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BY COURIER

April 17, 2009

Ms. Kirsten Walli
Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON.
M4P 1E4

Dear Ms. Walli:

EB-2008-0187 – Hydro One Networks' 2009 Distribution Rate Application 3GIRM– Final Argument

Attached are 10 copies of Hydro One Networks Final Argument.

An electronic version has been submitted through the Board's Regulatory Electronic Submission System and the proof of successful submission is also attached.

An electronic copy has been forwarded to EB-2008-0187 intervenors.

Sincerely,

ORIGINAL SIGNED BY SUSAN FRANK

Susan Frank

Attach.

c. EB-2008-0187 Intervenors

INTRODUCTION

Hydro One's Application seeks an adjustment to its previously-approved 2008 rates through the application of the Third Generation Incentive Regulation Mechanism ("3GIRM") including the Capital Adjustment Module ("CAM"). Hydro One's Application also seeks approval for a z-factor tax change rate rider to return to ratepayers their share of reductions in income tax and capital tax rates and a smart meter funding adder of $1.65 per month per metered customer. The Objecting Intervenors are AMPCO, CCC, CME, EP, SEC, and VECC, who ask that the Board dismiss Hydro One's request for a rate adder resulting from the application of the CAM developed by the Board in 2008. Almost all intervenors supported or took no position on Hydro One's proposed tax change z-factor rate rider and the smart meter funding adder of $1.65.

Hydro One submits that 3GIRM is a framework for adjusting rates using prescribed formulae and, in the case of the CAM, also requires supporting evidence for capital expenditures that are then factored in as a rate adder, using the Board-designed model.

During the hearing and in the final arguments of the Objecting Intervenors, the matter that drew the most attention was Hydro One's use of the CAM. In this Reply, Hydro One responds to the final arguments of Objecting Intervenors with emphasis on the request for approval of the CAM.

OEB'S CAPITAL ADJUSTMENT MODULE ("CAM")

1. OEB Introduction of CAM

The Objecting Intervenors questioned the validity of the CAM introduced by the Board in the September 17, 2008 Supplemental Report of the Board (EB-2007-0673). For example, both CME[1] and SEC[2] made reference to the recent Union Gas (UG) and Enbridge Gas Distribution (EGD) rate proceedings that are operating within a five-year incentive regulatory framework. Both CME and SEC point to the fact that neither UG nor EGD asked for a capital adjustment module, from which CME and SEC extrapolate that a CAM is unnecessary in an incentive regulation environment that uses price cap (UG) or revenue cap (EGD) adjustments.

In EB-2008-0673 the Board already established a CAM. This proceeding is not the time to reassess if a CAM is appropriate.

2. OEB's CAM Formulae

CME, SEC, and VECC questioned the appropriateness of Hydro One's use of the OEB's CAM "as is" in its application, including the use of the approved 2008 Cost of Capital parameters, as per the Board model, the income tax rates and calculations, etc. Hydro One submits that it thoroughly and appropriately adhered to the methodology, principles and quantitative parameters put forward by the Board in its 3GIRM CAM, as outlined in Exhibit B1, Tab 3, Schedule 2, Exhibit B2, Tab 1, Schedule 2, and continuously through the oral phase of this Application [TR Vol.1, pg. 91, 92; TR Vol. 2, pg. 27]. Hydro One did not "interpret" or "re-engineer" the Board model but followed it verbatim, including the applicable elements from the OEB decision associated with EB-2007-0681, such as the approved cost of capital parameters (i.e. ROE, deemed long term

[1] CME Final Argument, sections 27-36, pages 9-11, April 8, 2009
[2] SEC Final Argument, sections 2.1.13 and 2.1.14, page 10, April 8, 2009

debt, short term debt rates). Hydro One anticipates the GDP-IPI factor recently approved by the Board for use in 2009 3GIRM applications will be used to modify the capital threshold in the Board decision in this Application. Hydro One is confident that the Board model applies the appropriate cost of capital parameters and methodologies to estimate the assorted components of the revenue requirement attributed to the test year incremental capital expenditures.

3. One-Year Application

The Objecting Intervenors have alleged that Hydro One did not follow the Board's rules for applications under the 3GIRM framework. The simplest of the criticisms concerning Hydro One's use of 3GIRM is that Hydro One applied for only one-year rate adders in this Application and that Hydro One has already informed the Board of its intention to file a two-year cost-of-service application for distribution revenue requirement and rates for 2010 and 2011. The Objecting Intervenors' view is that 3GIRM is unavailable to be used for only a one-year period. Hydro One rejects that view and states that Hydro One has followed the rules set out in the Board Report and Board Supplemental Report, including amended filing requirements. 3GIRM is not a multi-year rate adjustment. There is nothing prescriptive in the 3GIRM framework that requires an applicant to commit to the entire period of 3GIRM, nor do the rules stipulate that a distributor who applies for only one year of 3GIRM adjustment should have its application judged outside the rules of the 3GIRM framework.

4. Full-Year Return on Capital Expenditures

VECC questioned the appropriateness of Hydro One's submission of its revenue requirement for capital based on the Board's 3GIRM methodology assumption of the "full-year" rule for test-year capital additions. In VECC's view, Hydro One should assume the "mid-year" rule for such capital additions, as Hydro One will be submitting a cost-of-service application later this year for 2010 and 2011.

Hydro One rejects VECC's view. Hydro One submits that all 3GIRM applications are constituted as single-year, not multi-year, applications. Therefore, Hydro One's 3GIRM Application should be viewed in the same context as other such applications. It would be inappropriate to view the Application in any other way, including requiring that a mid-year calculation of return on incremental capital expenditures be submitted. The effect of the full-year rule calculation under 3GIRM is to provide partial funding for 2008 rebasing year capital additions, which would be fully reflected in 2009 rate base in a cost-of-service application. Consequently, under a 3GIRM application, both the applicant and the ratepayers are held whole in the 2009 test year. A full year for 2009 is a simple approximation of the final half year for 2008 and first half for 2009 [TR Vol. 2, pg. 3 to 6]. The use of the CAM does not result in any over-recovery of capital.

APPROPRIATENESS OF HYDRO ONE'S APPLICATION OF THE CAM

The Objecting Intervenors raised issues about the appropriateness of Hydro One's use of the CAM. The following section describes how Hydro One dealt with each of these concerns in their pre-filed evidence, in interrogatory responses and during the oral hearing.

1. "Unusual Circumstances"

Several intervenors questioned whether Hydro One qualified for the CAM as they believed that Hydro One had failed the "unusual circumstances" test. The "unusual circumstances" test as described by the Board in the September 17, 2008 Supplemental Report of the Board, page 31, EB-2007-0673 stated:

> "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".

Hydro One demonstrated throughout this proceeding that the "unusual circumstances" test adopted by the Board as a condition for triggering use of the CAM are precisely those under which the Applicant finds itself. Despite attempts by the Objecting Intervenors to state that Hydro One had no unusual categories of expenditures or unusual capital projects, the fact remains that the Board's words were "unusual circumstances." Hydro One submits that the Board's choice of the words "unusual circumstances" lays out a condition that better reflects the nature of utility operations. Hydro One believes that the Board recognized that a simple price cap index adjustment would be insufficient for a distributor with increasing, high capital expenditures and that use of an additional mechanism was necessary to reflect that reality.

As explained by Dr. Poray in his direct evidence and in cross-examination, Hydro One's unusual circumstances are an aging system with end-of-life assets resulting in a stark growth in necessary capital expenditures. [TR Vol. 1, pg. 46]. Hydro One also explained that there has been a significant increase in the need for generation connections since 2002. Dr. Poray stated that Hydro One's present and expected future capital expenditures are different from historic trends that existed before 2002. In unusual circumstances such as these, Dr. Poray continued, the application of a price cap formula[3] is insufficient to cover the projected capital expenditures for 2009. [TR Vol. 1, pg. 78].

Hydro One also explained and defended in this proceeding that all of the capital expenditures are required in 2009 to meet existing standards, licence obligations and code

[3] The formula was developed taking into consideration utility data over the 1988-2006 period.

requirements and that Hydro One has no other options for meeting its capital requirements besides using the CAM. Use of only a price cap adjustment to 2008 distribution rates would be insufficient.

2. Evidence Required in a 3GIRM Application

Another criticism made by the Objecting Intervenors was that Hydro One did not provide enough evidence concerning the capital expenditures that triggered Hydro One's use of the CAM. Hydro One rejects that criticism and states that the evidence it provided in the Application itself, through more than 200 interrogatory responses [TR Vol. 2, pg. 122], through the four witnesses made available at the hearing and through their answers during cross-examination, is entirely consistent with the level of detail required to examine the underlying drivers of the capital expenditures and entirely in line with the Board's requirements.

Hydro One submits that the level of detail required in a 3GIRM application is not greater than the level required in a cost-of-service application and that in this Application Hydro One provided evidence on capital program expenditures required for its Sustaining, Development, Operations and Shared Services programs. Furthermore, Investment Summary Documents were provided for all programs over $5 million. These documents provide additional details of Hydro One's need and prudency associated with its distribution capital program. Hydro One has therefore fully met the burden of proof required by the filing requirements in providing the necessary supporting evidence for its planned capital expenditures in 2009.

Hydro One also provided the output sheets from the Board's model, information on the rate riders and adders and appropriate rate information, and demonstrated in this proceeding that its capital expenditures are the result of a rigorous and robust planning process, a process that the Board and intervenors have also examined in past proceedings[4]. The business planning process requires several iterations, all with a view to balance the interests of the ratepayers and the shareholder, while maintaining the paramount duty of providing a safe, efficient and reliable distribution system, consistent with government policy directives. Hydro One notes that no intervenor has suggested how the business planning process could be improved.

3. Level of Spending

a) Work is Non-discretionary

VECC submitted that Hydro One has not demonstrated that the costs presented in this Application are non-discretionary. Hydro One states that not only are the costs non-discretionary [TR Vol. 1, pg. 169] but also that failing to identify work which needs to be completed would be a dereliction of Hydro One's obligation to provide a safe and reliable electricity supply to its ratepayers and a safe work environment for its employees. Another allegation made in SEC's Argument, page 28, was that Cornerstone may be discretionary and is not really required spending. Hydro One rejects that allegation. The costs requested in this Application are for the 2009 Cornerstone Phase 2 initiative, which includes putting in place an International Financial Reporting system ("IFRS")-compliant financial system for use as of January 1, 2010. This timing is necessary in order to test the system and deliver prior year comparables when IFRS comes into effect on January 1, 2011. Hydro One states that this work is non-discretionary work that must be undertaken in 2009.

[4] EB-2005-0378 and EB-2007-0681

b) Minimum Level of spending

VECC submitted that since the proposed expenditures are above the minimum spending level of $419 million shown in the planning document Exhibit K1.10, the excess expenditures may not be required. However, as Mr. Van Dusen testified,

> "…the minimum level of expenditure represents an expenditure level that, if maintained over a period of approximately five years, you would expect there to be some event occur, with high probability, that would be very detrimental to the system reliability, safety, for example, to the Company."
>
> [TR Vol. 1, pg. 57, 58]

4. Capitalization of Overheads

Some intervenors, SEC and VECC in particular, took the stance that "it is inappropriate for Hydro One to selectively update parameters of the revenue requirement calculation (the overhead capitalization rate) so as to shift a portion of these costs to capital and then apply to have them recovered through an ICM adjustment factor". That statement is incorrect in many ways. As outlined by Mr. Van Dusen [TR Vol. 2, pg. 58, 59]:

> "So the overhead capitalized process, which is the Board-approved methodology … takes a look at the overall dollars in the common services, takes a look at the amount of those which are appropriately attributable to capital, takes a look at the size of the capital work program and then computes the appropriate rate to attribute the correct dollars to the capital program in T&D."

This was also enunciated by both Messrs. Somerville and Quesnelle [TR Vol. 2, pg. 64 to 67]. Hydro One is required to recalculate the overhead capitalization rate to reflect changes in work program activity, otherwise an inappropriate amount of costs would be expensed or capitalized and reflected in Hydro One's financial statements. Further, as explained by Messrs. Van Dusen and Dumka under cross-examination, as the total Shared Services spend level to support the Distribution program has increased in absolute terms in 2009, despite a change in the volume of costs allocated to capital in 2009, the net overall Shared Services OM&A levels have increased beyond the 2008 rebasing levels [TR Vol. 2, pg. 57, 58]. The use of the CAM does not result in any over-recovery of capital due to the change in the capitalization of overheads.

5. Timing of In-Service Additions

Several Objecting Intervenors, such as SEC and VECC, took issue with Hydro One's assumption in its 3GIRM application that 2009 capital expenditures would essentially equal in-service additions in the same year as outlined by Hydro One in evidence and during cross examination [TR Vol. 1, pg. 164]:

> "DR. PORAY: our understanding is that the capital expenditures will reflect the capital additions in 2009. So $461 million of capital additions will be put in-service in 2009. That's in accordance with the model. That's how we see the model working."

The facts support Hydro One's assumption in this Application that in any given year, capital expenditures will equal in-service additions [TR Vol. 1, pg. 165]:

> "MR. DUMKA: If we take a look at Hydro One Distribution's capital expenditures over a four- or five-year time frame, from 2004 to 2008, essentially our capital spend and our in-service additions in any given year are fairly close. The average over that period from 2004 to 2008 is

> roughly 97 percent. So it's pretty close, give or take, in any given year, in terms of our in-service additions and our capital expenditures."

HYDRO ONE'S CAPITAL PROGRAM CONSIDERATIONS

Some of the Objecting Intervenors made allegations that Hydro One used the CAM to over-recover its capital expenditures in 2009. The following sections describe how these allegations are incorrect and unsupported by the facts.

1. Cornerstone

Some Objecting Intervenors, including VECC and SEC, took the view that any savings resulting from Cornerstone Phase 1, which went into service in 2008, should fund expenditures for new Cornerstone phases in 2009. As noted by the OEB in its EB-2007-0681 Decision With Reasons, of December 18, 2008, page 22:

> "Board Findings
>
> The Cornerstone project has been developed over a number of years and it is an accident of timing that the third-generation IRM will operate to insulate some of the savings associated with the project. As a result the Company will have a period where it alone enjoys the benefits of the efficiencies resulting from the Cornerstone project. This, however, is how incentive rate mechanisms operate. It would be inappropriate and contrary to regulatory principle for the Board to intervene a situation such as this to deny the Company this benefit prior to the next rebasing. The Board therefore will make no adjustments to the revenue requirement to account for future savings resulting from the Cornerstone project."

Hydro One submits that this makes it quite clear that within the context of 3GIRM, it would be inappropriate to deny Hydro One the benefit of Cornerstone savings.

2. Leasehold Improvement Costs

In its Argument, SEC suggested that the 2009 Hydro One leasehold improvements for new facilities will generate payments from the landlord to Hydro One which have not been reflected in the 2009 capital expenditures. SEC alleges that these payments “should be taken into account by the Board in further offsetting the rate relief claim”. SEC also stated in its Argument (Page 33, #4.11.16) that “the Applicant refused to provide the lease”.

As stated by Mr. Van Dusen [TR Vol. 2, pg. 39], the final lease agreements had not been finalized and were therefore not available to be provided to the Board. Further, as outlined by Mr. Van Dusen in testimony, the leasehold improvement amount contained in the 2009 capital expenditures are forecast “net” numbers that have already taken into account the planned payments to be received from the landlord [TR Vol. 2, pg. 39]. Mr. Van Dusen also clarified for the Board that the leasehold improvement estimate in this 3GIRM application is a good and reasonable estimate [TR Vol. 2, pg. 42].

3. New Connections Capital Expenditures

AMPCO suggested in its Argument that the 2009 capital program for customer connections should be reduced to 90% of 2008 actual costs to reflect AMPCO’s view as to the number of 2009 housing starts. In response, Hydro One states that its projected 2009 new connections of 17,685 and housing starts of 70,300 is reasonable in light of the evidence it has put forward. As stated in evidence Exhibit I, Tab 5, Schedule 8, part a):

> “Demand for housing reflects an investment decision and, as such, is subject to a lagged response in relation to changes in business conditions.

> For example many houses are sold one or two years in advance and then built. On the average, there is also a nine-month lag between obtaining a building permit for a new house and finally building it. In view of this business-condition lag, Ontario GDP growth rates for two prior years would also be relevant. The GDP growth rate was 2.1% in 2006, and 2.0% in 2007."

This was further elaborated upon by Hydro One witnesses [TR Vol. 2, pg. 81, 85] where it was outlined that the forecasted 2009 new connections would be housing which was started in the latter part of 2007 and first part of 2008 (for subdivisions, the lot clearing and preparation) and through 2008 (start of the actual home builds) and were now completed or are to be completed in 2009. Due to the housing lag effect, the primary impact of the economic downturn would be reflected in forecast 2010 new connections. Hydro One therefore submits that its forecast of new connections for 2009 is reasonable.

4. Smart Grid

AMPCO suggested that the smart grid pilot projects be deferred until the Board develops standards and processes for implementation (AMPCO Argument page 7). VECC also commented that smart grid spending should be disallowed. Hydro One explained during cross-examination that the proposed investments are:

> "an absolute necessity. The need is based on where you have a system, a distribution system, that is -- supplies load predominantly without generation being injected into it. The fact that we are now experiencing a number of new generation connections, there are certain elements of risk to our customers, to our system, that, if we do not understand fully, if we

do not make the appropriate adjustments, as time goes on we are going to experience significant problems. To prepare for that and to modernize our systems, these investments are absolutely necessary." [TR Vol. 2, pg. 52]

Hydro One states that deferring expenditures on smart grid pilot projects would delay Hydro One's ability to connect generators. Because of the high demand for generation on the Hydro One system, and the fact that the distribution system was not designed for such connections, these investments are required, failing which the connection of green energy will need to be deferred until the Board has completed the facilitation of the Smart Grid. These investments will provide dynamic reactive power control capability and automation where Distributed Generator's ("DGs") are expected to connect. Without such controls, system instability may result that will negatively affect power quality (voltage swings) and customer reliability. A number of large DGs are scheduled to be connected to Hydro One's rural system when the Green Energy Act comes into effect. It is expected that the number of generators connecting will increase, and without the ability to effectively control voltage levels and provide automation, Hydro One will not be able to respond to these demands. Outstanding technical problems to connect generators need to be resolved now in order to respond to DGs that will be connecting and those projected to connect in the near future, and in the process protect customer reliability. The pilot projects under the Smart Grid category have been designed to respond to these demands.

BILL IMPACT

Regarding the amount of rate increases, VECC's Argument (page 18, paragraph 47) states that the material provided in Exhibit C, Tab 1, Schedules 3-6 understates the bill impact for customers that receive the additional mitigation plan approved by the

Board for 2008 rates. As shown in Exhibit I, Tab 6, Schedule 2, only about 1,700 customers receive this additional mitigation out of over 1.2 million customers being served by Hydro One. Therefore the information provided in Schedules 3 to 6 is correct for 99.9% of Hydro One's customers.

VECC's Argument (page 18 and 19, paragraph 48) asks the Board to order Hydro One to extend the implementation of the 2008 additional mitigation plan for low use consumers in the event that the Board approves Hydro One's requested incremental capital adjustment. Dr. Poray testified [TR Vol. 2, pg. 74] that Hydro One would consider a request from the Board as suggested by VECC for the additional mitigation.

ECONOMIC DOWNTURN

CME submitted (CME Argument pages 2 to 5) that the state of Ontario's economy should play a role in approval of increases to a utility's rates. CME also submitted that infrastructure spending should be "funded by governments and not by competitive markets participants and their customers. In recessionary times, utilities should behave similarly." (CME Argument page 5, #14).

While the Board will consider current economic conditions, it would be inappropriate to artificially suppress rates and curtail necessary capital projects and other programs because the economy is currently depressed.

Hydro One's objective is to provide safe and reliable service to its customers. The utility is obligated to provide that service in an efficient, cost-effective way and must also be given a reasonable opportunity to earn its allowed rate of return and maintain its financial integrity.

Hydro One must look ahead and plan on a steady and consistent basis while meeting its mandated obligations. Its capital projects are large, and planning cannot be stopped and started quickly. The Applicant cannot wait until the economy improves to undertake needed sustainment and development projects.

Hydro One therefore submits that its Application must be assessed on the evidence before the Board and that it would be inappropriate to disallow necessary projects simply due to the present state of the economy.

SUMMARY

The Board opened the hearing of this Application by stating that the Board's guidelines provide for "a mechanistic and formulaic adjustment to rates between cost-of-service applications, as well as provisions for incremental and capital investments." Hydro One has been an active participant in the 3GIRM process from the outset and firmly believes that its Application honours the spirit and intent of 3GIRM as well as the rules and conditions set out by the Board for use and applicability of 3GIRM. Hydro One submits that the great degree to which a number of the Objecting Intervenors wish to circumscribe and limit the use of 3GIRM and the CAM flies in the face of 3GIRM's spirit, intent, rules and conditions, and that the theories of the Objecting Intervenors were developed in an effort to render 3GIRM, including the CAM, of no use to Hydro One and other utilities with growing capital expenditures. Hydro One submits that the Board should reject those limiting theories, as well as the allegation that Hydro One's Application, answers to interrogatories, witness panel, direct evidence and answers in cross-examinations provided anything less than the standard of evidence required by the Board.