EB-2009-0139

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

AND IN THE MATTER OF an Application by Toronto Hydro-Electric System Limited for an Order or Orders approving or fixing just and reasonable distribution rates and other charges, effective May 1, 2010.

REPLY SUBMISSIONS OF TORONTO HYDRO-ELECTRIC SYSTEM LIMITED

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DELIVERED FEBRUARY 24, 2010

A. INTRODUCTION

1. Toronto Hydro-Electric System Limited ("THESL") is pleased to file these reply submissions in connection with its application for 2010 electricity distribution rates (the "Application").

2. THESL confirms and adopts the submissions made in its February 12, 2010 Argument-in-Chief and has limited its reply submissions to responding directly to submissions made by Board Staff on February 18, 2010 and by the Building Owners and Managers Association of the Greater Toronto Area ("BOMA"), the Consumers Council of Canada ("CCC"), the Energy Probe Research Foundation ("Energy Probe"), Pollution Probe Foundation ("Pollution Probe"), the School Energy Coalition ("SEC"), the Smart Sub-metering Working Group ("SSMWG") and the Vulnerable Energy Consumers' Coalition ("VECC") on February 19, 2010. THESL received no final submissions from AMPCO, CUPE Local One, and the OPA.

3. No party in this proceeding has objected to any component of the Settlement Agreement, accepted by the Board at the outset of the oral phase of the hearing,

after the oral hearing and intervenor argument phase have concluded. THESL is pleased to see that the collective efforts of the utility and the intervenors to conclude a reasonable agreement during the settlement process have succeeded in greatly limiting the scope of issues that the Board must now consider in this proceeding. THESL submits that the Board should adopt the Settlement Agreement as its findings on the settled and partially settled issues contained therein.

4. THESL has organized the remainder of its reply submissions in the same manner as its Argument-in-Chief, addressing the following issues which were raised by staff and intervenors in their submissions:

(a) Cost of Capital and Capital Structure;

(b) Distributed Generation (Combined Heat and Power);

(c) Suite Metering;

(d) Gain on Sales; and

(e) Income Taxes (new issue raised in BOMA's submissions).

5. Capitalized terms used in these submissions are given the meaning attributed to those terms herein, and if no such meaning is given then the meaning attributed to those terms in THESL's Argument-in-Chief.

B. COST OF CAPITAL AND CAPITAL STRUCTURE

6. While various intervenors have made submissions in regard to THESL's cost of capital and capital structure, it is worth noting at the outset that Board Staff's submissions on this issue are entirely consistent with THESL's proposal to

comply with the Board's December 2009 cost of capital report (the "December 2009 Report").

7. The Board has received numerous intervenor submissions in this proceeding in direct response to the Board's updated cost of capital policy issued December 11, 2009 during THESL's settlement conference. By way of general observation, THESL notes that while the submissions vary in terms of scope, most represent a dramatic departure from the Board's standard policies and approaches to determining a utility's cost of capital with little regard given to the objectives of predictability and certainty that underpin the Board's policy.

8. When assessing a utility's cost-of-capital needs, there is more at stake than short-term rate impacts. There is also the ability of a utility to secure the ongoing financing necessary to continue to operate, refurbish and expand its distribution system. This too is in ratepayers' long-term interests. This necessarily involves the interests and views of other financial markets participants, which the Board did obtain and consider when it updated its cost of capital report but which are notably absent in this proceeding. When assessing the issues in this proceeding, THESL submits that the Board should carefully consider the factors of predictability and certainty that financial market participants consistently identify as a key objective for regulators.

9. As noted throughout the December 2009 Report , in the context of the globalized capital markets in which THESL competes for capital, the Board's updated return-on-equity remains below the returns allowed by regulators for comparable U.S. based distributors.

10. It is in this context that THESL will address the major themes arising from intervenors' submissions as they relate to: (i) new approaches to social policy; (ii) new approaches to the deemed capital structure; (iii) new approaches to the

allowable return on equity; (iv) the proper amount of forecasted long-term debt; and (v) the proper forecast of the long-term debt rate.

New Social Policy: The Proposition that Distributors should begin to subsidize Non-Distribution Costs

11. CAC proposes a dramatically new form of social policy in its submissions when it suggests that rate increases resulting from the increased ROE due to the Board's 2009 cost of capital report should (i) be considered as relevant by the Board in the context of setting the cost of capital and (ii) should be considered in conjunction with external factors outside of the control of THESL. Specifically, CCC suggests that a distribution utility should track various costs external to its business and outside of its control and include those costs in its proposal for setting new distribution rates - in other words THESL should voluntarily reduce its ROE and business requirements to subsidize external cost drivers that are completely outside of the distributor's control such as policy directions and/or business decisions taken by the Province, OPG, the OPA, the OEB and HONI in respect of the Global Adjustment and the *Green Energy Act.*

12. The Federal Court of Appeal in *TransCanada Pipelines Ltd. v. National Energy Board*, 2004 FCA 149 at paras. 35-36 was clear that the overall ROE must be determined solely on the basis of a company's cost of equity capital and that the impact of any resulting toll increase is an irrelevant consideration in that determination. The Board agreed with this principle during its assessment of the fair return standard in determining its new formulaic ROE at page 19 of the December 2009 Report. THESL submits that this remains the correct approach.

13. Given that THESL's operating and capital costs have been settled, and in light of this principle, THESL submits that it is entirely inappropriate for intervenors to now argue for a reduction in THESL's allowable ROE on the basis of mitigating distribution rate impacts. THESL submits that it is also inappropriate for

intervenors to argue for a reduction in THESL's allowable return on the basis of mitigating non-distribution rate impacts that are entirely outside of THESL's control. The distribution sector is not, and should not be re-cast as some electricity price slush fund from which a new social welfare policy can be financed wherein LDC's cost of capital is manipulated in order to subsidize other cost drivers of consumer's overall electricity bills. There would be a devastating impact on utilities and the investor community if the Board granted CAC's relief and reduced a utility's ROE and revenue requirement to subsidize other unrelated costs in Ontario's electricity sector.

14. If CAC has concerns with Provincial policy directions under the *Green Energy Act* or otherwise, it should address those concerns to Queens Park and not as part of this cost-of-service rate proceeding which is being made based on well established rate making principles pursuant to the objectives and requirements of the *Ontario Energy Board Act, 1998*.

Capital Structure: Equating Working Capital to Short-Term Debt

15. BOMA has proposed a convoluted (and ultimately incorrect) argument that the Board should depart from its well established approach to capital structure to effect an increase in the deemed short-term debt component of THESL's capital structure on the basis of a purported "mismatch" between the level of deemed short-term debt and the requirement for short-term funding based on THESL's requested working capital component of its rate base. Energy Probe adopts BOMA's submissions in this regard. SEC adopts a similar analysis and argument, although it arrives at a different conclusion.

16. THESL submits that the intervenors have confused two very important, but ultimately distinct concepts of utility rate making - the **<u>financing of rate base</u>** with the **<u>return on rate base</u>**.

17. A working capital allowance is intended to reflect the on going (i.e., current) cost of financing a full suite of distribution services that ratepayers enjoy from a base of approved net fixed assets. The financing of such services includes the lead times involved in paying for wholesale cost of power, taxes, operating expenses, etc. prior to these costs being collected from ratepayers due to the normal lags in distribution billing and collection cycles. In fact, an appropriate amount of working capital that is sought by distributors is precisely what a lead-lag study establishes, and as BOMA has pointed out, THESL's lead/lag study was approved by the Board as part of EB-2007-0680.

18. Conversely, a deemed capital structure and all its components (i.e., short-term debt, long-term debt and equity) provides for the return on the approved rate base. As the Board has pointed out, the deemed 4% short-term component is intended to signal that some short-term debt is a suitable tool to meet **fluctuations** in working capital levels (discussed further below). That is why THESL (and no doubt other LDCs) have short-term bank credit lines on standby.

19. THESL's long-term financing signals stem from two completely different concepts than those erroneously cited by BOMA. The first of these signals is the absolute amount of cash on hand in the company, and the second signal is the absolute level of "free cash flow" in the company[1]. THESL submits that its forecast of long-term debt flows from its current forecast of these two financial metrics. THESL submits that these two financial metrics provide it with a very rigorous forecast of the actual amount of long-term debt required to finance capital expenditures. Using this methodology, THESL was able to significantly reduce its forecast of the required amount of long-term debt from $260 million to $200 million following the Settlement Agreement with the agreed-to adjustment of the capital budget from $423 million to $350 million.

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[1]THESL defines Free Cash Flow as Earnings Before Taxes *times* (1 *minus* Tax Rate) *plus* Depreciation *less* Capital Expenditures *plus* changes in Net working Capital.

20. THESL submits that the intervenors have failed to produce reasons sufficient to justify the Board departing from its well established policy on Cost of Capital. At page 49 of the December 2009 Report, the Board states that:

> **The Board's current policy with regard to capital structure for all regulated utilities continues to be appropriate.** As noted in the Board's draft guidelines, capital structure should be reviewed only when there is a significant change in financial, business or corporate fundamentals.

21. The Board's current policy is articulated in the Board's December 2006 Report, where the Board adopted a single deemed capital structure for all distributors for rate-making purposes - fixing a split of 60% debt, 40% equity for all distributors and including a short-term debt amount fixed at 4% of rate base. The Board has been rightfully hesitant in past proceedings to depart from its policy on deemed capital structure. The policy is the result of a broad public consultation process and it has created much needed certainty for both distributors and intervenors in the Board's rate setting process.

22. The Board justified its deemed short-term debt amount at page 9 of the December 2006 Report, noting (emphasis added):

> Based on filings of distributors pursuant to the Board's Electricity RRR and in 2006 rate applications, it is clear that many distributors use short-term debt. The actual average for the industry is about 4%. Some distributors use it extensively as a substitute for long-term debt. **This may be advantageous in a period characterized by low inflation and interest rates, but such a practice exposes the distributor – and its customers – to inordinate risk if rates climb**.

23. To take advantage of the low interest rates currently applicable to short-term debt, intervenors argue that the Board should abandon its well established policy and increase the short-term debt component of THESL's capital structure beyond the deemed amount of 4%.

24. The Board has previously considered and rejected as problematic an approach that would use the actual short-term debt of a distributor to determine the appropriate

percentage of the distributor's capital structure. Specifically, page 11 of the December 2006 Report states (emphasis added):

> Although using a distributor's actual short term debt component may seem to be a more accurate approach, **<u>it may be problematic</u>**. Short-term debt is optimally used as an interim solution for managing a firm's financing requirements. It may fluctuate, although generally within a limited range. **<u>Using a firm's actual short-term debt component would be administratively challenging given the number of electricity distributors and the associated volume of data that would need to be reported and verified</u>**.

25. THESL submits that the intervenors' approach is similarly problematic. Specifically, if the Board accepts BOMA's argument the Board will create a tremendous administrative challenge as it opens the floodgates to numerous parties making a wide variety of arguments to change the deemed capital structure based upon a mix of evidence on a distributor's current capitalization rates and evidence drawn from elsewhere in the rate application which has no direct relationship to the capital structure of the utility. Indeed, BOMA does not make reference to THESL's actual short-term debt to suggest that the deemed rate is inappropriate. Instead, it makes a tremendous leap in logic to imply that the working capital component of THESL's rate base is somehow equivalent to what Toronto's actual short-term debt amount should be.

26. THESL submits that its proposed working capital allowance was prepared strictly for the purposes of contributing to the rate base component of the Application. The working capital allowance has no real correlation to Toronto's actual level of short-term debt nor should it be used as a proxy for the level of short-term debt the Board will use for rate setting purposes. THESL submits that its proposed capital structure, including the short-term debt component, complies with the December 2009 Report and is appropriate for rate setting purposes.

27. THESL further submits that the intervenors have erred in suggesting that all working capital should be financed through short-term debt. THESL submits that

this is simply not the case, and that intervenors' arguments equating working capital to short-term debt is misleading in this regard.

28. At page 10 of the its December 2006 Report, the Board states that (emphasis added):

> 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.

29. It is a well understood principle of corporate finance that firms need both a long-term (or permanent) investment in working capital and a short-term or cyclical one. The permanent working capital investment provides an ongoing positive net working capital position, that is, a level of current assets that exceeds current liabilities. This allows THESL to operate with an acceptable financial margin and minimizes the risk of being unable to pay its employees, vendors, lenders, or the government (for taxes). To have a continuous positive net working capital, a company must finance part of its working capital on a long-term basis.

30. Beyond this permanent working capital investment, THESL also needs seasonal or cyclical working capital. Since the demand for power and THESL's controllable expenses vary over the course of a year, THESL needs to finance these costs to prepare for its peak sales period and accounts receivable until cash is collected.

31. Were the Board to accept BOMA's submissions, utilities would be incentivized to finance long-term assets with short-term bank lines thereby exposing their operations to floating interest rate risk and the potential for harm to ratepayers. To accept BOMA's convoluted logic would also represent a significant departure from well thought out and accepted utility practices.

Return on Equity

32. Various intervenors (BOMA, CAC, SEC and VECC among them) recommend a dramatic departure from Board's policy in respect of allowed return-on-equity by suggesting that the Board should exclude from its ROE calculation an implicit 50 basis points for flotation costs. These intervenors go on to suggest that THESL's Application must include "evidence" to support its requested ROE, failing which the intervenors propose various approaches by which the Board should reduce the allowed ROE.

33. CCC claims that it had no opportunity to question THESL on its position regarding cost of capital since THESL led no evidence on this topic in this proceeding or in the cost of capital proceeding, and concludes that the Board cannot grant any ROE other than 8.01%. THESL submits that its position on this issue, as set out in paragraph 10 in THESL's Argument-in-Chief, has been clear from the beginning and is entirely consistent with Board Staff's submission on this issue. Specifically, THESL agrees with Board Staff's observation that although a 9.75% ROE was used in Appendix B of the Settlement Agreement, this number is an estimate only. THESL submits that the Board's final cost of capital parameters to be published in February 2010 based on January 2010 data should be used to determine ROE and other applicable rates for determining the final revenue in a manner consistent with the Board's December 2009 Report. THESL submits that this approach alone satisfies the Board's legal obligation to meet the fair return standard in establishing just and reasonable rates.

34. THESL submits that despite the intervenor submissions to the contrary, the Board should not reinvent the wheel during each subsequent individual rate hearing when it has already designed a comprehensive policy on a generic basis to address various interrelated and complicated concerns.

35. In its December 2009 Report, the Board affirmed its use of the fair return standard (the "FRS") and the comparable investment standard to determine its ROE formulae. In the report the Board notes that "the FRS expressly refers to an opportunity cost of capital concept, one that is prospective rather than retrospective." That is to say that the FRS does not consider historic costs, and instead it looks to comparable investments in a forward looking approach to determine an appropriate ROE. The Board noted at page 21 of its December 2009 Report that:

> Continued investment in network utilities does not, in itself, demonstrate that the FRS has been met by a regulator's cost of capital determination, and in particular, whether the determination of the equity cost of capital meets the requirements of the FRS. This is a particular challenge – how does the regulator determine when investment capital is not allocated to a rate regulated enterprise? These decisions are typically made within the utility/corporate capital budgeting process and rarely, if ever, broadly communicated to stakeholders. The Board notes that acquisition and divestiture activities of regulated utilities are not definitive in this regard, one way or the other, and notes that there are many reasons why investors are willing to acquire or desirous of selling utility assets, notwithstanding their view of whether an allowed ROE meets the FRS.
>
> **<u>The primary tool available to the regulator to rectify this lack of transparency is the comparable investment standard. By establishing a cost of capital, and an ROE in particular, that is comparable to the return available from the application of invested capital to other enterprises of like risk, the regulator removes a significant barrier that impedes the flow of capital into or out of, a rate regulated entity.</u>** The net result is that the regulator is able, as accurately as possible, to determine the opportunity cost of capital for monies invested in utility works, with the ultimate objective being to facilitate efficient investment in the sector.

36. THESL submits that the inclusion of an implicit 50 basis point flotation cost is not intended to reflect floatation costs if THESL was to issue equity. Rather, the 50 basis points is intended to reflect legitimate costs and a fair return to equity owners (in this case, THC and ultimately the City of Toronto) for holding an equity interest in THESL given comparable investment opportunities in other

enterprises of like risk. In other words, the implicit 50 basis point flotation cost has nothing to do with whether or not THESL intends to issue equity, and it has everything to do with recognizing a fair return that an equity owner would receive for a comparable investment. That is why this cost was included in the equity risk premium formula in the OEB's December 2006 report, and it is why it remains legitimate to include in the Board's formulaic approach to ROE for THESL. Notably, the premium for flotation and transaction costs has been included ever since the Board first introduced the premium in the early 1990s. The Board has never before asked distributors to produce evidence of their flotation and transaction costs to support recovery the allowable ROE.

37. The intervenor's approach to demand evidence supporting the allowed ROE creates an entirely new and unexpected burden of proof that would open the floodgates to numerous arguments about all aspects of the allowable ROE – requiring utilities to hire costly consultants to justify a proposed ROE on the basis of a fair return standard and comparable investments and subjecting the Board to lengthy administratively cumbersome proceedings on disputed ROE allowances. This is exactly the situation the Board was trying to avoid when it adopted its deemed capital structure and set a formulaic ROE pursuant to the December 2009 and December 2006 cost of capital reports. Further, THESL submits that the Board's formulaic approach to ROE as articulated in its December 2009 report provides a degree of predictability and certainty that in itself helps attract investor capital from comparable investments (i.e., investment advisors and credit rating agencies can understand the policy and make recommendations based on it) which would be lost if the Board began determining ROE on a case-by-case, utility-by-utility basis.

38. If the situation were reversed, and THESL in its Application had instead sought a higher ROE than what the Board's cost of capital policy ultimately proposed – inevitably the intervenors would have argued for the lower amount given the

Board's revised policy. THESL submits that it is entirely inappropriate for parties to cherry-pick from the Board's cost-of-capital policy – it is appropriate as a package of individual parts that together produce an outcome that is appropriate and which will result in just and reasonable distribution rates.

Long Term Debt: The Importance of Prudent, Evidence Based Forecasting

39. BOMA suggests in its submissions that THESL's forecast of $200 million in long-term debt planned to be issued in June 2010 is overstated on the basis that the actual amount of long-term debt should more closely match the deemed amount of long-term debt.

40. THESL submits that BOMA has confused THESL's actual long-term debt needs with a regulatory concept of deemed debt used for calculating a utility's allowed return on rate base. This is clearly illustrated in the following exchange between BOMA's consultant, Mr. Aiken, and the THESL witness panel found at pages 50-52 of the Volume 1 (Feb. 4, 2010) transcript:

> MR. AIKEN: […] So my question is, why do you need actual long-term debt that is essentially equal to your deemed and short-term debt in total?
>
> MR. SARDANA: I think to best answer your question, our long-term borrowing requirements are based on -- really are predicated on our capital program.
> We are spending on capital using cash today. We know we're going to now deplete cash by June -- by the June time frame, and that's when it is optimal for us to go out and borrow money.
> $200 million is the amount that is required for us to keep that cash at virtually a zero balance but you know obviously while meeting our working capital obligations. So it sort of steps away from the deemed structure for a bit but it is still tied into the deemed structure.
>
> MR. AIKEN: Would you agree that if the actual long-term debt were to be constrained to be something in the order of magnitude of, as the deemed long-term debt, you would only need to issue about $40 million rather than the $200 million in 2010?
>
> MR. SEAL: I am not sure it is totally a relevant question.
> We are comparing the actual cash needs of the company and actual debt issuance needs to the deemed structure.
> The deemed structure is a structure that is used to determine our overall cost-of-capital for the company, but the cash needs and our investment plans are what is driving our actual borrowing needs, so I am not sure you can compare them in the way you are trying

> to compare them.
>
> MR. AIKEN: I guess my question is why can't you borrow some of that 200 million on a short-term basis rather than long-term?
>
> MR. SARDANA: I think that gets to the fundamental notion of, we are borrowing for capital which are long-term assets, and there is a principle in finance where you try and match your assets to your liabilities and the right signal for a company operating its business is to do just that.
> So we are borrowing on a long-term basis to on the liability side to match the assets that we're putting into the ground.
>
> MR. AIKEN: So all of this $200 million is for long-term assets?
>
> MR. SARDANA: That's correct.

41. As is correctly noted by Mr. Sardana and Mr. Seal in the exchange above, THESL's need for long-term debt is based on its cash forecast and the size of its capital budget - not on some spurious connection between the financing of rate base and the return on rate base. It is through the judicious management of its cash flows that THESL has been able to fund its long-term assets to-date. However, the size of THESL's capital budget (which was agreed to in the Settlement Agreement subject to Pollution Probes specific concerns regarding CHP) is now large enough to signal the need for long-term borrowing. THESL submits that its forecast in this regard is appropriate.

Forecasted Long-Term Debt Rate: Different Bonds for Different Purposes and the Importance of *Pari Passu*

42. Various intervenors (BOMA, SEC and VECC) made submissions about THESL's forecasted rate of 5.79% applicable to the $200 million in unissued long-term debt. This forecast is based on the most recently available Conference Board of Canada's December 2009 Report forecasting Government bond yields and THESL's forecast of corporate spreads over equivalent term Government bond yields. Notably, THESL's forecast of 30-year term debt is lower than the OEB's own current deemed cost of long-term debt.

43. VECC suggests that THESL has underestimated the effect that the Board's new policy in respect of the allowed ROE will have on THC's forecasted cost of debt. THESL submits that this is simply not the case. As Mr. Sardana noted during the first day of the oral hearing, the market's assessment of a company's credit risk is based on an assessment of the company as a whole. While changes in the allowed ROE may trigger a change in credit risk over time as a company's other financial metrics improve, this change does not occur instantaneously.

44. Credit rating agencies provide a robust and impartial assessment of the market's view of credit risk. In response to Undertaking J1, THESL filed with the Board a DBRS newsletter dated December 16, 2009 which analysed the Board's updated December 2009 cost of capital policy (the "Decision") and concluded by noting that (emphasis added):

> "While the Decision is viewed as supportive of current ratings, in general, <u>it is not expected to materially reduce any utility's financial risk and, therefore, its implementation is not expected to directly result in any positive rating actions</u>."

45. The evidence demonstrates that DBRS is of the view that while the change in ROE is a positive development it is not expected to materially reduce a utility's financial risk nor will it directly result in a change in a utility's borrowing rate (which is driven primarily by the rating).

46. Various intervenors (BOMA, VECC and SEC) question why THESL has proposed to issue debt through its parent THC (which THESL has done for all of its existing unaffiliated third party debt) and is not borrowing the $200 million directly from Infrastructure Ontario.

47. THESL noted during the oral hearing (Volume 1 page 55) that staff of the utility, including the CFO, have previously met with Infrastructure Ontario (IO) staff to discuss the opportunities associated with using IO bonds, and their project

financing rates, to finance a portion of THESL's long-term debt needs. THESL concluded, as a result of these discussions, that the IO instruments were not appropriate to meet THESL's current financing needs, although THESL notes that they will continue to entertain discussions with IO in the future.

48. In arriving at this conclusion, THESL considered the following three points (see the transcript at Volume 1, pages 55-59):

49. First, the interest sheet submitted into evidence by VECC showed only rates offered by IO for serial and amortizer bonds. These types of debentures incorporate both interest and principal payments due regularly throughout the term of the debt. These IO bonds have a materially different risk profile than THESL's existing debt instruments, which require only regular interest payments throughout the term and a single final payment of the principal amount at maturity. Quite logically then the interest rate commanded by serial and amortizing bonds can be expected to be lower than that on "plain vanilla" bonds that only pay interest on a semi-annual basis, and repay the principal at maturity. Because of these different risk (and repayment) profiles, the IO rates are not directly comparable with a plain vanilla bond rate (and suggesting otherwise is entirely misleading).

50. Second, IO generally requires a utility to grant priority of IO debt over existing bond holders, a condition that THESL could not accept as it would breach *pari passu* covenants with existing bond holders. Indeed, bond holders with serial and amortizing bonds would logically rank ahead of bond holders that hold current plain vanilla bonds. Currently all of THESL's long-term debt ranks *pari passu* with other debt (e.g., short-term lines, etc.), so new debt cannot be issued that would rank ahead of existing debt.

51. While BOMA suggests that the *pari passu* issue is trivial and should not be a roadblock, THESL submits the *pari passu* covenant is a legal requirement which

restricts the ability of THC and THESL to create security interest, incur additional indebtedness not raking *pari passu*. In the worst case scenario, THESL might risk breaching a material covenant in an existing bond which in turn may trigger an event of default and a repayment in-full of the entire principal outstanding plus potentially liquidated damages in the amount of future interest owed on that bond. These consequences are anything but trivial, and must be considered by management when assessing its options in terms of new long-term debt.

52. Third, IO only offers bonds that relate to specific capital programs and as a result these bonds were not appropriate instruments to use to replace THESL's existing City Note. Since the majority of THESL's previous bond issues were aimed at replacing parts of the City Note, THESL's discussions with IO represent a relatively recent development (reflecting the changing nature of THESL's debt needs). As noted during the oral hearing, THESL expects to continue discussions with IO to determine the appropriateness of their financing for future debt issuances.

53. Finally, it is entirely unclear to THESL how VECC derives its spread of 115-120 basis points, and it is further unclear how adding that spread would lead to a long-term rate of 5.6% to 5.7%. It seems that VECC is simply adding an arbitrary 115-120 basis points to the cost of THESL's 10-year notes, ignoring bond market fundamentals. The bond market always prices an issue with reference to the equivalent term Government bond. Accordingly, THESL's forecast cost of 30-year debt is priced with reference to the underlying forecast of 30-year Government of Canada bonds. As noted in the quote at paragraph 40 above, THESL's forecast is associated with long-term assets. This is the methodology that THESL has used, and remains the standard methodology in the bond market. It is also worth noting that this is how the Board itself derives its deemed cost of long-term debt.

54. In consideration of the foregoing, THESL submits that the Board should accept its forecasted long-term debt rate and the resulting total cost of long-term debt as appropriate.

C. DISTRIBUTED GENERATION (COMBINED HEAT AND POWER)

55. Pollution Probe ("PP") was the only party to make substantial submissions on the issue of distributed generation. Board Staff, VECC, BOMA, CCC, and Energy Probe took no position on PP's issues, and Schools effectively submitted that it would be unwise for the Board to follow PP's recommendations outside of the existing policy framework. THESL concurs.

56. THESL submits that much of PP's participation in this proceeding has been in furtherance of its advocacy and promotion of its favoured brand of distributed generation, namely natural gas-fired combined heat and power ("CHP"). THESL acknowledges that valid issues may be raised by any party concerning its distribution system investment plans and does not seek to foreclose debate on those issues. However, PP's submissions mostly fail the tests of relevance and reasonableness.

57. PP begins by attempting to show that widespread deployment of natural gas-fired CHP is a public policy imperative that demands urgent action by the Board and THESL. The case it makes is misplaced in this proceeding. This is at root a supply optimization issue and should therefore be addressed in the context of the IPSP or a similar generic demand/supply planning process. It is clear, even from PP's own submissions, that a coordinated approach would be required between several parties, including Hydro One, the OPA, the IESO, THESL, and the Board, so it is at best a piecemeal approach for PP to use the THESL rate hearing as a forum for its promotion of natural gas-fired generation.

58. Furthermore, the Board has no basis in evidence to accept the fundamental argument of PP, which it states as follows at page 3: "While building a third line to provide power to the Hearn Transformer Station on the Toronto waterfront will ensure that Toronto's lights stay on if Leaside supply path is lost, it will not enable Toronto's hospitals to continue to operate at full capacity in the event of a provincial or North American blackout. *Therefore* the best option to meet Toronto's dual security of supply challenges is to install numerous small-scale, high-efficiency CHP plants in Toronto's hospitals, buildings and factories." (emphasis added)

59. PP simply has not made the case (nor would it have been appropriate to do so here) that this conclusion follows, along with the consequence that installation of CHP is an imperative and that 'barriers' to that must be removed as fully and quickly as possible. The evidence and argument to support such a conclusion did not appear in this proceeding nor should it have. At a minimum such evidence would have to include a comprehensive assessment of the relative costs, risks and merits of natural gas-fired CHP as against other forms of generation and conservation. THESL does not assert that such evidence is impossible to develop or out of place in another forum; it merely submits that THESL's rate case is not now that forum and that if anything, the issue should arise in a THESL rate case *consequently* to a general determination of the issues elsewhere.

60. PP goes on to assert the existence of four 'barriers' to the installation of natural gas-fired CHP. The first is the wholesale electricity price and the apparent lack of an OPA program to provide a higher price to gas-fired CHP generators. This 'barrier' is clearly outside of THESL's control and does not go to anything in THESL's revenue requirement or rate proposals.

61. The second 'barrier' is the constraint on short-circuit capacity at transmission facilities. This is clearly outside of THESL's control and does not go to anything in THESL's revenue requirement or rate proposals; nevertheless, THESL has and

will continue to work closely with Hydro One to identify and remedy any deficiencies on the transmission system that have an effect on transmission service to Toronto.

62. The third ‘barrier’ is alleged to be THESL’s policy regarding connection cost responsibility for gas-fired CHP generators. The Board and the parties have already visited this issue in the course of PP’s motion for interrogatory responses; in its Decision on that motion, the Board clearly ruled this issue out of order for this proceeding, yet PP persists in burdening the record in pursuit of it. On the basis of the Board’s ruling, THESL will not here address PP’s proposals related to this issue.

63. The fourth ‘barrier’ is alleged to be the existence of short-circuit constraints on THESL’s distribution system, which ‘impede’ the installation of natural gas-fired CHP. PP states “Therefore it is Pollution Probe’s submission that the Board should direct THESL to file, within six months, a plan and budget to upgrade its distribution system to permit the installation of at least 300 MW of natural gas-fired CHP in downtown and central Toronto as soon as practically possible.” PP apparently does not concern itself with the costs that could be imposed on customers of THESL, who would be required, at very substantial expense, to upgrade their electrical equipment and protection systems in the face of increased fault currents consequent to natural gas-fired CHP installation.

64. PP takes as a given that it is imperative to install its brand of distributed generation, natural gas-fired CHP, and therefore demands urgent action on the part of the Board and THESL. THESL submits that PP has not made its case that such action is imperative or even preferred to other supply alternatives, nor has it demonstrated its priority over other urgent needs on the distribution system, all of which must be funded out of a strained revenue requirement. Furthermore such a plan would necessarily be only a fragment of an overall plan, which would not yet be determined, and which would likely overtake the fragmentary plan should they

be developed in that sequence. Therefore it is unlikely that the fragmentary plan demanded by PP could be guiding for any Board decision or action on the part of THESL. In addition the execution of such a plan would necessarily impose significant retrofit costs on parties, namely customers of THESL in downtown Toronto, who have had no notice of this issue in this hearing.

65. Therefore THESL submits that the Board should not require THESL to complete a plan and budget within an arbitrary horizon of six months for PP's purposes. A more appropriate course would be to have THESL develop a specific plan for its system after an overall course has been determined. THESL is quite prepared to contribute significantly to the development of an overall plan in an appropriate, inclusive forum where all affected parties can participate.

D. SUITE METERING

66. The issue of the appropriateness of THESL's suite metering activities was raised by the Smart Sub-metering Working Group ("SSMWG"), a trade association of non-customers with narrow economic interests in ensuring that its members face as little counter-pressure as possible from rate-regulated, licensed electricity distributors.

67. Apart from the hyperbole of the SSMWG's submissions, the allegations of the SSMWG are that the Board-approved rates and economic evaluation practices, charged and employed by THESL under law and Code, are predatory and unjustly interfere with the economic prospects of its members. The SSMWG claims that "the market" in which it operates is competitive and that THESL's Board-approved practices are anti-competitive. The SSMWG alleges that because the meters used by THESL in some suite metering applications are more expensive than standard meters, an unjust cross-subsidy financed by THESL's other customers exists which imperils the livelihood of its members.

68. However, the Settlement Agreement approved by the Board put the issue more specifically as: "Is Toronto Hydro's cost allocation in respect of residential customers residing in individually metered multiple unit residential units ("suite metered customers") appropriate?"

69. THESL continues to rely in this area on its submissions in argument-in-chief. THESL will further address the objective claims of the SSMWG in sequence. First, it makes much of the claim that the market for sub-metering in Ontario is contestable. However, the expert recruited from the United States by the SSMWG, Mr. Hanser, admitted under cross examination that he had conducted no independent analysis of the structure and functioning of that so-called market[2]. Mr. Hanser therefore cannot be said to be an expert regarding how the suite meter "sector" actually works here; at most he is an expert in abstract theory concerning competition in real markets. Mr. Hanser has no first hand expert knowledge of how members of the SSMWG secure contracts from developers or whether that process is compatible with the requirements of exempt distribution and the prohibition on the resale of electricity distribution for profit.

70. Furthermore, Mr. Hanser drew no distinction between the procurement and installation of sub-meters on one hand and the ongoing provision of distribution service on the other. THESL acknowledges that the procurement and installation of sub-meters is contestable in that it may be provided by multiple vendors, but regardless of whether it can be construed as an 'associated service', there is no doubt whatsoever that ongoing distribution service is a regulated monopoly. Once a metering system is installed, there is no practical exit or choice for individual customers, who become captive. The model of the SSMWG is to extend, under the banner of 'competition', the role of sub-meterers from participation in contestable markets into natural monopoly regulated markets, albeit without the regulation. To be clear then, what Mr. Hanser and the SSMWG

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[2] Transcript Vol. 3 pages 88-89

agitate for is unfettered access to a captive market in which SSMWG members can, at the present time, charge unregulated rates and reap monopoly profits. This is the underpinning motive which propels the efforts of the SSMWG to manipulate regulation to its own economic advantage.

71. In this effort Mr. Hanser and the SSMWG attempted to show that THESL's Board-approved rates were unjust and unreasonable by asserting that one element of the overall cost to serve suite metered condominium customers, namely the metering component, was higher than the average cost of that component for residential customers. The SSMWG asserts that this is contrary to the principle of rates being cost-based. The SSMWG further quotes Mr. Hanser at paragraph 23 of their submissions, where it states: "By using 'cost of service' as the basis for rates is meant that the rates that utilities charge for the services they provide should hew as closely as possible to the costs incurred for providing the services." Notably, the quote is not that rates should hew as closely as possible to *some of* the costs incurred. THESL maintains that there are other costs of service that would be lower, or absent, for residential customers in condominiums, but cannot say without the proper, thorough analysis what the overall cost effect would be.

72. Both the Consumers Council and VECC conclude independently that Mr. Hanser's analysis done for the SSMWG failed to show, definitively, that any degree of undue cross-subsidization exists, and that fact is admitted outrightly by Mr. Hanser under cross examination.[3] As THESL submitted at paragraph 27 of its argument, the Hanser evidence is not meaningful because it is not comprehensive or balanced.

73. The simple fact is that the required analysis has not been done, by THESL or any other party. However, THESL accepts no blame for that, as would be attributed to it by the SSMWG; the SSMWG is impatient that THESL and the Board do not

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[3] Transcript Vol. 3 page 113

rush to part the waters for it, but the SSMWG defines neither the Board's filing requirements nor the content of THESL's rate applications. Furthermore, it does not dictate the Board's ratemaking policy agenda.

74. What the SSMWG advocates in this area amounts to a fundamental re-examination of the cost allocation model and the definitions of customer classes. That is a mandate that will necessarily involve all Ontario utilities as well as most of the other stakeholder groups, notably those representing customers. THESL is prepared to enter upon such an undertaking but submits that the as-yet uncertain but impending impacts of Bill 235 make it prudent to await that legislation and the associated regulations before embarking on that task.

75. In addition to the submissions above, THESL is compelled to correct the record with respect to several other unsubstantiated claims made by the SSMWG.

76. First, at paragraph 5, the SSMWG submits that THESL has not met its burden to show that its rates are just and reasonable. However, with respect to existing rates, the SSMWG should understand that it is the Board that approved those rates and THESL has no burden in that regard. Furthermore, THESL is not proposing any structural change or other innovation with respect to rates, rate classifications, or cost allocation; the change to residential rates is just with respect to level. Therefore the SSMWG's claim in this matter is simply inaccurate and misplaced.

77. Second, at paragraphs 5, 9, and 25 the SSMWG alludes to purported requirements of the Distribution System Code ("DSC") and submits that an exemption from those requirements would be necessary for THESL to conduct economic evaluations of connection plans in the manner that it has. However, contrary to the assertions of the SSMWG, there is nothing in Section 3.2.1 or Appendix B of the DSC that requires the treatment of metering costs described by the SSMWG.

78. At paragraph 12, the SSMWG asserts that it is THESL's evidence that upon the installation of suite metering, the revenue obtained by THESL for a given building will decline. That assertion is false and depends on misconstruing THESL's evidence that upon the installation of suite meters, *load* can be expected to decline, other things remaining equal. In fact, this assertion of the SSMWG is directly contradicted by its own further assertions at paragraph 16, where it observes that in situations of metering conversions, THESL's revenues increase.

79. At paragraph 31, the SSMWG asserts that there is no need for THESL's suite metering program. Apart from ignoring the requirements placed on utilities by the DSC, the SSMWG states that "...[since] Ontario Regulation 442/07 under the Electricity Act mandates that all new condominiums be suite metered or smart sub-metered, it is clear that there is no need for THESL's program. Building developers are required, as a matter of law, to install smart meters or smart sub-meters." Even if that statement were true, the conclusion does not follow, but in any event, the statement is not true: Ontario Regulation 442/07 does not state that "Building developers are required, as a matter of law, to install smart meters or smart sub-meters", and counsel for the SSMWG confirmed that with THESL's witness during the hearing.[4]

80. At paragraph 16, the SSMWG complains more generally about the economic evaluation process and points to what it describes as an "absurd" result: that condominium developers are required to pay a greater capital contribution under the bulk meter/sub-meter configuration than under the suite meter configuration. In fact, this is not an "absurd" result but rather one that flows directly from the provisions of the DSC, and the SSMWG's complaint about it simply shows that it is seeking every economic advantage it can obtain through the regulatory process without regard to principle. THESL's evidence is clear that the connection and

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upstream system costs are the same regardless of the metering configuration[5] and it is those costs that figure into the capital contribution calculation. Opposite that, the revenues, under Board-approved rates, vary for an identical load depending on rate class and are higher under residential rates. Under the present system this is really a result of the facts that the developer is not the ultimate customer, and that the installation itself can be transferred from one rate class to another, which is not the case for other commercial projects. However, the fact that this arrangement may not conduce to the greatest enrichment of SSMWG members should not be determinative of, or even significantly influential on Board policy in this area.

81. On a related issue, at paragraph 27 the SSMWG complains that 'the principle of cost causality has been abandoned', in this instance because its target customer group, condominium developers and corporations, are not charged under current rate structures for the meters that THESL installs. However, were they to be charged, an instance of double-recovery would clearly result, since, for example, a condominium corporation would itself pay for the meters (under the SSMWG scheme) and individual residents would pay again through residential rates.

82. At paragraph 13, the SSMWG attempts to weave these factors into an allegation of unfair competition based on 'commercially unreasonable and unsustainable terms' and asks rhetorically how a sub-meterer can compete in such circumstances. THESL's response at the time of the hearing, and now, is that that is not its issue, meaning that it is not THESL's responsibility to bend the rules under which it operates for the convenience of the SSMWG, and indeed that it would be irresponsible to do so.

83. More generally, the default position of the SSMWG is that a duty is owed to it by THESL to unconditionally remove every factor that could be seen as

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unfavourable, or even not favourable enough, to its competitive position and economic prospects. The duty arises because, in the SSMWG's submission, THESL is a regulated utility operating in a contestable market. The SSMWG fails to acknowledge the converse which is equally arguable: that the members of the SSMWG are competitors attempting to operate in a regulated market. As noted by the Consumers Council at paragraph 17, "In effect, this is both a regulated and unregulated activity". Regulated utilities existed far before the SSMWG and its members, and the institutional arrangements under which utilities are regulated have evolved for the purpose of answering the particular needs of customers and utilities in that regulated sector. THESL's first obligations are to its customers and the Board, together with the province, and THESL submits that it carries out those obligations diligently and in good faith. After these obligations are met, THESL attempts to accommodate the interests, commercial and otherwise, of other stakeholders.

84. Nevertheless there is nothing expressed in provincial policy that states either THESL or the Board must make way or hastily change the arrangements of regulation for the benefit of the SSMWG. The Board has no objective to promote competition in the sub-metering market or the economic well being of sub-meterers, especially at the expense of any other parties such as captive customers. Sub-meterers are not customers, and the Board has ruled that they may not be customers of utilities. Furthermore, the SSMWG has brought no evidence that competition in the sub-metering market actually furthers, directly or indirectly, any other objectives of the Board such as conservation. Instead, it would have parties accept as a mere article of faith that in this market, the invisible hand will bring positive effects. THESL submits that so far, the invisible hand has indeed been invisible.

85. Ultimately all parties to the regulatory compact must be prepared to change with changing times. THESL is itself prepared to do so and believes that it has amply

demonstrated both its willingness and ability. However, the pace and direction of change should be measured, balanced and deliberate, and should first take into account the proper interests of customers and utilities.

86. The regulatory innovations insisted upon by the SSMWG are clearly designed for no other purpose than the economic advantage of its members. The Board has already rejected the concept, urged by the SSMWG, that utilities undertake suite metering through affiliates. The Board should not now deal with other generic issues such as the unbundling of distribution rates and the re-casting of cost allocation parameters in the confines of the present proceeding. No adequate evidence supporting such an enterprise has been filed in this case and no notice of generic outcomes has been afforded to other affected parties. If the Board is persuaded that the issues raised by the SSMWG are worth examining it should convene a properly constituted generic hearing to do so. In the meantime it should not accept the one-sided and self-serving propositions of the SSMWG.

E. GAIN ON SALES

87. The issue before the Board in this area is how to properly give effect to the "Sale Proceeds Order" (or "SPO") from its EB-2007-0680 Decision in the context of this proceeding. That Order concerned the disposition of the net after-tax gains on sale of a specified set of properties (the "Gains" on the "Named Properties"). The background of this strand of the EB-2007-0680 proceeding has been recited several times up to this point and for purposes of this discussion, THESL accepts the rendition set out in the 'Background' section of Board Staff's submissions.

88. Essentially, Board Staff and certain other intervenors argue that the Board must somehow now implement the Sale Proceeds Order as though nothing of consequence had occurred since it was originally issued. In particular, they argue that the figure of $10.3 million, cited by the Board in the Sale Proceeds Order as well as in its Decision on THESL's ensuing June 2008 Motion for Review, must

now be deducted from THESL's 2010 revenue requirement and corresponding rates.

89. Despite the concerns and objections set out below, THESL believes there is more common ground on this issue between itself and Board Staff together with the intervenors than might be superficially apparent from the submissions. THESL believes that its proposal to clear substantially all of the realized and realizable Gains by way of a revenue offset to the 2010 revenue requirement more than meets the intent and requirements of the Sale Proceeds Order. That is because its proposal gives effect to the actual Order concerning three of the Named Properties, and further credits ratepayers with the net after-tax gains on sale issuing from the balance of the properties, the disposition of which was not determined in the Sale Proceeds Order and which was to be the subject of future submissions.

90. The central portion of the Sale Proceeds Order is as follows (emphasis added):

> "...the Board finds that *100% of the net after tax gains* from the sale of 228 Wilson Avenue, 175 Goddard Street, and 28 Underwriters Road, the properties that are planned to be sold in 2008, should go to the ratepayer. The Company's revenue requirement *for the 2008 test year* shall be adjusted downward by $10.3 Million *to reflect* this finding." (Decision, page 27)

91. It is highly significant that the Board did not simply disallow $10.3 million from entering revenue requirement directly. If the Board had chosen to do that, the matter would have been concluded in the EB-2007-0680 case. Instead, the Board went to shareholder assets themselves and expressly tied the revenue offset to the *actual* results of real estate transactions that were not then completed. That intention is made crystal clear by the Board's express reference to "*100% of the net after tax gains"* rather than a discrete disallowance amount; and by its direction that a variance account be established (emphasis added):

> "The Board further directs the Company to employ a variance account to record *any differences* in the gains reflected in rates and the *actual gains* achieved from the sale of these properties either in 2008 or beyond." (Decision, page 28)

92. Therefore, the Board's order is that 100% of the *actual* Gains should go to the ratepayer. At the time, "100% of the Gains" were known by the Board and all parties not yet to have been realized and to be simply the subject of a forecast. The figure of $10.3 Million, the accuracy of which THESL has disputed from the outset, was merely a 'reflection', in the Board's own words, of its intention for the *2008 revenue requirement*, based on the information available at the time. The Board's Order intrinsically dealt not with a fixed amount but with a *concept* that would be realized at a future time through the operation of the real estate market: had the Board intended to remove a fixed amount from revenue requirement, it would simply have done so. THESL acknowledges that this feature of the SPO was unusual compared to other rulings of the Board that might come under appeal and be delayed in implementation; nevertheless it is a direct consequence of what the Board consciously chose.

93. It is also clear from the SPO that the figure of $10.3 million did not represent a floor amount but rather a point estimate, at that time, of the actual Gains that would be realized in the future. Again, this is evident from the Board's own wording, which was that "*any differences*" were to be recorded in the variance account.

94. That being the case, it is clearly not in keeping with the SPO for any party to cling to a figure of $10.3 million as the appropriate revenue offset for the *2010 revenue requirement*, since that $10.3 million figure is now not more than an outdated forecast and in fact represents nothing relevant to the implementation of the SPO at this time. Board Staff's submission is flawed in this regard, since it construes the SPO as specifying a fixed dollar amount rather than a concept, which is clearly not the case.

95. Instead, the Board is obliged, as it has always been, to use the best available information to determine the appropriate 'reflection' of its directions. Now that the subject Gains have largely been realized, or in the case of Goddard can be forecast with reasonable certainty based on a signed Offer to Purchase, it would be highly inappropriate and a major departure from accepted practice for the Board to substitute outdated forecast figures, which are known to be inaccurate, for amounts which have actually been realized. The figure of $10.3 million, though inaccurate because it represented the forecast of gains *before* tax, was the figure used by the Board for the 2008 revenue requirement; for the 2010 revenue requirement, which is the subject of this proceeding, the Board should certainly use both the actual and best forecast information which is now available.

96. Board Staff's suggestion that the variance account, dealing with the Gains and using as a reference figure the amount of $10.3 million, not be cleared at this time is also plainly flawed and should be rejected. Board Staff does not offer any reason for its suggestion; it simply asserts that it would be 'more appropriate' if the account were cleared in the proceeding for 2011 rates, and that this approach would 'also' provide some further mitigation of rate increases in 2010.

97. If implemented this suggestion would amount to the deliberate introduction of a spurious variance into revenue requirement, which would improperly create rate volatility and not advantage ratepayers, who would simply have to repay the variance amount in the next year together with interest. Furthermore, if the Board were willing to proceed in 2008 with the forecast that then existed, there is certainly no reason to delay now, given that the Gains are mostly realized or can be forecast with reasonable assurance. To suggest that a variance account now be constructed with fictional entries representing known, actual events (i.e., the actual Gains) is an unjustifiable approach to ratemaking which the Board should reject.

98. Board Staff also suggests that THESL's proposal is not in accordance with the Board's Decision of January 22, 2010 on THESL's Motion to Review (the "December Motion"), and that "the fact that THESL has not sold, or may not sell, two of the named properties is irrelevant to its implementation".

99. First, Board Staff incorrectly implies that THESL's proposal in the December Motion somehow rested on the fact that THESL has not and may not sell two of the Named Properties. THESL's proposals then and now accommodate that fact but do not spring from it. THESL brought the December Motion simply for the purpose of making a constructive proposal to conclude this matter since the setting of new rates for 2010 was imminent and no process had been defined. The Board itself in the December Motion Decision stated that further direction from the Board was required. It is arguable that since the Board dismissed that Motion on threshold, it made no findings on substance which would apply to this issue, but in any event THESL regards that case as closed.

100. Nevertheless Board Staff has secondly misconstrued THESL's motion as somehow depending on the 'passage of time' argument. That misses the point because it fails to distinguish between the Board's finding that 100% of the Gains should go to ratepayers, which is independent of the passage of time, and the Board's 2008 estimate of the actual revenue requirement impact of that finding. THESL did not submit in that Motion, nor does it submit now, that the 'passage of time' itself could operate to defeat the purpose of a Board Decision; conversely, THESL's proposals both now and in the December Motion were to give effect to the Board's ruling. The only factor that changes is the currency and accuracy of the forecast (where necessary) of the quantity in question.

101. This is further illuminated and validated by asking what the position of Board Staff and intervenors would be if developments in the real estate market, which were completely exogenous to THESL and the Board, had evolved in the opposite direction. If the actual gains were now $20 million, would Board Staff and

intervenors argue that the Board must stick with the outdated forecast? The answer, undoubtedly, is no, which simply illustrates the confounding of principles and forecasts that underlies the positions of these parties.

102. VECC has made proposals at paragraphs 43 and 44 of its submissions which THESL largely agrees with, apart from three points. First, VECC proposes that interest be calculated on an opening balance of $10.3 million, but that the principal be reduced as the properties in question were sold.

103. THESL accepts in principle that interest should accrue. Nevertheless, THESL has repeatedly raised the point that the $10.3 million represents the forecast of *before* tax gains. In its June 2008 Motion for Review, THESL specifically sought correction of the figure and cited at page 6, paragraph (b) (iii) the evidence underlying the original before-tax figure of $10.218 million and the fact that the after-tax amount was $8.95 million. However, the Board's Decision on Motion of June 2008 was silent on this point, which with the passage of time is now moot.

104. Whatever the origin (or correctness) of the forecast reference figure, the Board's SPO was that the *actual* Gains be credited to ratepayers. Had the $10.3 million been deducted from the 2008 revenue requirement, the subsequent sale of properties for more than the forecasted amount would have created a credit entry, and interest on that amount should arguably have begun at May 1, 2008, since the actual sale and determination of the net after-tax gain would serve to 'correct' the forecast. Conversely a sale producing a gain less than the forecasted amount would have produced a debit entry. The operation of interest in effect compensates for the fact that the original forecast, whatever its basis, did not match the actual gains realized. For example, if one property had been forecast to produce a gain of $4 million, which was reflected in rates set, then if it had actually produced a gain of $6 million, the operation of the variance account and simple interest together should produce a result where ratepayers and THESL are made (approximately) whole, given the Board's SPO.

105. Recognizing that the 'forecast' of Gains embedded in 2008 rates was zero, THESL submits that a fair, principled resolution of this particular issue is for interest at the prescribed rates to be calculated from May 1, 2008 to April 30, 2010, *on the actual Gains realized together with the forecast for Goddard (i.e., $4.050million)*, and to be credited to ratepayers along with the proposed principle amount $4.050 million. On this basis ratepayers also receive the benefit of effectively having the Named Properties comprising this amount disposed of on May 1, 2008, in advance of their actual sale.

106. Second, at paragraph 43 b) VECC proposes that THESL 'provide justification' for the difference between its original forecast and what has actually occurred or what is now forecast to occur.

107. THESL submits that this is unreasonable, beyond providing any broad and obvious statement that could be made about the dramatic deterioration of the economic climate in the intervening period. THESL has no special expertise in real estate valuation and relies now, as it did then, on external opinions. Furthermore, an answer at any level of detail would require THESL's speculation on why parties offered what they did for the properties and why unknown parties did not make other offers.

108. There has been absolutely no evidence suggesting that THESL has in any way acted as something other than a normal economic agent in arms-length transactions with independent third parties with respect to the properties that have been sold as well as Goddard.

109. Third, in a similar vein, VECC suggests at paragraph 45 that THESL be required to show that the actual capital gains were reasonable, and that 'its decision not to sell 211 Sterling Road was reasonable', or else face the Board deeming amounts which would apply.

110. THESL's evidence is that Sterling Road has significant and unresolved environmental problems and that certainly explains why the property has not yet been sold. With respect to the actual capital gains, these are determined by the sale price and the accounting book values. THESL cannot manipulate the latter and nothing suggests that THESL can control the offer price or has accepted less than what was commercially reasonable. Furthermore nothing suggests that the Board itself has the required information and expertise, or even the appetite, to enter the business of real estate appraisal. These suggestions are unreasonable if not outrageous on their face and should be rejected by the Board.

111. In summary, THESL's proposal to dispose of the Gains amounts is that:

(a) The actual Gains realized to date together with the forecast of the Gain for Goddard, amounting to $4.050 million, be applied as a revenue offset to 2010 rates;

(b) Interest on $4.050 million be calculated from May 1, 2008 to April 30, 2010 and also credited to ratepayers as a revenue offset, with documentation of calculations provided for review at the time of submitting the Draft Rate Order;

(c) Any difference between the actual Gain on the Goddard property and the forecast reference amount of $2.4 million be subject to the prescribed variance account treatment and be disposed at a subsequent proceeding; and

(d) Any subsequent Gains from the sales of the Sterling and Underwriters properties be subject to the prescribed variance account treatment and be disposed at a subsequent proceeding.

112. THESL submits that its proposal properly distinguishes between the Board's Sale Proceeds Order, which pertains to the *actual net after-tax gains on sale of the Named Properties*, and the now-dated forecast of the ratemaking implications of that Order. The now-dated forecast quantity was intended for the 2008 revenue requirement and cannot be properly used for the 2010 revenue requirement; to do so would wrongly set aside actual information in favour of outdated forecasts known to be inaccurate. THESL's proposal fairly implements the SPO in today's circumstances and does not imply that the Board's Decisions are subject to a lack of finality; conversely, THESL's proposal accurately implements the SPO without introducing spurious rate fluctuations that would occur under other proposals. For these reasons, THESL submits that the Board should accept its proposal as outlined here.

F. INCOME TAXES

113. THESL submits that while it agrees in principle with BOMA's suggestion that as a general policy its PILs calculations should be updated in the final rate order to accurately reflect the most current information, THESL does not agree with the specifics of the adjustments proposed by BOMA each of which is based on incorrect and misleading assumptions or an unsubstantiated forecast made by BOMA (for instance, the number of apprentices or co-op students forecasted in the original Application may be reduced in part as a result of the Settlement Agreement which included a reduction in OM&A from the original Application). THESL submits that it will update all applicable information in its draft rate order, and will include specific discussions to address the particular concerns raised by BOMA.

G. CONCLUSIONS

114. For all of the foregoing reasons as well as those raised in its Argument-in-Chief, THESL requests that the OEB approve its proposed 2010 Electricity Distribution Rates and other charges.

All of which is respectfully submitted this 24th day of February, 2010.

Original Signed by J. Mark Rodger
J. Mark Rodger

Original Signed by John A.D. Vellone
John A.D. Vellone

Counsel to Toronto Hydro-Electric System Limited

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