EB-2009-0139

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

February 19, 2010

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1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 On August 28, 2009 Toronto Hydro Electric System Limited filed an application for new distribution rates commencing May 1, 2010. The Application, after a number of adjustments including in particular changes in the cost of capital, sought a substantial overall increase in rates, which would have resulted in a net increase in the distribution bills for schools in Toronto of about 32%.

1.1.2 As a result of a successful ADR process, all issues in this proceeding (except for four) were settled. The comprehensive settlement agreement was filed on January 22nd, and was accepted by the Board on February 4th. The four remaining issues are as follows:

(i) Cost of capital, including capital structure, cost of debt, and return on equity.

(ii) Provisions for combined heat and power projects in the City of Toronto.

(iii) Smart sub-metering policies and practices.

(iv) Sales of real estate assets.

1.1.3 This is the Final Argument in this matter on behalf of the School Energy Coalition on the issues that have not been settled.

1.1.4 In preparing this Final Argument, we have benefited with respect to the fourth issue from a review of the excellent Staff Submission dated February 18, 2010. We have also been able to discuss and/or review drafts with respect to the submissions of BOMA, VECC, and CCC. All of these have been most helpful in either limiting the scope of these submissions, or reducing the time required.

2 COST OF CAPITAL

2.1 *General*

2.1.1 The Board will be aware of our concerns with the Report of the Board dated December 11, 2009 on the cost of capital. By its terms it is a policy document, and it was clearly not based on evidence properly delivered and tested. Therefore by its terms it is not binding on this or any other panel of the Board. Notwithstanding these facts, as a practical matter it is clear – and we saw this in the Hydro One Distribution case recently – that the Board intends to treat the conclusions in that Report as if they were properly based on evidence and therefore could form an appropriate basis for setting rates.

2.1.2 We have not at any time hidden our disagreement with this state of events, nor have we changed that view. In our opinion, substantial across-the-board rate increases such as this one (4.4% on average) without a proper evidentiary foundation undermine the reputation of the Board as the objective and independent regulator of the energy sector.

2.1.3 That having been said, it is not in our view useful for us to "rail against the injustice of it all", as if that would somehow change reality. It is what it is, and in these submissions we are assuming that the Cost of Capital Report will form the core of this Board panel's decision with respect to the Applicant's cost of capital for the test year. Nothing in these submissions should be interpreted as agreement by SEC with the manner in which this substantial across-the-board rate increase was determined, merely acceptance of the reality for the purpose of analyzing the specific circumstances of the Applicant.

2.1.4 That having been said, within the parameters of the Cost of Capital Report there remain, in this proceeding, three issues relating to Toronto Hydro's cost of capital that should be resolved:

(i) ***Percentage of Short Term Debt***. What percentage of rate base should be designated as financed by short term debt for the purposes of determining overall cost of capital?

(ii) ***50 Basis Points Flotation Allowance***. To what extent should the Applicant be entitled to claim from ratepayers a flotation allowance that it will not in fact incur?

(iii) ***Effective interest rate on new long term debt***. What evidence does the Board have on which to base the expected cost of new long term debt, particularly in the context of the changes in the ROE?

2.1.5 We will limit our submissions on the cost of capital to those three issues.

2.2 *Percentage of Short Term Debt*

2.2.1 One aspect of the Cost of Capital Report with which we agree is the drive toward convergence of the cost of capital principles used for the gas distributors and those used for the electricity distributors. Central to that is the expectation that cost of capital

components for electricity distributors will increasingly be tested against market realities. This is a welcome change. It suffers from the same weakness as the new ROE formula – lack of evidence – but given that we are accepting the Report for the purposes of these submissions, this new direction should also apply in this case.

2.2.2 The most obvious component of rate base that should be financed with short term debt is the working capital allowance. By its nature, the working capital allowance is the backstop for short-term cash requirements of a utility. In a commercial company, working capital is financed by demand loans from the bank or, in larger firms, bankers acceptances. This component of corporate financing needs to have maximum flexibility, because the cash needs it is financing are the most immediate and variable.

2.2.3 The Board deems short term debt at 4% of rate base. However, for the Applicant the working capital allowance is 12.8% of rate base. That being the case, in our submission the cost of capital on 12.8% of rate base should be the short term debt rate. On the evidence in this proceeding, that rate is 2.30%.

2.2.4 It is therefore submitted that the cost of capital for 12.8% of the Applicant's rate base should be 2.30%.

2.2.5 That is not the end of the issue, however. There remains 87.2% of rate base that has to be allocated between long term debt and equity. Both of these components of financing are long term in nature, and thus finance the bulk of the assets of the utility, which are by their nature long term.

2.2.6 As a matter of policy, the Board has established that the ratio of long term debt to equity is 56:40, since under the "plain vanilla" approach the remaining 4% is short term debt.

2.2.7 If the same ratio is maintained, consistent with Board policy, the result should be that long term debt should be 50.9% of rate base, and equity should be 36.7% of rate base.

2.2.8 Thus, in our submission the cost of capital for the Applicant should be calculated on the following basis:

(i) Long term debt: 50.9%

(ii) Short term debt: 12.8%

(iii) Equity: 36.3%

2.2.9 It is therefore submitted that the cost of capital should be recalculated consistent with this more appropriate capital structure, and consistent with the submissions below on the cost of equity and the cost of long term debt.

2.2.10 We note that, if the Board agrees with our recalculation of the capital structure consistent with Board policy, then there will be an additional decrease in the amount of PILs payable in the test year (and thus recoverable from ratepayers in rates).

2.3 *Cost of Equity*

2.3.1 It is a general principle of cost of service ratemaking that, if a utility has a cost to serve the customers of its regulated business, it can recover that cost from those customers. The converse is that the utility does not recover a cost that it will not actually incur.

2.3.2 There are exceptions to this rule. For example, the Board deems a certain working capital level, and the costs associated with that deemed level are not reviewed to see if they are actually incurred. However, in every case those exceptions are ones in which an industry average or standard is identified, and each individual utility could be above or below that average. What the Board does is deem the amount of the cost, not the cost itself. This is true in virtually every case in which cost of service is based on deemed rather than actual costs.

2.3.3 In the current situation, the Board calculates the fair return on the equity of electricity distributors using a formula that results – currently – in 9.75%. That 9.75% is not the actual fair return. Rather, it is made up of two components: an actual fair return of 9.25%, plus a cost of 0.50% to achieve that return. The latter cost, called the flotation allowance, is the amount that a utility is assumed to spend annually, on an amortized basis, to issue equity securities.

2.3.4 In our submission, the Board's policy allows two different recovery amounts with respect to equity

(i) A "fair return", currently established by formula at 9.25%, reflecting compensation for the shareholder's risks in funding the distributor under a given assumed capital structure; and

(ii) An assumed amount of out of pocket costs – 50 basis points – relating to the amortized costs for the issuance and maintenance of equity capital.

2.3.5 In this case, the above-mentioned out of pocket costs that form part of the Board's policy are not in fact being incurred, and the Applicant admits it [Tr1:34].

2.3.6 Therefore, it is submitted that the Applicant should be entitled to include in rates the 9.25% net return on equity that reflects the fair return standard as the Board has determined it. This amount will fully compensate the Applicant under the fair return stand.

2.3.7 But, the Applicant should not be entitled to include in rates costs associated with issuing and/or maintaining equity that it will not in fact incur. This is just a cost recovery. These costs do not need to be recovered, because they do not exist.

2.4 *Cost of Long Term Debt*

2.4.1 The Applicant calculates its long term debt costs with the assumption that it will issue $200 million of new 30 year debt in June, 2010, at 5.79%, calculated as long Canadas plus 205 basis points. In this, the Applicant is assuming that the cost of 30 year debt will

increase by 20 basis points between November 2009 and June 2010.

2.4.2 We have four problems with this forecast:

(i) The forecast does not take into account the fact that, with a substantially higher ROE, the Applicant will have improved interest coverage and other revenues, which will reduce the annual borrowing costs.

(ii) The forecast does not reflect the fact that the Applicant's borrowing in 2010 is expected to be less, with the result that its overall creditworthiness should be higher and thus its unit costs of debt should be lower.

(iii) The forecast does not reflect the upgrading of the Applicant's credit rating from A trend to A stable.

(iv) The forecast is not consistent with the current Infrastructure Ontario interest rates for the same time period, which at present are about 5.3% for thirty-year money. Even if this increases by the 20 basis points that the Applicant projects to June 2010, that still leaves 5.50% money available to the Applicant in June 2010.

2.4.3 In our submission:

(i) The Board should reduce the forecast cost of the debt to be issued by the Applicant in 2010, and the amount of the reduction should be a net of about 29 basis points, which assumes an interest rate in June 2010 of 5.50%, representing the current Infrastructure Ontario thirty year rate, plus the increase in the overall debt market of 20 basis points, currently anticipated in 2010; and

(ii) The Board should reduce the forecast cost of the debt to be issued by the Applicant in 2010 by a further 20 basis points, representing the combination of a) the substantially improved debt service ratios that the Cost of Capital Report provides, b) the fact that the Applicant's credit rating has increased over the last twelve months, and c) the fact that the Applicant will be borrowing less in 2010 than it originally planned.

2.4.4 We are conscious that this latter 20 basis points reduction we have proposed is not rooted in the evidence. This is true, but we note that the onus is on the Applicant to support the cost of debt. The Board will be aware that the improved debt service ratios, the higher credit rating, and the lower borrowing, will together reduce, as a matter of normal market forces, the cost of long term debt. Since the Applicant has not provided evidence on the reductions that any of those factors will cause, the Board is forced to determine a reasonable amount. In our submission, 20 basis points is a reasonable, if perhaps conservative, amount to reflect these lower borrowing costs.

2.4.5 We are also conscious that the use of the Infrastructure Ontario debt rate may already take into account the higher creditworthiness than the Applicant has enjoyed in 2009, continuing and expanding n 2010, and therefore that the 20 basis points we have suggested may already be subsumed in the Infrastructure Ontario rate, in whole or in part. Due to the

paucity of the evidence, we simply have no basis on which to conclude whether these matters are connected, and if so in what way.

3 COMBINED HEAT AND POWER

3.1 *General*

3.1.1 The School Energy Coalition is concerned that combined heat and power be afforded appropriate support – including infrastructure spending by electricity distributors – particularly in urban areas. That having been said, in general recent government policy initiatives have provided significantly more support for renewable energy generation than for CHP.

3.1.2 Thus, while we support in principle the positions of Pollution Probe on this group of related issues, we believe that the Board should await a policy signal from the provincial government before embarking on major changes relating to support for CHP projects.

3.1.3 This does not mean that the Board should reject the proposals of Pollution Probe. Rather, we propose that the Board assess those proposals on the basis of existing Board responsibilities and initiatives. To the extent, for example, that changes to the Applicant's operating approach benefiting CHP are consistent with existing regulatory policies, we believe the Board should support them. On the other hand, to the extent that the proposals of Pollution Probe seek to extend indirectly the statutory framework currently applied to renewables to CHP, much as we may think that is a good idea we do not think that the Board should be initiating such an extension.

4 SMART SUB-METERING

4.1 *General*

4.1.1 We have long thought it important as a matter of principle that, when utilities engage in contestable activities, they should be held to a strict market discipline preventing them from using their preferred (i.e. regulated utility) status to gain any market advantage. This keeps both rates, and the cost of energy services in the market, down to reasonable levels. We know this is the Board's view as well.

4.1.2 This issue is on the Issues List to ensure that the Applicant's approach to smart submetering does not run afoul of this principle.

4.1.3 We have no submissions on the specific aspects of the Applicant's policies and practices, nor on the submissions of the Smart Sub-Metering Working Group. This is a complex issue driven by its facts. As the Board determines those facts, our only submission is to urge the Board to follow the contestability principle we have noted. Smart sub-metering is contestable, and the Applicant should not be allowed to use its preferred status to influence the market for this contestable service.

5 SALE OF REAL ESTATE ASSETS

5.1 *General*

5.1.1 This issue is about whether utilities act as the Board directs, and whether by appealing a Board decision a utility can outlast the forecast facts, and later seek to apply the real facts as they unfolded. It is also about whether a sensible and practical solution should be implemented in the face of that more general principle.

5.1.2 The situation has been well described in the Staff Submission. In the end, the question boils down to this: should the utility be required to implement what the Board has already ordered (especially since they appealed fully, and lost completely, on this)? Or, if the facts as they unfolded have been different from those on which the original Board order was based, should the utility be allowed a less onerous implementation that is consistent with the facts as they actually happened?

5.1.3 This is a very difficult question. On the one hand, the Board should be vigilant in ensuring that its orders are respected. "Appeal as much as you want," the Board should say, "but in the end do what you are ordered to do." On the other hand, the Board is supposed to be practical and realistic, and insisting that a utility do something that is simply contrary to reality does not support that reputation.

5.1.4 Against this background, our conclusion is that in this particular case, the principle is more important than the pragmatic result. The suggested resolution by the Applicant is sensible and protects both the ratepayers and the utility. However, it is not consistent with the Board's order, against which the Applicant appealed and lost (and not just once).

5.1.5 In our submission, in order to protect the integrity of the Board's processes, and to enforce respect for the Board's orders, the Board should require specific compliance with the original decision, according to its terms. The fact that reality did not unfold as forecast should not be relevant to compliance with that Board decision.

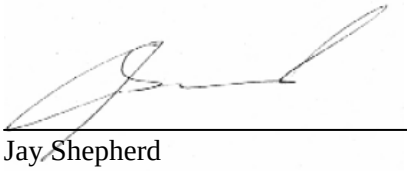
5.1.6 One part of us says "This is silly", since in the end the gain on sale will not be the amount forecast, and some amount will have to be clawed back. This is not optimal, but the alternative is for the Board to send the message to regulated entities that you can "wait out" a Board decision through the appeals process, and even if you lose the appeal maybe never have to comply with that decision. This is not a good message to send to the entities the Board regulates.

6 OTHER MATTERS

6.1 *Costs*

6.1.1 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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