EB-2008-0224

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 Canadian Niagara Power Inc. and Port Colborne Hydro 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 in the Port Colborne franchise area.

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

August 20, 2009

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1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 On August 15, 2008 Canadian Niagara Power Inc. ("CNPI") filed an application (EB-2008-0224) for new distribution rates commencing May 1, 2009 in its Port Colborne franchise area. Pursuant to Procedural Order #1 dated October 10, 2008, the Board deemed Port Colborne Hydro Inc. ("PCHI"), which also holds a distribution licence for this franchise area, to be a co-Applicant for the purposes of this rate application. CNPI confirmed in their oral evidence [Tr.4:18] that they are also representing PCHI in this proceeding.

1.1.2 This Application was originally combined with the applications by CNPI for their Fort Erie and Gananoque service areas. Subsequently, the Board dealt with those applications separately, and a Decision was rendered on July 15, 2009 (the "FE/EOP Decision").

1.1.3 The Application identified a deficiency of $1,137,610, and sought approval for rates to recover a service revenue requirement of $5,969,947, plus LV charges of $20,783, less revenue offsets of $286,000, for a base revenue requirement of $5,704,730 [Ex. 7/1/1, p.2]. On April 20, 2009 CNPI filed updated evidence, increasing their regulatory costs by $60,599 per year over an assumed three year IRM period. The resulting service revenue requirement of $6,030,546 is the number referred to in the Argument-in-Chief at page 6, representing a deficiency of $1,198,209. When adjusted for LV charges and revenue offsets, this leaves a base revenue requirement of $5,965,739. This represents a one-year increase in revenue from rates of about 25.13%.

1.1.4 This is the Final Argument in this matter on behalf of the School Energy Coalition.

1.1.5 This proceeding does not have a Board-approved Issues List. Therefore, we have organized these submissions by subject area, similar to those laid out in the Application. However, as the lease from PCHI was such a major part of the proceeding, we have treated it as a separate section, at the outset of these submissions.

1.1.6 Some of the issues relevant to Port Colborne have been dealt with in the FE/EOP Decision. Where the same reasoning would be applicable here, we have assumed that the Board will apply it. Where there is a factual or structural difference in Port Colborne that would make the reasoning inapplicable, we have sought to point that out in the appropriate section of these submissions.

1.1.7 As is normally the case, in this proceeding the intervenors shared drafts of their submissions. We have benefitted from reviewing the submissions of both VECC and Energy Probe, and as a result have not made detailed submissions where we agree with theirs.

2 LEASE OF ASSETS FROM PORT COLBORNE HYDRO INC.

2.1 *Introduction*

2.1.1 Effective July 19, 2001 CNPI and PCHI entered into a Master Implementation Agreement under which**,** on April 15, 2002, after tax department and OEB approvals had been granted, CNPI leased from PCHI the Leased Assets for a period of ten years, to end April 15, 2012. As defined on page 12 of Appendix A of the Master Implementation Agreement, the Leased Assets include all of the assets used to provide distribution services in the Port Colborne franchise area at that time, with the exception of cash, receivables, and prepaid expenses.

2.1.2 As Mr. King, testifying on behalf of the Applicant, put it in oral evidence [Tr.4:126]:

> *"There are no other transactions like this in Ontario. It's unique."*

2.1.3 The Lease Transaction was the culmination of negotiations between CNPI, its parent company (now FortisOntario), the City of Port Colborne, and PCHI that started with an RFP dated July 10, 2000 by the City and PCHI seeking offers to purchase all of the shares of PCHI. The Fortis companies were at a disadvantage in such a transaction, because the vendor would be required to pay a substantial transfer tax if Fortis purchased more than a 10% interest in the distribution company. Other potential bidders, owned by municipalities, were exempt from this tax. FortisOntario therefore proposed to lease the assets for a period of ten years, with an option to purchase at the end of the term. The lease payments would be present valued and paid up front, a $10.74 million lump sum payment that they did not expect would attract the transfer tax. Once the option payment was made, the ultimate transfer tax payable would, under the plan that was implemented by the parties, be "relatively small" [Tr.4:25].

2.1.4 In the end, the City determined (for political reasons – Tr.4:34] that it would be preferable not to take all of the money up front**,** so the final structure was 120 monthly payments of $127,350, in aggregate $15,282,000. At the time of the transaction, the book value of the assets being leased was $8,782,538 (being $8,232,538 from Undertaking JT4.4, and $550,000 of inventory), and the present value of that stream of payments, at a 7.62% discount rate, was $10.74 million [SEC IR#12, App. F, p. 4].

2.1.5 As calculated by the Applicant [U/T JT4.7], the lease payments over the ten year period exceeded the amount that the Board would allow PCHI to recover in rates for the same period, if they were in rate base and recovered in the normal way, by $3,255,734. The bulk of that difference, $1,957,115, arises in the four years covered by this rebasing application and the subsequent IRM period. That is all based on the calculations of the Applicant. As we note below, we believe those calculations understate the differential, but even at their calculations the difference is material.

2.1.6 The impact on the Test Year revenue requirement is to create a substantial sufficiency if the proposed rates are approved. If the Leased Assets were in rate base in the Test Year, the amount of rate base would be $4,227,790, the depreciation would be $509,724, and the debt component of rate of return would be $157,649 [all from U/T JT4.7]. Based on a gross lease payment of $1,528,200 in the Test Year, this leaves $860,827 available for return on equity and PILs, on an equity base of $1,831,901. With a tax rate of 33%, this calculates to an ROE on these assets of 31.48% in the Test Year, or a sufficiency of $641,819 using the Board's normal method for calculating sufficiency.

2.1.7 The onus is on, and at all times remains on, the Applicant, to show that the amounts being proposed for rates are just and reasonable. It is submitted that the onus is particularly stringent where, as here, choice of a transaction structure that is inconsistent with normal practice results in a materially higher "cost" to be recovered in rates.

2.2 ***Essential Question to be Determined***

2.2.1 The Applicant, in their Argument in Chief [at p. 28 et seq.], and throughout their Direct Oral Evidence, start from the premise that the question is whether this lease transaction was an operating lease or a capital lease. They appear to believe that SEC seeks "capital lease" treatment, and further that if the transaction is not a capital lease, it cannot be included in rate base by virtue of . 26 of the 2006 EDR Electricity Distribution Rate Handbook.

2.2.2 With respect, while it is true that we believe this transaction was a sale structured as a lease for tax purposes, that is not the basis of our argument. The basis of our argument is that the amount proposed to be recovered in rates is demonstrably in excess of a just and reasonable amount, and results in either CNPI and PCHI, the co-Applicants in this matter, between them a return in excess of a fair return relative to these assets. The fact that the unusual structure was tax-driven is useful in understanding the facts, but is not essential to the Board's determination of the fair result.

2.2.3 The question in this case is how the Board should calculate the amount recoverable in rates for a given group of assets. There are two basic models:

(a) ***Conventional Rate Base Approach.*** Most assets used to carry out an electrical distribution business are included in rate base and charged to rates through a comprehensive system for calculating amortization, rate of return, and taxes. In every Ontario LDC except CNPI and PCHI, the costs of their assets of the particular types in question are in fact recovered from ratepayers using this conventional approach, as the Applicant freely admits [Tr.4:159]. These Applicants are the only ones that propose a different approach to ratemaking for these types of assets.

(b) ***Market Rental Rates Approach.*** Sometimes distribution utilities lease assets – like cars, buildings, etc. – from others at market rates. This is normally because it is cheaper to do so, or the allocation of risk relating to the assets is more favourable. There are no other circumstances in Ontario in which assets of the types being dealt with here are being leased at market rates, and there is no market price available to determine if the lease transaction in this case is at market rates.

2.2.4 The co-Applicants in this case have structured their transaction so that it looks like the second category of transactions, except that it is not at market rates. While the overall consideration for the assets (lease payments plus option price plus time value of money) can be presumed to be fair market value, the Board has no evidence before it that would allow a conclusion that the lease payments are market-based. There is no external set of market pricing, and it was in the interests of both co-Applicants to maximize the lease payments and minimize the option payment, to reduce the transfer tax as much as possible. Therefore, the fact that they "negotiated" the lease payment is completely irrelevant. No-one at the table had as part of their interests decreasing the lease payments and increasing any other component of the price.

2.2.5 We do not for a minute suggest that the transaction was structured the way it was to increase the amount recoverable in rates. It is plain on the face of the record that it was structured the way it was to avoid the transfer tax. In fact, as seen from the initial proposal made by FortisOntario [Ex. X4.1 at para. 2.3], it is clear that they did not actually expect the lease structure to impact rates. In response to a requirement in the City's RFP to "Describe assumptions regarding changes in distribution rates following closing of the proposed transaction." [Ex.X4.2, p. 4], Fortis Ontario said in their proposal that up until the time of market opening, rates would be unchanged, and then at that point:

> ***"****We anticipate that rates will be determined based upon the methodologies established by the OEB using the book value (rate base) of Port Colborne Hydro Inc."*

While the Applicant's witnesses sought to weaken this response by calling the initial proposal a "marketing document" [Tr.4:13], that is not credible, and they ultimately backtracked from this characterization [Tr.4:15, Tr.4:23-24]. This was a business transaction. Unless CNPI wishes to say that FortisOntario was deliberately misleading the City of Port Colborne and PCHI, it is clear that FortisOntario thought it would get the assets at book value for rate-making purposes.

2.2.6 In our submission, the essential question to be determined by this Board is whether the appropriate ratemaking treatment of these distribution assets is through the conventional approach – rate base – or through the unique alternative presented by the Applicants, as operating expenses.

2.2.7 CNPI would like the Board to see this issue as one of SEC challenging the conventional wisdom, playing Don Quixote tilting against windmills while the Ministry of Finance, the CICA, and even the Board's own 2006 EDR Handbook stand foursquare in support of the Applicants. This is a convenient but incorrect characterization of what is going on. SEC on occasion does tilt against windmills, as the Board well knows, but it is not doing so here.

2.2.8 In fact, what is really happening is that these two co-Applicants, CNPI and PCHI, between them own all of the assets being used in the distribution business in the Port Colborne franchise area. For $13,295,618 [Ex. 1/2/1, p. 10] of those assets, owned by CNPI, the total amount proposed to be included in rates is $1,786,365 [return, amortization and taxes, from the same cite]. For the remaining $4,227,790 of those assets, owned by PCHI, the total amount proposed to be included in rates is $1,528,200. Normally, the total amount included in rates for this latter group of assets would be $641,816 less [see para. 2.1.6 above], but the co-Applicants take the position that, <u>because of a transaction between the co-Applicants that has no economic impact on the distribution business itself,</u> it is appropriate for the Board to order a significantly higher recovery in rates for those assets.

2.2.9 In fact, it is submitted that in this case CNPI and PCHI are "taking a shot" at recovering in rates on these assets considerably more than they even expected when they initiated the transaction, on the basis, we presume, that they have nothing to lose by asking. Their worst case is that they get what they expected at the outset. Their best case is that they get a windfall in rates as an unexpected collateral benefit from their tax plan.

2.2.10 It is therefore submitted that the essential question is whether the amount recoverable by the co-Applicants from the ratepayers for the cost of these assets should be artificially increased because these two licensees have chosen a transaction between them with a "unique" structure. For the reasons summarized above, and detailed below, we believe they should not.

2.3 ***<u>The True Nature of the Transaction</u>***

2.3.1 As noted earlier, the decision of the Board on this issue does not turn on whether this transaction is in substance a lease, or in substance a sale. However, anyone with experience in the sector, and applying simple common sense, can see that the transfer of legal ownership of the remaining assets under lease from PCHI to CNPI in 2012 is inevitable.

2.3.2 There are three reasons for this conclusion:

(a) ***Intention of the Parties.*** PCHI and the City of Port Colborne set out to divest themselves of their distribution utility. The RFP [Ex. X4.2] makes this crystal clear, and there is nothing in that document that suggests an intention other than complete divestiture. The only reason the FortisOntario offer was not a purchase

was the transfer tax. Without the transfer tax, they were the logical purchaser, because of their position in Fort Erie next door [Tr.4:128]. The business should be worth more to Fortis than to anyone else because of the operating efficiencies available to it. The transfer tax stood in the way, but good tax planning avoided that problem as well. This intention is further supported by the 2002 Annual Report of Fortis Inc., which, at page 29, lists the Port Colborne transaction, closed in that year, under the heading "Acquisitions", along with numerous other purchases of companies and businesses. While it clearly refers to the transaction as a lease, the categorization is inconsistent with their attempt today to treat it as something other than an acquisition.

(b) ***Amount of Option Payment.*** CNPI admits [Tr.4:102] that it had no valuation done to determine the fair market value of this business at the time the option kicks in. The option price was agreed to be $6.9 million, at a time when the book value of the assets at the end of the lease was expected to be $3.84 million [both figures from SEC IR#12, App. E, p.7]. The difference between the two is goodwill, and Mr. King, testifying for CNPI, told this Board [Tr.4:96] that there is some question whether that amount of goodwill, $3.06 million will be justified. If it cannot be justified, there will be a problem with supporting the option payment, he says. With respect, this is not credible. The effective goodwill amount, if it is all contained in the option premium, is for the purchase of monopoly distribution rights for about 9,200 (at that time) customers, or about $333 per customer. The Board is well aware that current transactions in which distribution utilities are being sold include premiums in the $1,000 to $2,000 per customer range or more. Most of the documents in which price-related figures are set out are filed in confidence in Board proceedings, so it is not possible to be more precise, but the range is well known by the Board and in the industry. To suggest that Fortis will pass up on the chance to purchase the franchise rights for 9,200 contiguous customers that they are already serving for $333 apiece is not believable. Mr. King's evidence on this point is technically correct, but it is not in fact what anyone – including Mr. King - expects will happen.

(c) ***Alternative if Option Not Exercised.*** In the event that CNPI elects not to exercise the option, the result under the Master Implementation Agreement is that PCHI is required to buy all of the assets owned by CNPI and used in the distribution business for book value less $160,000 [Tr.4:97], a total price that is likely, at that time, to be around $13,000,000 [Current rate base, plus capital additions for two years, less working capital]. PCHI does not have $13 million, and it seems unlikely that it will be in a realistic position to fund such a purchase. Even if it were, the Port Colborne franchise does not currently have its own separate operations, as they are fully integrated with the Fort Erie operations [Tr.4:65]. In fact, it is clear that the parties never considered how PCHI would operate the franchise if it took it back at the end of the lease, and, since CNPI today doesn't anticipate that any of its employees would be transferred to PCHI [Tr.4:4:97], they could only "speculate"

that maybe they would continue to operate the utility on a contract basis at the end of the Lease. It strains credibility to contemplate a purchase by PCHI in these circumstances, particularly when, under the agreement, they will have only six months notice that they have to take over the utility once more. Indeed, one potential outcome is that the impossibility of purchase by PCHI will give CNPI leverage, and they can renegotiate the option price. For example, if the book value of the assets is lower than originally planned, as now anticipated [Tr.4:96,124], CNPI could argue that PCHI should reduce the option price. PCHI will not have any viable alternative but to agree.

2.3.3 There is an old saying: "If it looks like a duck and it quacks like a duck, it's a duck." This deal is, indeed, a "duck". While it is undoubtedly true that the deal has been legally structured as a lease, and it is also undoubtedly true that CNPI is not legally obligated to complete the purchase in April, 2012, it would be nothing short of shocking – to us, to PCHI, to CNPI, and to all of the CNPI witnesses, we're sure - if the sale were not completed at that time. None of the parties would have achieved their original goals, and all of them would be worse off than if the sale were consummated as planned.

2.3.4 We note, however, that we are not saying to the Board: "This is a disguised sale, so treat it as a sale." What we are saying is that this is in no way similar to leasing a car. This is not a case of a company saying "We would like to use your assets for a while in our business, and we'll pay you a monthly fee for that privilege." CNPI has taken over the entire PCHI distribution business, including fully integrating operations into their own operations, taking over all of the day to day operating liabilities of the business, assuming all of the risks and rewards of the business, upgrading the physical infrastructure at their own expense, supplying all capital, and taking responsibility for all employees and their management. The only aspect of this business that is not currently fully within the Fortis umbrella is 24% of the physical assets, for which legal title remains in the name of PCHI. (In fact, even that 24% is overstated, since some of these assets have been taken out of service, and the amount still remaining may not be as high as originally expected.)

2.3.5 In determining the appropriate ratemaking treatment for these distribution assets, their business status is not identical to either the conventional rate base situation, nor to the market based lease situation. Unlike the conventional rate base situation, these assets are not owned by the company that is operating the distribution business, but rather by their co-Applicant. Unlike the market based lease situation, these assets are not being leased as physical assets for a limited period, but rather the entire business has been taken over, for at least ten years, by another party. It is our submission that the CNPI-PCHI structure is in substance, if not in form, more similar to conventional rate base than it is to a market based lease of assets.

2.4 ***<u>Specific Problems with Lease Treatment</u>***

2.4.1 Even if one looks at the lease from the point of view of form rather than substance, which we believe is incorrect, there are at least four fundamental problems with treating the lease payments at operating costs, none of which have been answered by the co-Applicants.

2.4.2 ***Assets Retired or Destroyed.*** The terms of the Lease provide that the lease payments continue without change even though some of the physical assets being leased have been retired or destroyed. This is a problem because the concept of leasing an asset requires that an asset exist to be leased. If there is no asset, it is not possible to lease it.

2.4.3 At the outset of this arrangement, the parties knew that the assets being leased would disappear over time [Tr.4:141]. Looking at their own forecast [J4.4], it is clear that five of the original fifteen categories of assets would cease to exist before the current Test Year even starts: General Office, Computer Hardware and Software, Store Warehouse Equipment, Miscellaneous Equipment, and Rolling Stock. Three other categories, Distribution Stations Equipment, Tools, and System Supervisory Equipment, would not survive until the end of the Lease. That is, as originally contemplated eight of the fifteen asset categories being leased were not expected to continue through the entire term of the lease, even though the lease payments would remain the same.

2.4.4 When you take into account what actually happened, it is even more stark. While CNP has confirmed that of course things like vehicles and other rolling stock in existence at the beginning of the lease no longer exist today [Tr4:109], it is also true that intervening events have meant that many other assets that they did expect to continue have not. These include certain of the transformer stations [Tr.4:72], and assets damaged in storms and for other reasons during the interim period [Tr.4:91]. (As a further but minor complication, some of the Leased Assets were never, from the outset, used in the distribution business – Tr.4:67.)

2.4.5 The erosion of the Leased Assets is a problem for the Applicants because the Lessor in this case has no responsibility to make good on any of these disappearing assets. Under the terms of the Lease, if any assets have to be replaced, the Lessee CNP has to pay for that, and of course seeks recovery from the ratepayers, but still pays the same Lease payments, which it is also seeking to recover from the ratepayers.

2.4.6 The result of this is that, at the beginning of the Lease, CNP was leasing $8.2 million of assets for $1.528 million per year, but now it is leasing less than half as many assets, with less than half as much value, but still wants to claim that the lease payments are prudent, just and reasonable. Even if the rent at the beginning was reasonable, which we argue it was not, it is hard to argue that a lease payment for assets that no longer exist is just and reasonable.

2.4.7 ***Grouping of Assets and Expected Life.*** This leads to a second and related question. In Undertaking J4.4 the Applicants seek to demonstrate that the useful life of the assets being leased was seventeen years at the time the Lease was entered into. This is to meet the test stipulated in the tax rules that no more than 75% of the remaining life of the assets was used up during the lease period.

2.4.8 Now that we see the details, it is clear that, for most of the assets, their expected life does not meet the statutory test. Although the Tax Ruling was granted on the basis that the stipulated fact – a seventeen year life of the assets – was true, in fact it turns out that it wasn't true for most of the assets. For the Land, Land Rights, Buildings, and a small percentage of the Meters, Transformers and Overhead Distribution Lines, this was true. For everything else, more than 75% of their remaining life was during the term of the lease. They were not exempt assets. This includes assets with more than 50% of the net book value at the time of the lease.

2.4.9 The position of the Applicants appears to be that this test should not be applied to individual assets, but to the pool of assets as a whole. But what was it that they in fact "leased"? According to them [Tr.4:89-90], it was specific listed assets. If that is the case, then it is submitted that their tax exemption for most of those assets was invalid. Nothing in the tax rules suggests that the remaining life of assets leased can be averaged in some way.

2.4.10 In fact, what they really thought they were leasing was the distribution business as a whole. We have no comment on whether this was allowed for tax purposes, although we note that generally speaking tax rules such as this are applied on an asset by asset basis, and we invite the Applicants in their Reply Argument to provide precedent for not applying the capital vs. operating lease test to individual assets in the tax context. We also invite them to show that they advised the Minister of Finance in seeking their tax ruling that most of the individual assets they were leasing would not meet the 75% test.

2.4.11 The problem with the "leasing the business" characterization is that then this Board is faced with a structure that is not similar to anything they have ever seen. It is not like that contemplated in the Accounting Procedures Handbook, where there is a distinction between an operating lease and a capital lease that clearly applies to specific physical assets, and it is not like the situation to which the rules in the CICA manual apply, and it is decidedly not like the situation contemplated by the tax rules. In fact CNP leased from PCHI an entire business as a going concern. CNP and PCHI are invited in their Reply Argument to show that the APH, the CICA Manual, or any other such "authority" contemplates - in any explicit or implicit way - that the capital vs. operating lease distinction should be applied to the lease of an entire distribution business as a going concern. Nowhere is this possible interpretation suggested in any way in any of those documents.

2.4.12 In our submission, the key point the Applicants rely on in their submissions on this point – i.e. that the Ministry of Finance has already decided the issue – aside from being irrelevant (as we have noted earlier), is also incorrect. In this situation, the decision of the Ministry of Finance was based on incomplete disclosure, and if they had fully disclosed the lives of the assets being leased, the Tax Ruling may not have been obtained for all of the assets. It is submitted that this is a double-barreled problem for the Applicants. First, the decision of the Ministry of Finance, even if grounded on full disclosure, was never intended to be determinative of ratemaking results, and is not appropriate for that purpose. Second, that decision may not have been grounded on full disclosure in the first place, and on the evidence before this Board most of the Leased Assets did not qualify for operating lease tax treatment.

2.4.13 ***Inventory.*** The final component of the "what are they leasing" set of issues is the problem of the inventory. There was considerable confusion about how the inventory is treated under the Lease [Tr.4:104-119]. It is clear that the inventory that was originally leased no longer exists as inventory [Tr.4:106], but it is also clear that the original inventory is no longer in the leased assets. It has either been used up in operations, or it has been incorporated into capital assets. Since the original cost of the leased capital assets has not been increased, the only place that inventory could go is capital assets that are subsequent additions to regulated rate based.

2.4.14 This is fundamentally a question of what is capable of being leased. If you are in the business of printing books, you can lease a printing press for ten years, but it is ludicrous to think that you could lease paper for ten years. You use up the paper in your operations, so leasing it is simply not feasible.

2.4.15 Mr. King, who is an accountant, quickly understood the absurdity of this, but his response was to suggest that CNP is obligated to give back $550,000 of inventory at the end of the lease, reflecting the amount they leased in the first place. It would be different inventory, but it would mean the inventory amount was constant. It is understandable that he would assume this, since without a return of the inventory to the lessor, the concept of including inventory in a lease would not be possible even from an accounting point of view.

2.4.16 We have no doubt you could structure a lease so that one of the obligations was to maintain a certain inventory level, and hand back inventory equal in type and value to what was included in the first place. You would not be leasing the inventory, legally, but it would have a similar economic effect. The Lease has no such obligation, despite the fact that what happens at the end of the Lease is set out in some detail. It is submitted that, as a matter of simple law, if the Lease does not have this obligation, there is no legal principle that implies it, and in fact at the end of the Lease, if CNP had to give back the assets, no inventory would be included. It is irrelevant whether that is what Mr. King thinks "must have been" intended. That is what the legal documentation says. The Applicants structured the transaction in a certain way, and that structure does not include return of $550,000 of inventory.

2.4.17 An analogy may assist in understanding the legal principle involved. Businesses regularly provide a charge against their assets as security for bank loans. When they do, those charges or mortgages often include inventory. Because inventory changes on an ongoing basis, special rules had to be developed to deal with it, the concept of the "floating charge". This concept, developed over many years by a legal system struggling to deal with security on changing assets, contemplates a charge that does not attach to the assets until the security is realized. It "floats" over them, allowing the business to deal with them in the ordinary course, and only *potentially* applying to the inventory pool as it exists from time to time. The only time it *actually* attaches to specific assets is when the security is realized or a predetermined event occurs, at which time the float "fixes" on the assets in existence at that point in time.

2.4.18 This is relevant because there is no equivalent concept in leasing law to the "floating charge". If you want to lease a pool of assets that changes over time, then there are numerous provisions that have to be included in the legal agreements to allow that to happen. None of those provisions are found in the Lease.

2.4.19 Inventory is either incorporated into assets owned by the owner of the inventory (in this case the lessor PCHI) or title is transferred to another person. Since this inventory was not subsequently incorporated into the assets owned by the lessor, it had to be transferred to another person, but CNP does not have title to make that transfer. Leased property is owned by the lessor. A lessee would not have title in order to sell the inventory to a third party, or to incorporate it into assets owned by either a third party, or even the lessee. The Lessee can only have the right to do that as agent for the Lessor, and only if specifically granted that right in the Lease. None of that is the case here.

2.4.20 In fact, there are no special provisions in this Lease relating to the inventory. It is handed over from the Lessor to the Lessee, and thereafter the Lessee CNP deals with it in all respects as if CNP is the owner. This is not consistent with a lease relationship. If you transfer assets to another person, and thereafter they can deal with them without restriction, that is ownership, and in this situation it is legally incontrovertible that the ownership of the inventory was transferred to CNPI at the time the Lease was signed.

2.4.21 ***Excess of Lease Payments over Book Value.*** Finally, the lease payments create a different category of problem, because the value of the lease payments exceeds the value of the assets being leased. If the assets had been purchased, the value equal to book value would be recoverable from ratepayers over time in the normal course. The value in excess of that would not be recoverable from ratepayers. That premium of purchase price over book value is good will, as Mr. King correctly pointed out [Tr.4:96], and it is not recoverable from ratepayers.

2.4.22 In this case, the net present value of the rental payments is stated by the Applicants to be $10.74 million. The net book value of the assets, excluding inventory (which as noted above is used up relatively quickly) was $8.23 million at the time of the Lease.

2.4.23 However, the problem for the Applicants is a little more acute than that, because not all of the net book value is used up during the Lease. At the end of the Lease, it was expected that the NBV of the leased assets would be $3.84 million [cite], meaning that the lease payments were payment for $4.39 million of the book value of the assets. The Option Payment is said [Tr.4:96] to pay for the remaining $3.84 million of assets.

2.4.24 What that means is that each lease payment includes a premium or goodwill amount, being an amount in excess of book, of 59.12% of the payment (excess of NPV $10.74 million over book used up $4.39 million, divided by total NPV lease payments of $10.74 million). That is, if the payments are $1,528,000 in a year, $903,354 of that is non-recoverable goodwill, and the balance pays for the book value of the assets.

2.4.25 CNP will respond to this argument by saying that this only accounts for the principal component, not the time value of money/cost of capital, which must also be included in any such calculation. With respect, that is incorrect. The figure of $10.74 million provided by the Applicants is already discounted to reflect the time value of money on the lease payments. Comparing the value in 2002 of the lease payments to the book value to be used up during the lease is exactly the correct comparison, and yields the result above.

2.4.26 An alternate way of doing it is to ignore the time value of money, and just compare the total payments to the total book value. If you do that, the total payments of just over $22 million (lease plus option price) compare to the total book value of $8.723 million, and the ratio of the two is, magically, about 60%, the same as if the net present value of the lease payments is compared to the book value reduction during the lease. The reason for this "co-incidence"? The net present value of the option price is exactly equal to the book value of $3.84 million the parties expected to be remaining in 2012 [Tr.4:122].

2.4.27 The position of the Applicants on this point appears to be that lease payments cannot include goodwill, by definition [Tr.4:125]. With respect, this is incorrect. If that were the case, then any structure legally called a lease could be used to subvert the Board's policy that goodwill cannot be recovered from ratepayers. In the instant case, it is unchallenged that the value of the lease payments exceeds the value of the assets applicable to the lease period. If that differential is not goodwill, no LDC acting rationally and in the interests of the shareholder would buy a utility and accept non-recovery of goodwill. They would instead have a readily available method of including at least a major part of the goodwill in amounts charged to ratepayers.

2.4.28 In our submission, if the Board determines that it is appropriate to treat these payments as lease payments, it should also determine that in substance 59.12% of each lease payment is a payment for goodwill, and on the Board's normal principles that payment is not recoverable from ratepayers.

2.5 ***Just and Reasonable Recovery for Leased Assets***

2.5.1 ***The "Default" Standard.*** The Applicants would have the Board start with the premise that lease payments are generally speaking recoverable from ratepayers. By implication, this suggests that the onus. i.e. to prove recovery of this amount is not appropriate, shifts to the ratepayers. This is not correct as a matter of law, and it is not good ratemaking.

2.5.2 In our submission, the "default" is "How much would ratepayers normally pay for these assets, absent the unusual transaction structure?" There are three numbers the Board could pick from in identifying this default number:

(a) $995,914, being the amount calculated by the Applicants in Undertaking J4.7 representing rate base (cost of service) treatment of the PCHI distribution assets for the 2009 rate year.

(b) $886,181, being the amount of the lease payments, $1,528,000, less the sufficiency of $641,819 that we have calculated for these assets in the Test Year in para. 2.1.6 above.

(c) $624,646, being the amount of the lease payments less the 59.12% portion of those payments properly attributable to goodwill, $903,354, as set out in para. 2.4.24 above.

2.5.3 In our submission, there are arguments in favour of any of these numbers as the starting point, but there is no argument in favour of $1,528,000 as the starting point. If the Applicants want to recover more than the Board would normally allow for these assets, then the Applicants bear the onus of proving that such additional recovery is just and reasonable. No evidence has been led that would form the basis of such a conclusion, and in our submission that onus has not been met.

2.5.4 Indeed, the evidence of the Applicants, aside from the "form over substance" argument that grounds their basic premise, suggests that characterizing these amounts as operating expenses is simply incorrect. In fact, faced with the benchmarking implications of an operating expense characterization of these payments, the Applicants are quick to point out that they are not <u>really</u> operating expenses [Tr.4:159].

2.5.5 ***The Problem of Two Licensees.*** There is one further issue that needs to be addressed in the context of the rate recovery for these assets. Both CNPI and PCHI are licensed electricity distributors, both with the right and obligation to distribute electricity in the Port Colborne franchise area. They have established a relationship between them that allows them to share the responsibility (one owns some of the assets, one has everything else, including operational responsibility), but in the end there is one franchise area, and electricity is only being distributed to the ratepayers once.

2.5.6 We have had a chance to review the draft submissions of Energy Probe on this point. Energy Probe raises the same issue, and notes that if the lease payments are allowed to be recovered in full from ratepayers, two licensees are being compensated for taking the same risks, when only one of them is actually doing so.

2.5.7 We agree that Energy Probe's characterization identifies an important concern, but we do not believe that it represents the complete picture of the "two licensees" problem. In our view, the problem is more fundamental. The two licensees that together are licensed to distribute electricity in this franchise area together own all of the assets necessary to do so. They can only do this in co-operation with each other. Neither can achieve their license objectives independently. There is a known cost to the ratepayers for the distribution assets employed to deliver this licensed service. Their position is that, because they have divided ownership and operational responsibility between them, they can ask the ratepayers to pay more for those assets, even though the actual overall cost of those assets has not changed.

2.5.8 This puts the Board in a difficult situation. On the one hand, looking just at Co-Applicant CNPI, the Board is being urged to agree that it should recover an amount, $1,528,000, it is in fact paying for the use of these assets. In this context, the Board is also being urged to ignore any facts beyond the artificial dividing line of ownership between CNPI and PCHI.

2.5.9 On the other hand, looking just at Co-Applicant PCHI, the Board is urged to agree that, since it is not charging any rates to ratepayers, the Board does not have to approve anything for that Co-Applicant. The fact that the $1,528,000 is, in CNPI, flowed through to the ratepayers is irrelevant to PCHI, and should just be ignored. Again, the interrelationship – the artificial dividing line of ownership – must be ignored on this view of the situation.

2.5.10 In our submission, the Board's best response to this difficult problem is not to try to determine, as between CNPI and PCHI, who should be bearing what costs. Rather, the Board should focus on its statutory mandate, "just and reasonable rates". Under that mandate, franchise-holders own certain assets, and there is a known cost to be paid by ratepayers for those assets, calculated in a way that this Board well understands. Any transactions between the Co-Applicants should be ignored for the purposes of determining what amount the ratepayers should pay toward the cost of the distribution system that the co-Applicants are using to serve them.

2.5.11 ***The "Customer Benefit" Argument.*** Before leaving this issue, it is appropriate to deal with one collateral issue. In their Direct Evidence, and many times throughout the oral hearing, the Applicants argued that the Port Colborne customers benefited from the fact that the PCHI distribution system was in "disarray", and CNPI came in and saved the day. This is not a credible argument. If CNPI had not taken over PCHI's operations, there many things that could have happened. Hydro One could have purchased, in which case we agree with CNPI that rates might well be higher today. Alternatively, another neighbour, Welland Hydro, could have purchased, in which case rates would likely have been much lower today. Or what about Chatham-Kent, or Niagara Falls, or Horizon, or other potential acquirers.

2.5.12 The issue here is not whether rates today are lower than a specific alternative scenario. We could not argue that costs should be disallowed because, if Welland or Chatham-Kent had been the purchaser, they would have been more efficient and rates would be lower. The Board's responsibility is to look at the situation as it is, and assess whether, based on the prudence and the just and reasonable standards, the costs claimed are the ones that should be charged to rates. Here, they are not.

2.5.13 Are the customers in Port Colborne better off in the Fortis family rather than still served by PCHI? Perhaps, but they will be even better off if their rates are based on real costs, not costs artificially increased by a tax planning transaction.

2.6 ***Proposed Resolution of the Issue***

2.6.1 It is tempting to argue that, since the Applicants want to treat this as a lease, they should be allowed to do so, but with the calculated goodwill component of the lease payments excluded. As we have noted in para. 2.4.24 above, this would result in a reduction in revenue requirement of $903,354. In substance, it would result in CNPI recovering from ratepayers the book value component of the lease payments, but not the goodwill component of the lease payments.

2.6.2 This is a legitimate position, but in our view it is not the best one. In our view, the best approach for this Board to take in this situation is to treat the leased property as rate base, and include in rates the amortization, cost of capital, and tax provision associated with that rate base. Another way of putting this is that the co-Applicants would be looked at jointly, and the assets owned by one co-Applicant would be included in the combined rate base for the purpose of setting the rates that the co-Applicants ultimately both benefit from.

2.6.3 There is some confusion as to what the correct amount should be in that situation. On the one hand, the Board's traditional approach to ratemaking involves calculating the implied ROE relating to rate base, deriving a sufficiency or deficiency from that, and grossing that up to a revenue requirement equivalent. Where that is done, the resulting reduction in revenue requirement in this case is $641,816, as calculated in para. 2.1.6 above. In J4.7, the Applicants reach a different number by applying different assumptions for tax implications of the specific assets in question.

2.6.4 This is then further complicated by the need to adjust for four items that have been highlighted in the VECC Final Argument.

(a) Adjustments to the 2009 cost of debt and cost of equity for CNPI, as ultimately determined by this Board in this proceeding;

(b) Assets no longer in service in the Test Year, either as a result of damage or taken out of service for other reasons, which cannot form the basis of rate base or cost of service calculations in the Test Year;

(c) Impact of the $550,000 of inventory on the calculation of CNPI's working capital allowance; and

(d) Confirmation that the J4.7 calculation deals only with the fixed asset component of the leased property, and not the inventory component, and integration of the answer to this question with (c) above.

2.6.5 In our submission, the appropriate resolution is for this Board to order the Applicants, in filing for their rate order, to recalculate revenue requirement for the Test Year on the basis that:

(a) The rate base includes the current book value of all of the leased assets that are fixed assets and are expected to be used and useful in the Test Year; and

(b) The Operating Expenses exclude the entire $1,528,000 amount of the lease payments current included.

2.6.6 It is submitted that the resulting revenue requirement, approximately 10% less than the proposed revenue requirement, most fairly represents the actual cost of service of the Applicants for the Test Year.

3 LOAD FORECASTING AND METHODOLOGY

3.1 *Methodology*

3.1.1 We have had an opportunity to read a draft of the VECC submissions, and in general we agree with their analysis and conclusions.

3.1.2 We do want to particularly note that CNP has made a genuine effort to develop a model that provides useful forecasts for cost of service purposes. While we agree with VECC that the resulting model is not optimal, and should not be used going forward, as there are now better models available, the attempt by CNP was not a wasted effort, and the results are close enough that they can still be used for this Test Year.

3.2 *Total Loss Factor*

No submissions.

4 RATE BASE AND CAPITAL SPENDING

4.1 *Capital Spending Plan*

4.1.1 The Applicant has proposed a capital spending plan that is more than double the spending in their Bridge year, which in most circumstances would be a red flag. However, in this case the two main areas of increased spending – the Beach Road D.S., and the SCADA improvements – appear to have been well justified in the evidence. It would also appear that the Applicant has managed the spending in other areas closely in order to husband resources for these larger projects. This exhibits prudent operational oversight.

4.1.2 Subject to our comment below, therefore, we believe that the capital program has been appropriately supported.

4.1.3 The one concern we have is that the Beach Road D.S. is replacing a distribution station that is still be leased by CNPI from PCHI. As we have noted earlier in these submissions, that is a fundamental problem with the lease structure being proposed. If the Board adopts either of the two approaches to the lease that we have recommended, then the spending on Beach Road D.S. is not a problem. On the other hand, if the lease payments are recoverable from ratepayers, this would create a situation in which the ratepayers would be paying for two assets that are 100% redundant, and that in our view cannot be considered to be just and reasonable.

4.2 *Rate Base*

4.2.1 ***Fixed Assets.*** Subject to our comments with respect to the Lease, we have no concerns with respect to the Fixed Assets component of rate base proposed for the Test Year.

4.2.2 ***Working Capital.*** We have expressed our concern to the Board on many occasions that the 15% working capital standard operates to over-recover from ratepayers in this category. We have had an opportunity to see a draft of the submissions of VECC in this regard, and we concur with their recommendation that the Board order a lead/lag study, the results of which should be filed no later than the Applicant's next cost of service application.

5 OPERATING EXPENSES

5.1 *2009 OM&A Budget*

5.1.1 We have had the chance to review the draft submissions of VECC in this area, and, with one exception, we concur with their analysis and recommendations.

5.1.2 ***Regulatory Costs.*** We have a concern about the Applicant's proposal to dramatically increase regulatory costs because of the interlocutory activities in this case. In our submission, it is appropriate for the shareholder to be at some risk when it consciously refuses to co-operate with the regulatory process.

5.1.3 In this case, SEC sought information relating to the Lease, and much of it was refused on the grounds that it was not relevant to the issues before the Board in this case. We accept that this was a defensible position for the Applicants to take. While we disagreed with it, then and now, it was not so completely unreasonable as to attract some form of penalty imposed by the Board. That is, it was not an abuse of the Board's process. It was a position taken in an adversarial context, and while ultimately determined to be incorrect, it was a position a reasonable utility could take in that context.

5.1.4 That having been said, there still remains the question who should fairly be required to pay for the decision to take that position. On the one hand, participating in the regulatory process is a normal cost of doing business for LDCs, and as such is generally a cost that is borne by the ratepayers through their rates. On the other hand, the decision to refuse information that is ultimately material in this matter was a decision that could only benefit the shareholder. There was never an argument that the refusal could benefit the ratepayers. Thus, the Applicants are seeking to have the ratepayers bear an additional 1.1% rate increase so that they could protect the interests of the shareholder.

5.1.5 This is further complicated by the fact that cost of service is normally done on a prospective basis, using forecasts rather than actual costs. In the normal course, regulatory costs would be forecast by the Applicant based on a normal hearing, and their expectations as to how much it would cost them to participate. Under that paradigm, decisions during the hearing that increase regulatory costs above the forecast are borne by the Applicants, and conversely decisions that reduce regulatory costs give the Applicants a benefit.

5.1.6 This doesn't just come up where hearings become more complex. It also comes up where utilities make a forecast, and then settle all issues in ADR. In that case, there is a benefit, and unless the benefit is shared as part of the ADR settlement, it goes to the shareholder.

5.1.7 In this situation, it is submitted that it is inappropriate for the cost of the Applicants taking the position they did to be borne entirely by the ratepayers. In our view, the fairer approach is to split that cost. In this case, the increase allocated to CNPI-PC is about $182,000. We propose that the Board split this equally, so that the regulatory costs for the Applicants are increased from $59,400 to $150,300. The result, if this recommendation is accepted, is that the regulatory costs included in rates for the Test Year would be $50,100, as opposed to the $80,399 currently proposed.

5.2 ***Depreciation Expense.***

5.2.1 Subject to our submissions with respect to the Leased Property, we have no further submissions on Depreciation Expense.

5.3 ***Capital and Property Taxes***

No submissions.

6 COST OF CAPITAL INCLUDING PILS

6.1 *Long Term Debt*

6.1.1 We have been unable to find any logical difference between the Port Colborne situation and the FE/EOP Decision, and therefore it would appear to us that the reasoning in that Decision should apply to this franchise area.

6.2 *Short Term Debt*

No further submissions.

6.3 *Return on Equity*

No further submissions.

6.4 *Payments in Lieu of Taxes*

No submissions.

7 REVENUE REQUIREMENT

7.1 ***Revenue Requirement Calculation***

No additional submissions.

7.2 ***Other Revenues***

7.2.1 While we are concerned with the substantial drop in other revenues for this Applicant, the explanation for that drop – a $122,000 reduction in standby revenues due to a change in customer operating plans – appears reasonable.

8 REGULATORY ASSETS

8.1 *Disposition of Existing Deferral and Variance Accounts*

No submissions.

8.2 *New Deferral and Variance Accounts*

8.2.1 It is our understanding from the Application that no new deferral or variance accounts have been proposed.

9 COST ALLOCATION AND RATE DESIGN

9.1 *Cost Allocation*

9.1.1 ***Transformer Allowance.*** We have had a chance to review the draft submissions of VECC with respect to how the Transformer Allowance should be incorporated into cost allocation and rate design, and we concur with their now widely-accepted approach. We note that CNPI's evidence already incorporates this methodology

9.2 *Revenue to Cost Ratios*

9.2.1 ***General Position.*** We continue to be of the view that the Board should a) start with more rigorously calculated revenue to cost ratios, and b) move all revenue to cost ratios towards unity over time. We remain concerned that the Board's current policy of stopping when rate classes come within the recommended ranges runs the risk of institutionalizing inter-class subsidies, and we hope that the Board will prioritize further work to allow this problem to be dealt with.

9.2.2 ***Calculation of Revenue to Cost Ratios.*** We have had the chance to review the draft submissions of VECC with respect to a number of corrections in the revenue to cost ratio calculations, and in general we agree with their conclusions and recommendations.

9.2.3 ***Adjustments to Revenue to Cost Ratios.*** Under the Board's Guidelines, the Sentinel Lights, Street Lights, and USL classes should each move 50% of the way to the bottom end of their range, with further adjustments in 2010 and 2011 to bring them to the bottom of the range. The concomitant reduction in cost responsibility should be in the GS>50 class, the only one above unity. We estimate this would reduce the revenue to cost ratio for GS>50 to 126.1% in 2009, 122.8% in 2010, and 119.7% in 2011. While we are concerned with the continuing overcollection from this class, year after year, this movement is at least directionally sound, and we hope that by the time of the next rebasing of this utility, updated information will form the basis for further narrowing of the range.

9.2.4 VECC has proposed that changes in aggregate billing parameters in each class between 2006, when the cost allocation study was done, and today result in anomalies. For both Street Lighting and Sentinel Lighting, they correctly point out that there has been little movement and so any anomalies are likely to be small. With respect to USL, they posit that those anomalies could be larger.

9.2.5 While we agree in general that, as the cost allocation study becomes more outdated, changes in load and customer composition will become increasingly problematic, we do not agree with the solution they have proposed in this case. The USL class is small, and the difference between moving one-third of the way to the bottom of the range, and 50% of the way, is non-material. We believe it is better for the Board to apply a consistent approach to all three classes in this instance.

9.3 ***Fixed/Variable Splits***

9.3.1 CNPI Port Colborne has one of the highest fixed charges in the province for the GS>50KW class, which includes most schools. Under the Board's Guidelines, the low end of the range for the GS>50KW fixed charge is $61.22, and the high end of the range is $236.58**.** The current fixed charge for the class is $620.00, and CNPI proposes to increase it to $649.60. This means that, for smaller customers within the class, such as schools, their annual distribution bill is almost $5,000 more than it would be if the Board's Guidelines were being adhered to.

9.3.2 The Board has generally taken the position that utilities are given the discretion when and how to propose to move within the fixed charge range for any given class. In this case, it is submitted that this is not appropriate, and the Board should be more proactive in requiring the Applicants to make this adjustment.

9.3.3 It is submitted that, prima facie, the use of such a high fixed charge, and even increasing it in the face of the existing anomaly, is unfair to customers at the lower end of that class, and their rates are not just and reasonable. In these circumstances, the onus is on the Applicant to demonstrate that the rates they are asking this Board to approve are just and reasonable, and where, as here, they diverge so severely from the Board's existing Guidelines, that onus should be particularly stringent.

9.3.4 In this case, the Applicant has made no attempt to justify the unusually high fixed charge for this class. It would be one thing if they offered a rationale for this situation, so that the Board would have a basis on which to conclude that this fixed charge represents just and reasonable rates. Nothing of this type has been proffered, and it would appear that the Applicant is just opting for the status quo without any attempt to justify it.

9.3.5 It is widely accepted that, each time this Board establishes rates, it is under a fresh legal obligation to determine that those rates are just and reasonable. While the Board has broad discretion in how it makes that determination, that determination still must be based on evidence before it. In this case, the only evidence before it is a) CNPI-PC has one of the highest fixed charges for GS>50KW in the province, b) the Board's own analysis of appropriate ranges does not support a fixed charge anywhere near this high, and c) the Applicant has not sought to justify the high level of this fixed charge.

9.3.6 Given this background, it is submitted that the only basis on which the Board can be confident that the rates for the GS>50KW class for CNPI-PC are just and reasonable is by following its own Guidelines for fixed/variable split, which in this case would result in a fixed charge for this class of $236.58.

9.3.7 We therefore ask the Board to order that the fixed charge for the GS>50KW class be reduced accordingly, and the revenue responsibility for that dollar amount be transferred to the class variable charge.

10 OTHER MATTERS

10.1 *Costs*

10.1.1 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.

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