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Ontario

BY E-MAIL

March 15, 2010

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Chatham-Kent Hydro Inc.
2010 Distribution Rate Application
Board Staff Submission
Board File No. EB-2009-0261

In accordance with the Decision on Partial Settlement and Procedural Order No. 5, please find attached Board staff's Submission in the above proceeding. Please forward the following to Chatham-Kent Hydro Inc. and to all other registered parties to this proceeding.

Yours truly,

Original Signed By

Keith C. Ritchie
Project Advisor – Applications & Regulatory Audit

Att.

ONTARIO ENERGY BOARD

STAFF SUBMISSION

2010 ELECTRICITY DISTRIBUTION RATES

Chatham-Kent Hydro Inc.

EB-2009-0261

March 15, 2010

INTRODUCTION

Chatham-Kent Hydro Inc. (“CK Hydro” or the “Applicant”) is a licensed electricity distributor serving approximately 32,000 customers in the towns/communities of Blenheim, Bothwell, Chatham, Dresden, Erieau, Merlin, Ridgetown, Thamesville, Tilbury, Wallaceburg, Wheatley and the Bloomfield Business Part, located in southwestern Ontario. CK Hydro is comprised of twelve geographically separate service territories and each territory is bounded by Hydro One Networks Inc. (“Hydro One”), which services customers in the rural areas of the Municipality of Chatham-Kent. CK Hydro filed its 2010 rebasing application (the “Application”) on October 5, 2009. CK Hydro requested approval of its proposed distribution rates and other charges effective May 1, 2010. The Application was based on a future test year cost of service methodology.

The Vulnerable Energy Consumers’ Coalition (“VECC”), the School Energy Coalition (“SEC”), and Energy Probe Research Foundation (“Energy Probe”) were granted intervenor status. No letters of comment were received.[1]

In Procedural Order No. 1, issued on November 11, 2009, the Board stated its intention to proceed by way of an oral hearing, but made provision for written interrogatories. In Procedural Order No. 2, issued on December 1, 2009, the Board provided dates for making written submissions objecting to the request for confidential treatment of Chatham-Kent Utility Services Inc. (“CKUS”) 2008 financial statements as well as information detailing smart meter costs. No submissions were received. In Procedural Order No. 3 issued on January 15, 2010 the Board outlined dates for a technical conference and a settlement conference between the Applicant and intervenors with the objective of reaching a settlement among the parties on the issues. In that procedural order the Board also rendered its findings with respect to the claims for confidentiality of certain information.

A transcribed technical conference was held on January 26, 2010, followed by a settlement conference on February 4 and 5, 2010. The Parties reached a partial settlement. Pursuant to Procedural Order No. 4, the oral hearing scheduled for February 16, 18 and 19, 2010 was cancelled. A proposed Partial Settlement Agreement arising from the Settlement Conference was filed with the Board on March 3, 2010. The Board issued its Decision on Partial Settlement on March 11, 2010, in which the Board

[1] Response to Board staff IR # 3.

accepted the Partial Settlement Agreement and established timelines for written submissions on unsettled issues.

In the Partial Settlement Agreement, the Applicant and the intervenors reached a settlement on all issues, with the exception of the following:

1. Lead/Lag Study – the appropriateness of a lead/lag study for Chatham-Kent's next rebasing application;
2. Applicability of Ontario Small Business Tax Credit for the calculation of taxes/PILs; and
3. Cost of Capital: the appropriateness of the ROE and the short-term debt component of deemed capital structure.

Board staff's submission does not address issues for which settlement was reached and subsequently approved by the Board.

Working Capital – Lead/Lag Study for next cost of service application

In its original application, CK Hydro forecasted a Working Capital Allowance ("WCA") of $8,668,139. CK Hydro has used 15% of OM&A and cost of power in the calculation of working capital. The Partial Settlement Agreement includes an updated WCA of $8,985,311, as shown in Attachment K, page 2 of 2.

No lead/lag study was provided; in this Application CK Hydro has relied upon the commonly-used formula whereby the WCA is set as 15% of the sum of controllable expenses plus the cost of power. As documented in the Partial Settlement Agreement the parties agreed that requiring the filing of a lead/lag study by CK Hydro for its next Cost of Service rate rebasing application is an unsettled issue.

Discussion and Submission

In the Partial Settlement Agreement no parties took issue with CK Hydro's use of the 15% WCA formula in the current Application. Similarly, Board staff takes no issue with CK Hydro's methodology for calculating the WCA in this Application. However, Board staff submits that CK Hydro should update the WCA in determining the revenue requirement and associated distribution rates in preparing its draft Rate Order, to reflect any changes in controllable expenses and load forecasts as determined by the Board in its Decision, as well as to reflect the most current estimate of the RPP and non-RPP commodity prices, and current uniform transmission prices. Further, Board staff submits that CK Hydro should provide sufficient detail and discussion to aid other parties in understanding the numbers provided and their derivation.

CK Hydro has used the standard Working Capital Allowance derivation as 15% of the sum of the Cost of Power and controllable expenses. This methodology was inherited from the regulation of the electricity distribution sector by Ontario Hydro prior to restructuring and was documented in the *2000 Electricity Distribution Rate Handbook*. The Board has generally accepted this approach for setting electricity distribution rates to date, although certain larger distributors have conducted lead/lag studies to provide alternative working capital requirements.

Board staff notes that CK Hydro has indicated that it does not intend on conducting a lead/lag study as part of its next cost of service rebasing application.

In this Application CK Hydro has noted that it is implementing monthly billing and TOU pricing by March of 2011[2], in conjunction with deployment of smart meters. These changes will, in Board staff's submission, materially alter the utility's working capital requirements. Implementation of smart meters and billing based on TOU or interval demand and commodity prices will better align the billing by the IESO of energy delivered to CK Hydro's wholesale metering points and reduce variances due to estimated billing. The move to monthly billing will also reduce the lag between when the utility pays the IESO and when it receives payment from its customers. While many larger demand industrial customers may already be billed monthly demand, smart metering and TOU pricing will affect a significant portion of demand for Residential and smaller General Service customers.

In response to interrogatories, CK Hydro stated its belief that the anticipated impact on working capital of moving to monthly billing will not change its working capital. CK Hydro stated that: "[s]ome of the current assets balances (unbilled revenue, accounts receivable and cash) which are included in the calculation of working capital will change, but the changes will offset each other and the overall current asset total will remain the same."[3]

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[2] Exhibit 9/Tab 2/Schedule 1, page 2, lines 25 -26

[3] Response to Energy Probe # 81.

Board staff disagrees. The move to monthly billing for all customers and changes due to smart meters and TOU will affect the timing on the leads or lags for some costs and revenues, while others are unchanged. For example, the monthly billing for commodity by the IESO will remain unchanged, however the frequency with which CK Hydro bills for and receives revenues from its ratepayers will shorten for those customers, primarily Residential and smaller General Service, who will be billed every month instead of every two months. Other costs, such tax instalments to CRA or employee paycheques, should be unaffected, but the timing for the recovery of these costs will change by the move to monthly billing. In other words, Board staff submits that changes that Chatham-Kent Hydro is implementing for Smart Meters, TOU pricing and monthly billing will, in all likelihood, affect CK Hydro's working capital requirements thus underscoring the need for a new study.

All of this is in addition to existing factors supporting a review of the methodology. As stated above, the 15% WCA formula was developed a number of years ago, and a review to re-confirm its suitability or to develop an alternative is long overdue. The Board has required larger distributors like Hydro One Networks Inc. and Toronto Hydro-Electric Systems Limited to undertake lead/lag studies in recent applications, and updated studies have resulted in reduced working capital requirements. Other distributors, like London Hydro Inc.[4], have been directed to conduct and file lead/lag studies for their next cost of service rebasing applications.

Board staff also notes the Board's findings in its Decision with Reasons on Burlington Hydro Inc.'s 2010 electricity distribution rates:

> The Board agrees with Board staff that further work on the formulaic WCA approach is warranted. The Board expects to initiate a generic proceeding / consultation on determining a new working capital methodology in advance of Burlington's next cost of service filing. The Board will not direct Burlington to conduct an independent lead/lag study at this time.[5]

Board staff submits that it is inappropriate that CK Hydro should rely on the existing methodology, based on the changes in the industry and the concerns raised regarding the continued appropriateness of the current approach. Board staff submits that CK Hydro should participate in any Board-led process to review working capital and update

[4] Decision and Order, Board File No. EB-2008-0235, August 21, 2009, pg. 33
[5] Decision and Order, Board File No. EB-2009-0259, March 1, 2010, pg. 23

its working capital methodology based on the outcomes of such process. Alternatively, CK Hydro may wish to undertake its own lead/lag study. Whichever approach is taken, Board staff submits that CK Hydro should reflect the outcomes of either a generic study or its own study in its next Cost of Service rebasing rate application, and should not rely on the current approach. Further, CK Hydro should provide adequate support for its Working Capital Allowance in any subsequent Cost of Service rate application.

Ontario Small Business Tax Credit

On December 15, 2009, Bill 218, *Ontario Tax Plan for More Jobs and Growth Act*, 2009, S.O. 2009, c. 34[6], ("the Act") received Royal Asset. Schedule U of the Act amends the *Taxation Act*, 2007, S.O. 2007, c.11 (Schedule A).

Amendments include the reduction of the basic rate of tax under subsection 29(2) from 14% to 10%, and the reduction of the small business deduction rate under subsection 31(4) from 8.5% to 5.5% by July 1, 2013. Subsection 32(3) was amended to eliminate the small business deduction surtax payable by corporations that claim the small business deduction effective July 1, 2010. The benefit of the small business deduction is now extended to all Canadian-controlled private corporations, which will be taxed at the new small business rate of 4.5 per cent, effective July 1, 2010, on the first $500,000 of active business income, regardless of income level.

In Exhibit 4/Tab 3/Schedule 1/Table 4-28, CK Hydro provided its tax calculation of grossed-up income tax of $956,858 and Ontario Capital tax of $30,805. CK Hydro calculated a net income tax of $660,232, which is comprised of an effective Ontario tax rate of 13 per cent and a federal tax rate of 18 per cent, for a total of 31 per cent. CK Hydro did not apply the small business deduction as of July 1, 2010.

Board staff notes that other distributors of similar or larger size to Chatham-Kent Hydro have applied the change to the small business tax credit in determining the tax or PILs allowance recoverable in rates for 2010, and these proposals have been approved by the Board. For example, in the Partial Settlement Agreement for Cambridge and North

[6] Bill 218, *An Act to implement 2009 Budget measures and to enact, amend or repeal various Acts*, 2009, S.O. 2009, c. 34.

Dumfries Hydro, the PILs calculations include the Ontario small business tax credit[7]; Cambridge and North Dumfries Hydro has an estimated rate base of $104,581,021, larger than that of CK Hydro. Similarly, in the Board's Decision and Order on Burlington Hydro's 2010 distribution rates application, the Board directed that Burlington Hydro reflect the small business tax credit in updating its PILs allowance to be recovered in rates.[8]

Board staff submits that, based on current enacted tax legislation and for the above reasons, the Ontario Small Business Tax Deduction will apply to CK Hydro after June 30, 2010, and hence should be reflected in the PILs allowance to be recoverable in 2010 distribution rates. Board staff submits that tax/PILs calculations should be updated to incorporate all known tax changes for the 2010 test year.

Cost of Capital

Background

In the original Application, CK Hydro proposed its Cost of Capital treatment in accordance with the Board's Cost of Capital guidelines then in effect, as documented in the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation Mechanism for Ontario's Electricity Distributors*, issued December 20, 2006.

The Board subsequently revised and documented its guideline Cost of Capital methodology in the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* (the "2009 Report"), issued December 11, 2009, under Board File No. EB-2009-0084. The 2009 Report is a guideline, but departures from the methodology in the 2009 Report are expected to be adequately supported. While the 2009 Report was issued subsequent to the filing of this Application, the 2009 Report does state that the revised guidelines apply to applications for rates effective in 2010 or later and determined through review of Cost of Service applications. Thus, the 2009 Report supersedes the guidelines documented in the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* and is now applicable to CK Hydro's Application.

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[7] Decision on Partial Settlement, Board File No. EB-2009-0260, February 18, 2010. The Partial Settlement Agreement is attached as Appendix A to the Decision on Partial Settlement. Attachment F – Updated Tax Calculation, page 42 of the Partial Settlement Agreement shows explicitly the application of the credit.
[8] Decision and Order, Board File No. EB-2009-0259, March 1, 2010, Page 17

In Exhibit 5 of its Application, CK Hydro has proposed its requested Cost of Capital. This is summarized in the following table:

Cost of Capital Parameter	**CK Hydro's Proposal**
Capital Structure	60.0% debt (composed of 56.0% long-term debt and 4.0% short-term debt) and 40.0% equity
Short-Term Debt	1.33%, but to be updated in accordance with section 2.2.2 of the Board Report.
Long-Term Debt	7.62%, in accordance with the Cost of Capital Parameter Updates for 2009 Cost of Service Applications issued by the Board on February 24, 2009.
Return on Equity ("ROE")	8.01%, but to be updated in accordance with the methodology in Appendix B of the Board Report.
Return on Preference Shares	Not applicable
Weighted Average Cost of Capital	7.52% as proposed, but subject to change as the short-term and long-term debt rates and ROE are updated per the Board Report at the time of the Board's Decision.

As noted, CK Hydro has affirmed in its Application that the ROE, deemed Short-term Debt Rate and deemed Long-Term Debt Rate, as applicable, would be updated based on Bank of Canada, *Consensus Forecasts*, and TSX data for January 2010 in accordance with the methodologies documented in the 2009 Report.

In its application CK Hydro requested a return on Long-term Debt for the 2010 Test Year of 7.62% for its existing debt as well as new debt. In response to interrogatories and the technical conference CK Hydro confirmed that an existing debt of $23.5M is a reflection of the debt arrangement with the municipality as it has had since corporatization, although no formal promissory note existed until November 1, 2009. In the approved Partial Settlement Agreement, CK Hydro and the intervenors agreed to a long-term debt of 7.04% or the deemed Long-Term Debt Rate, whichever is lower.
CK Hydro and the intervenors did not settle on the following aspects of the Cost of Capital:

- That the ROE should be determined in accordance with the methodology as documented in section 4 and Appendix B of the Board's Cost of Capital report; and
- That the short-term debt component of the deemed capital structure, set at 4%, should apply for setting the weighted average cost of capital.

On February 24, 2010, the Board issued a letter documenting the updated Cost of Capital parameters to be used in determining distribution rates for 2010 cost of service applications, based on the methodologies documented in the Cost of Capital Report. These are summarized in the following table:

Cost of Capital Parameter	**Updated Value for 2010 Cost of Service Applications**
Return on Equity	9.85%
Deemed Long-term Debt Rate	5.87%
Deemed Short-term Debt Rate	2.07%

Therefore, the deemed short-term debt rate of 2.07% and the deemed long-term debt rate of 5.87%, being lower than 7.04%, will apply for setting the cost of capital for CK Hydro's 2010 distribution rates in this Application, per the Partial Settlement Agreement.

Discussion and Submission

CK Hydro has affirmed that the cost of capital parameters are to be updated in accordance with the guidelines in the Cost of Capital Report based on data available at the time of the Board's decision. Board staff submits that CK Hydro's proposals for Cost of Capital, including the deemed capital structure of 56% long-term debt, 4% short-term debt, and 40% equity, and CK Hydro's proposal for the ROE for setting 2010 electricity distribution rates, and as amended through discovery, comply with the guidelines documented in the 2009 Report.

- All of which is respectfully submitted -