January 27, 2010

BY EMAIL & COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge St, Suite 2701
Toronto ON M4P 1E4

Dear Ms. Walli:

Board File No. EB-2009-0263
Festival Hydro Inc. – 2010 Cost of Service Application
Energy Probe Argument

Pursuant to Procedural Order No. 2, issued by the Board on December 7, 2009, please find two hard copies of the Final Argument of Energy Probe Research Foundation (Energy Probe) in the EB-2009-0263 proceeding for the consideration of the Board. An electronic version of this communication will be forwarded in PDF format.

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Should you require additional information, please do not hesitate to contact me.

Yours truly,

David S. MacIntosh
Case Manager

cc: William Zehr, Festival Hydro Inc. (By email)
Debbie Reece, Festival Hydro Inc. (By email)
Randy Aiken, Aiken & Associates (By email)
Intervenors of Record (By email)

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

AND IN THE MATTER OF an application by Festival Hydro Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective May 1, 2010.

ENERGY PROBE RESEARCH FOUNDATION ("ENERGY PROBE")

ARGUMENT

January 27, 2010

FESTIVAL HYDRO INC.
2010 RATES

EB-2009-0263

ARGUMENT OF ENERGY PROBE RESEARCH FOUNDATION

A - INTRODUCTION

This is the Argument of the Energy Probe Research Foundation ("Energy Probe") related to the setting of 2010 rates for Festival Hydro Inc. ("Festival Hydro" or "FHI") effective May 1, 2010.

This Argument has been structured to reflect the major components of the Festival Hydro evidence. Where readily available, Energy Probe has attempted to provide the impact of its submissions on the revenue requirement of Festival Hydro. However, in order to minimize intervenor time and costs, a comprehensive impact analysis has not been undertaken. If the Board accepts any or all of the Energy Probe submissions, it is assumed that the direct and indirect impacts will be determined by Festival Hydro and reviewed by intervenors and Board Staff through the associated draft rate order. An example of a comprehensive impact analysis would include the direct impact on rate base of a reduction in $10,000 in OM&A expenses and a $25,000 reduction in capital expenditures. Depreciation expense would also be directly impacted by the capital expenditure change. The indirect impacts would include the change in total cost of capital and taxes (due to CCA and interest expense changes) and the change in the working capital allowance.

Festival Hydro was forecasting a significant deficiency. As shown in the Revenue Sufficiency/Deficiency sheet in the Revenue Requirement Worksheets at Exhibit 1, Tab 2, Schedule 5, Appendix E, the gross revenue deficiency was $979,468 on forecasted total net revenues (assuming no rate changes) of $9,532,113. The deficiency represents an increase in total revenues of more than 10%.

Adjustments to the Cost of Service Application

Festival Hydro has made a number of adjustments to the cost of service application based on interrogatory responses filed throughout this proceeding. A summary of the changes made to the application was provided by Festival Hydro in response to Board Staff Interrogatory # 48. These changes include a reduction in OM&A costs associated with ongoing IFRS compliance costs, an increase in Streetlighting margin and corrections and updates to the PILS calculations. Energy Probe accepts these changes, subject to any further comments provided in the various sections that follow.

The resulting revenue deficiency of the adjustments noted above is also shown in the response to Board Staff Interrogatory # 48. The gross revenue deficiency is now $824,790 on forecasted total net revenues (assuming no rate changes) of $9,547,098. This deficiency represents an increase in total revenues of nearly 9%. It should be noted, however, that this deficiency still reflects a return on equity of 8.01%. Energy Probe estimates that the increase in the grossed up deficiency from moving from 8.015% to a 9.75% return on equity is about $400,000.

B - RATE BASE

a) Capital Expenditures

FHI is forecasting total capital additions in the 2010 test year of $3,357,000. This compares to a bridge year forecast of $3,402,000, $5,063,167 in 2008, $2,822,415 in 2007 and $2,399,343 in 2006 (Exhibit 2, Tab 2, Schedule 1). The 2008 figures includes reclassification costs of $648,253 related to the inclusion of inventory in capital assets and a further $968,310 for asset disposal reclassification.

Energy Probe further notes that the most recent 5 year capital forecast shows expenditures in each of 2011 through 2013 in the range of $3.6 million per year, consistent with the forecasts for 2009 and 2010. With the exceptions/adjustments noted below, Energy Probe accepts the capital expenditure forecast as being appropriate.

i) Elimination of the Provincial Sales Tax

As noted below in Section F – Taxes, part c) HST Harmonization, Energy Probe submits that a reduction related to the elimination of the provincial sales tax effective July 1, 2010 is an appropriate reduction that should be made to the 2010 capital additions forecast.

In the response to Energy Probe Interrogatory #1, FHI indicates that it currently has a provincial sales tax expense of $11,500 per month, 25% of which is capitalized. This translates into an annual capitalized cost of $34,500.

However, Energy Probe is concerned that this amount may be significantly too low, as it only represents approximately 1% of the total capital expenditures of $3,357,000 shown in page 8 of Exhibit 2, Tab 2, Schedule 1. Energy Probe notes, for example, that in its rates proceeding (EB-2009-0259) Burlington Hydro did an extensive review of its expenses related to the provincial sales tax. Burlington Hydro estimated that its 2010 capital expenditures for 2010 of $8,836,100 (Exhibit 2, Tab 3, Schedule 1, page 5) included $344,929 in provincial sales tax (Energy Probe Interrogatory #1). This figure represents almost 4% of the capital expenditures, which is in line with historical figures from 2006 through 2009.

Energy Probe is willing to accept the FHI forecast of $34,500 and the subsequent reduction in capital expenditures of one-half of this amount, or $17,250, but only if a variance account is established. This variance account is explained in more detail in the Taxes section below. If no variance account is established, then Energy Probe submits that the amount of the reduction should be increased to $67,000, being one-half of 4% of $3,357,000.

ii) Asset Disposal Reclassification

Festival Hydro corrected its accounting practice related to asset disposal and retirement costs at the end of 2008 to more properly align with the practices followed by other distributors (Exhibit 2, Tab 2, Schedule 3, page 25). At 2008 year end $968,310 was transferred to the respective asset accounts.

However, as shown in the response to Board Staff Interrogatory # 2, FHI has not restated its financial results retrospectively. This results in rate base being $94,613 higher than it should be in the test year. This figure is the accumulated depreciation that would have occurred in year prior to 2008 had the correct accounting practice been followed.

Energy Probe submits that ratepayers should not provide a return on assets that should have been depreciated in prior years.

b) Working Capital

i) Cost of Power Methodology

Energy Probe does not support the methodology used by Festival Hydro to calculate the commodity component of the cost of power. Festival Hydro has used a single rate per kWh regardless of whether the customer is an RPP or non-RPP customer.

Energy Probe submits that the estimation of the kWh's that are associated with RPP consumers and the kWh's associated with non-RPP consumers and the application of the appropriate prices to these different sets of volumes to calculate the cost of power component of the working capital allowance is appropriate. This is especially important for a utility like Festival Hydro where the working capital allowance associated with the power supply expense (excluding transmission and wholesale costs included in the cost of power) represents nearly 14% of the total rate base. It is imperative to estimate as accurately as possible the impact on rate base of the commodity cost of power.

Energy Probe Interrogatory # 9 requested that the Festival Hydro update the cost of power component of the working capital allowance to reflect the October 15, 2009 RPP Report and to provide the calculation if the RPP and non-RPP volumes were used. It is clear that the use of RPP and non-RPP volumes has a significant impact on the cost of power. Based on the methodology used by Festival Hydro, the commodity cost of power is $37,571,967 (Energy Probe Interrogatory # 9 (a)) if the RPP/non-RPP split is ignored, while based on the RPP/non-RPP volume split, the cost of power declines to $35,940,626. This is a reduction of 4.3% or more than $1.6 million, which translates into a reduction in rate base of nearly $250,000. This is equivalent to removing capital additions in the test year of $500,000.

Energy Probe submits that the use of separate prices for RPP and non-RPP volumes provides a more accurate estimate of the commodity cost of power. Given the significant impact on rate base, it is submitted that the Board should direct the distributor to reflect this methodology in its working capital allowance calculation.

ii) Cost of Power Update

Consistent with Board Decisions related to 2009 cost of service rebasing applications (for example, EB-2008-0247 Decision and Order dated July 7, 2009 for Welland Hydro-Electric System Corp., page 19), Energy Probe submits that the cost of power should be updated to reflect the most recent cost of power forecast presented to the Board by Navigant and to reflect the latest Board approved transmission charges at the time of the Board's Decision in this proceeding.

iii) Changes to Controllable Expenses

Energy Probe submits that if the Board makes any adjustments to the controllable OM&A expenses in its Decision, these changes should be reflected in the calculation of the working capital component of rate base.

iv) Requirement for a Lead/Lag Study

Energy Probe submits that the Board should direct Festival Hydro to undertake a lead/lag study in time for its next rates rebasing cost of service application. As shown in page 1 of Exhibit 2, Tab 1, Schedule 1, the 2010 test year working capital allowance is more than $7.3 million and represents more than 18.5 of the total rate base. This means that a one percentage point change in the 15% factor currently used to estimate rate base is equivalent to nearly $0.5 million in rate base and represents more than 1.2% of total rate base.

If the Board is concerned with the potential costs associated with a full lead/lag study, then Energy Probe submits that a lead/lag study should be undertaken for the cost of power component of the working capital calculation. As shown in Exhibit 2, Tab 4, Schedule 2, the cost of power (including commodity costs, transmission costs, rural rate assistance and wholesale market service costs) accounts for approximately 92% of the total working capital allowance. A review of these expenses should be undertaken because of their significant impact on rates.

C - REVENUES

a) Forecast Methodology

Festival Hydro has used a three step methodology to generate a load forecast. This methodology is described in detail in Exhibit 3, Tab 2, Schedule 1, beginning at page 5. The first step in the methodology is to develop a total system, weather normalized, purchased energy forecast based on a multifactor regression model that incorporates historical load, weather and economic data. The second step is the adjustment of the weather normalized purchased energy forecast by a historical loss factor to produce a weather normalized billed energy forecast. The final step is to disaggregate the total billed energy forecast into forecasts for the various rate classes using forecasted customer numbers and historical usage patterns.

Energy Probe supports the use of the methodology used by Festival Hydro. Although Energy Probe believes that the regression analysis should be conducted on individual rate classes and their associated monthly billed kWhs, it is aware that sufficient reliable data on a rate class basis is not yet available for this approach to produce reliable results.

Energy Probe submits that the approach used by Festival Hydro is an improvement to that based on the normalized average consumption ("NAC") methodology. The approach taken by Festival Hydro allows the impact of weather (heating degree days and cooling degrees days) and of the economy (Ontario real gross domestic product) and calendar factors to be taken into account. The NAC approach relies on average consumption in one year only and does not make adjustments for economic activity or changes in the weather.

While supporting the methodology used by Festival Hydro, Energy Probe does have concerns with the practical aspects of what Festival Hydro has used to generate its forecast.

The equation used by Festival Hydro is shown at pages 7 through 10 of Exhibit 3, Tab 2, Schedule 1. The deficiency in the Festival Hydro equation is that the estimated coefficient on the population variable has the wrong sign. An increase in the population, all else equal, should result in increased kWh's purchased and consumed, not a reduction.

In the response provided to Energy Probe Interrogatory #10, Festival Hydro has tried to rationalize the negative coefficient associated with the population. Festival Hydro indicated that it believed that:

> *"the impact of the conservation programs is to reduce average consumption across the entire customer base and that small individual reduction exceeds the modest increase associated with new customers".*

Festival Hydro has admitted that there is an increase (modest) associated with new customers. New customers are directly related to the population. As a result, an increase in population and customers would result in an increase in load, not a decrease as suggested by the equation. There are two factors at play: CDM is reducing volumes, while increases in population are increasing volumes. The equation used by Festival Hydro does not adequately separate these two influences on total volumes.

In the response to Energy Probe Interrogatory #44, Festival Hydro has provided the same equation, except that the population variable has been removed. The resulting equation does not have any estimated coefficients that have the wrong sign. This is an improvement over the Festival Hydro equation, even though the R2 statistic is lower in the revised equation.

The R^2 statistic relates to the goodness of fit. A good fit is important. However, a good fit is irrelevant if some of the estimated coefficients have incorrect signs or are statistically no different from zero with a reasonable level of confidence.

The R^2 statistic is the coefficient of determination for a regression equation and represents the proportion of the total variance in a dependent variable that is explained by the regression. In other words, the R^2 statistic is a measure of the explanatory power of the regression. However, it is widely acknowledged that the use of the R^2 figure must be used carefully in comparing regressions[1].

For example, the value of R^2 will remain the same or increase as more explanatory variables are added to the equation – it cannot decrease. This means that the addition of an explanatory variable such as a random variable totally unrelated to the dependent variable can increase the R^2 value. Therefore, this means that an increase in the R^2 value by itself does not mean the equation will provide a better forecast.

[1] See, for example, Econometric Models, Techniques, & Applications by Michael D. Intriligator, 1978, Prentice-Hall, Inc.

It is also inappropriate to compare the R^2 of two regression equations with different numbers of explanatory variables. It is an appropriate use of the R^2 to compare regressions if the number of explanatory variables is the same.

Comparison of the R^2 value from the equation without the number of customers as an explanatory variable to the equation with it included would be invalid since the two equations do not have the same number of explanatory variables.

A more accurate comparison of the goodness of fit across equations that have a different number of explanatory variables is the adjusted coefficient of determination, or the adjusted R^2. The adjusted R^2 takes into account the number of explanatory variables. It can decline as the number of explanatory variables is increased, effectively indicating that the added variables are masking some of the explanatory power of other variables.

Energy Probe submits that econometric modeling is an inexact science. As with any science there are basic tenants that need to be followed and observed. Energy Probe submits that econometric modeling is not merely a matter of regressing demand against a list of potential explanatory variables and accepting the outcome based on the best R^2 statistic. The estimated model needs to pass basic reasonableness tests, the first of which is – Are the coefficients plausible in sign? – and the second of which is – Are the estimates significant at a reasonable level of confidence? If not, it does not matter what the R^2 is. The R^2, or more accurately, the adjusted R^2 is relevant in comparing equations that first pass the reasonableness tests.

The adjusted R^2 statistic for the equation estimated in response to Energy Probe Interrogatory #44, which removes the number of customers as an explanatory variable, is 72.3%. Relative to similar equations used by other distributors, this value is relatively low. The corresponding figures for equations used by other distributors are typically in excess of 90%.

The predicted total system purchases based on the equation estimated in response to Energy Probe Interrogatory #44 is 647,348,768 kWh, which is significantly higher than the Festival Hydro forecast of 589,782,229 kWh (Table 5 of Exhibit 3, Tab 2, Schedule 1). This level is also higher than the weather normal purchases for 2008 and other past years as calculated and shown in the response to VECC Interrogatory #10 (i).

As shown in the graph below, however, this forecast is relatively consistent with the normalized actual volumes recorded by Festival Hydro since 2002.

Energy Probe has also reviewed the two methodologies used in response to Board Staff Interrogatory #39. The NAC approach uses the average consumption per customer in 2008 while the IESO change methodology uses the actual 2008 billed energy as the starting point. Energy Probe submits that neither of these approaches is appropriate. Both of these methodologies suffer from the same problem. They use actual 2008 consumption as the base or starting point of the analysis. The NAC approach is, in fact, not a "Normalized" Average Consumption approach since the use per customer figures upon which the forecast is based are actual figures for 2008, not normalized figures. As the degree day data shown in the response to Energy Probe Interrogatory, not only was 2008 a warm winter relative to the normal used by Festival Hydro, but it was also a cool summer relative to the normal. This has significantly decreased both average use and volumes in 2008.

Similarly the IESO approach of a decline of 4.0% in 2009 followed by a 0.3% decline in 2010 is applied to the actual 2008 billed energy level in 2008. It should be applied to the normalized level, since the IESO numbers are based on weather normalized figures, included weather normalized consumption for 2008.

Energy Probe submits, however, that the IESO change methodology can be adapted to provide an estimate of the consumption for 2009 and 2010. If the starting point to which the 4.0% decline in 2009 and the 0.3% decline in 2010 are applied reflects normalized

weather, then such an approach could be used to estimate the normalized forecast for 2009 and 2010. Festival Hydro has information related to actual billed energy by rate class for 2008. However, it does not have any way of normalizing the billed energy volumes by rate class.

The 2008 actual purchased kWh's, however, can be normalized. The regression equation used by Festival Hydro can be rerun, replacing the actual heating and cooling degree days with the forecast of these variables. With all other explanatory variables remaining unchanged, the difference between the predicted values is the change in volume due to the difference in the heating and cooling degree days. This information was provided in the response to VECC Interrogatory #10. When this normalization adjustment is subtracted from the actual purchased energy amounts, the result is the normalized actual purchased energy.

The following table shows the calculation of the normalized actual purchases from 1998 through 2008, using actual purchases from Table 5 of Exhibit 3, Tab 2, Schedule 1 and the normalization adjustment found in the response to the VECC interrogatory noted above.

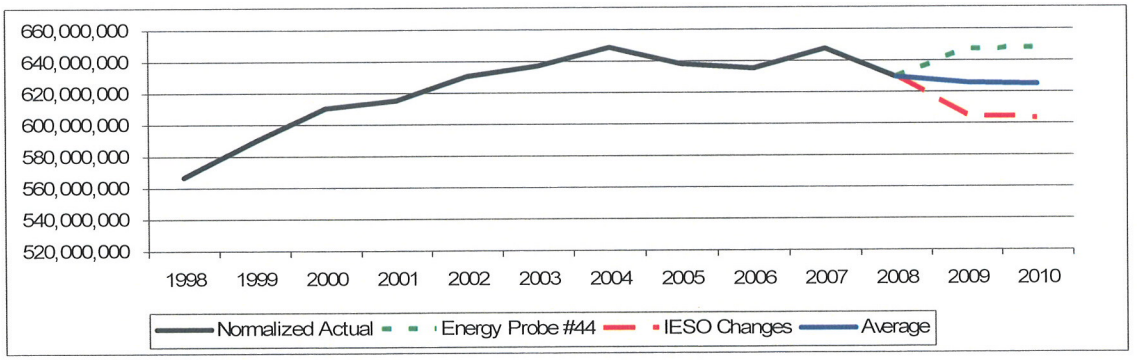
	Actual	Normalization Adjustment	Normalized Actual
1998	567,117,349	156,184	566,961,165
1999	593,828,652	4,535,265	589,293,387
2000	611,283,741	914,016	610,369,725
2001	616,059,685	1,212,763	614,846,922
2002	639,349,517	8,586,756	630,762,761
2003	640,334,466	3,267,555	637,066,911
2004	649,308,540	265,242	649,043,298
2005	650,800,740	12,307,219	638,493,521
2006	635,441,692	267,535	635,174,157
2007	634,322,920	(13,207,580)	647,530,500
2008	611,667,199	(18,304,955)	629,972,154

Application of a 4.0% reduction to the normalized 2008 figure of 629,972,154 kWh yields 604,773,268 kWh and the further reduction of 0.3% for 2010 yields a purchased energy forecast of 602,958,948 kWh.

Energy Probe submits that this is a more relevant forecast based on the IESO change methodology than that provided in the response to Board Staff Interrogatory #39. However, this methodology suffers from the assumption that the change in electricity consumed in the Festival distribution area will exactly mirror the change for the province as a whole. A comparison of the changes in the historical levels in the Festival distribution area with those of Ontario show this is not the case historically.

Energy Probe submits that neither the IESO change methodology, as amended for a 2008 normalized starting point, nor the equation that excludes the population variable provided in the response to Energy Probe Interrogatory #44, should be relied on solely to determine an accurate forecast of kWh's for 2010. Energy Probe does submit, however, that both methodologies provide information that can be relied upon. Energy Probe submits that a simple average of the forecasts from the two approaches should be used as the forecast for 2010. As noted above, the forecast for 2010 based on the Energy Probe Interrogatory #44 response is 647,348,768 kWh, while the adjusted IESO change forecast calculated above is 602,958,948 kWh. The average of these two figures is 625,153,858 kWh.

The following graph shows these forecasts. Energy Probe submits that the average of the Energy Probe response and the IESO methodology yield a reasonable forecast for the total energy purchased for the 2010 test year.



b) Adjustments to the Forecast

i) Total Purchased Energy

As noted above, Energy Probe submits that the Board should direct Festival Hydro to use the average of the equation contained in the response to Energy Probe Interrogatory #44 and the IESO methodology as applied to 2008 normalized total energy purchases to forecast the purchased energy volumes for 2010. This forecast is 625,153,858 kWh which is approximately 6% above the Festival Hydro forecast of 589,782,229 kWh.

Festival Hydro added a further 1,984,923 kWh to the total purchased energy forecast to reflect the addition of two GS > 50 kW customers, as shown in Table 6 of Exhibit 3, tab 2, Schedule 1. Energy Probe submits that these additions are appropriate.

As a result, the total energy purchased forecast for the 2010 test year, including the additions related to the two GS > 50 kW account additions, is 627,138,781 kWh.

ii) Loss Factor Adjustment

The second step in the forecast process utilized by Festival Hydro is to adjust the total purchased energy forecast by a loss factor to calculate a total billed energy forecast. This adjustment is described in Exhibit 3, Tab 2, Schedule 1 beginning at page 13. In particular, Festival Hydro had used a loss factor of 2.58%, as shown in Table 7 of the evidence.

Energy Probe submits that this loss adjustment factor should be adjusted. As shown in Table 7, the 2.58% figure is based on the average of loss factors for 2000 through 2008. However, as noted in the evidence at page 6 of Exhibit 3, Tab 2, Schedule 1, Festival Hydro used a longer period – 1998 through 2008 – to estimate the regression equation.

Energy Probe submits that the use of a loss factor that is calculated over a different period than the regression equation introduces a bias into the estimation of the total billed energy forecast. This is because the average loss factor includes information for a shorter period than does the estimate of the total purchased energy forecast. If Festival Hydro did not

have the actual loss factors for 1998 and 1999, their approach would be acceptable given the data limitations. However, Festival Hydro has this information. The 1998 loss factor is 2.06% and the corresponding figure for 1999 is 2.15% (Energy Probe Interrogatory #12 (b)).

Based on the information in Table 7 for 2000 through 2008 and the figures provided in response to the Energy Probe interrogatory, the average loss factor over the 1998 through 2008 period is 2.49%. Energy Probe submits that this loss factor should be used to adjust the total purchased energy forecast to the total billed energy forecast. Based on the recommended total purchased energy kWh forecast provided above, the change in the loss factor from 2.58% to 2.49% increases the billed energy forecast by approximately 536,000 kWh, an amount more than double the volumes forecast for the sentinel light class of customers.

iii) Allocation to Rate Classes

Energy Probe is concerned with the assumptions used for the weather sensitivity portion of the forecast methodology that adjusts the non-normalized weather billed energy forecast by rate class to align with the total weather normalized billed energy forecast. In particular, Energy Probe submits that the assumption that 100% of residential and GS < 50 kW volumes are weather sensitive (Exhibit 3, Tab 2, Schedule 1, Table 14) is not appropriate for Festival Hydro.

Energy Probe submits that a substantial portion of the volumes for residential and GS < 50 kW customers is independent of the weather. The Board is aware that the vast majority residents and businesses in the areas served by Festival Hydro have access to natural gas. It can reasonably be assumed that the vast majority of these customers use natural gas for space hearing. Electricity is used for numerous non-weather related applications including substantial volumes related to lighting, microwaves, stoves, refrigerators, computers, televisions, dishwashers and numerous small kitchen appliances. Electricity used for water heating is also non-weather related. Weather related uses are basically for air conditioning, furnace fans and small room space heaters.

In light of the above, Energy Probe submits that a more reasonable assumption is that 50% of volumes consumed by residential and GS < 50 kW customers are weather-related. Even this percentage may be too high. However, for purposes of this application Energy Probe submits it is a better assumption to be used than 100%. The impact on the revenue deficiency of using this assumption in place of that used by Festival Hydro is shown in the response Energy Probe Interrogatory #20 is a reduction in the revenue deficiency of $44,434. Energy Probe submits that the Board should direct Festival Hydro to use this assumption in calculating rates as it is a more realistic assumption.

iv) kW Forecast

Festival Hydro has used the average ratio for kW/KWh as calculated over the 2000 through 2008 period to forecast the kW billing determinants for the 2010 test year (Exhibit 3, Tab 2, Schedule 1, Table 18). Energy Probe submits that if no trends in the ratios exist for a particular rate class then this methodology is appropriate.

However, as seen in Table 18, there are pronounced trends in the kW/kWh ratios for each of the four rate classes shown. In particular, the ratios for the GS > 50 kW and Large Use classes have been rising, while the ratios for the street and sentinel lighting classes have been declining. Based on these trends, Energy Probe submits that use of the 2008 ratios in place of the average for the 2000 through 2008 period will provide a more accurate forecast for the kW figures for each of the rate classes.

The impact of these changes to a more accurate forecast reduces the revenue deficiency as originally forecast by Festival Hydro from $979,467 by $137,710.

c) Other Distribution Revenue

In its original filing, Festival Hydro had a 2010 forecast for total other distribution revenue of $659,450 (Exhibit 3, Tab 3, Schedule 2).

i) Streetlighting Margin

In response to Energy Probe Interrogatory #45, Festival Hydro indicated that it had added $14,985 to the forecast for margin on street lighting revenues. This additional revenue has also been reflected in the summary of proposed changes included in the response to Board Staff Interrogatory #48. This margin was calculated based on a return of 8.01%.

Energy Probe submits that it is appropriate for Festival Hydro to include a margin on the Streetlighting work in the same manner as there is a margin associated with billing and collecting services provided for water and sewer services. Energy Probe further submits that this margin should be adjusted to reflect the actual return on equity awarded to Festival Hydro relative the 8.01% used in the estimate.

ii) Streetlighting Costs and Revenues

As shown in the response to Energy Probe Interrogatory #45, Festival Hydro has forecast a net revenue deficit of $16,081 in the test year related to the revenues and costs associated with streetlighting capital and maintenance activities. In the response to Energy Probe Interrogatory #17 (c) Festival Hydro indicates that it does charge the full cost of delivering street lighting services. It further states that the revenues do not appear to cover the total costs because of the actual timing of billing for the service. However, as shown in the response to Energy Probe Interrogatory #45, there is a net revenue deficit in 4 of the 5 years shown that in aggregate totals more than $90,000.

Energy Probe submits that the Board should deem additional revenues of $16,081 in 2010 so that the streetlighting revenues cover the associated costs. It is not appropriate for ratepayers to subsidize the streetlighting costs of the municipalities in which Festival Hydro operates.

iii) Updated Forecasts

In response to VECC Interrogatory #23, Festival Hydro has provided an updated forecast for other distribution revenues. This forecast reflects changes to all the various categories of revenues and reflects stronger than forecast revenues for the 2009 bridge year.

Festival Hydro indicates in the response that selective updating of specific accounts only where the change favours the ratepayer is not equitable. Energy Probe agrees. Energy Probe submits that the update should reflect all accounts, for a total increase in the 2010 other distribution revenue forecast of $36,336. As this amount includes the $14,985 related to the streetlighting margin discussed above, the incremental increase is $21,351.

D - OM&A EXPENSES

Energy Probe has reviewed the change in OM&A costs on the basis of both an overall or envelope approach (part (a) below) as well as specific adjustments of individual expenses (part (b) below) arrived at through a more comprehensive review of the OM&A expenses.

a) Overall Increase in OM&A Costs

Festival Hydro is forecasting total OM&A costs, excluding depreciation, PILS and interest costs, of $3,968,610 for the 2010 test year (Exhibit 4, Tab 1, Schedule 1, Table 1). This is an increase of 2.7% in 2010 from the level of $3,863,171 forecast for the 2009 bridge year. This bridge year amount, in turn, was a forecasted increase of 4.6% over the actual level of OM&A costs recorded in 2008. Small increases in total OM&A costs were recorded in 2007 and 2008 of 1.6% and 0.2%, respectively.

Energy Probe submits that the increase of 2.7% forecast by Festival Hydro for the increase in the 2010 level of expenses as compared to the forecast for 2009 is the maximum increase that the Board should allow given the slowdown in the rate of inflation during the recession. Energy Probe is also concerned with the increase of 4.6% that was forecast for 2009. As the Board is aware, the increase for inflation allowed

distributors in 2009 based on the Implicit Price Index for National Gross Domestic Product (GDP-IPI) for Final Domestic Demand ("GDPIPIFDD") was an increase of 2.3%. As a result, the Festival Hydro increase in OM&A costs was double the level of inflation.

As noted above, the inflation rate has slowed during the recession. In particular, data from Statistics Canada indicates that the GDPIPIFDD increased by 2.8% on a year-over-year basis for the first quarter of 2009, 1.8% for the second quarter of 2009 and 0.6% for the third quarter of 2009. The fourth quarter information is not yet available. The average of the first three quarters of 2009 is 1.7% a full percentage point below the increase projected by Festival Hydro for the 2010 test year.

Applying an increase for inflation that is 50% higher than the 2.3% for 2009 and 1.7% for 2010 (i.e. 3.45% for 2009 and 2.55% for 2010) to the actual level of expenditures in 2008 of $3,693,585 would result in a 2010 total OM&A expense of $3,918,450. This is a reduction of just over $50,000 to the forecast by Festival Hydro.

In addition to the reduction from this envelope approach, Energy Probe submits that there is an additional reduction of $51,750 associated with the elimination of the provincial sales tax (see below). This reduction reflects that the envelope will no longer contain the costs associated with the provincial sales tax as of July 1, 2010.

In summary, Energy Probe submits that on a modified envelope basis, a reduction in the 2010 OM&A expense forecast of $101,750 is appropriate.

b) Specific Adjustments

The following is a list of adjustments that Energy Probe submits are reasonable in light of the evidence provided in this proceeding.

i) IFRS Costs

Festival Hydro has included an amount of $25,000 in the 2010 test year to cover the cost of transition to International Financial Reporting Standards ("IFRS") over four years for a total cost of $100,000 (Exhibit 4, Tab 2, Schedule 3, page 17).

In the response to Energy Probe Interrogatory #24, Festival Hydro indicated that the forecasted costs included both one-time transition costs as well as on-going compliance costs. Festival Hydro has agreed to reduce the costs included in the 2010 revenue requirement from $25,000 to $14,000 for on-going compliance costs only. The one-time transition costs would be recorded in a deferral account. Festival Hydro has reflected this $11,000 decrease in the summary of proposed changes shown in the response to Board Staff Interrogatory #48.

Energy Probe accepts the reduction as appropriate. Energy Probe would not be opposed to the inclusion of the $11,000 in the 2010 revenue requirement (and the estimate of $44,000 for one-time transitional costs) assuming that the deferral account would be changed to a variance account to track differences between the forecasted amount and actual one-time transitional costs related to IFRS.

ii) Rate Rebasing Costs

The total costs associated with this rates rebasing application have been forecast by Festival Hydro to be $160,000. Amortized over 4 years, the cost included in 2010 is $40,000. These figures are shown in the response to Energy Probe Interrogatory #23. Further, the interrogatory response indicates that the $160,000 in costs was based on a written process and did not include any costs associated with an oral hearing.

Energy Probe agrees that the amortization over 4 years is appropriate given the expected application of the IRM rates methodology for three years following this cost of service application.

Energy Probe submits that the total cost of $160,000 is too high. As shown in the following table, the approved regulatory costs associated with the 2009 rebasing distributors are on average lower than $160,000. As the table illustrates, the average approved cost is less than $130,000.

File No.	Distributor	Approved Regulatory Cost
EB-2008-0222	CNPI - Eastern Ontario Power	75,000
EB-2008-0223	CNPI - Fort Erie	100,000
EB-2008-0224	CNPI - Port Colborne	241,197
EB-2008-0225	Centre Wellington Hydro Ltd.	163,000
EB-2008-0226	COLLUS Power Corp.	140,000
EB-2008-0233	Innisfil Hydro Distribution System Limited	148,000
EB-2008-0234	Lakeland Power Distribution Ltd.	104,000
EB-2008-0236	Midland Power Utility Corporation	125,000
EB-2008-0237	Niagara-on-the-Lake Hydro Inc.	100,000
EB-2008-0241	Peterborough Distribution Inc.	50,000
EB-2008-0245	Thunder Bay Hydro Electricity Distribution Inc.	99,000
EB-2008-0246	Tillsonburg Hydro Inc.	106,000
EB-2008-0247	Welland Hydro-Electric System Corp.	95,000
EB-2008-0248	WestCoast Huron Energy Inc.	140,000
EB-2008-0250	Westario Power Inc.	240,000
	Average	128,413
	Average excl. two highest and two lowest	120,000
	Median	106,000

Note - Does not include costs for London Hydro, PowerStream, Bluewater or ENWIN. In each of these cases these distributors had Decisions or Settlement Agreements that approved an overall level of OM&A expenses, with no Board Approved or Settlement Amount related to the COS rebasing expense.

The above table reflects 2009 rates proceedings where the majority of the proceedings followed the same process as that for Festival Hydro. In particular, there were two rounds of interrogatories and no oral component to the proceeding. In some instances, such as the CNPI group of companies, there was an oral component to the proceeding that would have added to the total costs.

Energy Probe submits that a reduction in the rebasing costs is appropriate. Energy Probe submits that a 10% reduction to $144,000 is appropriate and is still more than 10% higher than the average Board approved costs approved for 2009 rebasers. The total reduction of $16,000 would result in a reduction to the 2010 revenue requirement of $4,000.

iii) Elimination of the Provincial Sales Tax

As noted below in Section F – Taxes, part c) HST Harmonization, Energy Probe submits that a reduction of $51,750 related to the elimination of the provincial sales tax effective July 1, 2010 is appropriate.

iv) LEAP Funding

Festival Hydro has included $12,000 for funding associated with the Low Income Energy Assistance Program (Energy Probe Interrogatory #25 (b)). Festival Hydro had previously included $4,400 for this expense, resulting in a net increase of $7,600 related to LEAP. It is not clear to Energy Probe if these are the only LEAP related incremental costs included in the revenue requirement. The evidence indicates that the administrative costs associated with Festival Hydro administering the LEAP program are included in collection costs (Exhibit 4, tab 2, Schedule 3, pages 17 & 18).

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Festival Hydro indicates that the incremental $7,600 is required to meet the requirements of guidelines of the Board. Festival Hydro has acknowledged that the Board's letter of September 28, 2009 indicated that the Board was deferring further work on LEAP as a result of a request from the Ministry of Energy (Board Staff Interrogatory #11). In that letter the Board noted that the Minister of Energy and Infrastructure requested that the Board not proceed to implement new support programs for low-income energy consumers in advance of a ministerial direction.

Festival Hydro, however, states that it *"**expects it will incur costs associated with development of the Ministry's integrated program**"* (Board Staff Interrogatory #11). As a result Festival Hydro has not agreed to remove these costs from the revenue requirement.

Energy Probe submits that this is not appropriate. The direction given by the Minister to the Board is clear. These costs should be removed. If and when a ministerial direction is provided the Board can deal with any costs to be incurred by the distributors through deferral accounts or a generic proceeding since this issue may affect all distributors in the province. As a consequence, the $7,600 in direct LEAP costs should be removed from the revenue requirement, as should any amount associated with the administration of the program.

v) Wage Increases

The evidence indicates that Festival Hydro forecast labour and benefits to increase by 3.0% for both the bridge and test years (Exhibit 4, Tab 1, Schedule 1, page 2).

Energy Probe submits that increases of 3.0% in both the bridge and test years are excessive given the inflation levels noted above of 2.3% for 2009 and 1.7% for 2010 based on three quarters of data from Statistics Canada. Energy Probe submits that a 2.0% increase for non-union employees in 2010 is appropriate for revenue requirement purposes. Based on the response to Energy Probe Interrogatory #21 (c), the impact of this increase in wages and benefits for non-union employees is a reduction in the 2010 revenue requirement of $40,000.

In summary, Energy Probe submits that a reduction in total wages and benefits costs to reflect the slowdown in the rate of inflation of $40,000 is appropriate.

vi) Summary

The following table summarizes the specific submissions of Energy Probe with respect to the reductions in OM&A proposed in this submission.

IFRS Costs	($11,000)
Rate Rebasing Costs	($4,000)
Elimination of the Provincial Sales Tax	($51,750)
LEAP Funding	($7,600)
Wage Increases	($40,000)
Total	($114,350)

The total shown in the above table of $114,350 approximates the $101,750 overall reduction in OM&A costs calculated by Energy Probe on an envelope approach applied to the 2008 actual level of OM&A costs presented earlier in this submission.

E - DEPRECIATION & AMORTIZATION

a) Depreciation Rates Used

Energy Probe submits that the depreciation rates used by Festival Hydro are consistent with the rates found in Appendix B of the 2006 Electricity Distributors Rate Handbook (Exhibit 4, Tab 7 & Tab 8), with the exception of Account 1908 Buildings & Fixtures. Instead of a 50 year life, Festival Hydro has used a 30 year life. Festival Hydro provided its reasoning for using the 30 year life estimate in the response to Board Staff Interrogatory #15 and indicated that the impact on the depreciation expense was $7,000 in the test year (Energy Probe Interrogatory #39).

Given the rationale provided and the limited impact of this deviation, Energy Probe submits that the Board should approve the Festival Hydro proposal.

b) Half Year Rule

In its evidence Festival Hydro indicates that it takes a full year's depreciation on capital additions during the year of purchase (Exhibit 4, Tab 2, Schedule 7). Energy Probe has reviewed the test year calculations provided in Exhibit 4, Tab 7, Schedule 7, Appendix C page 5 and confirms that Festival Hydro has calculated a full year of depreciation on the 2010 capital additions.

Energy Probe submits that Festival Hydro has failed to follow the Board's policy that has established the use of the half year rule for calculating the depreciation expense in the test year and has significantly overstated the 2010 depreciation expense.

In the EB-2008-0230 Decision and Order dated December 1, 2009 for Greater Sudbury Hydro Inc., the Board stated that it's *"policy has established the half-year rule for all electricity distributors and this has been implemented by all distributors in the 2008 and 2009 cost of service proceedings."* (page 28) Energy Probe submits that the Board should direct Festival Hydro to recalculate its depreciation expense based on the Board's policy and submit the details as part of the draft rate order.

Based on the information provide in Exhibit 4, Tab 2, Schedule 7, Appendix C, page 5, Energy Probe estimates that the reduction in the depreciation expense for the test year of using the half year rule applied to the capital additions shown would be approximately $94,000.

c) Changes to Capital Expenditures

If the Board makes any changes to the capital expenditure forecast for 2010, then Energy Probe submits that these changes should be reflected in the calculation of the depreciation expense calculated for the 2009 test year.

F - TAXES

Energy Probe submits that the distributor should calculate its income and capital taxes using the most recent information available, including tax rates that are expected to be applicable to 2010. This would include any changes that result from federal and provincial budgets that are known to the Board and other parties when the Decision is issued. Further, the appropriate tax rates should be applied. There are different federal and provincial tax rates that are applicable at different levels of taxable income.

a) Ontario Capital Tax

i) The Calculation

The calculation of the Ontario capital tax is shown in the response to Energy Probe Interrogatory #31 (a). The calculation reflects the use of the forecasted paid up capital for 2010 less the exemption of $15 million with the difference multiplied by 0.075%.

Energy Probe submits that this calculation is correct and should be accepted by the Board.

ii) Update to Rate Base

Energy Probe submits that if the paid up capital is changed as a result of the Board's Decision, then the capital tax calculation should also be updated to reflect this revised figure.

b) Income Tax

i) General Income Tax Rates

As shown in Exhibit 4, Tab 3, Schedule 1, page 97, Festival Hydro has used a federal tax rate of 18.0% and a provincial tax rate of 14.0% for 2010. The federal tax rate reflects a decline from 19.0% in 2009. The provincial rate of 14.0% reflects no change from the rate used in 2009.

Energy Probe accepts the federal rate of 18.0% as being appropriate, but submits that the 14.0% provincial general income tax rate is out of date.

In response to Energy Probe Interrogatory #33, Festival Hydro confirmed that the provincial tax rate will decline from 14.0% effective July 1, 2010 to 12.0%, resulting in an average tax rate of 13.0% for 2010.

It appears as if Festival Hydro has updated its revenue requirement in the Summary of Proposed Changes provided in the response to Board Staff Interrogatory #48. However, this cannot be confirmed as Festival Hydro shows a provincial tax rate of 12.3%. This rate would reflect both the 13.0% noted above for 2010 as well as a reduction associated with the provincial small business tax which is discussed below.

Energy Probe submits that the Board should direct Festival Hydro to use the general provincial income tax rate of 13.0% for 2010.

ii) Provincial Small Business Deduction and Surtax

The provincial small business deduction provides a lower provincial corporate income tax rate of 5.5% on the first $500,000 of business income. The benefit of this reduction is gradually phased out on taxable income between $500,000 and $1.5 million. This is achieved through the application of 4.25% surtax on taxable income between $500,000 and $1.5 million. If the taxable income is in excess of $1.5 million, there is no tax savings for a corporation as the claw back exactly offsets the reduction on the first $500,000 of taxable income.

Effective July 1, 2010, the small business tax rate is reduced from 5.5% to 4.5% on the first $500,000 of taxable income. The effective rate for 2010 is the average of these figures, or 5.0%. Also effective July 1, 2010, the surtax of 4.25% has been eliminated. For 2010, this means that the effective surtax rate applicable to taxable income between $500,000 and $1.5 million is 2.125%.

Energy Probe has estimated that these changes in the small business tax rates results in a reduction in income taxes payable for a distributor with taxable income in excess of $1.5 million to be $18,750 in 2010 (Energy Probe Interrogatory #34). Festival Hydro has regulatory taxable income in excess of $1.5 million for the 2010 test year as shown in Exhibit 4, Tab 3, Schedule 1.

The $18,750 reduction in taxes is the difference between the small business reduction and the claw back associated with the surtax, as explained below.

The reduction associated with the first $500,000 in taxable income reflects the difference between the 13.0% general provincial tax rate and the small business tax rate of 5.0%. This 8.0% differential in the tax rate, when multiplied by the $500,000, results in a reduction of $40,000. The surtax claws back a portion of this reduction. Application of the 2.125% surtax rate to the $1.0 million difference between the $500,000 and $1.5 million of taxable income results in a claw back of $21,250.

As indicated in the response to Energy Probe Interrogatory #34, Festival Hydro has indicated that it does not believe that this reduction is applicable to them. Festival Hydro states that this reduction would not have any impact on them because the taxable income is in excess of $1.5 million. Festival Hydro appears to believe this means that the claw back would eliminate all of the benefits of the reduction on the first $500,000 of taxable income. However, in the response to Energy Probe Interrogatory #51, Festival Hydro appears to acknowledge that there will be savings to them from the small business deduction.

As noted above, Festival Hydro has used an average provincial income tax rate of 12.3% in the response to Board Staff Interrogatory #48. This would appear to reflect the impact of the tax savings associated with the provincial small business deduction.

iii) Adjustments to Utility Income

Festival Hydro has made a number of adjustments to the utility income before taxes, as shown in Exhibit 4, Tab 3, Schedule 1, page 97. Energy Probe accepts these adjustments as appropriate, with the exception noted below.

As shown in the 2010 test year column in Exhibit 4, Tab 3, Schedule 1, page 97, Festival Hydro has added an amount of $3,900 to the accounting income for interest and penalties on taxes.

Energy Probe submits that the Board should disallow this $3,900 addition to income for calculating the regulatory taxable income. Ratepayers should not be expected to pay higher taxes because a distributor did not pay their taxes on time and are subject to interest and/or penalties on their taxes.

iv) Apprenticeship Tax Credit

As can be seen in the evidence at Exhibit 4, Tab 3, Schedule 1, page 1, Festival Hydro has not made any deductions to reduce taxes for available tax credits such as the Apprenticeship Training Tax Credit (federal or provincial), the Co-operative Education Tax Credit or the Investment Tax Credit, as these amounts are considered to be "immaterial".

In the response to Energy Probe Interrogatory #35, Festival Hydro has provided a forecast for the apprenticeship training and co-operative education tax credits for 2010. In particular the provincial apprenticeship tax credit is an amount of $20,000 and the co-op tax credit would be $0. In addition to the provincial apprenticeship tax credit, there would be a federal training tax credit of $2,000 (Energy Probe Interrogatory #52).

In addition to the inclusion of the tax credits as a direct reduction to the amount of tax payable, the tax credits need to be reflected as an addition to income. In other words, the net impact of the tax credits is the after tax value of the credits claimed. The federal tax credit claimed in any year is to be included in income in the following year. Festival Hydro appears to have done this as the response to Energy Probe Interrogatory #52 references the addback of $4,000 for the 2009 federal apprenticeship tax credit in 2010.

It is unclear to Energy Probe whether or not Festival Hydro has included the impact of these tax credits in its Summary of Proposed Changes in the response to Board Staff Interrogatory #48. The table provided in the response to that interrogatory in Appendix B lists a number of PILS related changes. However, inclusion of these tax credits is not among the items listed.

Energy Probe submits that the Board should direct Festival Hydro to apply these tax credits to the calculation of the PILs amount to be included in the revenue requirement.

Energy Probe also submits that the Board should direct Festival Hydro to provide a detailed calculation of PILs as part of its draft rate order to allow parties to confirm that all the changes have been correctly incorporated into the calculation.

v) Capital Cost Allowance

Energy Probe has reviewed the capital cost allowance schedules shown at Exhibit 4, Tab 3, Schedule 2 for 2009 and 2010 and believes they accurately reflect the capital additions for both years and the proper allocation of the capital expenditures to the CCA classes, with the exception of computer software (Energy Probe Interrogatories #29, 30 & 49). However, based on the amounts that are misclassified in each of 2009 and 2010, the correct classification appears to result in the same CCA claim for 2010 as claimed by Festival Hydro.

Energy Probe submits that any changes to the capital additions in 2009 and 2010 should be reflected as changes in the CCA additions.

vi) FMV Reduction in CCA

Festival Hydro has included a Fair Market Value ("FMV") reduction in the calculation of the 2009 capital cost allowance. This reduction is shown in Disallowed FMV Increment column in the 2009 CCA schedule shown on page 2 of Exhibit 4, Tab 3, Schedule 2. This reduction is then carried forward into the 2010 CCA calculation. Festival Hydro indicated that it was their understanding that this FMV bump should not be considered in the tax calculation for regulatory purposes (Energy Probe Interrogatory #32 (e)).

In the response to Energy Probe Interrogatory #50, Festival Hydro indicates that the FMV bump should not reduce the UCC balance in calculating the CCA used for tax purposes. Including the FMV in the CCA calculation increases the CCA deduction and reduces the tax expense in the test year by approximately $64,000. It appears that Festival Hydro has included this adjustment in the response to Board Staff Interrogatory #48 as one of the proposed changes that they accept. Energy Probe submits this adjustment is appropriate.

vii) Update to Regulatory Taxable Income

Energy Probe submits that if the regulatory taxable income is changed as a result of the Board's Decision, then the income tax calculation should also be updated to reflect the revised level of regulatory taxable income.

c) HST Harmonization

i) The Impact

The provincial sales tax ("PST") and the goods and services tax ("GST") have been combined into a harmonized sales tax ("HST") effective July 1, 2010. The PST is included as part of the expense included in an OM&A expense and as part of the cost of capital expenditures. This is different from the GST. The GST is not included as part of the cost of an OM&A expense or as part of the cost of a capital expenditure. The GST paid by a utility is a credit that is used an offset to the amount of GST collected. The difference between the amount collected and amount paid is remitted to the government.

The HST will operate in a similar manner to the GST. The effect of this change for businesses will be a reduction in OM&A expenses and capital expenditure costs related to the PST.

In response to Energy Probe Interrogatory #1, Festival Hydro provided an estimate of the costs related to the PST included in OM&A and capital expenditures for the 2010 test year. Based on one representative month, Festival Hydro paid $11,500 in PST. Approximately 25% of this amount was capitalized. These figures translate into annual costs of $103,500 in OM&A costs and $34,500 for capital expenditures. Festival Hydro also indicated that it had not made any adjustments to either the OM&A expense forecast or the capital expenditure forecast to reflect the elimination of the PST effective July 1, 2010.

Energy Probe submits that the OM&A expense forecast for 2010 should be reduced by one-half of the forecasted PST cost of $103,500, or $51,750 to reflect the July 1, 2010 implementation date for the HST. Similarly, Energy Probe submits that the capital expenditures should be reduced by one-half of the $34,500 or $17,250.

ii) Need for a Variance Account

As indicated in the responses to Energy Probe Interrogatory # 41 and Board Staff Interrogatory #47, Festival Hydro does not accept that accurate accounting entries could be made in such a deferral/variance account if it were established.

Energy Probe respectfully submits that the establishment of a variance account to track the difference between any expenses incurred for which PST would have been paid and for which the distributor is now eligible for an HST input tax credit and the expenditure reductions forecast by Festival Hydro is appropriate. It will provide necessary protection to both the distributor and its ratepayer from a government mandated change.

One possible way to avoid the issues described by Festival Hydro would be to track the actual PST invoiced to Festival Hydro from January 1, 2010 through June 30, 2010 and use that as a proxy for the reduction to be experienced in the second half of 2010. Any variance between that amount and the amounts calculated above would be cleared to/from ratepayers in the future.

d) Property Taxes

Festival Hydro is forecasting a property tax expense of $30,000 in the test year (Exhibit 4, Tab 3, Schedule 2, Table 17). Given the level of property taxes in previous years, Energy Probe submits this amount is appropriate and should be accepted by the Board.

G - LOSS ADJUSTMENT FACTOR

Festival Hydro has calculated its total loss factor based on the average wholesale and retail kWh for a five year historical period from 2004 through 2008 (Exhibit 8, Tab 1, Schedule 1, Appendix 2-Q). The average total loss factor is 1.0307 over this period.

Festival Hydro is requesting an increase in the supply facility loss factor ("SFLF") from 1.0045 to 1.0075. This requested figure is a weighted average of the 1.0045 charged for the IESO connected points and 1.0340 for the embedded metering points from Hydro One. Festival Hydro indicated that due to an oversight in previous filings it had used the 1.0045 SFLF (Board Staff Interrogatory #25).

Energy Probe submits that the total loss factor as estimated by Festival Hydro for 2010 is appropriate, as is the request to increase the SFLF to 1.0075.

H - COST OF CAPITAL

The EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities dated December 11, 2009 indicates that the result of the Report is Board policy and that the process was not a hearing process that did not, and indeed could not, set rates. The Report goes on to state that the refreshed cost of capital policies will be considered through rate hearings for the individual utilities, at which it is possible that specific evidence may be proffered and tested before the Board. Specifically, the Report states:

> *"Board panels assigned to these cases will look to the report for guidance in how the cost of capital should be determined. Board panels considering individual rate applications, however, are not bound by the Board's policy, and where justified by specific circumstances, may choose not to apply the policy (or a part of the policy)."* (page 13)

Energy Probe submits that based on the December, 2009 Report of the Board and the evidence on the record in this proceeding there are two adjustments that Board should make to the cost of capital for the distributor. The first of these adjustments relates to the deemed capital structure and the second relates to the allowed return on equity.

a) Deemed Capital Structure

Short-term debt was not factored into electricity distribution and transmission rate-setting prior to 2008. As part of the December 20, 2006 Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors, the Board adopted a deemed short-term debt component of 4% of the capital structure. As part of that Board Report, the Board stated:

> *"As a general principle for ratemaking purposes, the Board believes that the term of the debt should be assumed to be similar to the life of the assets that are to be acquired with that debt. This suggests that, in theory, for an industry with long-lived assets, the majority of debt should be long-term. However, in reality, some short-term debt is a suitable tool to help meet fluctuations in working capital levels."* (page 10)

As noted in the December, 2009 Report of the Board, capital structure was not a primary focus of the consultation. The Board determined that the split of 60% debt and 40% equity is appropriate for all electricity distributors (page 50). The Board did not explicitly state that the 60% debt component of the capital structure should remain at 56% long term debt and 4% short term debt, although Table 2 provided in the Summary section of the Board Report reflects the continuation of these figures.

Energy Probe submits that the evidence in this proceeding indicates that the 4% deemed level of short-term debt is not reasonable and that the incremental costs imposed on ratepayers by this are neither just nor reasonable.

Energy Probe agrees with the Board's comments provided in the December, 2006 Report of the Board that the term of the debt should mirror the life of the assets that the debt is used to finance. By its very nature, equity is long-term financing. This leaves the mix of long-term and short-term debt to be used to provide an appropriate balance within the capital structure to reflect the actual mix of assets being financed.

As noted by the Board in the December, 2006 Report, short-term debt is a suitable tool to help meet the fluctuations in working capital levels. As explained in Exhibit 2, Tab 4, Schedule 1, page 1 the working capital allowance has been calculated using the 15% factor. This effectively represents in average lag of 54.75 days between when a distributor pays its expenses and when they collect revenue from the customers. This reflects the short-term nature of the working capital.

As illustrated in Table 1 of Exhibit 2, Tab 1, Schedule 1 the working capital allowance component of rate base in 2010 is $7,335,724. This represents 18.5% of the total rate base of $39,583,651. The same exhibit illustrates that this percentage has been very stable. Over the 2006 through 2008 period, the actual percentage has averaged 19.5%.

At the same time, using the 4% deemed shot-term debt component to finance total rate base, the deemed amount of short-term debt is only $1,583,346 in 2010 (Exhibit 5, Tab 1, Schedule 2, page 2). The resulting shortfall in deemed short-term debt in 2010 as compared to the working capital level is $5,752,378.

Energy Probe submits that this mismatch between the level of deemed short-term debt and the working capital level included in rate base is not appropriate. The distributor is effectively financing short term assets through long-term debt. This means that ratepayers are being asked to pay long-term interest rates on short-term assets.

The impact on the revenue requirement of this unjustified mismatch can be calculated based on the difference between the long-term and short-term interest rates as shown in Exhibit 5, Tab 1, Schedule 2. In particular, the following table utilizes the long-term debt rate of 7.40% and the short-term debt rate of 1.33%.

	2010
Long-term Debt Rate	7.40%
Short-term Debt Rate	1.33%
Difference	6.07%
Deemed Shortfall	$5,752,378
Interest Cost Impact	$349,169

Energy Probe is aware that the differential between the long-term and short-term interest rates is likely to be substantially less than that shown in the above table, based on the methodologies to be used as described in the Board's December, 2009 Report. The difference in the rates is likely to be around 3.0%. Even at this lower differential, the interest cost impact is nearly $173,000. This amount represents a significant proportion of the total revenue requirement of just over $10,371,888 (Board Staff Interrogatory #48).

As noted above, the distributor is effectively financing a significant portion of short-term assets with long-term financing at a higher rate. It has a significantly different level of short term working capital levels in relation to rate base than a deemed short-term debt component of 4% would imply.

Energy Probe submits that it is neither just nor reasonable for the Board to expect ratepayers to pay long-term interest costs to finance short-term assets. This is no more appropriate that if the distributor applied a high depreciation rate associated with computer software to a long lived asset such as poles that should have a low depreciation rate. In both cases the resulting revenue requirement is artificially inflated.

As noted earlier, the Board, in its December, 2009 Report indicated that panels assigned to individual utility rate cases are not bound by the Board's policy where justified by specific circumstances. Energy Probe submits that the evidence is clear. A 4% deemed short-term debt component is not appropriate when the distributor has a short-term asset component of rate base of more than 18%.

It should be noted that the distributor has actual long-term debt of $18.1 million (Energy Probe Interrogatory #36 (b)). The difference between the deemed long-term debt and the level of actual long-term debt is more than $4 million. If this amount was simply classified as short-term debt, the short-term debt component of rate base would increase to about 14.1%, much closer to the appropriate level. Based on a 3.0% differential in rates, this would reduce the revenue requirement by about $120,000.

It should also be noted that moving the difference between the deemed long-term debt and the actual level of long-term debt to short-term debt has no negative impact on the distributor since it does not have an actual cost associated with the unfunded long-term debt.

Finally, Energy Probe notes the Board's comments at page 52 of its December, 2009 Report:

> *"The Board wishes to emphasize that the long-term debt guidelines relating to electricity distribution utilities are expected to evolve over time and are expected to converge with the process used by the Board to determine the amount and cost of long-term debt for natural gas distributors."*

Energy Probe submits it is time for the evolution to begin.

b) Allowed Return on Equity

The Board has determined a methodology to determine the return on equity as part of the December, 2009 Board Report. Based on this methodology and based on the September, 2009 information the return on equity would be 9.75%. This figure will be updated by the Board based on January, 2010 information.

The Board determined the 9.75% figure based on a long term Government of Canada bond yield of 4.25% and an initial equity risk premium of 550 basis points. This equity risk premium includes an implicit 50 basis point for transactional costs (page 37 of the December, 2009 Report). This is the same amount included in the equity risk premium as determined in the Boards December, 2006 Report. In that Report the Board noted that

it would continue to include an implicit premium of 50 basis points for floatation and transaction costs. The Board further noted that this inclusion had been the case ever since the Board first introduced the premium in the early 1990s.

Flotation costs of capital are applicable in cases where a particular distributor releases some new stocks in the market or if it issues debt. These costs generally consist of charges for underwriters, commissions to be paid to brokers, legal fees and cost of administration.

As shown in Exhibit 5, Tab 1, Schedule 1, page 2, the common equity forecast for 2010 is $15,833,460. Based on this figure, the 50 basis point allowance for the floatation and transactional costs represent a significant amount of the revenue requirement. This cost amounts to $79,167 and when grossed up for taxes is more than $114,000.

Energy Probe submits that inclusion of the implicit 50 basis points for transactional costs is not appropriate for this distributor. There is no evidence to support that the distributor expects to incur any floatation or transaction costs in the test year. There simply is no evidence to suggest that this distributor will incur any of these costs.

As noted above, the inclusion of some provision for floatation or transactional costs in the equity risk premium component of the return on equity has been long standing at the Board, and indeed, at other regulators across North America. Energy Probe submits that distributors that have such costs should be able to recover them. Energy Probe makes no comments as to whether an allowance of 50 basis points is appropriate, is too high, or is too low. In any case, that is irrelevant in the current situation.

The evidence in this proceeding is that the cost for this distributor is $0.

As noted earlier in the submissions on the capital structure, the Board panel assigned to individual utility rate cases are not bound by the Board's policy where justified by specific circumstances.

Energy Probe submits that the evidence is clear. The specific circumstance in this case is that there are no floatation or transaction costs associated with equity that needs to be recovered from ratepayers.

The Board should not, indeed cannot, allow a distributor to recover costs that the Board knows do not exist. To do so would not result in just and reasonable rates.

The Board would not allow a distributor to include a capital expenditure that it knew would not take place in the test year to be added to rate base. The Board would not allow a depreciation expense to be included in the revenue requirement if that depreciation expense was calculated on an asset that did not exist. The Board would not allow an OM&A expense to be included in the revenue requirement if the evidence indicated that the money would not be spent or the addition to staff was not going to take place. The Board would not allow a cost of debt of 6% if the evidence indicates that the forecasted cost of debt for the test year is 5.75%. Why would the Board allow recovery of any cost that the evidence clearly indicates does not exist?

Energy Probe submits that it would be grossly unfair to ratepayers to expect them to pay for equity-related costs that do not exist.

Energy Probe also submits that this would be unfair to other distributors that do have floatation and transaction costs. In the case of such a distributor, it would earn 9.75% on its deemed equity and some portion of that would be related to costs that were actually incurred. If the 50 basis point allowance is appropriate and accurate, then the shareholder effectively earns an after cost return on equity of 9.25%. The shareholder of the distributor that has no such costs, however, is allowed to earn an after cost return on equity of 9.75%.

Energy Probe submits that the Board should not discriminate on this basis. Shareholders of all distributors should be allowed the opportunity to earn the same after cost return on equity.

c) Short Term Debt Rate

Energy Probe submits that the short term debt rate should be updated to reflect the Board's methodology as outlined in Appendix D of the EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities.

d) Long Term Debt Rate

Festival Hydro has two promissory notes with its shareholder, the City of Stratford in an aggregate amount of just under $14.5 million. Festival Hydro is forecasting the addition of $2.5 million in long-term debt from Infrastructure Ontario in the test year.

Festival Hydro indicates that since the promissory notes are with an affiliate and is callable on demand, it is requesting a return on this long term debt in the test year of 7.62%, subject to the update of this rate to reflect January, 2010 market information.

Energy Probe submits that all of the affiliate long term debt held by Festival Hydro is from an affiliate and is callable within the test year. As such, the deemed long term debt rate as calculated based on the methodology outlined in Appendix C of the EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities should apply to this debt.

The Infrastructure Ontario loan will have a 15 year term (Exhibit 5, Tab 1, Schedule 1). The interest rate quoted as of June 16, 2009 on the Infrastructure Ontario website was 5.04%. However, Festival Hydro used a forecast of 6.0% to allow for volatility between when the evidence was filed and when the loan is drawn in 2010.

As of the date of the first round of interrogatory responses (November 23, 2009), the applicable Infrastructure Ontario rate had fallen to 4.72% (Energy Probe Interrogatory #36 (c)). This rate has remained at or near this level since that time. As of January 15, 2010 the rate on the Infrastructure Ontario website for a serial loan with 15 year term was 4.63%, while that for an amortizer loan was 4.73%. Energy Probe submits that the Board should use the rate of 4.72% for the $2.5 million loan from Infrastructure Ontario as this is the most recent figure available and appears to be in line with current rates.

I - DEFERRAL AND VARIANCE ACCOUNTS

a) Accounts and Amounts to be Cleared

Energy Probe submits that the accounts and the amounts proposed to be cleared by Festival Hydro as shown in page 5 of Exhibit 9, Tab 1, Schedule, are appropriate with one exception related to the accounts and one exception related to the amounts.

The one exception related to the accounts relates to Account 2405 Other Deferred Credits. Festival Hydro has indicated that they are not requesting disposition of this account and that it was included in the table of accounts requested for disposition in error (Board Staff Interrogatory #35). The amount requested for disposition is therefore $2,149,357 rather than the figure of $2,167,527 shown in the table. Energy Probe accepts this change as being appropriate.

The one exception related the amount concerns the interest rate used by Festival Hydro to calculate the interest on the accounts from January 1, 2010 through April 30, 2010. In particular, as shown in page 4 of Exhibit 9, Tab 1, Schedule 2, Festival Hydro has used a rate of 1.0% which was the Board's prescribed interest rate for the second quarter of 2009. Energy Probe submits that the interest for the January 2009 through April 2010 period should be based on the rates of 2.45% in the first quarter of 2009, 1.0% for the second quarter of 2009 and 0.55% for the subsequent periods to match the actual prescribed rates.

b) Allocation to Customer Classes

Energy Probe accepts the allocation of the amounts to be recovered/rebated to customers and the calculation of the associated rate riders, including that associated with the Global Adjustment sub-account as provide by Festival Hydro in Exhibit 9, Tab 1, Schedule 2, Appendix A.

Energy Probe submits that the Board should adopt a separate rate rider for recovery of the Global Adjustment sub-account whenever the distributor is able to apply different rate riders to different customers within a rate class, as this follows the cost causality principle. However, Energy Probe is concerned with the potential costs that may be incurred to do this and that these costs may outweigh the benefits in the test year.

At the same time, however, Energy Probe is aware that the Global Adjustment is an adjustment sub-account is likely to have balances that need to be cleared on an annual basis going forward. Over the long term, therefore, a significant expenditure may be justified. Energy Probe submits that the Board should direct Festival Hydro to investigate the cost of being able to have different rate riders for different customers within a rate class.

The Board should initiate a consultative to review who can and who cannot dispose of the Global Adjustment to non-RPP customers only, and what is the likely cost and benefits for those distributors and their ratepayers that currently cannot follow the principled approach.

c) Recovery Period

Festival Hydro proposes to dispose of the balances in the deferral and variance accounts over a four year period (Exhibit 9, Tab 1, Schedule 2, page 4). Energy Probe accepts this proposal given the overall impact on bills.

J - COST ALLOCATION & RATE DESIGN

Energy Probe submits that the revenue to cost ratios shown in Exhibit 7, Tab 1, Schedule 2, Appendix 2-P and as amended in the response to Board Staff Interrogatory #20 to correctly reflect the transformer ownership allowance are all within the Board approved ranges with the exception of the street lighting, sentinel lighting, USL and residential Hensall class.

Energy Probe submits that the Board should direct Festival Hydro to reduce the USL ratio to 120% in 2010 and to move the ratios for the street lighting and sentinel light classes 50% of the way to the 70% bottom of the approved Board range.

Energy Probe further submits that the Board should direct Festival Hydro to move the street lighting revenue to cost ratio to the bottom of the Board approved range of 70% over the following two years rather than a three year horizon shown in the response to Board Staff Interrogatory #42.

Consistent with past Decisions of the Board, Energy Probe does not support the movement of revenue to cost ratios that are within the Board approved range closer to unity unless the movement is to reduce the ratio for some classes. The additional revenue created by moving the street lighting and sentinel light classes to the bottom of the approved range should be used to bring down the ratio for the classes that are above unity. These additional revenues should be allocated to as to bring down these ratios at the same rate.

With respect to the residential – Hensall rate, Energy Probe submits that the increase proposed by Festival Hydro in the 2010 test year is too high. Energy Probe submits that the ratio for this class should be increased to 82.65% or whatever level results in a 10% total bill impact for the smallest customers. This ratio should then be increased in each of 2011 through 2013 such that the maximum impact on the smallest customers is a 10% total bill impact. Energy Probe submits that this is a reasonable approach to use to harmonize the residential and residential – Hensall rates.

In addition, Energy Probe submits that any additional revenue generated from the increase in the residential – Hensall rate class should be allocated in its entirety to reducing the residential revenue to cost ratio. Since these rates are to be harmonized, increasing the Hensall ratio and decreasing the residential ratio will move the rates together.

K - SMART METER FUNDING ADDER

Festival Hydro is proposing to continue to use the current approved smart meter adder of $1.00 per meter per month for 2010 rates (Exhibit 9, Tab 1, Schedule 4, page 1). Energy Probe supports this proposal.

L - COSTS

Energy Probe requests that it be awarded 100% of its reasonably incurred costs. Recognizing the size of Festival Hydro, Energy Probe has attempted to minimize its time on this application, while at the same time ensuring a thorough review.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

January 27, 2010

Randy Aiken

Consultant to Energy Probe