cost of service at any time.

2.1.14 It is tempting to say that, for the same reason, Hydro One simply never qualifies for ICM rate relief. They are like the gas distributors – big enough to apply for cost of service in any year that IRM doesn't work for them. The ICM provides a remedy that they never need. Further, because their spending is so high, they may always pass the threshold, but their circumstances will never be unusual.

2.1.15 Until the Green Energy Act, we might well have said that, and it would have been a defensible argument. However, now we see one example – the GEA – that could have an impact on the Applicant that is both material and unusual. It may be more appropriate for them to apply for cost of service to deal with GEA impacts, but if they chose to seek ICM rate relief on this basis, it would be difficult to argue that they did not have unusual circumstances.

2.1.16 Of course, this Application is not based on the Green Energy Act, and in fact, when the GEA kicks in, mainly in 2010, Hydro One expects that it will be under cost of service due to an application they expect to file this year. [This is discussed at Tr.1:157-8, where the Applicant admits that in 2009, it actually plans to spend less in this area than they were approved in 2008, when they also underspent.]

2.1.17 Without a "special case" argument like the Green Energy Act, in our submission Hydro One simply does not come within the purpose and intent of the ICM. Hydro One's spending is, by their own admission, "business as usual" [e.g Tr.1:84]. It is higher than seven years ago, but it is in most respects a continuation of programs that were in existence in 2008, their last rebasing year. Most of those programs will continue in 2010, their next rebasing year. Nothing in the 3rd Generation Report or the Supplementary Report suggests that the middle (IRM) year in a multi (COS) year capital spending program is the type of thing that the ICM is designed to deal with. It is not. No evidence was provided of a spending cycle, or an usual number of assets at

"end of life". In short, the only evidence before this Board is that Hydro One does not, in fact, come within the purpose of the ICM.

2.1.18 It is therefore submitted that, before even looking at the individual criteria and requirements, it is appropriate for this Board to say to Hydro One:

> ***You have misunderstood what this remedy is all about. It is not about taking up for the shortcomings of 3rd Generation IRM. It is about exceptional cases. Your situation is not exceptional, and this remedy is not designed for you.***

2.2 *Evidentiary Burden on the Applicant*

2.2.1 ***Formulaic and Mechanistic.*** Hydro One argues that the capital module was intended to be formulaic and mechanistic, just as the base 3rd Generation IRM adjustment is [Tr.2:120], and in this they are supported by the PWU [Final Argument, p. 12]. While they attempt to soft-pedal the notion that they are seeking to avoid full evidence, their position is put clearly in the following quote from Mr. Engleberg, in a discussion with the Chair:

> *"MR. ENGELBERG: ...there must be some difference, some significance, when there is a* ***formulaic, mechanistic module****, as to whether the filing requirements and the volume of information and answers that need to be provided are the same as they would be for a cost-of-service." [Tr.1:128] [emphasis added]*

When the Chair followed up on this point, Mr. Engelberg went on to say:

> *"MR. ENGELBERG: ...in stating that it is formulaic and mechanistic, Hydro One's submission is that that applies to the entire 3rd Generation IRM module and not simply the calculation of the price cap index." [Tr.1:130]*

With respect, these positions are not consistent with the 3rd Generation Report and the Supplementary Report.

2.2.2 It is submitted that the IRM structure seeks to make the normal annual adjustments in a formulaic and mechanistic way. This applies to the basic elements of the IRM structure, but – with one exception – the Board never says or implies that the capital module is formulaic or mechanistic.

2.2.3 The exception? On page 32 of the Supplementary Report, the Board says the following:

> *"With respect to the threshold itself, the Board believes that distributors should be able to determine whether or not they are eligible to apply with relative ease. Making that determination should not be an unduly cumbersome exercise. It*

> *should be formulaic and it should be relatively easy to populate with the required data."*

2.2.4 That is, the calculation of eligibility to apply should be straightforward and mechanistic. But after that? Nowhere does the Board say that any other aspect of the ICM process is formulaic or mechanistic.

2.2.5 Indeed, the opposite is decidedly true. Look at any of the requirements in Appendix B to the Supplementary Report. Prudence? Is that mechanistic? Need? Is that mechanistic? What about non-discretionary, or significant influence? None of these are about filling in a spreadsheet and seeing what pops out. They are about substance and about the application of judgment by the Board.

2.2.6 The Board said this directly as well:

> "*A review of the application...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....The proceeding to consider an eligible distributor's application for rate relief would examine the reasonableness of the distributor's increased spending plan." [Supplementary Report, p. 31]*

Nothing in that speaks to formulaic or mechanistic analysis. This is about judgment, applied on a case by case basis.

2.2.7 How is the ICM efficient ratemaking, then? Why wouldn't a utility simply apply for cost of service?

2.2.8 For Hydro One, the simple answer in most cases probably is: You should. But for most utilities, that is not the case. When a distributor is the exceptional case for which the ICM was intended, they are allowed to treat their OM&A and many other aspects of cost of service as a given, without filing any supporting evidence. It is only on the capital plan that detailed evidence is required. For a small utility, that difference is substantial.

2.2.9 In our submission, the ICM created a hybrid. The two traditional paradigms of pure IRM and pure COS would remain in place. And, the principle that ratemaking based on cherry-picking should be avoided would also remain. But in a carefully defined class of exceptions, distributors would be allowed to seek "partial COS', in effect, in which their OM&A and other things would be formulaic, but their capital would be scrutinized much like a cost of service application. This is a mid-way point between a full COS, and plain IRM, designed to deal with those special cases in which capital could be scrutinized in isolation.

2.2.10 ***The Level of Evidence Appropriate.*** In Section 4 of this Final Argument, we go into some detail about the evidence that should have been filed, and the questions that should have been answered, but were not. In particular, we note that the Applicant had available a detailed justification for the spending proposed in this Application, but declined to file it with the Board. It is our submission that justification was a necessary part of this Application, and failure to file it is fatal to the Application.

2.2.11 What does this mean from a policy point of view? The Applicant is seeking the approval from this Board for $461 million of capital spending, every dollar of which it seeks to recover from ratepayers over time. This is not just a number. It is real money. The 79 pages filed by the Applicant in support of this $461 million ($5.8 million per page) was patently inadequate.

2.2.12 In our submission, the Applicant approached this proceeding as if justifying their capital plan was not required. They assumed that ICM is a shortcut, and the level of justification for this spending would be limited. The quotes above make that clear.

2.2.13 Given the purpose of ICM, and the specific requirements the Board has outlined in the Supplementary Report, assuming a short-form approach was, in our view, unwise. It is not the normal practice of the Board to give its imprimatur to $461 million of capital spending without a thorough review, and the Board signalled in the Supplementary Report that it planned to do just that.

2.2.14 The question arose in the oral hearing whether, with respect to capital spending, a higher standard is required than cost of service. Logically, that must be true, at least in theory. The requirements established by the Board for ICM include prudence and revenue requirement impact, which are essentially the cost of service paradigm, but they also include a number of other things. Unless those other things are merely duplicative, simple logic says that the evidentiary burden for the ICM is higher than COS on the capital component of revenue requirement.

2.2.15 In practice, however, that may not be the case. It may instead be true that COS and ICM have, with respect to capital spending, the same evidentiary burden. The reason for this is that, in practice, a utility supporting a capital plan within a COS application would include evidence on, for example, unusual circumstances, benefits from the spending, impacts of growth, etc. etc. Nothing in the filing requirements appears to be different from what is normally filed in a COS application. The tests may be different (in COS, evidence is usually led on what is non-discretionary, for example, but that is not an absolute requirement), but the evidentiary burden is probably very close.

2.2.16 In our submission, and on the broadest level, Hydro One has simply failed to meet this standard. In a COS proceeding, the Board would not look at the paltry evidence in this case, and the many refusals to support that evidence with documentary backup, and say: Sure, $461 million, rightyo then. We will provide examples throughout these

submissions, but the overriding point is more stark. Hydro One thought they could get a $461 million approval without the normal scrutiny. They were wrong, we believe, and we believe that the Board should tell them that.

2.2.17 ***Approval of the Hydro One Board of Directors.*** During the course of the oral hearing, there was considerable discussion about whether the Hydro One Board of Directors was even aware that this additional ICM rate relief was being sought [e.g. Tr.2:13-14, but there are many other examples]. Mr. Engelberg [Tr.2:17] took umbrage at this, as if parties including SEC were questioning whether this Application had been properly authorized at all.

2.2.18 No such issue was being raised. We are familiar with the indoor management rule, and we have confidence that if Hydro One management "goes off on a frolic" without the authority or approval of their Board of Directors, there will be new management in place in short order.

2.2.19 The issue that was being raised was a different one. The evidence of Hydro One was that the operative internal approval here was that of the Board of Directors in November, 2008. In fact, the Board of Directors was told that the utility would achieve its allowed ROE with this capital budget, and without a capital module. Subsequently, management made a separate determination, never approved by the Board of Directors, to keep the capital plan as is, but seek an additional $21.3 million from ratepayers. Thus, it is the approval process of senior management that is the level at which this was gated.

2.2.20 Thus, when we asked for the detailed justification of this capital plan provided to the executive management team, the company said that the presentation to the Board of Directors was sufficient [Tr.2:22-4]. In fact, the presentation to the Board of Directors was relevant only to the extent that it disproves the need for ICM rate relief. In terms of the justification for this Application, without the detailed justification of the capital plan that the executive management team saw, this Board is not in a position to approve this Application.

2.2.21 ***"Rigorous Risk-Based Planning Process".*** This leads to a related point. Many times in the oral hearing [Tr.1:44, Tr.1:156, Tr. 1:169, Tr. 1:175, Tr. 2:55, among other cites] the Applicant emphasized that the justification for the capital plan and the need was the "rigorous, risk-based planning process" that Hydro One undergoes each year. We do this the right way, says Hydro One, so you can rely on the result that comes out of our process.

2.2.22 With respect, that is another way of saying: We don't have to justify our plan to the regulator. We justified the plan to senior management, and the regulator should rely on the decision of senior management and not look behind it or test it.

2.2.23 We don't deny that there may be circumstances in which a regulated entity could have such rigorous approach to a regulatory number (like Capex) that any reasonable person would accept the result of that rigorous review without seriously questioning it. That would be an unusual approach for a regulator, but not by definition impossible.

2.2.24 No evidence of that is the case here. The Applicant has many times talked about their rigorous approach, but whenever the Board or parties drilled down, the rigour was not so apparent. There is a minimum spending level [discussed at Tr.1:57], but on occasion spending below the minimum, even in critical areas like generation connections, is approved, for example [Tr.1:157].

2.2.25 And, when invited to provide to this Board the detailed justification that would prove the rigour of their planning process (if that is, indeed, true), and support the resulting capital plan, the Applicant declined to do so [Tr.2:23].

2.2.26 In our submission, the constant resort to the "rigorous, risk-based planning process" is irrelevant if the Applicant is unable and unwilling to demonstrate the rigour and impact of that process. Without compelling evidence supporting that, the process is, frankly, irrelevant, and the Applicant must actually prove <u>to this Board</u> that the spending is justified, cost-effective, etc. It has elected not to do so, and in our submission their Application fails as a result.

3 HAS THE APPLICANT MET THE MATERIALITY THRESHOLD?

3.1 *The Calculation of the Threshold*

3.1.1 The Applicant has admitted that the calculation of the materiality threshold is incorrect in at least one way. The materiality threshold as calculated in Exhibit X is based on an X factor of 0.98%, but the final X factor for 2009 IRM applications is 1.18%. As a result, the threshold is not $287.1 million [Ex.B2/1/2,App.D, p.6], but $$295.6 million [Tr.1:109]. This can be confirmed through direct calculations. As a result, the incremental capital amount is $168.2 million, and the claim for ICM rate relief is reduced to $20.3 million [Tr.1:110]. This is all uncontested by the Applicant.

3.1.2 In cross-examination, Mr. Buonaguro raised the question of whether the growth factor in the calculation of the threshold was correct [Tr.2:69-71]. From that exchange, there is certainly considerable doubt as to whether the growth factor in the calculation of the threshold (based on 2008), and the growth factor in the development of the capital plan (based on 2009 forecast) were consistent, and whether, if there is a difference, it results in double counting.

3.1.3 In our view, the evidence is not clear on this point. The Applicant appears to have used the correct number in calculating the materiality threshold, but whether the same number should be used for the capital plan, or for the calculation of impact on revenue requirement, is another question. However, given the lack of conclusive evidence, we are not in a position to comment on the impact of this disjunct.

3.2 *Application of Adjustments to the Capital Budget*

3.2.1 ***Fixed Assets.*** The calculation of the materiality threshold proceeds from the basis that the capital plan itself is the right starting point. In Hydro One's view, they are entitled – perhaps even required – by the ICM formula to assume that all 2009 capital expenditures incurred in 2009 close to rate base in 2009, even if they know that is not the case [Tr.1:94].

3.2.2 In our submission, the capital plan includes at least $50 million, and probably closer to $100 million or more [Tr.1:165-6], of capital spending that is not expected to close to rate base in 2009. Those amounts should not be included in the capital plan that is tested for ICM eligibility.

3.2.3 There are two reasons for this. First, it cannot have been the Board's intention that applicants under the ICM would get more recovery for their capital spending than distributors proceeding under cost of service. This would mean that the Board would be providing rate recovery for capital assets prior to the date they are 'used and useful', which would be a very fundamental change in ratemaking principles.

3.2.4 In fact, we note that this is not the first time that Hydro One has sought such a change from this Board. In their EB-2007-0816 transmission rate case, Hydro One said that, given their large capital spending needs over a period of years, it would be appropriate for the Board to allow them to get rate recovery for certain large assets before they are in service, saying that this constituted a special need. The subject was extensively discussed in the hearing and in final arguments. The Board declined to do so [page 60 of the Decision], saying:

> *"There is no evidence in this case that any regulator other than FERC has approved a package of special regulatory treatments like those advocated by Hydro One. FERC regulatory initiatives can be important guidance in some cases and the Board will continue to monitor FERC's actions to incent new transmission. However, the Board is not convinced that FERC's approach to incentives for transmission investments justifies the special treatment that Hydro One has requested. ... The Board is of the view that conventional regulatory treatment for the three designated projects provides the appropriate balance between the interests of ratepayers and utilities."*

3.2.5 It is submitted that the same result should apply here. Hydro One should not be allowed to recover from ratepayers for assets that are not "used and useful" in the test year.

3.2.6 Second, we note that in Hydro One's view, the fact that some 2008 spending closes in 2009, and some 2009 spending closes in 2010, is effectively a wash. On this theory, Hydro One should be able to recover from ratepayers for spending in 2009 that closes in 2010, because that indirectly gives Hydro One recovery from ratepayers for spending in 2008 that closes in 2009.

3.2.7 There is enticing logic to this, so, if it is in fact as intuitive as it seems, perhaps it should apply to all utilities under IRM in 2009. Clearly, it does not. Most distributors rebased in 2008 will have capex in 2008 that will become used and useful in 2009, when they are under IRM. The 3rd Generation IRM has no mechanism to adjust for this. Why? Because it is not necessary. This carryover happens every year, so if 2008 does not carryover to 2009, it will carryover, indirectly, in the next rebasing year. In effect, the year to year carryover of CWIP is a steady state fact, and thus is by definition included in the econometric studies of past data that form the basis of the X factor.

3.2.8 What Hydro One proposes is that they are special, and because they meet the materiality threshold for the ICM, an additional benefit they get is indirect recovery from ratepayers of 2008 spending.

3.2.9 It is submitted this is not the intent of the ICM. The Board is clear that only the direct

revenue requirement impacts of capital spending in 2009 (in this case) are potentially recoverable. Any capital spending in 2009 that does not close to rate base in 2009 does not, by definition, have a revenue requirement impact in 2009. That will come in 2010, when Hydro One is coming in for COS in any case.

3.2.10 In passing, we note that where the Board decided to alter the normal rules for calculation of revenue requirement impact (i.e. the half-year rule), the Board did so expressly, and explained why. The Board did nothing similar for CWIP at the beginning and end of the IRM test year.

3.2.11 We therefore submit that the incremental capital spending should be reduced by the amount that is not closing to rate base in the test year, as it is not capital spending for which rate relief can reasonably be requested. The Applicant has refused to provide that information, despite repeated requests, but admits that it is somewhere in the $50 million to $150 million range [Tr.1:165-6]. While in our view a fair adjustment is the midpoint, we propose that the adjustment be $50 million, since in any case a larger adjustment will not change the calculation of the result. It will end of being zero anyway, as we discuss later in this Final Argument.

3.2.12 Given the above analysis, it is our submission that the Applicant has met the materiality threshold to be eligible to apply for the ICM, but the incremental capital expenditures resulting from the calculation, once the correct X factor is used and ineligible capital spending is removed from the budget, should be $118.2 million, not the $173.7 million in the original Application. Using the math proposed by the Applicant to adjust for capital plan changes, this reduces the maximum ICM relief that might be available under the Board's policy from $21.3 million as applied to $20.3 million for the X factor threshold change [see earlier discussion], and from $20.3 to $14.3 million for the $50 million reduction in qualifying spending [see Tr. 1:93 for the appropriateness of translating a 10.8% reduction in capital budget into a 29.7% reduction in ICM relief maximum].

4 THE SUBSTANTIVE REQUIREMENTS FOR RELIEF

4.1 *The Requirements*

4.1.1 The Supplementary Report sets out in specific detail the requirements an applicant must meet in applying for an incremental capital module. In this section of our Final Argument, we will go through those requirements in turn, to assess whether the Applicant has met those requirements.

4.1.2 In this review, we have not considered the requirements in order, but rather have looked at them in the logical order that arises out of the evidence in this particular proceeding.

4.2 *Need for Rate Relief*

4.2.1 The Board says, at page 31 of the Supplementary Report:

> *"A review of the application will…scrutinize the need for the requested capital relief."*

4.2.2 Later we consider this issue of whether the capital spending is needed, but this is a separate requirement. This is the question of whether the rate relief is needed.

4.2.3 In our submission, the Applicant's own evidence demonstrates that the requested capital relief is not in fact "needed". Management of the Applicant went to their own Board of Directors in November and told them [Tr.1:69 and Ex. KX1.6] that they would meet their Board-approved rate of return in 2009 with a 1% rate increase under 3rd Generation IRM. It is submitted that, if the Applicant was able, in 2009, to meet their target ROE without resort to the incremental capital module, then by definition no rate relief is needed. This would not be a situation "where the distributor has no other options for meeting its capital requirements within the context of the financial capacities underpinned by existing rates".

4.2.4 Just stopping at that point, we believe it is fair to say that the only evidence before this Board as to whether the Applicant is able to meet their Board-approved target ROE without this ICM is the presentation by management to their Board of Directors. There is no contrary evidence on this point that we have been able to identify in the evidence.

4.2.5 Therefore, without more it is submitted that the Applicant should be completely disqualified from rate relief on this ground. The ICM is not intended to be a method of allowing a utility to enhance their returns. It is intended to be a method of providing "relief" where the consequences of the 3rd Generation IRM are unduly harsh.

4.2.6 That leaves the question of whether something has happened subsequently that changes what was presented to the Hydro One Board in November.

4.2.7 The evidence of the Applicant is that, in November, management had not yet determined whether to apply for the ICM. They intended to wait to see the results of the 2008 rates decision (which came out in December), before making a final decision [Tr.1:69,77 and many similar statements].

4.2.8 Asked how the 2008 rates decision would be relevant to whether the Applicant would need the ICM, they gave a number of answers. First, in cross-examination by Mr. Thompson, Mr. Dumka said:

> *"We submitted a, I will call it a placeholder 3GIRM application, with the assumption smart meters would be in rate base, that is not what happened in the decision in December." [Tr.1:73-4]*

4.2.9 Mr. Thompson followed up with Mr. Van Dusen, who confirmed that, saying:

> *"As Mr. Dumka clearly indicated, there were major changes in the distribution decision affecting what we would have included, the major one being the inclusion of smart meters which we had asked to be put in rate base." [Tr.1:75]*

4.2.10 Mr. Van Dusen describes the wait for the 2008 rates decision as necessary to deal with "uncertainty", and Mr. Thompson pursued that, as follows:

> *"MR. THOMPSON: All right. Now list for me the factors that were giving rise to that uncertainty.*
> *MR. VAN DUSEN: Sir, it has to do with the smart meters, as I indicated. It was whether smart meters would be included or not, and that would have a huge impact on the submission.*
> *And that was the great uncertainty. It's a large number of dollars, $168 million, and it was that uncertainty, sir.*
> *MR. THOMPSON: Smart meters only?*
> *MR. VAN DUSEN: Generally speaking, that was the major item. We knew at that point, as well that there was some – that the legislation around PCBs, as wlel, could impact the filing as well. But, obviously in terms of relative dollars, it was small." [Tr.1:77]*

4.2.11 Thus, the Applicant left no doubt that the reason for waiting for the 2008 rates decision before deciding whether to apply for ICM was smart meters [although there was some confusion about this later, and Mr. Dumka appeared to recant this earlier evidence: see Tr. 2:30].

4.2.12 However, on cross-examination, it became clear that the smart meter relevance of the

2008 rate decision was only about **how much** Hydro One could ask for in an ICM application, not whether it was a good idea. In fact, the 2008 rate decision effectively **reduced** the amount of the ICM that could be applied for [Tr.2:31]. Hydro One has never explained, in this proceeding, how the smart meter decision for 2008 could have caused them to change their minds about whether to apply for the ICM, and thus apply for it after telling their own Board of Directors they didn't need it.

4.2.13 It is submitted that this Board in fact has before it the real reason why this Application has been made. The Board has, in Exhibits KX1.6, KX1.7, and KX1.8, forecasts by Hydro One management to their Board of Directors of the rate increases they will be seeking year by year over several years.

(a) In KX1.7, at page 8 of the Powerpoint presentation by Ms. Summers in August, 2008, a pattern of distribution rate increases is described. To maintain confidentiality, we will not quote the numbers, but urge the Board to go to the exhibit to see that pattern.

(b) In KX1.6, at page 14 of the attached Powerpoint presentation by Ms. Summers in November, 2008, the new pattern of planned distribution rate increases is described. The change is that the large 2011 rate increase appears to be spread more equally over 2010 and 2011, but the assumption of a 2009 IRM filing with no capital module is retained.

(c) The final evolution of the multi-year rate increase plan comes about after the December 2008 release of the 2008 rate decision. The 2009 rate increase is now changed from an assumption of 1% in November (which, management projected to their Board, would result in them earning their allowed ROE), to 4.38% today. While some of that is smart meters, the balance is the capital module. This change is not expected to result in a reduction of the rate increase requested for 2010 [Tr.1:154], so it can only be for the purpose of offsetting their perceived losses in the 2008 rate decision. That is, either they have a change in their revenue and expense expectations for 2009 since November (which has not been put in evidence before this Board or to their own Board of Directors), or they need a bigger increase this year because they didn't get as big an increase as they requested last year.

4.2.14 It is submitted this pattern makes clear an expectation by Hydro One that they will have certain cumulative rate increases over the next four years, and their thinking as to the timing of the annual increases to get to the final result has been changing. When they did not get everything they asked for in the 2008 rates decision, they did not change their final cumulative target. They just added a further rate increase – this capital module application – to give them an alternate route to their goal.

4.2.15 It is submitted that the ICM was never intended to be a back-door method of getting

rate increases that have already been denied by the Board. In this case, the only evidence before this Board is that, without the ICM, Hydro One expects to earn their allowed ROE in 2009. That being the evidence presented, it is incontrovertible that Hydro One has no need for ICM rate relief in 2009**.**

4.3 ***Unusual Circumstances***

4.3.1 The requirement established by the Board is the following:

> *"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. The capital module is intended to be reserved for unusual circumstances that are not captured as a Z-factor."[Supplementary Report, p.31]*

4.3.2 It has been our understanding that this is intended to cover a situation in which a distributor has a requirement for a substantial increase in capital spending during the IRM period, but is not intended to cover a situation in which capital spending is high every year. In fact, this appears to be implied by the Board, when it refers on the same page of the Supplementary Report to its intent to "examine the reasonableness of the distributor's **increased** spending plan" [emphasis added], and the result of a successful application being that "the Board will adjust rates to reflect a **higher CAPEX** as appropriate" [emphasis added].

4.3.3 The paradigm that was often used during the consultations and discussions with respect to 3rd Generation IRM is the small utility that has to build or refurbish a transformer station, an expenditure that does not happen every year. If a utility that spends $5 million a year on capital is at the point where it has to spend an additional $2 million on a transformer station, its rates may not be sufficient for them to bear that additional burden, especially if they are early in the IRM cycle. The Board accepts that this is an unusual circumstance, and have provided the ICM as a mechanism for reviewing whether some rate relief is warranted.

4.3.4 Hydro One was asked about its "unusual circumstances" supporting this Application, and they gave two, perhaps complementary, answers. On the one hand, as we have discussed earlier in this Final Argument, they have taken the position that their spending pattern does not need to be exceptional or unusual (for them) to attract ICM rate relief.

4.3.5 While we believe they are mistaken in their interpretation, they have also proposed that they do have unusual circumstances in any case, because they are at a stage in their cycle of spending in which capital investment is higher than normal. This is based on the "end of life" argument [Tr.1:46, Tr. 2:114 and others].

4.3.6 This end of life position was the subject of many comments by the witnesses over the two days of oral testimony, but perhaps the best explication comes in this exchange between Mr. Quesnelle and Dr. Poray, at pp. 114-116 of the Transcript on Day 2:

> *" MR. QUESNELLE; The need for it occurs when there is a funding gap based on the capital expenditures outstripping the depreciation.*
>
> *You felt that that was the -- what gives rise to your need in the use of the module; is that correct?*
>
> *DR. PORAY: That's correct.*
>
> *MR. QUESNELLE: You went on to say that that was based on, and as a result of, a combination of circumstances that the company finds itself in.*
>
> *Now, could you elaborate on what it is about the combination of circumstances? Is there anything unusual about it -- has to be unusual about the circumstance? What I am just trying to say, is it straight mathematical, or can you further describe the combination of circumstances?*
>
> *DR. PORAY: In general,* ***the concern that we have is the work that has to be done in the company in terms of the aging asset base. So a lot of our assets are reaching the end of life.***
>
> *So these assets need replacement, and, therefore, there are significant capital expenditures associated with that.*
>
> *We've got the connection of the distributor generation. There is quite a significant program response to the renewable energy standard offer program that Hydro One is involved in. So there is a lot of new generation that is coming on board, and there are implications for the distribution system, as Mr. Juhn outlined, with that.*
>
> *So in relation to the sort of work that we're doing, it is not unusual work. It's the unusual circumstances that we find ourselves in that our capital expenditures have been growing over the years, and I pointed out that in fact since 2002 our capital expenditures have increased by 75 percent.*
>
> *As a result of that, the trending in capital expenditures is outstripping the growth in depreciation, and that's causing a funding gap. So it's not -- what I'm trying to say,* ***it is not unusual work or unusual costs. It is the unusual circumstances in terms of the work that has to be done.***
>
> *MR. QUESNELLE: That unusual circumstance, though, has been -- it's not an unexpected circumstance. It is just an unusual one in the way you are framing it, but it has been in existence at any point in time in that continuum since 2002?*
>
> *DR. PORAY: Well, I think the way I would characterize it is* ***we are now on the upswing of a cycle that occurs in a utility's life where you have a combination of factors that is driving out capital expenditures****, and there may be a point in time that we will reach where we have reached the maximum, and then we may decline where we're into a more steady-state type environment where we don't need such large capital expenditures.*
>
> *MR. QUESNELLE: It's the company's position that the module and the intent of the putting together the capital module was to take care of those periods in*

time, that actual ascending of that ramp?
DR. PORAY: That's correct." [emphasis added]

4.3.7 After reading this section, and looking at the many other places where Dr. Poray and other witnesses refer to "end of life" assets [starting with Tr.1:46] and this "cycle", we attempted to find some evidence in the Application, or in the interrogatory responses, or in the other exhibits, that supports this allegation. None was revealed, and it became increasingly clear that we found nothing because there is nothing.

4.3.8 It may well be true that a utility that goes through, say, a twenty year cycle of spending, with periods of peaks and valleys, could be disadvantaged by IRM if it occurs during the period of peak spending.

4.3.9 But in our submission, to rely on a spending cycle as the basis for your "unusual circumstances", it is incumbent upon the Applicant to provide evidence of that cycle. The evidence could be, for example, comparison of average asset ages by class relative to industry benchmarks, or it could be long term historical capital spending, showing increases and decreases in real, growth-adjusted amounts over time. There are many ways this cycle could be demonstrated to this Board. (Cycles are relatively easy to demonstrate because they are essentially mathematical in nature, and they can be tested with common statistical tools.)

4.3.10 This Applicant has provided no such evidence. This closest is, in fact, evidence initiated by PWU [Ex. K2.1] showing that Hydro One has increased its capital spending year after year since 2002. While that evidence is admittedly unreliable because the annual figures are not comparable [Tr.2:93], it in any case shows only that spending has recently increased, but it shows nothing about the causes of those increases. Nothing in that evidence suggests that spending is cyclical, and nothing in that evidence suggests that Hydro One has assets that are any older or more decrepit than an average utility. In fact, Exhibit K2.1 could be evidence of weak management, or poor union negotiations, or even harvesting of the assets (underinvestment in capital) prior to the expansion of the Board's regulatory oversight in 2006. We could probably provide fifty explanations of the pattern in Exhibit K2.1, other than cyclical spending.

4.3.11 Thus, in our submission this Applicant has failed to demonstrate "unusual circumstances", and thus fails to establish a basic requirement for ICM rate relief. The only possible "unusual circumstances" that it has proferred, its capital spending "cycle", is unsupported by any evidence before this Board. It probably goes without saying that bald allegations, unsupported by evidence, are not an appropriate basis for rate relief.

4.4 ***Significant Influence on Operations***

4.4.1 The next requirement established by the Board is as follows:

> *"The amounts must…clearly have a significant influence on the operation of the distributor; otherwise, they should be dealt with at rebasing." [Supplementary Report, Appendix B, p. IV]*

4.4.2 We note that, while this is tied into the requirement that the materiality threshold be met, the conjunctive used is "and", signifying that this is an additional requirement, over and above satisfaction of the materiality threshold.

4.4.3 Dr. Poray was asked in cross-examination where the evidence was that supported a finding that this spending would have a "significant influence" as required by the Board. The exchange is as follows:

> *"MR. SHEPHERD: You filed evidence that the amounts will have a significant influence on the operation of the distributor.*
> *DR. PORAY: That's correct.*
> *MR. SHEPHERD: Okay. And that is contained in that 79 pages?*
> *DR. PORAY: It's part of the supporting information for our capital expenditure.*
> *MR. SHEPHERD: So if we want to look for that analysis, we would go to the filing and look at each individual project and in each individual project, you are going to tell us how that has a substantial influence, a significant influence, on your operations?*
> *DR. PORAY: The information that we filed in support of our capital adjustment module is the capital plan, the sustainment, development and operations, which were obtained from our planning process. That takes into account the risks to the company of the various projects and of doing them. So what came out of that plan is what needs to be done." [Tr. 1:155-6]*

4.4.4 This quote is consistent with statements by the Applicant elsewhere justifying this point. It raises two questions.

4.4.5 First, the Applicant appears to equate "significant influence on operations" with "non-discretionary". We have comments on whether this spending is non-discretionary, below, but in our view this is a separate and substantive requirement. In our submission, this is an example of the Board's view, expressed in the 3rd Generation Report and the Supplementary Report, that "business as usual" spending should not qualify for ICM rate relief. To qualify, spending must be "impactful", not merely a large amount. On this basis, the Applicant's many admissions that this is a "business as usual" plan [e.g Tr.2:97-100] would disqualify them from ICM rate relief.

4.4.6 Second, whether or not our interpretation of this provision is correct, it is clear that the

Applicant has not filed "an analysis demonstrating…that the amounts will have a significant influence on the operation of the distributor" [Supplementary Report, Appendix B, p. VI]. In fact, as seen in the exchange above, the Applicant is relying on their internal planning process to justify these expenditures. As we have noted elsewhere in this Final Argument, they decline to provide the actual evidence (their internal justifications) so that this Board can make its own determination of this point, instead asking the Board to trust the rigour and integrity of their internal processes. In our view, that is insufficient as the basis for this Board to bless spending $461 million of the ratepayers' money.

4.5 ***Underlying Causes***

4.5.1 The Board requires, at Appendix B, page VI of the Supplementary Report, that this Application include "a description of the underlying causes…of the capital expenditures".

4.5.2 In our submission, the Application and responses to interrogatories generally identify the causes of most of the spending proposed. In the following exchange, it is summarized:

> *"MR. SHEPHERD: Except for the PCBs which has a new cause, right, there was a change in the rules? So now you have this additional money you have to spend, right?*
> *Except for that, pretty well everything else look, to me, to have as a cause, it is part of our normal operations. This is something we normally have to do. Is that generally right?*
> *MR. JUHN: A large part of the work program, that is correct." [Tr.1:156-7]*

4.5.3 While this Board and the parties might well wish there had been fuller analysis of the reasons for some of the spending, it would not be fair to say that evidence meeting this requirement has not been filed. It has.

4.5.4 As we have noted earlier, however, Hydro One has not filed evidence of any overriding cause of the spending levels in 2009. They have shown the causes of individual components, but nothing shows how this year has any different causes from any other year.

4.6 ***Related to the Claimed Cause***

4.6.1 Appendix B, page VI of the Supplementary Report also requires that the Applicant file "justification that amounts being sought are directly related to the claimed cause".

4.6.2 While we believe that the causes itself is contrary to the purpose of the ICM, there is little doubt that the connection between the spending and its causes has been presented.

The cause is "business as usual". The spending is, by the Applicant's admission, and plainly on its face, "business as usual".

4.7 ***Timing of the Expenditures***

4.7.1 The Board also requires, at Appendix B, page VI of the Supplementary Report, that this Application include "a description of the…timing of the capital expenditures".

4.7.2 We asked what is provided in this regard, and got the following:

> "*MR. SHEPHERD: I take it the only timing information you have provided, for the most part, is whether it's going to be in 2009 or not, right?*
> *DR. PORAY: That's correct." [Tr.1:161]*

4.7.3 There follows a lengthy discussion of whether assets will close to rate base during the test year, and the impacts of the half year rule in both 2008 and 2009 on 2009 rate base and revenue requirement. That discussion is dealt with below.

4.7.4 Aside from that, there is no further evidence on timing of expenditures in the test year. However, we do note that, for some multi-year projects, the Applicant has provided timing information related to further spending in subsequent years.

4.7.5 In the context of this particular Application, it would appear to us that the lack of better information on timing of expenditures affects the revenue requirement impact of the 2009 spending, and thus the quantum of any rate relief if granted. We deal with that below.

4.8 ***Further Application Likely?***

4.8.1 The Board requires that the Applicant advise whether a further ICM rate relief application is likely [Supplementary Report, App. B, p. VI].

4.8.2 While the Applicant has not complied with this requirement in the Application itself [Tr.1:168], the Board has separately been notified that the Applicant intends to file for cost of service for 2010. Further, in cross-examination Dr. Poray admitted that, if not for that cost of service application, further ICM relief would likely be required "in the succeeding years of the IRM" [Tr.1:168].

4.8.3 In our submission, the purpose of this requirement is that the Board doesn't want to get itself in a situation in which a utility comes in, year after year, for additional rate increases because of their high levels of capital spending all the time.

4.8.4 This stands to reason. There can only really be two reasons for a multi-year general increase in capital spending: high growth, and cyclical spending pressures. In the case

of high growth, the ICM already adjusts for that. In the case of cyclical spending pressures, where that is demonstrated the Board can engage in its supervisory role to make sure that the pattern of rate relief matches the cyclical needs. However, to do that the Board needs to know what those cyclical needs are, and when the cycle is going to move in the opposite direction.

4.8.5 In this case, the Applicant would, barring cost of service applications, simply come in year after year for additional rate increases [see Tr.1:123].

4.9 ***Non-Discretionary***

4.9.1 The next requirement is that the reason for the expenditures "must be clearly non-discretionary" [Supplementary Report, App. B, p. VI]. That is, unlike our discussion earlier about the "need" for rate relief, this requirement relates to the "need" for the capital spending spending proposed.

4.9.2 The first thing to note about this requirement is that it is tougher than would be the case in cost of service. In cost of service, it is often the case that some discretionary spending is included in the budget. The justification of most spending is still "we have no choice", but for at least some of the spending it is "we think this is a good idea".

4.9.3 By contrast, the ICM does not allow for discretionary spending. While the utility may indeed engage in some discretionary spending, something that is promoted during IRM, that spending cannot ground rate relief under the ICM. Utilities are expected to do this as part of the basic IRM framework, to drive efficiencies.

4.9.4 A good example of this may be Cornerstone. In a cost of service application, an initiative such as this may well be approved, as it was in 2008. It is not really required spending. The utility could carry on just fine without this outlay. However, a case can be made that, over time, it will produce more benefits than costs, and therefore it is a good idea.

4.9.5 The ICM is not built for that. IRM is built for that. IRM does contemplate that utilities will invest capital in order to drive future benefits. No additional rate relief is appropriate in that case, because the spending should be paid for by the benefits. That is a fundamental concept in incentive regulation.

4.9.6 The ICM is designed so that, if a utility can't avoid a major non-discretionary spending increase during the IRM period, it can get some rate relief. Investments to achieve future benefits are more appropriately considered in a cost of service proceeding, where all benefits and costs can be weighed and balanced.

4.9.7 The second thing to note about this requirement is that, combined with the requirement of prudence, below, it contemplates a thorough review of the capital spending plan, the

need to spend the money, the choices on how to achieve the results sought, and the prioritization between projects. This is similar to a cost of service review, except of course that it is limited to non-discretionary projects.

4.9.8 This leads to a critical point in this analysis. The Applicant has a detailed package of justifications for the spending in this capital plan, and has declined to file it in this proceeding. That package, which is what was used by the Applicant's executive management team to base its approval of the capital plan, is described in the following two exchanges:

> *"MR. SHEPHERD: In those meetings, the asset management group makes a presentation to the senior management team, the executive management team – this is what we want to do. Here is our justification for the need. Here is the extent to which it is discretionary or non-discretionary, here is our minimum level, and here is what else we put in. That sort of thing is all built into that package of information your provide them, right?*
> *MR. VAN DUSEN: Yes, sir, it is." [Tr.2:20]*

> *"MR. SHEPHERD: If you would turn to K1.9 you see it says: Asset plan, final. So at that point there is a presentation to your executive management team that says, okay, here's the final package for you to say "yes" to. Isn't that right?*
> *MR. VAN DUSEN: Yes, sir.*
> *MR. SHEPHERD: Okay. And that's more detailed than what goes to your board later?*
> *MR. VAN DUSEN: Yes, sir." [Tr.2:21]*

4.9.9 Asked to file that detailed justification, the Applicant declined to do so, despite being told by SEC counsel that the lack of this justification would be the basis for an argument that they had not met their evidentiary onus and burden in this Application [Tr.2:23].

4.9.10 Faced with a situation in which the Applicant admits to having in its possession detailed justifications for its capital spending program, and refuses to provide it, it is submitted that this Board should draw an adverse inference from that refusal. If this material was helpful to the Applicant's case, we submit that any rational Applicant would file it to give further support to their request for ICM rate relief. Their failure to do so, in our submission, can only lead the Board to conclude that this material contains information that would reduce the Board's willingness to grant ICM rate relief. We believe the Board should draw that inference from this refusal.

4.9.11 In addition, it is submitted that the material filed by the Applicant in this proceeding is insufficient to justify the spending of $461 million. Only 79 pages were initially filed, and although extensive interrogatory responses were filed, they were rife with refusals to provide just this kind of justification. In the SEC IRs alone, there are hundreds of

refusals.

4.9.12 The Applicant has taken the position [Tr.2:124] that SEC cannot complain about the refusals, because SEC did not file a motion to compel production. With respect, the Applicant completely misses the point. This is not SEC's application. It is a Hydro One application. Hydro One wants the Board to approve $461 million of capital spending this year, and has the onus and burden of justifying that spending. It is not up to SEC to drag a complete application out of them. It is up to us to test the material they do file, and point out the gaps in their evidence.

4.9.13 In our submission, many of the documents and answers requested by SEC and refused would be of assistance to the Board in understanding the justification for this spending. By failing to provide that information, the Applicant did not refuse information to SEC. Rather, it refused to meet its own burden of proof.

4.9.14 The easiest way to see why that is true is this. Before the senior management team of Hydro One approved this $461 million of spending, they had to see a certain package of justifications. **In our submission, for this Board to approve that same spending, it should have the opportunity to see that same package.** While in fact this Board may not need to drill down to the same level of detail on every item, it is appropriate for this Board to see that full justifications exist, and to be able to test some of them to see that they stand up to scrutiny.

4.9.15 Therefore, it is submitted that this Application fails to meet the requirements of demonstrating that the expenditures are non-discretionary, prudent and cost-effective, because material evidence that this Board knows is necessary to make an informed decision on those points (as it was for the executive management team) was, although available, not provided to this Board.

4.10 ***Prudent and Cost Effective***

4.10.1 Page VII of Appendix B of the Supplementary Report sets out the requirement that the Application include4 "justification that the amounts to be incurred will be prudent", and goes on to equate prudence with choosing "the most cost-effective option".

4.10.2 For the reasons set forth in the immediately preceding section, it is our submission that the Applicant has failed to meet this requirement.

4.11 ***Not Recoverable Through Other Means***

4.11.1 ***The Requirement.*** The question of whether the Applicant has other sources of revenue/funds to cover either the incremental capital spending itself or the increased revenue requirement associated with the incremental capital spending, an analysis required by the Board [Supplementary Report, App. B, p. VII] was not fully canvassed

in the Application or in the hearing.

4.11.2 For the Applicant, the question of whether they have sources to fund their extensive capital spending plan revolved around the structure of IRM. In the Direct Evidence, and at several other points in the oral hearing, they insisted that their current rates do not have a provision for any capital spending in 2009. This led, for example, to a perhaps unintentionally amusing exchange with the Chair, when Dr. Poray insisted that Hydro One has no money for 2009 capital spending without an ICM, and the Chair sought to understand how that could be the case.

4.11.3 What was missed in the extensive discussion of the structure of 3rd Generation IRM is the simpler question of whether the specific capital spending planned for the test year has implicit sources of funding, particularly given the plan to come in for cost of service in 2010.

4.11.4 ***Cornerstone.*** A good example of this is the Cornerstone project. Mr. Millar on behalf of Board Staff tried to run this down [Tr.2:103-113], but it was clear that the witnesses for the Applicant simply did not understand the relationship between the spending and the benefits.

4.11.5 Cornerstone is a massive multi-year computer software (primarily) project that replaces a number of legacy systems and seeks to generate more than $200 million of efficiency benefits. In EB-2007-0681 the intervenors complained that they would be bearing the capital spending for Cornerstone in rate base, but the benefits during IRM would enure to the benefit of the shareholder. The Board [see Tr.2:107-8], while recognizing their concerns, determined that it was a normal part of IRM ("This, however, is how incentive rate mechanisms operate"), and as a result those benefits should not be shared with the ratepayers in 2008.

4.11.6 The amount in the $461 million capital budget for the 2009 spending on Cornerstone is $44.8 million [Tr.2:109]. The benefits of the 2009 spending are not expected to arise until 2010 and beyond. However, the 2008 spending, which is on the ratepayers' ticket, generates $3 million in capex savings in 2009, and $4 million in opex savings in 2009 [Tr.2:110].

4.11.7 Hydro One has, quite correctly, determined that it must net out the $3 million in capex savings from the capital budget in 2009 [Tr.2:67]. Thus, the net budget for Cornerstone for the test year is reduced by that $3 million, for a net of $41.8 million [Tr.2:105]. In our view, this is the correct way to account for the capital benefits.

4.11.8 The Cornerstone project represents 23.5% of the incremental capital in 2009. That is, if the Cornerstone project were not included, incremental capital eligible for the ICM would be reduced by 23.5%. Based on the claimed revenue requirement impact of $21.3 million, the Cornerstone incremental revenue requirement is therefore $5.0

million.

4.11.9 How to pay for that? Well, revenue requirement is in fact reduced by $4 million due to the Cornerstone OM&A savings. Hydro One, however, says [Tr.2:110] that this cannot be counted toward the 2009 impact of Cornerstone, because efficiency savings belong to the company under IRM.

4.11.10 With respect, the Applicant cannot have its cake and eat it too. If they want to claim the Cornerstone project as "incremental" capital, then they have to recognize the benefits they are enjoying from the Cornerstone project. In fact, that is how investments work. You spend money at the outset, and the benefits that accrue ultimately pay for those investments.

4.11.11 It is therefore submitted that, with respect to Cornerstone, 80% of the 2009 cost is already covered by Cornerstone opex savings. No ICM is required for that component. Since the Applicant is applying for cost of service in 2010, anything beyond the 2009 cost of Cornerstone of $5.0 million is already covered because Cornerstone will be in rate base. Therefore, of that $41.8 million net spend in 2009, only a maximum of $1.0 million is represented by an increase in 2009 revenue requirement.

4.11.12 ***Other Capital Spending.*** The question of whether " the **incremental revenue requested** will not be recovered through other means" [emphasis added] is a more general one. Some capital spending is simply costs, without any balancing efficiencies or savings. But, some capital spending has concomitant impacts on OM&A or capital costs, in the test year. For example, if you replace a worn-out piece of gear in January, the relatively high maintenance costs for that gear drop virtually to zero for the balance of the year.

4.11.13 The Applicant has, in this proceeding, made no effort to assess how operating expenses are reduced as a result of the planned capital spending. It was obligated to do so – in fact, to provide "evidence" on that score under the Board's rules – and it made no attempt whatsoever to do that. OM&A savings in the test year from the capital spending proposed are not discussed, nor are the OM&A savings in 2009 from prior year savings in ongoing programs included in the 2009 capital plan. Cornerstone is the easiest example of that (2008 spending drives 2009 savings available to cover the carrying costs for 2009 spending), but the same is true in any ongoing capex program that has operational benefits.

4.11.14 At this point, the Board cannot know whether those impacts are small or large, since no evidence has been filed. The Applicant simply failed to meet this requirement in their Application. If the Board has to estimate, the only basis on which it could do so is Cornerstone. In that case, 9.1% of the capital spending in 2009 ($41.8/$460.8 million) produces a reduction in ICM revenue requirement impact of 18.8% ($4.0/$21.3 million). There is no evidence to the contrary.

4.11.15 ***Payments Under the Lease.*** An amount of $8-10 million of leasehold improvements for the new head office is planned for the test year [Tr.2:33]. The evidence of the Applicant is that there may be some other payments back and forth with the landlord in the test year, but some or all of the receipts would be treated as OM&A, not offsets to capital costs and not amounts available to cover the revenue requirement relating to incremental capital spending [Tr.2:35-6]. In a lengthy discussion about how the various amounts under the new lease arrangements would impact this application [Tr.2:33-43], the Board and the parties were left more confused at the end than at the start. The bottom line was that the Applicant refused to provide the lease, and refused to provide details of of cash payments back and forth between the landlord and the Applicant, because those amounts would be OM&A.

4.11.16 Given the refusal to provide information, it is our submission that some amount should be assumed as an offset for these leaseholde improvement costs. However, because there is no evidence, it is impossible for the Board to determine a reasonable amount. Since our end result below is that the known offsets already exceed the ICM rate relief claim, it is not necessary to pursue this further. On the other hand, if any of the offsets or calculations we have proposed are not accepted by the Board, in our submission the likely availability of funding for the leasehold improvements should be taken into account by the Board in further offseting the ICM rate relief claim.

4.11.17 ***Capitalization Policy.*** The other area in which the Applicant failed to reflect another source of funds to cover the revenue requirement impact of the capital plan is the change in the amount of capitalized overheads. The evidence of the Applicant is that 8.7% was added to each dollar of capital spending in 2008 to reflect overheads that should be capitalized, but in 2009 10.7% was added to each dollar to reflect capitalized overheads [Tr. 2:56 and Ex. I/1/2].

4.11.18 Before getting to the principle at play, we note that the evidence is confusing on this point. In Ex. I/8/3, the Applicant says that in 2008 it capitalized $44.6 million of overhead, and in 2009 it capitalized $47.9 million of overhead. This is an increase of $3.3 million, meaning that, all other things being equal, OM&A was reduced by $3.3 million.

4.11.19 We were confused by this, because the overhead capitalization rate is applied to capital expenditures, increasing them in order to get the fully loaded capital plan.

(a) The amount spent in 2008 on capital, $415.0 million, was made up of a base capital spending amount, plus 8.7%. By our math, that works out to base capital spending of $381.8 million, plus $33.2 million of capitalized overhead. This is not consistent with the figure of $44.6 million reported by the Applicant as capitalized overheads for 2008. (We note that if the capitalization figure in 2008 includes smart meters, but in 2009 does not, that might explain some of this discrepancy, but not all of it.

In any case, that would mean the $44.6 number is incorrect, and has to be adjusted to be comparable with the 2009 capital plan.)

(b) Similarly, the amount to be spent in 2009 on capital, $460.8 million, was made up of a base capital spending amount, plus 10.7%. Mathematically, this works out to $416.3 million of base capital spending, plus $44.5 million of capitalized overhead. This is closer, but still not consistent with the figure of $47.9 million forecast by the Applicant as capitalized overheads for 2009.

We note that the difference between the two derived numbers, $11.3 million, is more intuitive than the $3.3 million reported by the Applicant. A 2% increase in capitalization rate on a capital spend in excess of $400 million has to be something in excess of $8 million, plus the application of the full capitalization rate to the capital spending increase. A figure of $3.3 million makes no sense.

4.11.20 Whether the correct number is $3.3 million, or $11.3 million, that represents an increase in capital spending and a concomitant decrease in OM&A. And, although the witnesses say that OM&A in 2009 is increasing, the Board has no evidence of that, and in fact has an IRM structure that accounts for that. What is plain on the face is that an amount of several million dollars has, by reason of perfectly normal accounting decisions, been shifted from OM&A to capital in the 2009 forecast.

4.11.21 In our submission, this is another source of funds available to cover the 2009 revenue requirement associated with the incremental capital expenditures. That is, the $11.3 million increase in capital associated with capitalized overheads will be recovered from ratepayers over time through rate base. But, the $11.3 million reduction in OM&A that is the other side of that accounting entry is never paid to ratepayers. It simply drops to the bottom line on the 2009 income statement, and is thus available to the Applicant in 2009 to cover the revenue requirement impact of the incremental capital expenditures.

4.11.22 We have assumed for the purpose of this Final Argument that the mathematically derived increase in capitalized overheads, $11.3 million, is the correct figure. If the Applicant has filed cogent evidence showing that another increase is correct (other than Ex. I/8/3, which is inconsistent with their evidence on capitalization rates), then it would be useful for the Applicant to draw that evidence to the Board's attention, so that a better figure can be determined. Otherwise, in our submission their own evidence results in the $11.3 million figure being the correct one.

4.11.23 ***Conclusion.*** It is therefore our submission that the Applicant has not met this requirement. Because they failed to provide evidence on the benefits arising out of other capital spending, and the OM&A offsets to the leasehold improvements, the final amount of "other sources" is not determinable, and for that reason in our submission the Application should be denied. However, in any case if the capitalization increase is

actually $11.3 million, as we have calculated, then even without the benefits from other capital projects, the combination of that $11.3 million plus the $4 million from Cornerstone would reduce the available rate relief below zero.

4.12 *Outside of Current Rates*

4.12.1 It is Hydro One's stated position, of course, that all 2009 capital spending is "outside of current rates" [e.g. Tr.1:34, Tr.1:170]. This appeared to us from the beginning as a re-arguing of the 3rd Generation IRM proceeding. In that proceeding, SEC submitted that in fact under 3rd Generation IRM the threshold for a distributor like Hydro One should not be in the range of 150% of depreciation, but in the 200% range (i.e. the level of capital spending provided for in the IRM mechanism), while Hydro One proposed that all capital spending in excess of 100% of depreciation should be subject to ICM rate relief.

4.12.2 The Board accepted neither of these positions, instead opting for a formula based on the analysis of Mr. Aiken, producing the threshold set forth in the Supplementary Report.

4.12.3 There is no useful purpose to be served in re-arguing the issues in 3rd Generation IRM. The Board has selected a balanced approach, and both SEC and Hydro One are bound to accept that balancing. The Board is the regulator. Neither SEC nor Hydro One is the regulator.

4.12.4 In our submission, if the capital spending is below the threshold, or if it is offset by capital savings, or if the revenue requirement impact is offset by OM&A savings, then it is covered by current rates. These aspects are all separately considered under other Board requirements. We will not re-iterate them here.

4.12.5 Based on this test, the Applicant has not met this requirement, because a) their position is that spending up to the threshold is not covered by current rates, contrary to Board policy, and b) as noted above, they have not properly considered the offsets that cover components of their capital spending.

4.13 *Revenue Requirement Impact*

4.13.1 ***The Requirement.*** It is important in dealing with this issue, as in most of the requirements, to understand with precision what the Board has indicated must be provided. It is as follows:

> *"An analysis of the revenue requirement associated with the capital spending (i.e. the incremental depreciation, OM&A, return on rate base and PILs associated with the incremental capital)" [Supplementary Report, App. B, p. VI]*

4.13.2 The Applicant has made no attempt to calculate the actual revenue requirement impact of the incremental capital spending in its 2009 capital plan. In fact, the witnesses completely understood the difference between what they were claiming and the real world. For example:

> *"MR. VAN DUSEN: You are now talking about what will happen in 2009 actually, versus what we're witnessing here." [Tr.1:164]*

4.13.3 The Applicant made the assumption that using the Board's Excel spreadsheet to calculate the revenue requirement impact would be the end of the matter, and insisted time and again during the hearing that they were invulnerable because they did just that [e.g Tr.2:122]. With respect, the rules and principles for ICM rate relief are contained in the 3rd Generation Report and the Supplementary Report. The spreadsheet is only useful to the extent that it implements those reports faithfully and is applicable to the specific circumstances of the particular application being considered.

4.13.4 The first step in this analysis is to get the calculation of the threshold right, since it is only spending above that level that can be even considered for rate relief. As we have noted in our analysis earlier in this Final Argument, it would appear to us that the threshold is actually $295.6 million, the incremental capital is $118.2 million, and as a result, before any changes to the revenue requirement calculation, the maximum revenue requirement impact of that incremental capital is $14.3 million.

4.13.5 From that starting point, it is submitted that at least three adjustments are required:

(a) Re-instate the impact of the half-year rule.

(b) Recalculate cost of capital and PILs using correct data.

(c) Reduce the impact by $4 million to reflect the OM&A benefits of Cornerstone spending and $11.3 million to reflect the increase in capitalization of OM&A, both other sources of funds to cover the revenue requirement impact of the 2009 capital spending.

4.13.6 ***Adjustment for the Half-Year Rule.*** With respect to the half-year rule, Hydro One's position appears to be that the spreadsheet prepared by Board Staff does not adjust for the half-year rule, and the Board in the Supplementary Report made clear that it was not intending to adjust for the half-year rule, so Hydro One should get depreciation and return as if all assets were in service on January 1, 2009.

4.13.7 The Board, however, did not just reject the use of the half-year rule in the ICM. It also said why:

> *"In calculating the rate relief, the Board has determined not to apply the half-*

> *year rule so as not to build in a deficiency for subsequent years in the term of the plan." [Supplementary Report, p. 31]*

4.13.8 Thus, Hydro One has a dilemna. Hydro One will be coming in for cost of service in 2010, so the possibility of building in "deficiency for subsequent years" does not come into play. The reason for departing from normal regulatory principles in the ICM does not apply to Hydro One, but Hydro One appears to be saying that they want this additional benefit anyway.

4.13.9 The incongruous result is that Hydro One would, on their argument, collect more from ratepayers under the ICM for this incremental capital spending than their actual cost of the new assets. For example, they would collect a full year's depreciation for 2009, but when calculating rate base, would follow the normal rule of charging half to income in 2009. When they come in for cost of service in 2010, the rate base will be that much higher, and the difference – the excess collection in 2009 – will never be returned to the ratepayers. It is a windfall to the utility.

4.13.10 Similarly, when considering cost of capital for these expenditures, Hydro One's position requires the Board to assume that it capitalized all of these assets on January 1, 2009, and used that capital throughout the year. That is not in fact true, of course, as the capital needs only arise as the spending takes place. Further, many of the assets will have interest during construction, so there will be double counting. As the asset is being built, AFUDC will accrue, but the ratepayers will also be paying the financing costs for those same assets through the ICM.

4.13.11 In doing away with the half-year rule for the ICM, the Board was recognizing the fact that it applies for the year assets go into service, but it does not apply for subsequent years. Since utilities using the ICM would in most cases be facing IRM in subsequent years, using the half-year rule would leave them short in those subsequent years. This harm is not applicable to Hydro One, and therefore the policy – no half year rule – that aims to deal with the harm should also not be applicable to Hydro One.

4.13.12 It is therefore submitted that the half-year rule should apply to calculating the revenue requirement impact of the incremental capital, since failure to do so would overstate the potential rate relief the Applicant may need for the test year.

4.13.13 ***What About the Impact of the 2008 Capital Spending?*** Faced with questions relating to the half-year rule, the Applicant made the astonishing proposal that the Board should still give them a full year of rate relief because their 2008 capital spending is kicking in, and that rate base impact makes up for the lower actual rate base impact of the 2009 incremental capital [Tr. 1:118-9, Tr.2:4-6, and Tr.2:9]. This position is untenable, for a number of reasons.

4.13.14 First, the Board expressly rejected the notion, proposed by many utilities, that the ICM

should be used to adjust rate base in light of rate base increases during IRM. In the Supplementary Report, the Board said, at pp. 30-31:

> *"The distributors, on the other hand, percieve 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." [emphasis added]*

4.13.15 Second, if the Applicant is to be allowed any recovery of additional revenues due to the impact of the 2008 half year rule on 2009, what about the other LDCs in IRM in 2009, who don't qualify for the ICM? They are still impacted by the 2008 half year rule. Why is it that Hydro One should be afforded rate relief for 2008 capital spending in 2009, but other LDCs will not?

4.13.16 In fact, implicit in the design of 3rd Generation IRM is that the application of the half-year rule in the rebasing year does not have to be adjusted in the first year of IRM that follows. The Board has determined that the IRM structure is fair without that.

4.13.17 Therefore, if the Board were to accept Hydro One's argument that they alone, by virtue of the confluence of events – their ICM application, plus their COS plan for 2010 – are entitled to an additional adjustment to reflect the half-year rule's application in their rebasing year, it would necessarily follow that the 3rd Generation IRM is unfair to all other distributors in that respect.

4.13.18 Third, Hydro One's argument would only be correct if capital spending in 2009 is identical to capital spending in 2008. To the extent that the capital spending increases in 2009 over the rebasing year, allowing full year treatment of those expenditures in the ICM results in overcompensating Hydro One for the impact of the 2008 half year rule in 2009.

4.13.19 This was played out with precision in the oral hearing. The Applicant advised that the rate base increase in 2009 will be $200 million for the remaining half of the 2008 capex, and $230 million for half of the 2009 capex [Tr.2:5]. This was compared to the spending of $460 million, **less the dead band of $38 million**, leaving recovery from ratepayers on $422 million of capital under the ICM. The conclusion was that the utility is actually worse off to the tune of the depreciation and return on $8 million.

4.13.20 When SEC asked, in cross-examination, whether that only would apply if the dead band did not apply to Hydro One, the witnesses did not understand what we were talking about [Tr.2:10-11].

4.13.21 The bottom line here is that any connection between rate base increase in an IRM year

with ICM rate relief, and the Board's decision not to apply the half year rule to normal ICM applications, would be co-incidental. In fact, the more unusual the applicant's capital spending in the IRM year, the less Hydro One's comparison would be true. The comparison is only mathematically correct if spending in the IRM year is the same as spending in the rebasing year, exactly the situation in which ICM rate relief is least appropriate.

4.13.22 It is therefore submitted that the attempt by Hydro One to get additional rate relief in 2009 on the basis of their 2008 capital spending should be rejected in its entirety.

4.13.23 ***Adjustment for Cost of Capital and PILs.*** With respect to the cost of capital and PILs rates, to the best of our knowledge the Board did not address those issues in the 3rd Generation Report or the Supplementary Report. As a matter of principle, capital financed in 2009 should for regulatory purposes be treated as being financed at 2009 financing rates, since that is what is happening in fact.

4.13.24 There may be circumstances where a regulatory fiction is appropriate to achieve ratemaking objectives, but that is not the case here. The cost of capital and PILs associated with the incremental capital can be readily determined, and forms part of the "revenue requirement impact" of that spending. The utility is, in law, entitled to have an opportunity to recover its actual cost to provide service, plus a fair return. Using 2009 cost of capital and PILs does just that.

4.13.25 In this Application, Hydro One has instead used 2008 cost of capital and PILs [Tr.1:92 and Ex. B2/1/1, App. F, p. 8]. In our submission, this is not sustainable if the purpose of the ICM is to give appropriate rate relief.

4.13.26 ***Adjustment for Cornerstone and Capitalization Impacts.*** The rationale for adjusting the revenue requirement impact by the Cornerstone and Capitalization impacts is discussed above under Section 4.11.

4.13.27 ***Corrected Revenue Requirement Impact.*** The impact of those three adjustments is as follows:

(a) Half year rule – cuts the revenue requirement impact in half [Tr.1:89], so in this context would reduce the revenue requirement impact by $7 - 10 million, depending on the starting point selected (ie. $20.3 million as proposed by Hydro One, or $14.3 million, as we have proposed in Section 3.2 of this Final Argument);

(b) Corrected cost of capital and PILs – approximately $1.0 million on a $21.3 million base, so approximately $0.7 million on the reduced base;

(c) Cornerstone benefits and capitalized overheads increase - $15.3 million.

4.13.28 It is therefore submitted that the correct revenue requirement impact calculation, as required by the Board in the Supplementary Report, is ($8.7 million) which, since it is a negative, ends up being zero. In our submission, this is the maximum ICM rate relief that could be made available to the Applicant, if all other requirements had been met.

4.14 ***Proposal as to the Amount of Relief Sought***

4.14.1 The Applicant has met this requirement. They have proposed an amount of relief that, to their knowledge, is far in excess of the actual revenue requirement impact of the incremental capital spending they believe qualifies for the ICM. In fact, in their view testing recovery against the actual revenue requirement impact of the incremental capital spending is irrelevant to the ICM process [Tr.1:86,89 among other cites].

4.15 ***Actions Planned if ICM Denied***

4.15.1 Hydro One did not include in their Application, as required, a statement of what actions they would take if the Board does not approve their ICM rate relief. However, in cross-examination, Dr. Poray did make clear that Hydro One will proceed with their entire capital plan anyway, even if this Application is denied [Tr.1:176]. In our view, they have therefore met this requirement.

4.15.2 We note that PWU, in their Final Argument, at pp. 13-15, has a whole section dealing with the dire consequences of Hydro One failing to proceed with this capital plan. In particular, at para. 30 of their Final Argument, they quoted Dr. Poray on what would happen in that case.

4.15.3 What PWU failed to do is include the whole quote. Here it is:

> *"MR. LOKAN: I think the panel has told us previously that you're going ahead with this spending anyway, even if the ICM is not allowed on this application; is that correct?*
> *DR. PORAY: Well, we would certainly consider doing this work, because this work needs to be done.*
> *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 one of the bigger impacts."[Tr.2:95] [emphasis added]*

4.15.4 PWU quoted the second exchange in their Final Argument, as if they were talking about what would actually happen. Once the context is provided, it is clear that PWU was raising a hypothetical that Hydro One had already said is not what they would do

in fact.

4.15.5 We also note, in this regard, that as we have discussed above management of Hydro One has already told their Board of Directors that, with all of this capital spending, and without any ICM rate relief, they expect to achieve their allowed ROE in 2009.

4.16 *Conclusion and Recommendation on the Filing Requirements*

4.16.1 It is therefore submitted that the Applicant has failed in material ways to meet the requirements for ICM rate relief as established by the Board, and this Application should therefore be denied for that reason.

4.16.2 We note the submissions in the Final Argument of the Society on compliance with the requirements laid down by the Board. In essence, the Society argues that, since this is the first ICM application, it should not be denied "on a technicality". In effect, this Board should give Hydro One a break, because they were first in line and everyone is still learning about this.

4.16.3 With respect, that submission is neither tenable nor appropriate. As we have noted above, most of the requirements laid down by the Board are in fact substantive in nature, not technicalities. If Hydro One does not in fact need rate relief, as their evidence reveals, it is not a technicality to deny this Application. It is good ratemaking. If Hydro One has provided no evidence whatsoever of their alleged "unusual circumstances", it is not a technicality for this Board to say that it can't grant relief unless it has such evidence. It is good ratemaking. If Hydro One does not in fact come within the purpose of the ICM, it is not a technicality for the Board to deny relief on that basis. It is good ratemaking.

4.16.4 It is submitted that this is not about whether the Applicant filed the right pieces of paper, or whether it's Application was on time. These are substantive requirements established by the Board to ensure that ICM rate relief is only granted in appropriate cases, and in appropriate amounts. In our submission, Hydro One has failed to meet those requirements, and it is not appropriate to grant them ICM rate relief.

5 APPROPRIATE RELIEF

5.1 *Nature of the Test*

5.1.1 In the event that the Board determines that some ICM rate relief is appropriate in this case, our alternative submission is that the amount of relief requested has been substantially overstated.

5.1.2 The Board has already determined [Supplementary Report, p.31] that only the incremental capital expenditures may qualify for rate relief. It is our submission that the rate relief to be afforded cannot exceed the actual revenue requirement impact of those expenditures in 2009. As we have noted earlier, consideration of the impact in following years, which the Board planned to include due to the impact of the half-year rule on LDCs with multiple years of IRM, is not appropriate in this case, since the Applicant will not be in IRM year. It would result in double recovery if allowed.

5.2 *Relief if ICM Allowed*

5.2.1 ***Amount.*** Given the principles above, it is submitted that the maximum incremental capital expenditures level for rate relief is as set forth in Section 3 of this Final Argument, and as a result of that, and the corrected calculation of revenue requirement impact in Section 4.13 of this Final Argument, the maximum amount of rate relief that should be allowed is **zero**.

5.2.2 ***Timing.*** The Board has declared the Applicant's rates interim, because a May 1, 2009 implementation of revised rates is not realistically possible at this point. It is our submission that adjustments for the 3rd Generation IRM formula and other standard adjustments that would arise in a "plain vanilla" IRM application should be effective as of May 1, 2009. If they are implemented later, Hydro One should be allowed a rate rider to cover the revenue shortfall between May 1, 2009 and the implementation date. However, with respect to the ICM, if any rate relief is granted by this Board, it should be effective as of the implementation date, and any resulting revenue shortfall from May 1, 2009 until that date should be lost. The evidence in this Application was filed at the end of January. No justification has been given for that delay. Even if there was good reason for Hydro One to await the 2008 rates decision before finalizing this Application (and it is not clear why that would be), the six-week delay until the end of January is unexplained in the evidence. It would appear, however, that if the Application had been perfected with proper evidence even two or three weeks earlier, implementation of new rates on May 1, 2009 would still be possible. Given that the capital plan did not change between November and the end of January, there would appear to be no reason why it was not filed earlier than it was.

6 OTHER MATTERS

6.1 *Costs*

6.1.1 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

_____

Jay Shepherd, Shibley Righton LLP
Counsel for the School Energy Coalition