ONTARIO ENERGY BOARD

STAFF SUBMISSION

2008 ELECTRICITY DISTRIBUTION RATES

HYDRO ONE NETWORKS INC.

EB-2007-0681

August 15, 2008

Hydro One Networks Inc. ("Hydro One", the "Company") is the licensed electricity distributor serving approximately 1.2 million customers across Ontario. Hydro One submitted an application for 2008 electricity distribution rates on December 18, 2007. The application was based on a future test year cost of service methodology.

These submissions reflect observations and concerns which arise from Board staff's review of the oral and written evidence, and are intended to assist the Ontario Energy Board (the "Board") in evaluating Hydro One's application and setting just and reasonable rates. The submissions also pose questions on certain issues that all parties may wish to address in their written argument.

The Application

Hydro One has requested an as-filed revenue requirement of $1,067 million to be recovered in new rates effective May 1, 2008. The highlights are tabled below.

2008 Revenue Requirement ($ millions)	
OMA Expenses	$ 478
Depreciation & Amortization	$ 239
Capital Taxes	$ 11
Income Taxes	$ 39
Return on Capital	$ 300
Total 2008 Revenue Requirement	**$ 1,067**
Other items:	
Rate Base	$ 4,382
Capital Expenditures	$ 566
Deferral & Variance Accounts (Refund)	$ 49
External Revenues	$ 42

This submission contains staff comments on the following topics/issues:

1. Vegetation Management
2. Smart Meters
3. Deferral Accounts
4. Rate Base
5. Staffing and Wages
6. Conservation and Demand Management
7. Cost Allocation, Rate Design & Rate Harmonization

1. VEGETATION MANAGEMENT

Is Hydro One's proposal to move towards an 8-year vegetation management cycle adequate and appropriate, or should Hydro One be moving towards a 6-year cycle?

In its decision in Hydro One's last distribution rates case (RP-2005-0020/EB-2005-0378), the Board directed Hydro One to file an external benchmarking study and to report at a high level on its comparative performance and cost information against a group of other North American distributors with similar business models. PA Consulting performed the study with the purpose of understanding Hydro One's relative position among a group of 13 North American distributors across a range of cost, reliability and safety metrics. Based on these findings, Hydro One is proposing to change its current vegetation management cycle from 10-11 years[1] to 8 years. Board staffs concerns relate to two aspects of Hydro One's proposal - The impact of the proposed vegetation management cycle on system reliability and the proposal to move from an 11-year cycle to an 8-year cycle, when the evidence indicates a 6-year cycle is most appropriate.

In relation to the proposed vegetation management cycle's impact on reliability the PA Consulting study states "….Shortening of the cycle time will probably have the benefit of reducing the frequency of tree-caused outages for circuits and customers."[2] Hydro One's own internal study, the *2008 Vegetation Management Program Review*[3], indicates that from 2004 to 2007, tree contacts accounted for over 50% of all interruptions and concludes that a 6-year cycle is optimal for improving system reliability.[4] The internal study also indicates that tree contacts have a significant impact on reliability, both with respect to frequency as measured by SAIFI and duration as measured by SAIDI.

Regarding the issue of cycle length, in cross examination it was established that many of the peer group distributors already operate with shorter average tree-trimming cycles.[5] Further, the PA Consulting study states that other studies indicated that the optimum tree-trimming cycle length is nearer to 5-6 years than to the 11 years currently in practice at Hydro One.[6] Board staff notes that Hydro One's internal study concludes that a 6-year cycle would be the most cost-

[1] Hydro One Networks describes its vegetation management cycle as being about 10 years, while the PA Consulting study refers to Hydro One's cycle as 11-years. Also, Hydro One witness Mr. Juhn clarified that this is an "average" cycle, and that cycles of different lengths are used in different parts of Hydro One Networks' territory, depending on assets being serviced, vegetation types, length of growing season, etc. See Transcript, Vol. 2, p. 93, ll. 5-26., Vol. 2, p. 104 l. 11 to p. 106 l. 24.
[2] *Ibid*.
[3] Ex H / Tab 1 / S 14 / Attachment C
[4] Ex H / Tab 1 / S 14 / Attachment C, p. 4, Figures 2.1 and 2.2
[5] Transcript, Volume 2, p. 89, l. 18 to p. 123, l. 5
[6] *Op. cit.*, p. 4-21

effective.[7] The internal study estimates there would be further expected improvements in reliability by migrating to a 6-year cycle and that such improvements would be similar in scope to what is expected by moving to an 8-year cycle from a 10-11 year cycle.[8] However, the study does recognize the challenges of moving immediately to a 6-year cycle, and recommends that an 8-year cycle be the current target.[9] In undertaking J-2.7, Hydro One identified the resource constraints and incremental costs of moving to a 6-year cycle instead of the proposed 8-year cycle. However this undertaking does not consider other alternatives, such as a cost-benefit analysis of a gradual move to a 6-year cycle. In Board staff's view, a gradual move to a 6-year cycle could address the resourcing constraints identified by Hydro One in a more realistic and cost-effective manner.

Board staff submits that the Board may wish to consider if the Company's proposal to migrate to an 8-year cycle and then to reassess the situation is adequately supported by the two studies. In Board staff's view, the PA Consulting study demonstrates that current "good utility practice" is of the order of 5 to 6 years for distributors with similar environmental characteristics. Hydro One's own study suggests that, based on current data, a 6-year cycle would be optimal for balancing costs and improving reliability. In Board staff's view, another possible alternative could be a gradual move to a 6-year cycle consistent with the findings of the two studies. Board staff observes that a gradual but definite move towards a 6-year cycle could also result in increased savings in restoration services and storm damage costs. Such reductions may help offset the increased costs of moving to a shorter vegetation management cycle.

Board staff submits that parties should comment on whether Hydro One should be required to file a plan that includes costs, activities and timelines of a gradual move to a 6-year cycle. This plan would likely need to include identifying areas of prioritization to quickly realize benefits from increased vegetation management and also a reporting requirement to document progress.

2. SMART METERS

Has Hydro One adequately documented and supported historical or test-year smart meter costs as being prudent and compliant with government regulations for meeting minimum functionality?

[7] *Ibid*., p. 11, Figure 3.1
[8] *Ibid.,* pp. 7-8, Figures 2.5 and 2.6 showing, respectively, the estimated relationship between improvement in SAIFI and SAIDI relative to cycle length.
[9] *Ibid.* pp. 19-20

Hydro One is a named distributor in Ontario Regulation 427/06 and has been authorized to undertake smart metering activities related to procurement and installation of smart meters and supporting equipment to meet government goals.

In this proceeding Hydro One is requesting recovery of smart meter costs for 2008 in its proposed rates. This means that the 2008 capital costs are included in rate base and smart meter operating expenses are part of OM&A. Board staff notes that Hydro One's proposed smart meter costs relate to "minimum functionality" as defined in regulation and "beyond minimum functionality".

Under Hydro One's proposal, smart meters installed in 2006 and 2007, as authorized by regulation, are also included in rate base. The smart meter costs, both operating and capital are summarized below.

Table 2: Smart Meter Operating and Capital Costs ($ millions)

Description	**Historical**			**Bridge**	**Test**
	2004	**2005**	**2006**	**2007**	**2008**
Operating Expenses (Ex C1 / Tab 2 /Sch 2 / pg. 25 / Table 8)		2.4	4.9	6.2	9.7
Capital Expenditures (Ex D1 / Tab 3 / Sch 2 / pg 23 / Table 6)			14.1	76.7	164.8

The proposed smart meter costs represent a $22 million impact on the revenue requirement, with operating expenses representing $10 million and capital-related recoveries the remaining $12 million[10]. Hydro One further distinguished between smart meter costs meeting "minimum functionality" and "beyond minimum functionality".

In Board staff's view the smart meter costs for "minimum functionality" are consistent with both government regulation and Hydro One's earlier historical smart meter costs reviewed and approved in the combined Smart Meter Proceeding.

Is Hydro One's proposal for treating both historical and test-year smart meter costs in rate base and revenue requirement appropriate?

In this proceeding Hydro One is requesting recovery of smart meter costs for 2008 in its proposed rates. This proposal treats smart meters as if they were like any other distribution network asset. Board staff notes that the Board in other 2008 cost of service decisions has adopted a consistent approach when dealing with such costs. In Toronto Hydro Electric System Limited's ("THESL") 2008 rate case the Board dealt with a similar issue, and ordered that such

[10] Ex E1 / Tab 1 / Sch 3 / pg 3 / l. 15

costs continue to be tracked in the smart meter deferral accounts. In Board staff's view there do not appear to be any reasons to suggest the Board treat Hydro One's request differently from the THESL decision.

In 2007 the Board commenced a combined hearing, under file number EB-2007-0063 (the "Combined Proceeding") which reviewed historical incurred costs and evaluated the costs as complying with the "minimum functionality" cost recovery regulation for thirteen distributions named and authorized by regulation to undertake smart meter activities at that time. In that Decision, the Board approved Hydro One's smart meter costs related to minimum functionality, except for a portion of project management costs, for the period January 1, 2006 to May 31, 2007.

In the 2008 cost of service applications, various distributors proposed recovery of both historical and test year smart meter costs. For distributors that are not authorized to undertake smart metering activities, the Board has consistently disallowed the request and directed these distributors to track these costs in the established deferral/variance accounts. For distributors that are authorized to undertake smart metering activities, the Board has approved for inclusion in rate base, the audited historical smart meter costs to December 31, 2007. With regards to forecasted test year costs, the Board has ordered that these costs should not be recovered in rate base and revenue requirement, but should instead continue to be tracked in the smart meter deferral/variance accounts. Consistent with the above, in THESLs 2008 distribution rate application, the Board ordered that test year smart meter costs should not be recovered in rate base and revenue requirement and should continue to be tracked in accounts 1555 and 1556.

At the oral hearing, Counsel for Hydro One stated that the Company was aware of the Board's decision in THESL's rate case and has no "good reason" to be treated differently.[11] In Argument-in-Chief, Hydro One maintained its preference that "all these costs [i.e. historical and test year smart meter costs, both for "minimum functionality" and "beyond minimum functionality"] be approved for recovery as a regulatory asset up to April 30th, 2008 and be included in its core work program beyond that time for recovery as part of its revenue requirement."[12] However, in light of the THESL decision, Counsel for Hydro One also presented the Board with an alternative scenario where, if this Board Panel determined to follow the precedent of the Board's decision in the THESL rate proceeding, then the Company requests that all smart meter costs, both for "minimum functionality" and for "beyond minimum functionality" up to December 31, 2007 be approved for inclusion in rate base. Under this scenario subsequent costs would continue to be tracked in deferral accounts and the smart meter rate adder would continue at the current Board approved level[13].

[11] Transcript, Vol. 2, p. 70 ll. 10-26
[12] Transcript, Vol. 7, p. 24, l. 28 to p. 25, l. 3
[13] Transcript, Vol. 7, p. 42 l. 24 to p. 42 l. 13

It is evident from recent decisions that the Board has adopted a consistent approach when dealing with such costs. In Board staff's view, no evidence has been presented to suggest the Board should treat Hydro One's request in a manner inconsistent with recent Board decisions.

Should smart meter costs for "beyond minimum functionality" be approved? If so, on what basis, and for what time period?

Hydro One is requesting Board approval for smart meter costs related to "beyond minimum functionality". These costs were not reviewed in the Combined Proceeding. Summarized below is a description of the "beyond minimum functionality" costs and functionalities, as described in the pre-filed evidence:

- Meter Outage Detection Capability – installation of super capacitors to allow communication of outages, allowing Hydro One to detect and react faster and more effectively to system outages.
- Collector Outage Detections Capability – battery back-up of collectors to allow them to operate in the event of power outages (related to the above item); and
- Time-of-Use Capability and Integration

Table 3: Smart Meter Exceeding Minimum Functionality Under-Recovery ($ Million)			
	December 31, 2006	December 31, 2007	December 31, 2008
Revenue Requirement	0.6	3.4	5.7

These "beyond minimum functionality" features are built into the smart meters and are intended to improve service by allowing Hydro One to detect and more efficiently respond to outages. However, Hydro One's witness confirmed that these features, while active in the installed smart meters, are not integrated with Hydro One's network operations at this time, nor was it certain when such integration would occur and so benefit customers. [14]

The costs for "beyond minimum functionality" are built into the cost of smart meters being procured and deployed, and Board staff note there is no evidence to indicate an economic benefit to refit smart meters after installation with the super capacitor technology. However, these costs are not "used and useful" at this time because Hydro One has not upgraded its network management capabilities to operationalize and take advantage of these features.

Board staff ask all parties to comment on whether the Board should consider approving these costs given the fact that these features are not "used and useful" at this time.

[14] Transcript, Vol. 2, p. 71 l. 23 to p. 76 l. 22

Is the treatment of stranded meter costs appropriate?

Board staff understands that Hydro One is recording the costs of conventional meter due for replacement under the smart meter program in accordance with the Board's decision in the combined smart meter proceeding.

3. DEFERRAL AND VARIANCE ACCOUNTS

Hydro One is proposing to:

- Clear the balances of certain deferral and variance accounts, and
- Establish 3 new accounts.

Hydro One is requesting disposition of certain deferral/variance account balances as at April 30, 2008. The principal balances in these accounts are forecast beyond December 31, 2006 audited balances. The accounts being requested for disposition and the balances are summarized in the table below.

Table 4: Deferral/Variance Account Balances as at April 30, 2008[15]

Account Number	Description	Balance at April 30, 2008 ($ millions)
1508	OEB Costs Account	(0.9)
1592	Tax Changes Account	(5.0)
1555 and 1556	Smart Meter Minimum Functionality Under-recovery to May 31, 2007	6.9
	Smart Meter Exceeding Minimum Functionality Under-Recovery	5.7
	Smart Meter Minimum Functionality between June 1, 2007 and April 30, 2008	9.4
1580	RSVA Wholesale Market Services	(72.6)
1584	RSVA Tx Network & Tx Network Aggregation	1.4
1586	RSVA Tx Connection & Tx Connection Aggregation	2.5
1588 Sub-account Global Adjustment	RSVA Provincial Benefit	0.0
1550	RSVA Low Voltage	3.8
	Total Requested for Disposition	**(48.7)**

Hydro One is proposing to clear the above amounts over a four year period, starting May 1, 2008 to April 30, 2012, assuming distribution rates will be in place starting May 1, 2008.

[15] Ex F1/Tab 2/Schedule 1, Exhibit F1/Tab 1/Schedule 1, and Ex H/Tab 1/Schedule 116

Should the Board approve a four year recovery period?

Hydro One is requesting Board approval to dispose certain deferral/variance account balances over a four year period, identified in Table 4 above. Specifically, Hydro One proposes to phase-in the disposition, a refund to rate payers of $48.7 million over a four year period by means of a rate rider credit recovering $12.2 million per year. Board staff notes that in other 2008 cost of service decisions the Board has consistently ordered recoveries over a shorter time period.

Board staff notes that clearing these balances over a shorter period will impact Hydro One's rate mitigation plan, as a larger credit will be refunded to customers over a shorter period, versus the proposed four-year period. Board staff asks parties to comment on whether a shorter clearance period may result in improved intergenerational equity and may ease the impacts on customers who are severely impacted by the harmonization process.

Should the Board approve forecasted principal balances for disposition?

Hydro One is requesting recovery of forecasted principal balances and carrying charges to April 30, 2008 for all accounts being requested for disposition as summarized in Table 4 above. The principal balances in these accounts are forecast beyond December 31, 2006 audited balances, except for Account 1508 - OEB Costs account. Board staff is concerned with Hydro One's proposal to recover forecasted principal balances, rather than audited principal balances, as is the usual practice.

It is common practice for natural gas utilities when requesting disposition of deferral and variance account balances to forecast principal and interest on these balances to the end of the current Bridge year. These forecasts typically do not exceed two or three months and are updated before a decision is issued. The forecasted balances are then trued up to the actual and any differences are recorded in a deferral account for disposition at a later date.

This is not the practice in the electricity sector. The usual practice of the Board in the electricity sector is to rely on the most up-to-date audited balances, plus forecast of carrying charges to the start of the new rate year on those balances. The Board has adopted this approach in most 2008 cost of service applications.

Board staff submits that in this case the December 31, 2007 balances are the most recent audited values. The table below provides the December 31, 2007 audited balances, with interest forecasted up to April 30, 2008[16].

[16] Undertaking J-6.2

Table 5: December 31, 2007 audited balances, with interest up to April 30, 2008		
Account Number	**Description**	**Balance at April 30, 2008 ($ millions)**
1508	OEB Costs Account	(0.2)
1592	Tax Changes Account	(6.3)
1555 and 1556	Smart Meter Minimum Functionality Under-recovery to May 31, 2007	5.9
	Smart Meter Exceeding Minimum Functionality Under-Recovery	1.1
	Smart Meter Minimum Functionality between June 1, 2007 and April 30, 2008	(1.0)
1580	RSVA Wholesale Market Services	(63.4)
1584	RSVA Tx Network & Tx Network Aggregation	6.6
1586	RSVA Tx Connection & Tx Connection Aggregation	7.5
1588 sub-account Global Adjustment	RSVA Provincial Benefit	3.8
1550	RSVA Low Voltage	3.1
	Total	**(42.9)**

At Exhibit F1/Tab 2/Schedule 1/ page 1, Hydro One explains that the forecasted balances are "reasonably predictable" and should therefore be approved by the Board. In response to undertaking J-6.2 Hydro One also provided the actual principal balances to April 30, 2008 (unaudited) and actual accrued carrying charges recorded to that date. These actual balances are stated to have a total value of ($65.5 million). Board staff submits given that there is a difference of $16.8 million between the forecast ($48.7 million) and actual balances ($65.5 million), suggests these balances could be difficult to forecast. [Emphasis added]

Board staff submits that disposition of the audited balances at December 31, 2007, would be consistent with the larger body of practice associated with electricity distributors and most 2008 cost of service decisions. However, it must also be noted that forecasted principal balances were approved by the Board in Hydro One's 2006 cost of service proceeding (RP-2005-0020 / EB-2005-0378)[17]. Both options have been employed by the Board and staff seek comments from parties on whether the benefits to clearing forecasted amounts outweighs the potential disruption once amounts are confirmed in an audit.

Should the Board approve disposition of RSVA balances?

Hydro One is applying to clear Account 1580 – RSVA Wholesale Market Services, Account 1584 – RSVA Tx Network & Tx Network Aggregation, Account 1586 – RSVA Tx Connection & Tx Connection Aggregation, and Account 1588 – sub-account Global Adjustment (RSVA Power

[17] Exhibit H/Tab1/Schedule 119

Provincial Benefit). Hydro One is also applying to clear Account 1550 – Low Voltage Variance, which it classifies as a RSVA. However, Article 490 of the Accounting Procedures Handbook (APH) does not classify Account 1550 as a RSVA.

Under section 78 (6.1) of the *Ontario Energy Board Act 1998*, the Board is required to review each quarter the balance in Account 1588 - RSVA Power. The Board recently announced that it intends to launch an initiative to review this account and also indicated that it is considering the possibility of extending this initiative to include all RSVA accounts, including Accounts 1580, 1584, and 1586. Consistent with the above, Board staff note that the Board has not approved clearance of any of these accounts in most of the recent 2008 cost of service rate decisions. However, the Board has approved clearance of Account 1550 – Low Voltage Variance, in most of these cases.

Board staff invites all parties to comment on whether Hydro One's proposal to dispose RSVA account balances is appropriate, given that most of the recent Board decisions have not approved the clearance of these accounts.

How should Hydro One comply with the Board Order to record the line loss variance in account 1588 RSVA Power?

Hydro One is excluding the variance relating to distribution system losses from account 1588 RSVA – Power. The distribution system loss variance is the difference between the dollar value associated with actual line losses and the value of line losses arising from applying the Board approved line loss factors to customer metered quantities.

In the response to Pollution Probe Interrogatory Exhibit H/ Tab 2/ Schedule 25, Hydro One stated that it "uses the accrual method to record and report its financial results, and assumes that actual losses are the same as the OEB approved distribution losses." Hydro One also stated that "no variation exists between approved and actual losses, and consequently there is no variance or deferral account that would record the variation." In the Recovery of Regulatory Assets – Phase 2 Decision (RP-2004-0117, RP-2004-0118, RP-2004-0100, RP-2004-0069, RP-2004-0064), section 2.0.27, the Board directed Hydro One to "...include line loss variances in Account 1588, consistent with the other three Applicants and APH490."

Article 490 of the APH on page 19 states:

> "The RSVAPower account is established for the purpose of recording the 'net difference' in energy cost only. 'Net difference' refers to the difference between the amount charged by the IESO, host distributor or embedded generator based on the settlement invoice for the energy cost and the amount billed to customers for the energy cost. Note that these differences could

> be composed of differences in energy price and/ or energy quantities as well as the difference between estimated and actual line loss factors."[Emphasis added]

At the oral hearing[18] Hydro One explained that "this issue came up in the 2006 distribution rates hearing for Hydro One." Hydro One further submitted that there had been "a full discussion at that time on this issue and the Board's decision [*in Hydro One's last rate case (RP-2005-0020/EB-2005-0378)]* section 7.3.10 says: The Board acknowledges that an $80 million program of metering to more accurately estimate line loses does not appear to be a prudent approach." However, Board staff notes that page 54 of the Board's decision in RP-2005-0020/EB-2005-0378, on this issue states:

> The Board acknowledges that an $80 million program of metering to more accurately estimate line losses does not appear to be a prudent approach. The Board is of the view that either a less expensive metering program, or a second effort to evaluate line losses using current load data and local experience, may provide loss factor estimates that are more acceptable and credible to stakeholders. [Emphasis Added]

This issue relates specifically to the recording of variances between the Board approved factors and actual line losses in existing deferral accounts that were established for this very purpose. Board staff is also concerned that going forward without the variance account information, parties will be unable to assess the reasonableness of the factors chosen. Board staff invites parties to comment on whether there are actions that should be taken by Hydro One to address this issue.

Should the Board approve disposition of account 1592 - Tax Changes account?

Hydro One is requesting disposition of Account 1592 –Tax Changes, with a balance of ($5.0 million) forecasted to April 30, 2008. In the recent THESL 2008 rate case the Board disallowed the disposition of this account and stated:

> "With respect to account 1592, as the Board has commenced a combined proceeding which was announced on March 3, 2008 to deal with matters concerning pre April 30, 2006 PILs variances in account 1562, which may inform matters pertaining to the post April 30, 2006 PILs variance in account 1592, it will not dispose of this account in this proceeding."

During cross examination Hydro One confirmed that "we would follow the Board's guidance on that. If they would like us to combine that with – include this with the combined proceeding, we would also do that".[19]

[18] Transcript July 18, 2008, page 106, line 21
[19] Transcript Vol. 6, Page 109, Line 14-17

Board staff seeks comments from parties as to whether Hydro One would be disadvantaged if the Board were to deal with this issue as part of the recently announced combined PILs proceeding.

Is Hydro One calculating carrying charges on account 1555, smart meter deferral and variance account?

Board staff is unclear whether Hydro One is calculating an interest improvement on account 1555 as per Board staff Interrogatory 120. Board staff notes that the revenue requirement calculation accruing in these accounts already includes a full regulatory rate of return on equity, PILs and long-term interest. Therefore, Board staff submits that it appears incorrect to include a short-term interest improvement on this account as well. Board staff seeks clarification as to whether, and if so why, Hydro One is calculating interest improvement.

If the short-term interest is included as noted above, Board staff invites parties to comment on whether any carrying charges based on short-term interest rates that may have been recorded in Account 1555 should be reversed.

Should the Board approve the use of the new deferral accounts requested by Hydro One?

Hydro One is requesting Board approval for three new deferral accounts. These are the Pension Cost Differential Account, OEB Cost Differential Account and Bill Impact Mitigation Account.

In Board staffs view when evaluating this request the Board may wish to consider the regulatory principles of materiality, prudence, causation and inability of to management control the required expenditure, which guide the establishment of all new accounts.

With respect to materiality, Board staff notes that in cross examination Hydro One's witness confirmed that the Company does not have a materiality limit for deferral accounts. However, Hydro One suggested the use of $500,000 as the threshold, stating that it was consistent with the thresholds used in financial reporting disclosure and capital investments in the *2006 Electricity Distribution Rate Handbook*[20]. However, the *Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors*, issued July 13, 2008, recommends a materiality limit of "$1 million for distributors with a distribution revenue requirement of more than $200 million" for Z-factors.[21] Parties are asked to comment on whether the Board should consider using the above materiality threshold when determining the need for new deferral and variance accounts.

[20] Undertaking J-6.4
[21] Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, July 13, 2008 page 36

There are also two other considerations common to the three proposed deferral accounts that all parties may wish to consider. Firstly, in the electricity distribution sector, the Board has usually relied on the APH, the Uniform System of Accounts, and supporting letters of direction to allow the use of deferral and variance accounts by utilities. Deferral and variance accounts open to one utility, and the usage of those accounts, are usually open to all distributors. Therefore, creating a new deferral account for one distributor will set a precedent for other distributors. Parties are invited to comment on how should the Board address the issue of precedence if the accounts are approved? Second, the establishment of new deferral and variance accounts will reduce the level of business risk to which Hydro One is exposed. Parties may wish to consider whether this type of risk is that which is already accommodated through the equity risk premium component of the return on equity.

The three new accounts are discussed in more detail below:

Pension Cost Differential Account

In this account, Hydro One proposes to track the difference between actual pension costs booked using the actuarial assessment, provided by Mercer Human Resource Consulting, and the estimated pension costs used in its rate filing. Hydro One states its actuarial valuation as at December 31, 2006 was completed in August 2007 and filed with FSCO in September 2007. It is not clear to Board staff why Hydro One has not used the final valuation in calculating its pension costs.

Hydro One filed its original application with the Board on August 15, 2007. That application was deemed incomplete and Hydro One filed a revised and complete application in December 2007. Since then, Hydro One has provided several updates to its filing, but has opted not to update its estimated pension expenses with costs in the final evaluation. In cross examination Hydro One's witness confirmed that updating the evidence would in fact mitigate the need for the account.[22] Board staff notes that as a result of using an outdated estimate of pension costs, Hydro One's revenue requirement may be higher by approximately $130,000 per month (or $1.5 million per year)[23], than it otherwise would have been had the evidence been updated.

Board staff seek comments from parties as to whether Hydro One has adequately demonstrated that control of pension costs is outside of management's control.[24] Notwithstanding the collective agreement, Board staff seeks comments on whether management has the ability to structure its benefit plans, including the ability to choose a defined contribution pension plan (which does not present the exposure to pension cost risk). If pension expenses are a

[22] Transcript July 18, 2008, Page 115, Lines 17-21
[23] Exhibit H/ Tab1/ Schedule 123
[24] *Ibid.*, Page 122, Lines 8-16

component of OM&A and is in the company's control, is it prudent to have such an account during the IRM period?

OEB Cost Differential Account

In Exhibit F1/Tab 3/Schedule 1, Hydro One proposes to track the difference between the annual OEB Cost Assessments, intervenor cost awards, and costs associated with OEB-initiated studies and the amount for these expenditures approved by the OEB as part of the 2008 distribution rates.

Board staff submits that no dollar amounts were available for these accounts. The Company stated in response to Board staff interrogatory 124 that "costs or fees would only be booked to this account once they are known." It is also unclear to Board staff why Hydro One requires this account considering that it will be under an incentive regulation mechanism. Board staff seek comments from parties on whether in the absence of information on such costs or fees can causation be adequately demonstrated?

Board staff also notes the Board disallowed a similar request in the recent THESL 2008 rate case and stated that this matter required a sector-wide approach through the APH or direction by the Board through another instrument.

Bill Impact Mitigation Account

In Exhibit F1/Tab 3/Schedule 1, Hydro One proposes to record the difference between Hydro One's requested revenue requirement and distribution rates resulting from the application of the Cost Allocation for Electricity Distributors report issued by the Board on November 28, 2007.

Parties may wish to comment on whether the requested account meets the four principles. Is it prudent to have a fixed pre-determined balance accrued into this account every year? Parties may wish to comment on whether a deferral account is an appropriate medium to record such costs. In addition, parties may wish to comment on why Hydro One should not bear the risk of this shortfall.

4. RATE BASE

Are the amounts proposed for 2008 Rate Base appropriate?

Clarification

Board staff notes the 2008 rate base amount of $4,298.3 million in response to Board staff Interrogatory 2, is lower by $92.7 million from the amount of $4,382 million requested for

approval in the application. Board staff invites Hydro One to clarify the above differences using references to information already submitted in evidence.

5. COMPENSATION AND STAFF RESOURCING

Does the Hays Report meets the requirements of the Board's April 12, 2006 Decision?

The Board's April 12, 2006 Decision (RP-2005-0020/EB-2005-0378) directed Hydro One "to engage an independent party to develop a comparison of labour rates and overtime policies amongst Hydro One, other comparative Ontario electricity distributors, and other Canadian utilities as identified in the high level benchmarking study. This independent study should also be submitted as part of Hydro One's next main applications for distribution and transmission rates". Accordingly, Hydro One selected the Hay Group to undertake the Comparison of Labour Rates and Overtime Study. Hydro One submits this study illustrates that, the Hydro One sample jobs are generally within market rates and overtime policies for comparable positions.

During the hearing, Ms. McKellar explained that the Hay study was intended to be a comparison of labour rates and overtime policy and that a total compensation study would be filed as part of the impending 2009 transmission filing. Ms. McKellar stated that this study would "be a more comprehensive study looking at many more job classifications in Hydro One, and will deal with total compensation, including benefits and pension, which the current study does not deal with." (Transcript, Vol.3, p.23, L24-27)

Has Hydro One adequately justified the proposed overall level of increases?

The table below, from Exhibit C1 Tab 3 Schedule 2 Page 1 of Hydro One's evidence, summarizes changes in this area:

Board staff notes that the overall increase in employee compensation is from $459.3 million in 2006 to $580.7 in 2008 or a 26.4% increase, based on the revised numbers included in Hydro One's June 16, 2008 update. Hydro One explained during the oral hearing that the above numbers represented total compensation costs for both Hydro One Transmission and Distribution and, as explained by Mr. Van Dusen, these costs are then allocated to transmission and distribution work programs through the Rudden methodology. (Transcript Vol. 3, p.99 L 25 – p.100 L10, p.111, L11 – p.112 L4)

Hydro One stated that the increase is a reflection of the following three items:

(i) an increase in staff numbers due to increased work programs
(ii) base increases negotiated by the various trade unions for represented staff
(iii) base pay increase for management staff.

During re-examination of Ms. McKellar, Ms. McKellar made the point that there were increased levels of activities in transmission which may be affecting the overall level of costs and employees. Ms. McKellar was asked to provide some sense of the proportion of additional employees or additional work that would be attributable to transmission as opposed to distribution. Ms. McKellar responded that "It is definitely a large percentage will be based on the transmission projects that are coming up..." (Transcript Vol. 3, p.191, L 13 - 19)

Board staff notes that a precise proportion and allocation of the $580.7 million between the distribution and transmission would better assist the Board in examining the prudency of the costs and overall revenue requirement of Hydro One distribution. Board staff notes that there were discussions on this matter during the oral hearing, however a precise proportion and allocation was not presented (Transcript Vol. 3, p.104 L1 – p.108 L13). How should the Board deal with this lack of precise information?

Has Hydro One adequately justified the 2008/2006 levels of increase in overtime as reasonable?

Hydro One's evidence shows that overtime compensation increased from $66.5 million in 2006 to a projected level of $72.1 million in 2008, an increase of $5.6 million, or 8.4%. Hydro One explained that 2006 had been an unusual year in that there were six force majeure events, which was a record year (Transcript Vol. 3, p.171, L 18 - L21). Hydro One also explained that to reduce overtime it had put on a weekend line shift, which received regular pay, but worked Friday, Saturday and Sunday in order to reduce some of the overtime associated with doing new customer connects on the weekend (Transcript Vol. 3, p.171, L 28 – p.172 L5).

When Board staff Counsel expressed confusion as to why given both that 2006 was a record year for force majeure events and that Hydro One had put in place a weekend shift to reduce overtime, overtime was still increasing in 2008 relative to 2006 levels, Hydro One noted again that the overtime under discussion was related to both the transmission and distribution businesses. Hydro One explained that it had a very large transmission capital program and "that is driving much of the staff numbers that you see today. These outages that are taken by grid operations are being taken on the weekend, by and large, and that is – yet again, that is a transmission-related thing, but it going to result in large amounts of overtime" (Transcript Vol. 3, p.175, L2 – L7).

6. CONSERVATION AND DEMAND MANAGEMENT

Hydro One stated that it has included $1 million in the 2008 revenue requirement within the Other Shared Services – Other category to sustain existing CDM programs and maintain a minimum capability.

Board staff submits that if new funding has been included in the 2008 revenue requirement, Hydro One has not completed the filing requirements for funding through distribution rates. In the March 2, 2007 "Report of the Board on the Regulatory Framework for Conservation and Demand Management by Ontario Electricity Distributors in 2007 and Beyond" stated that the:

> "Filing requirements for new CDM programs will be the same as those outlined in the Board's Filing Requirements for Transmission and Distribution Applications, issued November 14, 2006."

The filing requirements were further updated in the March 28, 2008 "Guidelines for Electricity Distributor Conservation and Demand Management." Staff question whether there is sufficient information about the cost effectiveness and scope of the CDM programs to justify the expenditures. In other decisions where distributors sought CDM related costs, such as a lost revenue adjustment collection, the Board allowed a deferral account to be created and encouraged the distributor to refile for approval of the costs. Is a similar option warranted for Hydro One?

7. COST ALLOCATION, RATE DESIGN & RATE HARMONIZATION

Hydro One is proposing to implement 12 new customer classes to replace the 13 classes in its Legacy system and typically three or four classes in each of the Acquired LDCs. The Company filed a cost allocation study in which the 2008 revenue requirement is divided into 12 class revenue requirements for the proposed classes. It has derived target rates for each of the 12 classes that, if implemented in 2008, would yield the class revenue requirement or an amount close to it. For some classes, Hydro One proposes to implement the target rates in 2008, but for most classes it proposes a phase-in period of four years, such that the rates applied to each customer would move as quickly as possible to the target rates (volumetric rates) or in four equal increments (monthly service charges).

A revenue to cost ratio is calculated for each class, with revenue from the target rates compared to the class revenue requirement derived in the cost allocation study. For each class, the revenue to cost ratio is within the range established for that class in the Board's policy report[25]. For the purpose of comparison, revenue to cost ratios are also derived using class revenues

[25] Application of Cost Allocation for Electricity Distributors, EB-2007-0667, November 28, 2007

prorated from existing approved rates. For classes affected by the phase-in, the ratio prior to the fourth year would be between the existing ratio and the ratio derived from target rates.

Hydro One filed extensive information on customer bill impacts. Total bill impacts in 2008 are filed for a range of customer sizes in each class in each part of the service territory, i.e. the Legacy customers and each Acquired LDC. Total bill impacts are also filed for average-sized customers in the Residential and General Service classes based on the target rates.

The proposed 12 classes are listed, along with abbreviations that are used in the application and this submission:

UR: Urban Residential (High Density)
R1: Residential (Medium Density)
R2: Residential (Low Density)
Seasonal
UGe: Urban General Service energy-billed
UGd: Urban General Service demand-billed
GSe: General Service energy-billed
GSd: General Service demand-billed
ST: Sub-Transmission
Street Light
Sentinel Light
DG: Distributed Generation

Board staff note that moving from the existing approved distribution rates to the target rates proposed by Hydro One, maximum average bill impacts would be 30 – 40%, and that some customer classes would experience increases in their total bills in the range of 8 - 10% for four consecutive years. All of the customers in question are in Acquired LDC areas that did not meet the density standards required to obtain an “urban” classification, and so were assigned to the medium density classes R1 and GSe.

Hydro One has filed information on only one way of classifying its customers, which gives the Board no opportunity to understand how the classification was chosen or what the implications would be of other ways of defining classes. In particular, the line between the urban classes (UR, UGe and UGd) and the corresponding classes (R1, GSe and GSd) is unchanged from that used over a long period in the Legacy system. Many customers of smaller Acquired LDCs cannot be considered for the urban classes because they are not in a cluster of 3000 or more customers. Once placed together in a class, a cost allocation study is not capable of distinguishing whether there may be cost differentials in serving various groups within a given class.

Hydro One's target rates follow directly from the class revenue requirements that are derived in its cost allocation study. Board staff believes that the initial direction of rate changes, making the transition from the existing rates toward the target rates, is well justified by the cost allocation study. However, Board staff question whether the entire amount of the rate change proposed by Hydro One is warranted. Should there be a reconsideration of cost information after two years to support or to modify the further changes beyond the half-way point of the proposed harmonization?

Should the Board direct Hydro One to examine the criteria used in its Density Review?

The rates proposed for customers classified as urban are substantially lower than those that would be charged to the same customers if they were in the corresponding lower density class. Hydro One reviewed its service territory to identify groups of customers that would qualify for its urban criteria. The review is described at Exhibit G1 / Tab 2 / Schedule 4, and the detailed results of the review are at Exhibit G2 / Tab 3 / Schedule 1.

The criteria for urban density were not changed by Hydro One from those that were used for the Legacy system alone, prior to acquiring the 88 distributors.[26] The criteria remained as both 3000 customers in a contiguous area and 60 customers per kilometer of line. (Ref: Exh G1 / Tab 2 / Schedule 3 / p. 3)

Fourteen Acquired LDCs were analyzed[27], and a number of these customers are classified as urban. At the same time, a number of Legacy customers were re-classified from lower density classes to urban density classes. Most residential customers in the Legacy territory remain as R1 (Medium Density) or R2 (Low Density). Amongst the residential customers in the Acquired LDC territories, 72,682 were classified as R1. Under the density criteria used by Hydro One many of these customers were not eligible to be considered for urban density no matter how little primary or secondary line or how many line transformers might be required locally to serve them. The situation is similar for the General Service class, whether energy-billed or demand-billed. Board staff question if it would be prudent for Hydro One to reconsider its criteria for urban density to reflect the change in the nature of its service territory with the acquisition of the LDCs.

Should the Board accept the proposed ST class?

The proposed ST class would consist of customers described above from the existing T class, all embedded LDCs, all embedded Direct customers, and a number of Large Users located in

[26] Transcript Vol. 6, p. 163
[27] Ex G2 /Tab 3 /Schedule 1 /page 3

the Acquired LDCs. The proposed class would also include a number of customers with loads above 500 kW that are currently classified as General Service in the Legacy system or in Acquired Distributors. Target rates would come into effect in 2008, without a phase-in period.

The proposed classification discontinues the existing T class, and reassigns the customers to the General Service Demand Billed class or to the ST Sub-transmission class. The T class has been defined by voltage.[28] 175 customers in the existing T class would become General Service Demand Billed customers, and of the 670 delivery points in the proposed ST class only 124 would be those of existing T-class customers.[29]

Board staff notes that Hydro One has provided a well structured argument to support this new classification.

Cost Allocation

HONI's cost allocation methodology is described in general terms at Exhibit G1 / Tab 23 / Schedule 1, and in detail at Exhibit G2 / Tab 1 / Schedule 1. The latter includes a number of modifications to the standard model that was developed for general use in the industry. The detailed data inputs and results of the Hydro One cost allocation study are found in Attachment A to Exhibit G2 / Tab 1 / Schedule 1.

Should the Board accept Hydro One's cost allocation study?

The 2008 revenue requirement of $1,067 million is allocated in the cost allocation study. The cost allocation is performed using the 12 classes described above. Hydro One's assets are divided into three voltage categories: bulk, primary, and secondary, which enables many O&M accounts to also be divided three ways.

Board staff recognizes the effort required to perform a forward test year cost allocation study, and also the effort to divide the assets into the three voltage levels which is over and above the two levels presented by other distributors. Board staff also recognizes and supports the modifications that Hydro One has made to the model, and submits that the modifications described in Ex G2 /Tab 1 /Schedule 1 improve the accuracy of the results.

Should the Board accept the Revenue to Cost ratios proposed by Hydro One?

Hydro One's revenue to cost ratios are presented in two ways and both use the proposed customer classification. In both cases the cost allocation is identical, such that each class is

[28] Ex G1 / Tab 2 / Schedule 2 / p. 4
[29] Ex G1/Tab 2 / Schedule 3/ Tables 8 and 9

allocated a share of the 2008 revenue requirement. In the first case, the revenue from each class is proportional to revenue at current approved rates. In other words, current rates are adjusted by a common factor to yield the total revenue requirement of $1,067 million. These ratios represent the status quo.[30]

In the second case, the class revenues are based on the proposed target rates. The revenue to cost ratios represent the long-term objective that would pertain when all rates have been harmonized in each class across the whole service territory.[31]

The status quo and proposed revenue to cost ratios are listed in the following table, in columns 1 and 2 respectively. For convenience, the most nearly applicable target ranges are listed in column 3, based on the Board's report *Application of Cost Allocation for Electricity Distributors, EB-2007-0667*, November 28, 2007.

TABLE 6: REVENUE TO COST RATIO'S			
CLASS	**STATUS QUO RATIOS COLUMN 1**	**PROPOSED RATIOS COLUMN 2**	**TARGET RANGE COLUMN 3**
UR	0.87	1.0	0.85 – 1.15
R1	0.82	0.88	0.85 – 1.15
R2	1.04	1.04	0.85 – 1.15
Seasonal	0.92	1.0	
UGSe	1.29	1.2	0.8 – 1.2
UGSd	0.95	1.0	0.8 – 1.8
GSe	1.08	1.08	0.8 – 1.2
GSd	1.02	1.02	0.8 – 1.8
ST	2.35	1.15	0.85 – 1.15
DG	1.63	1.0	
Streetlights	0.60	0.7	0.7 – 1.2
Sentinel Lights	0.62	0.7	0.7 – 1.2

The proposed ratios are in the Board's target ranges in all cases, or at the nearest boundary of the range in the cases of the Sub-transmission, Streetlighting and Sentinel Lighting classes. Where the Board report does not have a readily applicable range, for Distributed Generation and for Seasonal, the proposed ratio is 1.0, which makes moot the lack of a range for those classes.

Rate Design

[30] Exhibit G1 / Tab 3 / Schedule 1 / Table 1
[31] Exhibit G1 / Tab 3 / Schedule 1 / Table 2

Under this heading, a number of specific questions are addressed under the general issue: "Are Hydro One's proposed rates appropriate?" along with the more specific issue "Is Hydro One's proposal to have both fixed and variable service charges for sub-transmission customers appropriate?"

Should the Board accept the fixed-variable split of revenues in the proposed distribution rates?

The following analysis and submission concerns the fixed-variable split with reference to the target rates only. With some exceptions, the volumetric rate (the "variable" part of the split) is proposed to be uniform within each class through the harmonization period, i.e. would be at the target level. On the other hand, the Monthly Service Charges would be part-way between those currently approved and the target rate for the class. The exceptions to this pattern are temporary measures introduced to mitigate bill impacts[32] or to work around constraints in the billing system.[33] The fixed-variable split during the transition period is beyond the scope of this submission.

The cost allocation model yields three calculations of customer-related cost, on a per-customer basis for each class. The three calculations are based on Avoided Cost, which covers the smallest number of cost components, Directly-Related Cost, and Minimum System which covers the largest number of cost components. The range of these calculations is found at Exhibit G1 / Tab 4 / Schedule 2 / Table 1, together with the proposed Monthly Service Charge for each class. The detailed calculations are found at Exhibit G2 / Tab 1 / Schedule 1 / Attachment A / p. 37.

For most classes the proposed monthly service charges are in the range between the Avoided Cost and the Minimum System Cost calculations. For three classes, the proposed Monthly Service Charge is at the upper boundary of the range, and one is at the lower boundary.

The proposed charges fall outside the range for three classes. For the R2 class, the proposed rate is at 10% above the range. The rate is footnoted as the "gross" rate, before application of Rural and Remote Rate Protection (RRRP).[34] The fixed rate net of RRRP is within the range.[35]

In the other two cases, the proposed Monthly Service Charge for the Streetlighting class and for Sentinel Lighting class is proposed at $1.00 per connection, which is below the lower end of the ranges which are $5.01 and $2.36 respectively. The proposed charge of $1.00 is in comparison

[32] Ex G1 /Tab 8 /Schedule 2 / p. 1
[33] Transcript Vol. 6, p. 171
[34] Ex G1 /Tab 4 /Schedule 2 /Table 1
[35] Ex G1 /Tab 8 /Schedule 1 /Table 1

to the current rate of $0. In other words, the proposed fixed-variable split is substantially less than would be indicated by the cost allocation study, but higher than the status quo.

Should the Board accept Hydro One's proposal for rate harmonization?

Board staff supports Hydro One's goal of harmonization. Board staff supports the Company's methodical approach that starts with cost allocation and derives the target rates for the whole service territory, and then moves from the existing approved rates toward those common rates in a way that recognizes annual bill impacts. Board staff recognizes the complexity of the rate design task faced by Hydro One in the transitional years, and notes that this approach is generally consistent with accepted rate harmonization plans.

All of which is respectfully submitted