

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 Toronto Hydro Electric System Limited pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates for the delivery and distribution of electricity effective May 1, 2010.

FINAL ARGUMENT ON BEHALF OF THE SCHOOL ENERGY COALITION

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1 GENERAL COMMENTS

1.1 Introduction

1.1.1 On June 30, 2009 Toronto Hydro Electric System Limited (THESL) filed an application by way of Z factor to recover some \$14.35 million of costs incurred in 2009. An oral hearing was held on October 8, 2009. This is the Final Argument in this matter on behalf of the School Energy Coalition.

1.1.2 In preparing this Final Argument, we are conscious not only of the specific amount requested for recovery, but also the issues this Application is raising for the first time, or in novel ways, before this Board. Those include:

- (a) The availability of Z factors for utilities under cost of service regulation;
- (b) The appropriate uses of account 1572 Extraordinary Events;
- (c) The Board's interpretation of the exogeneity criterion;
- (d) The Board's interpretation of the incrementality criterion; and
- (e) The responsibility of utilities to collect customer costs directly from customers.

It is these issues of principle that, in our opinion, are the most important aspects of this Application.

1.2 Summary of Argument

1.2.1 *Legal Basis of the Claim.* Of course, a utility can ask for a rate adjustment at any time, for any reason. The applicable legislation only circumscribes this by the test of "just and reasonable rates", and the only other restrictions are in the distribution licence of the distributor. However, in practice the Board establishes rules and guidelines to make the regulatory process manageable and predictable, and generally follows those rules and guidelines unless in an individual application there are special circumstances that warrant a departure.

1.2.2 In our submission, under both the rule/guideline basis on which the Application was made, and the alternative basis proposed in the oral hearing, the Application is ill-founded and should not be accepted. If the Board is to consider any relief for the Applicant, in our view it must either re-interpret its existing rules, or fashion a new remedy for situations of this type.

1.2.3 The basis proposed by the Application, a Z Factor under 3rd Generation IRM, is on the face of it simply not applicable to a cost of service year. The Applicant elected to treat 2009 as a COS year, to get a higher rate increase, and one of the results of that is that Z Factors are not applicable to that year.

- 1.2.4** The alternative basis in the oral hearing was Account 1572, Extraordinary Events. The Accounting Procedures Handbook specifically refers to the rules for this account in the 2000 Distribution Rate Handbook. That Handbook makes clear that the account is a Z Factor account specifically designed for PBR years. Thus, it should not be applicable either. The only other place in which Account 1572 is dealt with expressly is the Board's 3rd Generation IRM Report, which says that Z factor claims under that regime should use Account 1572. However, that would only be useful to the Applicant if the 3rd Generation IRM Z factor is applicable, which we note above it is not.
- 1.2.5** We note that section 12.1 of the Applicant's licence requires the Applicant to follow the Accounting Procedures Handbook.
- 1.2.6** The normal recourse for a utility in a cost of service year with unexpected and material costs is to seek an Accounting Order for a special deferral account. If the Board wishes to expand Account 1572 from its original purpose to capture extraordinary events in cost of service years, in our submission it should proceed cautiously, very clearly circumscribing any expansion to the existing practice.
- 1.2.7** ***Principles Applicable to this Application.*** Even if the Board determines that Account 1572 should be allowed as a basis for recovery, in order to do so in this case it would have to interpret two existing principles in broad ways: exogeneity and incrementality.
- 1.2.8** With respect to exogeneity, this Application would require the Board to expand the concept of exogeneity outside of actual external causes, to external events that bring an internal cause to public view. Further, it would require the Board to include in matters "outside of management's control" conscious decisions by management – such as the "run to failure" decision in this case – that are the direct cause of the problem. We consider neither of these approaches to be suitable.
- 1.2.9** With respect to incrementality, this Application would require the Board to interpret that concept as follows:
- (a)** Costs claimed as incremental should be "ring-fenced", and thus treated as incremental if those specific costs were not included in the original rate application on which the test year budget was approved, e.g. if there were no contact voltage costs in the original budget, all such costs are incremental. The concept of re-prioritization of costs within a budget category would be restricted (or, more correctly, repealed) in the context of Z factor type applications.
 - (b)** Alternatively, if the utility re-allocates spending priorities during the year from, say, operations and maintenance to administrative and general, and then finds itself short in the operations and maintenance area as a result of that re-allocation, that shortfall is an incremental cost.

In our view, neither of those interpretations is appropriate.

1.2.10 Specific Issues. If the Board determines that it should provide a new avenue for recovery by utilities of unbudgeted costs, and if the Board does adopt new interpretations of both exogeneity and incrementality, then in our view the Applicant still faces other barriers to recovery:

- (a) The first source of recovery for costs of this sort should be the customers whose equipment either caused or contributed to the problem. The Applicant did not even ask their shareholder, the owner of those assets, for any contribution.
- (b) All of the costs being claimed are not of the same type, and at least one category, the ongoing scanning program, is a new maintenance program adopted by the utility, not part of the emergency response to a safety issue.
- (c) The utility proposes to allocate remediation costs to the classes directly involved (streetlighting and USL), but scanning costs to all classes. This is logically impossible. If there were a cause of some sort that allows these costs to be recovered after the fact (which we say is not correct), then all costs flowing from the same cause should be allocated the same way. That would be to the classes served by the secondary system, in which the problems are occurring.

1.2.11 For these various reasons, in our submission the relief requested in this Application should not be granted.

2 LEGAL BASIS OF THE CLAIM

2.1 General

- 2.1.1** The general legal basis for any application affecting rates is “just and reasonable rates”. For the purposes of this Application, there are no formal legal restrictions on what THESL can apply for as rates. The THESL distribution licence contains restrictions on certain aspects of their operations, but except for section 12.1 of the licence, which requires compliance with the Accounting Procedures Handbook, there are no legal restrictions on what can be applied for in rates.
- 2.1.2** That having been said, the Board does not deal with every rate application as if it were reinventing the wheel. The Board spends a considerable amount of time and effort establishing standard approaches to rate applications for certain situations. This includes filing guidelines and other formal procedures for cost of service applications, comprehensive rules for IRM applications, rules relating to the applicability of particular relief provisions, such as Z factors and the like, and many other regulatory structures that organize and rationalize the ratemaking process. Similarly, there are less formal rules, or conventions, that the Board follows on a regular basis, such as the general prohibition against single issue ratemaking.
- 2.1.3** In this section of our Final Argument, we review the existing rules and guidelines under which this Application could be brought, and conclude that the Application does not fit within any of them. This leads to the result that this is a unique application, without any basis in precedent.
- 2.1.4** Once it is accepted that this Application is not based on any pre-existing rule or structure that has been established by the Board through its normal extensive public process, this Board is left dealing with this as a unique case, in which the Applicant is seeking either to broaden/reinterpret an existing ratemaking structure, or to fashion a new remedy available to utilities to seek rate increases.

2.2 Z Factor under Third Generation IRM

- 2.2.1** The Applicant has stated categorically that this Application is brought under the rules of 3rd Generation IRM. This is found throughout the oral hearing, but a particularly useful exchange is that between Mr. McLorg and counsel for SEC beginning on page 134 of the Transcript. Mr. McLorg, after referring to the Board’s report on 3rd Generation IRM, says:

“So our basic position is, there is nothing that says that we can’t come forward with a Z factor application for these kind of costs.”

There follows an exchange in which Mr. McLorg quotes from pages 35 and 37 of that report, and then says, at page 136 of the Transcript:

“I would note that it doesn’t specify a single or particular regulatory regime. It just says ‘the regulatory regime’”.

After quoting further from the Report, and a further exchange with counsel, he gives the answer:

“MR. SHEPHERD: Oh, okay. So you are applying under these [3rd GIRM] guidelines, then?”

MR. MCLORG: These are the most relevant guidelines and best articulate the test that THESL believes the Board should consider when it is considering this application.”

After a further request for clarification, Mr. McLorg says:

“We say, and we say it very clearly, that these costs meet the criteria for a Z factor – Z factors and that the Board should consider them within the established Z factor framework. We are not proposing anything new or novel.”

- 2.2.2** The Z factor in 3rd Generation IRM is found in the Appendix of that Report. At the beginning of that Appendix, the Board makes clear the applicability of the Z factor under 3rd Generation IRM:

“These filing guidelines set out the Board’s expectations for applications by distributors for rate adjustments on the basis of the third generation IR mechanism.”

The Z factor is not raised as a possibility for non IRM years. There is no discussion in the Report implying that the Z factor applies to COS years. In our submission, it is clear that the Z factor applies only to those utilities who are applying using the IRM mechanism.

- 2.2.3** The problem the Applicant faces here is that 2009 is not an IRM year for them. They elected not to follow the procedures laid out in the 3rd Generation IRM report, which provided for a one year cost of service rebasing, followed by three years of formula-driven rate adjustments. THESL sought multiple years of cost of service rate increases, in order to get significantly higher rate increases than would be allowed under IRM. In this, they succeeded.

- 2.2.4** THESL made a conscious decision not to avail itself of the rules contained in the 3rd Generation IRM Report. In order to get higher rate increases, it elected to create a different regulatory model from that preferred by the Board. In doing so, they must be taken to have elected both the good and bad aspects of that decision. On the good side, they got a higher rate increase than IRM would have provided. On the bad side, they

were not eligible for the relief mechanisms in the Report, which relief mechanisms are expressly designed to deal with the fact that utilities' rates are being set on a formula basis rather than cost of service.

- 2.2.5** It is therefore submitted that the Z factor in 3rd Generation IRM is not available to THESL, and the stated basis of their Application therefore fails. On this ground alone, in our view the Board should simply deny this Application.

2.3 Account 1572 – Extraordinary Events

- 2.3.1** The Applicant has also referred to Account 1572, Extraordinary Events, which is referred to in the Board's letter of March 4, 2009 to all distributors on the subject "Wiring Faults – Servicing Unmetered Load Connections".
- 2.3.2** THESL makes clear, at page 74 of the Transcript, that this letter is not the primary basis for the Application, but does suggest that the letter "is relevant to this application". However, in light of our conclusion on the primary ground of the Application, the 3rd Generation IRM Z Factor, it is appropriate to look at whether this account can independently form the basis of an application of this nature.
- 2.3.3** This account has an interesting history. It is currently described in Article 220 of the Accounting Procedures Handbook, which as we have noted earlier is legally binding on the Applicant by virtue of section 12.1 of their Distribution Licence. The APH describes this accounting as follows:

"This account shall be used to record extraordinary event costs that meet the qualifying criteria established in the 2000 Electricity Distribution Rate Handbook. Amounts recorded in this account does not imply Board acceptance of these amounts. Consequently, amounts are subject to regulatory review and approval prior to disposition of amounts in rates."

- 2.3.4** The APH also talks about this account under the heading "Accounting for Specific Items – Incentive Regulation and Related Accounts" in Article 480. There, the Board says:

"This account shall be used to record extraordinary event costs that meet the qualifying criteria established in the Electricity Distribution Rate Handbook."

The current Electricity Distribution Rate Handbook, the 2006 EDR, makes no reference to the criteria for this account.

- 2.3.5** When the November, 2000 Electricity Distribution Rate Handbook is reviewed, it reveals that Account 1572 is discussed under the heading "The Z Factor" on page 5-4.

There, the Board describes this as follows:

“A Z factor has been incorporated into the PBR rate mechanism to address extraordinary events, which could include catastrophic natural events, and the recovery of additional approved costs outside of the PBR rate adjustment mechanism framework (such as business re-engineering or transition costs)...

In order for transition or extraordinary event costs to be considered for recovery in the Z factor, the costs must satisfy all four tests set out below:

- *Causation...*
- *Materiality...*
- *Inability of Management to Control...*
- *Prudence...*

...In the following section, the eligibility of costs (extraordinary and transition) is first addressed. In order to track both cost and revenue associated with qualifying costs, accounts 1570, “Qualifying Transition Costs”, and 1572, “Extraordinary Event Costs”, are provided in the APH.”

- 2.3.6** We have included this lengthy quote because it is clear that, in fact, Account 1572 was established specifically to track costs that qualify for Z factor treatment, and that there is little doubt the Z factor, like that in 3rd Generation IRM, was only available to utilities in years in which the formula rate adjustment (RAM, as it was then called) was applicable.
- 2.3.7** It would therefore appear to us that, on the face of it, Account 1572 is not available under the normal APH rule for costs of this type. A utility could, of course, apply for and perhaps obtain an accounting order to record costs in 1572 for later disposition (since the Board can by order use Account 1572 any way they want), but without such an order it would seem that the account is not available at the instance of the utility. They would only be able to use it for qualifying costs in an IRM year, since that is what the Electricity Distribution Rate Handbook says it can be used for. Since the 1st Generation PBR is now long gone, the only category of expenses that would apparently be eligible for this account, without an accounting order, would be 2nd Generation or 3rd Generation Z factor amounts. THESL, which is under 3rd GIRM, but is not in an IRM year, would not qualify, as noted above, and so cannot record any amounts in this account. By including these amounts in Account 1572, THESL has, in fact, and subject to our discussion of the March 4th letter, below, acted contrary to the provisions of its own Distribution Licence, however inadvertently.
- 2.3.8** There is, however, the question of the Board’s March 4, 2009 letter. In that letter, the Board said:

“The Board recognizes that in some circumstances distributors may seek future recovery of the costs of repairs made to customer owned equipment or connections. In these circumstances distributors should record the appropriate amounts in deferral Account 1572 – Extraordinary Events Cost. Distributors may seek disposition of these accounts in conjunction with rate application filings. In seeking disposition distributors should be prepared to explain the amounts for which recovery is sought and what steps were taken to recover costs included in repairing the customer’s connection or equipment.”

2.3.9 While this is not an accounting order, it would seem overly technical to deny that the Board at least in this informal manner instructed distributors, including the Applicant, to use Account 1572 to record certain costs.

2.3.10 The problem with this is that, if the Applicant is relying on this letter as the basis for its Application, it would then be limited by the express terms of the letter. There are at least four important limitations:

- (a)* The Board emphasized the responsibility of the distributor to “have planned for...necessary maintenance”. As we discuss later, this Applicant did not do this. It made a conscious decision not to do this.
- (b)* The Board reminded distributors that they are “expected to recover from the customer the cost of repairs or isolation of customer owned equipment or connections”, which as we also note later, this utility did not attempt to do.
- (c)* This instruction is limited to “the costs of repairs made to customer owned equipment or connections”, but most of the costs in this case were, according to THESL, not clearly in that category.
- (d)* Distributors were directed to apply for recovery “in conjunction with rate application filings”, which THESL did not do.

2.3.11 In our submission, if THESL seeks to rely on the March 4, 2009 letter as their authority for use of Account 1572, then in addition to the criteria of exogeneity, incrementality, materiality and prudence that are part of the rules for that account, the other requirements outlined in the letter would also have to be followed.

2.3.12 It is therefore submitted that, on any view of the application of Account 1572 to this situation, it does not form any basis for recovery by the Applicant on the facts of this case.

2.4 What is the Relief in Serious Situations?

- 2.4.1** Although we have argued that the two bases for recovery proposed by the Applicant in this case – Z factor and Account 1572 – should not apply given the known rules applicable to them, we are also conscious of the ice storm example. It would seem self-evident that if a utility faces a serious external event, like an ice storm or hurricane or the like, there must be some mechanism for the Board to step in and make a rate adjustment, without offending the rule against retroactive ratemaking or turning the forward test year concept on its ear. In fact, the Distribution Licence of THESL, as with all distributors, says, in section 14.2, that THESL is obligated to report “material adverse changes in circumstances” to the Board within 30 days. It cannot be the case that this reporting obligation exists, but the Board does not have a mechanism to act once it has the information.
- 2.4.2** In addition, it appears to us that Account 1572 may well offer an appropriate mechanism for allowing Board intervention in extraordinary circumstances. While on our research it does not appear that the Account 1572 rules do that today, it is open to this Board panel, or any other Board panel, to use it to fashion a new remedy suitable to extraordinary situations.
- 2.4.3** In our submission, however, in the event that the Board wishes to consider fashioning such a remedy, it is of great importance that the Board carefully circumscribe what the remedy is, and how it can be used. This would be a new method by which utilities could recover costs already incurred and not included in approved revenue requirement, on a retroactive basis. It would apply only to utilities who are under cost of service (since there is already a comprehensive mechanism for IRM situations, the Z factor), and thus the Board should consider whether the threshold for recovery, and the criteria used, in a COS situation should be greater than, less than, or the same as the Board has already determined are appropriate in the IRM situation. It would also be appropriate to consider whether there are preconditions to using the mechanism (for example, an accounting order, as is the case with gas utilities), and whether there should be procedural requirements for clearance, such as filing with the rate application as set out in the Board’s March 4th letter.
- 2.4.4** In our view of the THESL fact situation, under any reasonable recovery rule they would not get recovery anyway, on several grounds detailed later in these submissions. Therefore, it would in our view be better for this Board panel not to propose a particular rule in this decision. Instead, we believe this Board panel should recommend that the Board establish a rule for extraordinary events recovery, after an appropriate consultation process.
- 2.4.5** Not only is it unnecessary to analyze the appropriate structure of a “COS Z factor”, if THESL would not qualify anyway, but the Board has not had an opportunity to hear a fulsome discussion of how such a special remedy should work in a range of cases.

There is a saying that “hard cases make bad law”, meaning that rules fashioned out of unusual fact situations often are not well-designed for general application in the future. That may be in play here.

2.4.6 In the event that the Board feels it should fashion a remedy for extraordinary event costs, in our submission the following should be essential aspects of that remedy:

- (a) The test of exogeneity should be the same as that for a Z factor, i.e. a cause entirely outside of the control of management. While the existence of a cost of service base for revenue requirement may mean that management has more control of budget in a cost of service year, the extraordinary nature of the causal event itself, as opposed to management’s budget availability, should not be different.
- (b) The test of incrementality should be tighter in a cost of service case. Revenue requirement established on a forward test year COS basis creates a budget that a utility is expected to reprioritize during the year in response to operating needs during the year. The Board has already made a conscious assessment of a reasonable amount required to run this specific utility for this specific period, with the knowledge that how the money is actually spent during the year will change. The incrementality threshold should include a review of whether normal spending shifts can, could have, or did in fact handle the unexpected cause.
- (c) The utility should be required to advise the Board as soon as the cause is known, and get permission from the Board to use Account 1572 (or another account) to track expenses for later review. This does not need to be as formal as an accounting order, but the Board should require this so that utilities understand how exceptional this remedy is, and the Board can monitor its use.
- (d) The application for clearance of the account should be filed with a rate application, as the Board directed in its March 4th letter, so that the Board can see the context of the spending, i.e. what else happened to the utility in the year, and whether the expenses were in fact incremental in the way we have described above.

2.5 Recommended Position of Board On the Legal Basis of the Application

- 2.5.1** In our submission, the existing remedies available to a utility for extraordinary events do not apply to this Applicant, since by their own choice they are under cost of service this year. Further, the Board’s March 4th letter does not give them relief because of its specific terms.
- 2.5.2** It may be appropriate for the Board to have a remedy in the unusual case that a utility has a Z factor type event happen in a cost of service year, but on any reasonable characterization of that remedy this Applicant would not in any case qualify.

Therefore, it would be better for this Board panel not to design it. Instead, this Board panel should deny the Application, but make a recommendation in the decision that the Board consider a new rule to cover Z factor events in cost of service years.

- 2.5.3** If this Board panel feels that it should fashion that remedy now, it should design it very carefully to ensure that it does not result in an avalanche of requests for after-the-fact ratemaking when utilities go over their Board-approved budgets.

3 PRINCIPLES GOVERNING THE APPLICATION

3.1 Principles

- 3.1.1** If the Board determines that some form of Z factor relief has to be considered in this situation, there are four principles that must be met before recovery is granted: exogeneity, incrementality, materiality, and prudence.
- 3.1.2** In our submission, the materiality principle has been met. Whether under the 2000 Electricity Distribution Rate Handbook, or the 3rd Generation IRM Report, this spending exceeds the materiality level. This would continue to be true even though, as we note later in these submissions, a significant part of the spending is not connected to the original Level III emergency.
- 3.1.3** In the sections below, we will conclude that the tests of exogeneity and incrementality proposed by THESL are unwise expansions of those concepts, and on more appropriate tests neither of these criteria have been met. In the final part of these submissions, we will then deal with prudence and related issues.

3.2 Exogeneity

- 3.2.1** The question of what causes count as exogenous for the purposes of a Z factor is raised squarely in this case. The Board's description of this criterion, found in the Appendix to the 3rd Generation IRM Report on page IV, is as follows:

"Z-factors are events that are not within management's control."

The Board describes the meaning of this in its discussion of the issue on pages 34-35, as follows:

"Z-factors are intended to provide for unforeseen events outside of management's control, and are a common feature of IR plans. In general, the cost to a distributor of these events must be material and its cost causation clear..."

For 2nd Generation IR, Z-factors are limited to natural disasters and tax changes. One distributor questioned whether Z-factors need to be this limited...

The Board has determined that the eligibility criteria are sufficient to limit Z factors to events genuinely external to the regulatory regime and beyond the control of management and the Board...

The Board expects that any application for a Z-factor will be accompanied by a clear

demonstration that the management of the distributor could not have been able to plan and budget for the event and that the harm caused by extraordinary events is genuinely incremental to their experience or reasonable expectations.” [emphasis in original]

- 3.2.2** The Applicant in this case takes the Board’s decision on 3rd Generation IRM to authorize a substantial expansion of the class of causes that would qualify for Z factor treatment. We disagree.
- 3.2.3** The traditional view of this is the ice storm model. A natural disaster occurs, something far beyond a normal occurrence, and a utility has to respond at great cost. It is a kind of “force majeure” concept.
- 3.2.4** In this case, the Applicant freely admits [Ex. J/1/7] that there was no extraordinary event of that type that caused the expenditures for which recovery is sought. What they argue, instead, is that an extraordinary event is not required. Z factors, they say, cover any expense they face that was necessary (i.e. non-voluntary) and not something they could reasonably have planned for.
- 3.2.5** This, if adopted, would constitute a substantial increase in the scope of the Z factor concept, and would as a result materially reduce the business risk of all utilities to which it applies.
- 3.2.6** Take an example. A smaller utility has four bucket trucks. They expect that every year or two they will have to take one out of service for major repairs. In a given year, they find that all four of them break down at the same time. This has never happened to them before. It would have been unreasonable for them to plan for this. Under THESL’s formulation of the Z factor concept, this is a Z factor and the costs of this “surprise” are recoverable after the fact from the ratepayers.
- 3.2.7** Take another example. A utility does an analysis and concludes that it can safely cut back its wood pole inspection program. A few years later, poles start falling down because the analysis, while correct on a probabilistic basis, did not properly account for various reasonable weather and other scenarios that sometimes can arise. The utility declares an emergency and inspects every one of their wood poles in a month. Substantial unbudgeted funds are spent. Under the THESL formulation, this is a Z factor, and these costs are recoverable.
- 3.2.8** In our submission, this is not what the Z factor is for. The Z factor is intended to reflect the fact that sometimes external, unusual events can impose material costs on utilities. A tornado destroys a substation. A new government regulation requires immediate replacement of all pole-mounted transformers. The Z factor is not intended to backstop utilities when their management of their distribution system includes results they did not expect.

- 3.2.9** As the Board said as recently as the 3rd Generation IRM Report (as quoted above), the Z factor is intended to deal with “*the harm caused by extraordinary events*”.
- 3.2.10** By their own admission, this utility did not experience any “harm caused by extraordinary events”. What happened was actually much more prosaic. THESL decided that the secondary system should be operated on a “run to failure” basis, and it failed. Not only was it not something out of their control. It was in fact the direct and expected result of a decision they made. They decided that they would let components of the secondary system fail, rather than inspect or maintain them. That is what ended up happening, just as they planned. The only “surprise” was that in the course of those components failing, a safety issue arose that they did not expect.
- 3.2.11** The Applicant is clear on the run to failure decision, as seen at page 162 of the Transcript:
- “MR. SHEPHERD: Understood. I guess the term that is used when you have something that you don't maintain is run to failure; right? You have certain aspects --*
MR. LaPIANTA: That is a term that is used frequently.
MR. SHEPHERD: You don't fix it, you just run it to it fails because when it fails, it doesn't hurt anybody. You know it has failed, you go and replace it; right?
MR. LaPIANTA: Correct.
MR. SHEPHERD: You operated the secondary system on a run-to-failure basis.
MR. LaPIANTA: That's fair, I accept that.”
- 3.2.12** There is nothing wrong with making a run to failure decision. Although it is not common in most aspects of operating a utility, it does make sense in some cases. As Mr. LaPianta pointed out, they also operate pole-mounted transformers on a run to failure basis.
- 3.2.13** But the trick is that to make that decision, two things must be true. First, the operating consequences of failure must be mild. In the case of the secondary system, that was satisfied, because having a streetlight or traffic signal out for a few hours, while inconvenient, is not the end of the world. Second, the failure cannot cause any other material negative consequences, such as a safety issue. In this case, it turns out that was not satisfied, because components of the secondary system that are not maintained can in the course of failing endanger public safety.
- 3.2.14** One may argue whether THESL should have known about this possibility, or should have made a different decision rather than run to failure for the secondary system. Certainly today they have switched to an inspect and maintain approach to the secondary system, as the previous decision has been shown to have been incorrect.
- 3.2.15** However, this does not mean the run to failure decision was a bad one. Hindsight is 20/20, and it may well be that any reasonable utility executive, knowing what THESL

knew over the last decade or more, would have made a similar decision. Indeed, Toronto is not the only city finding out the dangers of a deteriorating secondary system. The executives of THESL, if they were wrong, are in good company, and in our view it is not fair to criticize them for the run to failure decision. It may well have been reasonable at the time.

3.2.16 That having been said, whether the decision was a reasonable one is not relevant to the question of exogeneity. This is not a question of past prudence. It is a question of whether the cause of the problem was within management's control, or not. There is little doubt that it was.

3.2.17 We note that this is not about laying blame. Whether management could reasonably have been expected to prevent this from happening is not the question. The question is where the risk inherent in operating decisions is placed. The Board gives utilities a revenue requirement sufficient to operate their system in a reliable, efficient and safe manner. Then, the Board steps back and leaves the responsibility for operating the system to utility management, supervised by the board of directors. Generally, the Board does not second-guess the decisions they make, unless there are budgetary implications. Even there, utility management is given broad discretion.

3.2.18 But with that discretion comes responsibility and risk. Once a utility has their approved revenue requirement, the responsibility and risk associated with operating the system resides with them. The Board establishes a return on equity that explicitly assumes that business and operating risk are with the shareholder, not the ratepayers. The job of management is not to spend certain dollars on certain things. It is, instead, to achieve the goal of reliable, efficient and safe operation, and to make the day to day decisions necessary to do so. No matter how good they are at their job, not all of those decisions will be perfect, but they bear the risk for all of them.

3.2.19 In our submission, the risk that operational decisions, however well made, will prove to be incorrect is, within any given rate year, borne by the shareholder, and they are compensated for that risk.

3.2.20 It is therefore submitted that the test of exogeneity is not met in this case. The Z factor is founded on the concept of extraordinary events, and no such event existed in this case. Instead, the costs for which recovery is sought are the direct result of normal management decisions, the risk of which is assigned in the Ontario regulatory construct to the shareholder.

3.3 Incrementality

3.3.1 The Board's description of this test, on page V of the Appendix to the 3rd Generation IRM Report, is as follows:

“The amount must be clearly outside of the base upon which rates were derived.”

The same wording is used in the 2000 Electricity Distribution Rate Handbook, at page 5-5.

- 3.3.2** What does this mean? THESL proposes the following analysis of the criterion of incrementality, at pages 31-32 of the Transcript:

“MR. McLORG: Mr. Buonaguro, if I may add briefly to Mr. Couillard's answer, I think that you can hopefully think about the issue of incrementality as being composed of two separate questions.

The first question is whether or not the subject costs were actually part of the 2009 revenue requirement, and our evidence is that they were not. And I think that that evidence is fairly clear, but we are quite prepared to answer any questions you may have about that.

The second question having to do with incrementality is whether, as a result of the Level III emergency, there were any avoided costs that would normally have formed part of our work plan, and that is a separate question. And, again, our evidence is that, no, we did not and will not avoid any of the regular costs that were planned to be incurred as a result of our planned work activities.”

- 3.3.3** The concept being applied is one of “ring-fencing”, described by Mr. McLorg in an exchange with Mr. Millar at page 174 of the Transcript as follows:

“MR. MILLAR: But if there were not displaced costs, then there is nothing to offset, then you would say it doesn't actually matter if we greatly overearned because these particular expenses were incremental. I am not saying this is what has actually happened, I just want to approach it from a theoretical level. What you are saying is the actual expenditures that were made in 2009 are irrelevant. As long as these particular expenditures were incremental to the 2009 revenue requirement we sought and there are no other offsets, we should be entitled to that money. Is that a fair way to put it?

*MR. McLORG: I think that that follows from our view, because while **we put a ring fence around the contact voltage costs**, we were retain the risk that we bore from the beginning on both costs and revenues for 2009.*

So all of the – well, first of all, the revenues would scarcely be affected, but certainly the costs otherwise, the ones that are not related to contact voltage – well, it is our view we remain at risk for those.

And so to go back to a thing I said before, I think to pierce that boundary would amount to a reopening of 2009.”[emphasis added]

- 3.3.4** The approach, therefore, is one of isolating the contact voltage costs, and saying were they in the budget or not? If they are not explicitly in the Board-approved budget, then in the view of THESL they are incremental.

- 3.3.5** The necessary implication of this is that costs to remedy an unexpected event will always be incremental on this definition. If the budget includes the costs, then the event could not have been unexpected, and no Z factor applies. On this definition, incrementality is a direct function of exogeneity.
- 3.3.6** The problem with this is that the utility is asking for extra money, so common sense says that the Board should be determining whether they need any extra money.
- 3.3.7** Take a simple example. The utility has a team of people working on metering issues, and has a \$2 million annual budget in rates for that. The government imposes a new and unexpected regulation requiring immediate action. It happens that the metering team have the right skillset to do this, so they are shifted from metering to the new regulation for the year. The metering work is simply deferred until the next year.
- 3.3.8** In this example, the utility does what it normally does every year. It re-prioritizes its work activities to deal with those things that end up being important, regardless of the original plan. It is collecting the money in rates, but it uses it for a purpose different than the original one. This happens all the time. It is part of management's operational responsibility, and as ratepayers we in fact want them to make this prioritization decisions on a day to day basis.
- 3.3.9** Under the THESL formulation of incrementality, it is entitled to seek another \$2 million as a Z factor because it spent that much to deal with an unexpected and material government regulation. On the other hand, it gets to keep the \$2 million it collected from ratepayers for metering, even though it shifted that work to a later year.
- 3.3.10** In our submission, the reason that THESL did not include this in their rate application, as instructed by the Board, is not due to public reporting, as they claim. They claim [Tr.1:131] that they brought this Application early so that it can be reflected in their yearend financial statements. However, they do not have an explanation as to why this variance account, and none of the other ones, requires special treatment.
- 3.3.11** The real reason, it seems to us, is that they don't want this Board panel to explore their actual 2009 results. The Board saw that numerous places in the Transcript, of which one the best examples is the exchange from pages 123 – 129, in which Mr. Couillard suddenly could not remember important numbers from their recently filed 2010 rate case.
- 3.3.12** Here is the chart from EB-2009-0139, the THESL 2010 rate application, at Exhibit D1, Tab 3, Schedule 1, at page 1, summarizing their O&M spending compared to Board-approved:

Table 1: Distribution Expense Summary (\$ millions)

	2008 Board Approved	2008 Historical	2009 Board Approved	2009 Bridge	2010 Test
Operations	57.2	45.8	59.2	51.5	64.6
Maintenance	46.5	41.3	48.8	44.5	43.5
Billing and Collections	35.6	31.9	38.6	35.4	37.0
Community Relations	3.0	3.5	3.2	4.1	4.5
Administrative and General	35.4	46.1	33.8	46.8	62.6
Other Distribution Expenses	13.5	14.0	12.0	11.9	8.7
Amortization Expenses	146.9	149.0	154.4	158.4	167.0
TOTAL	338.1	331.6	350.0	352.6	387.9

It would appear that the 2009 Bridge Year numbers filed are “six and six”, i.e. six months of actual, and six months of forecast [Tr.1:132].

3.3.13 Two things are clear from the 2010 Application.

3.3.14 First, as Mr. Couillard correctly pointed out, they expect to spend about \$194.2 million on OM&A in 2009, compared to a Board approved of \$195.6 million, so the overall underspending is small. (Although we do note that Exhibit J1/1/1 of that application reports total Distribution Expenses for 2009 at \$347.3 million as opposed to \$352.6 million as above, a \$5.3 million difference which we are unable to explain. It does not materially change the underlying point, however.)

3.3.15 Second, however, they expect to spend \$96.0 million on Operations and Maintenance, compared to the \$108.0 million included in rates, and they expect to spend \$46.8 million on Administrative and General, as opposed to \$33.8 million included in rates.

3.3.16 In our submission, what has apparently happened here is that THESL has re-prioritized their 2009 spending by reducing O&M by \$12 million, in order to increase Administrative costs by \$13 million. However, faced with the contact voltage work to do, they suddenly find themselves short in the O&M budget that should be available to cover that.

3.3.17 When we wanted to ask about precisely this question, at pages 124-126 of the Transcript, the Applicant refused to talk about it. They should have, and we note that, having refused to submit to cross-examination on this point, it is now not appropriate for them to offer an explanation in their Reply Argument, free from the testing that cross provides.

3.3.18 The fact is that they had money in their Board-approved budget, almost enough to cover these costs. They chose to spend it on A&G instead, but one result of that is that

they can't now come back to the Board saying they don't have a budget for this. They do. They spent it on something else.

- 3.3.19** In our submission, even if the Board were to conclude that the cause of the Z factor were exogenous, this utility has not met the onus of showing that they need extra money from ratepayers to deal with it. On the evidence currently available to the Board, they apparently do not. We therefore believe that the Board should deny this Application due to the failure to meet the incrementality test.

4 ISSUES SPECIFIC TO THIS APPLICATION

4.1 Introduction

- 4.1.1** In our view, the previous sections provide a full answer to the Application, and lead to the inescapable conclusion that recovery should not be granted. In this section, we will deal very briefly with four other issues that have arisen during the course of the proceeding.

4.2 Prudence – How Did the Utility Respond to the Need?

- 4.2.1** One of the tests of a Z factor is whether the spending in response to the extraordinary event was prudently incurred.
- 4.2.2** It is possible to go through the actions of the Applicant in this case and assess whether every dollar spent was required, whether the strategy was optimal, whether the politically charged nature of the problem affected management's spending decisions, etc. With the benefit of hindsight, it is probably possible for the Board to find spending that could have been done better, cheaper, with greater efficiency.
- 4.2.3** In fact, though, this was a problem that needed to be solved quickly and thoroughly. Like all matters of public safety, fine distinctions between strategies were not the order of the day. Swift action was required, and THESL did that. The fact that the problem was the result of past decisions, or that it originally became a public issue in 2004 due to the New York incident, these are not really relevant to the issue of prudence of the spending.
- 4.2.4** It is therefore our submission that, on the evidence before the Board, the amounts expended were prudently incurred.

4.3 Prudence – Who Should Pay?

- 4.3.1** There is, however, another aspect to prudence, and that is the prudent recovery of amounts expended from those who should fairly bear them. The requirement to seek recovery from customers is set out expressly in the Board's March 4, 2009 letter, and is a normal responsibility of a utility.
- 4.3.2** THESL not only didn't arrange for any recovery from customers, but they didn't even ask the customer with almost all of the affected assets, their shareholder, the City of Toronto. At page 140 of the Transcript, Mr. Couillard admits this:

“MR. SHEPHERD: Where I was going with this is: Did you talk to the biggest customer affected, the City of Toronto, about whether they would contribute to the costs of this problem?”

MR. COUILLARD: We had discussion -- we had discussion with the city, obviously, you know, when this all happened. Most of the discussions were around safety, I think. You know, we won't hide the fact that, you know, this thing got a lot of profile, and we had discussion also with the senior official at the city.

***On the other hand, we never talked to them about, Should you guys pay directly for those services?”**[emphasis added]*

- 4.3.3** The explanation for this is that, in the emergency situation in which they found themselves, they were not able to do the investigations necessary to nail down whose equipment caused which expense, and therefore they couldn't give the City a bill that had any backup.
- 4.3.4** That explanation is probably true, as far as it goes, but it misses a key point. The Applicant is asking this Board to make that very determination, assigning cost responsibility to one group vs. another, with no more evidence than THESL had to present to the customer directly.
- 4.3.5** As a practical matter, the proper approach for THESL to take, and in our submission the approach they would have taken were the City not also their shareholder, would be to sit down with the customer and negotiate a split of cost responsibility. Businesses make decisions on incomplete information every day, and usually reasonable people can work out a solution that approximates what they collectively believe is fair.
- 4.3.6** In our submission, by failing to even broach the subject with the one customer that was involved in the vast majority of the problems, THESL acted imprudently. If there is any recovery to be granted in this Application, in our view a sizeable percentage of that recovery should be denied, since THESL's imprudence in this regard has significantly increased the amount for which recovery is now being sought.

4.4 How Much is Recoverable?

- 4.4.1** Another aspect of a Z factor is that the costs that are recoverable have to be the direct result of the event giving rise to the claim. Here, if the Applicant argues that it was the Level III emergency that “caused” the spending, then the Board must ask whether all of the costs were the direct result of that “event”.
- 4.4.2** In our submission, all of the costs after the end of February, when the problems had been resolved, are no longer the direct result of the Level III emergency. The contact voltage incidents meant that the Applicant had to inspect and fix its secondary system. It did that in February. The emergency was resolved. After that, it then separately decided to change its operating parameters of the secondary system, from a run to

failure model to an inspect and maintain model. That operational decision is like any other such decision made during a rate year. While the information that came out of the emergency may have prompted the decision, it was only that, an operational decision. All of the subsequent costs, including the scanning, were part of this new operational mode.

- 4.4.3** It is therefore submitted that costs incurred after February of 2009 do not qualify because they were not the direct result of the Z factor “event”.

4.5 Which Rate Classes Should Bear the Cost?

- 4.5.1** The same issue leads to another problem for the Application. THESL proposes that the costs to inspect and remediate the secondary system as part of the Level III emergency should be borne by the classes that are served by the secondary system, streetlighting and USL. However, the scanning costs, they say, should be borne by all customers, because they are protecting the safety of all customers.

- 4.5.2** Despite the “safety” argument, the Applicant in fact admits, at page 163 of the Transcript, that the reason for the scanning is the second system:

“MR. SHEPHERD: Although the scanning system, the scanning program is indiscriminate, in fact you have the scanning program for the secondary system. Don't you?”

MR. LaPIANTA: Well, no. I don't think that is fair. I think we have the scanning program to protect the public on the boulevard because it is not just scanning the secondary.

MR. SHEPHERD: No. I understand that. But the thing you have to inspect, the thing that you have identified as a problem that you feel that you now have to inspect that you didn't before is the secondary system; right?

MR. LaPIANTA: Correct.”

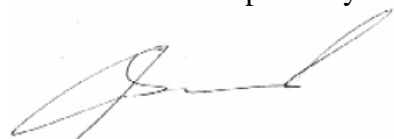
- 4.5.3** It could not be clearer that the scanning is to uncover problems in the secondary system. This puts THESL in a box from a regulatory point of view. If they support their own evidence, then it is incomprehensible that any customers would pay for the scanning other than those who are served by the secondary system. If the cost is solely driven by problems in the secondary system, those served by that system should bear the costs. Conversely, if they insist that they are scanning to detect problems in both the primary and secondary systems, then how does this have sufficient connection with the contact voltage emergency to qualify for Z factor treatment?
- 4.5.4** In our submission, the scanning costs are either a cost associated with the secondary system, in which case they should be borne by that customer group, or they are not, in which case they should not be included in the Z factor claim.

5 OTHER MATTERS

5.1 Costs

- 5.1.1** 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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