EB-2008-0187

ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an Application by Hydro One Networks Inc., for an Order or Orders approving rates for the distribution of electricity commencing May 1, 2009.

Written Argument Of
The Consumers Council of Canada

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HYDRO ONE NETWORKS INC. – 2009 DISTRIBUTION RATES

WRITTEN ARGUMENT OF THE CONSUMERS COUNCIL OF CANADA

INTRODUCTION:

1. Hydro One Networks Inc. ("HON") has applied to the Ontario Energy Board ("Board") for approval of its 2009 distribution rates effective May 1, 2009. HON, through its application, is seeking a rate adjustment which has been derived using the Board's 3rd Generation Incentive Regulation Mechanism ("3rd GIRM"). The key elements of HON application are:

    1. A rate adjustment for 2009 that reflects an escalation factor of 1.18%. The escalator represents the most recent Board approved values for inflation and productivity;

    2. An incremental capital module ("ICM") rate rider in order to recover $21 million of incremental revenue requirement on $174 million of incremental capital expenditures in 2009;

    3. A Z-factor tax change rate rider to return to ratepayers their share of reductions and income taxes and capital tax rates in 2009 from 2008 rates totalling $.3 million; and

    4. A smart meter funding rate adder of $1.65 per month per metered customer to provide advanced funding for its 2009 forecast smart meter expenditures and 2008 year-end smart meter additions.

2. HON's application reflects a distribution rate increase of 4.8% which includes the price cap adjustment, the smart meter adder and impact of applying the ICM. The ICM component represents 2.1% of the overall increase in rates.

3. These are the submissions of the Consumers Council of Canada ("Council") regarding HON's distribution rate application. The Council accepts all elements of HON application with the exception of the application of the ICM. The Council will set out why HON's proposal to adjust its rates to reflect its forecast of incremental capital spending for 2009

should be rejected by the Board. Prior to setting out its submissions regarding the ICM the Council will provide the relevant background regarding the Board's 3^{rd} GIRM process, and the Council's perspective on the application of the ICM.

4. In the preparation of these submissions, the Council has had the benefit of seeing the draft of one other intervenor's argument. In addition, the Council is aware that other intervenors will be making detailed arguments about the evidence. The Council relies on these arguments.

BACKGROUND:

5. On July 14, 2008, the Board, issued its "Report of the Board on 3^{rd} Generation Incentive Regulation for Ontario's Electricity Distributors" setting out the Board's policies and approach to 3^{rd} GIRM ("3^{rd} GIRM Report"). The 3^{rd} GIRM Report was issued after an extensive stakeholder consultation process that included the establishment of a working group, a Board Staff discussion paper and further consultations involving a number of industry experts in incentive regulation. The Council participated in all stages of the consultation process. In its Report the Board established that the 3^{rd} GIRM would be a <u>multi-year rate-setting plan</u> including the following key components:

- A comprehensive price cap for of adjustment mechanism;
- A term of 3 years;
- An inflation factor based on the year-over-year change in the GDP IPI FDD to calculate price escalation;
- An input price differential equal to zero;
- X-factors that will consist of an empirically derived industry productivity trend and a stretch factor;
- Z-factors limited to events genuinely external to the regulatory regime and beyond the control of management;
- A trigger mechanism with an annual ROE dead band of +/- 300 basis points; and
- An ICM that is subject to eligibility criteria and a materiality threshold. (3^{rd} GIRM Report, pp. 1-33).

6. From the Council's perspective it is important in assessing whether HON's proposal should be approved, to focus on some of the key findings and expectations of the Board regarding the ICM. In the 3rd GIRM Report the Board made the following key findings:

> The Board has determined that there will be an incremental capital module in 3rd Generation IR. Distributors with an amount of capital spending that exceeds the materiality threshold may best be accommodated through rebasing. However, on balance, as participants acknowledged, some incremental capital investment needs may arise during the IR term and the Board notes that a clearly defined modular approach is generally accepted. (p.33)
>
> While the module may provide for a broad scope for incremental capital needs, specific application must be made to provide for review and approval of stated need. Applications must be accompanied by comprehensive evidence to support the claimed need. (p. 32)

7. Board Staff had proposed that a distributor's application to the Board, requesting rate relief for incremental CAPEX during an IR, include a number of filing requirements. The Board, in its report, supported the application requirements proposed by Board Staff were reasonable. (p. 33)

8. For incremental capital expenditures to be considered for recovery prior to rebasing, the Board determined that amounts must satisfy the eligibility criteria set out in the following table:

Criteria	Description
Materiality	The amounts must exceed the Board defined materiality threshold and clearly have a significant influence on the operation of the distributor; otherwise they should be dealt with at rebasing
Need	Amounts should be directly related to the claimed driver, which must be clearly discretionary. These amounts must be clearly outside of the base upon which rates were derived.
Prudence	The amounts derived must be prudent. This means that the distributor's decision to incur the amounts must represent the most cost-effective option (not necessarily least initial cost) for ratepayers. (p. 33)

9. The Board in the initial report noted it would be assisted by further consultation on the appropriate materiality threshold. On September 17, 2008, following further consultation, the Board issued a further report addressing a number of outstanding issues arising from the original report. Those issues were the determination of the values for productivity, the stretch factor and establishing the capital module materiality threshold.

10. The Supplemental Report focused on what would be an appropriate materiality threshold for the incremental capital module. Specifically, the Board determined:

> The Board notes there are differences in perception as to the purpose of the incremental capital module. Ratepayer groups perceived the capital module as a mechanism aimed solely at addressing extraordinary or special CAPEX needs by distributors. The distributors on the other hand, perceive the module as a special feature of the 3rd Generation IR architecture which would enable them to adjust rates on an on-going, as needed basis to accommodate increases in rate base. (Supplemental Report, pp. 30-31)

11. 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 it July 14, 2008 Report. The distributors' concept better fits a "targeted OM&A" or "hybrid" form of IR. This alternative IR form was discussed extensively in earlier consultations but was not adopted by the Board. The intent is not to have an IR regime under which distributors would habitually have their CAPEX reviewed to determine whether their rates are adequate to support the required funding. <u>Rather, the capital module is intended to be reserved for unusual circumstances that are not captured as a Z-factor and where the distributor has no other options for meeting its capital requirements within the context of its financial capacities underpinned by existing rates.</u> Emphasis added (p. 31)

12. A review of an application will test whether the applicant has passed the materiality threshold, and, if it does, will scrutinize the need for the requested incremental capital relief. Such scrutiny will entail reviewing the distributor's assumptions and planning and examining alternative options and its overall CAPEX plan (p. 31)

13. If the application is approved a rate rider would be established to reflect an amount sufficient to accommodate the portion of the approved incremental spending that exceeds the threshold amount. 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. (p. 31)

SUBMISSIONS:

14. The Council submits that HON's ICM proposal is not consistent with the framework for setting rates under the 3rd GIRM, and should be rejected.

15. The Council participated in the working group and the consultations that led up to the policies established by the Board as set out in the 3rd GIRM Report and the Supplemental Report. Although there was recognition by all parties that during a three-year plan capital requirements may become a challenge, ratepayer groups, and ultimately the Board were of the view that the ICM should only apply in “unusual circumstances”. The evidence in this proceeding is that the capital plan proposed by HON largely represents a continuation of the capital plan approved by the Board in its 2008 rates proceeding (Tr. Vol. 1, p. 84). It is not comprised of one-time extraordinary cost elements.

16. HON’s evidence is that its 2009 capital plan represents unusual circumstances for two primary reasons. The first is that its capital spending has increased by 75% since 2002 and this is, in and of itself, unusual. (Tr. Vol. 1, p. 46). The other is that, as a result of the increased spending, its annual capital spending is outpacing its depreciation expense. This too, HON argues, is unusual. In effect, HON’s position is that the rates derived through 3rd GIRM, even with the 2009 escalation, are not sufficient to support its planned spending.

17. HON’s evidence regarding its Board of Directors approval of its 2009 application is inconsistent with the argument that the 2009 escalation is not sufficient to support the 2009 capital plan. The approval by the Board of Directors in November 2008 of HON’s 2009 rate application assumed a rate increase of 1%, exclusive of an ICM (Tr. Vol. 1, p. 96). The Council submits that the ICM is intended to compensate distributors, who during the three-year plan encounter unusual or extraordinary expenditures that require rate relief above that which is

allowed under the price cap mechanism. The evidence in this proceeding demonstrates that HON's application is not consistent with that intent.

18. HON has indicated that it will be filing a cost of service application for 2010 and 2011 later this year. In effect, HON's current 3rd GIRM application is for a period of one-year. The Council submits that this is a further reason to reject the implementation of the ICM for 2009. As noted above, the intent of the ICM was to compensate distributors during a three-year plan for unusual or extraordinary capital expenditures. The intent was not to effect a capital adjustment for a one- year plan.

19. HON's proposal assumes that all capital spent in 2009 will come into service in 2009. If the proposal is accepted all capital related to these projects would be added to rate base. If the Board accepts HON's proposal for the ICM the Council submits that it would be inappropriate to allow the full amount to be added to rate base. Given the fact that the projects would not all be in-service in 2009, HON would be achieving a windfall given its intent to rebase in 2010. The Board approved the application of the "full-year" rule in order to ensure that distributors who achieved rate relief under the ICM would not experience a deficiency related to its extraordinary expenditures in subsequent years of the plan (Supplementary Report, p. 31). In HON's case there are no "subsequent years of the plan."

CONCLUSIONS:

20. This proceeding represents the first time the Board has considered the application of the ICM component of it 3rd GIRM. The Council submits that the ICM represents a method to allow distributors rate relief for "unusual" capital expenditures that may arise during a three-year plan. The Council submits that HON has not presented a proposal that should qualify it for rate relief under the ICM.

21. For the following reasons, the Council urges the Board to reject HON's proposal to increase its rates by a further 2.1% in order to capture the impacts of its 2009 capital expenditure program:

1. HON has proposed capital spending that exceeds the threshold established by the Board in the development of the ICM. HON has not established that the spending is both non-discretionary and prudent;

2. The ICM is meant to apply during a multi-year incentive regulation plan. HON is applying for rates for one year, not part of a multi-year plan;

3. HON's Board of Directors approved the 2009 rate application without an ICM. In effect, they were confident the application was sufficient to allow HON to earn its allowed return. HON has, therefore, not demonstrated that its rates need to be increased above what is allowed with the application of the approved price cap.

4. The Board should only grant the use of an ICM in extraordinary circumstances and not to simply allow distributors to recover costs associated with ongoing capital plans.

5. Were the Board to approve HON's proposal, it would serve as an implicit invitation to all other LDCs to apply for the recovery of costs associated with ongoing capital plans. It would, in effect, fundamentally erode an important component of the 3^{rd} GIRM scheme.

COSTS:

22. The Council requests that it be granted 100% of its reasonably incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

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