TAB 26

Ontario Energy Board | Commission de l'énergie de l'Ontario

Ontario

EB-2009-0096

IN THE MATTER OF AN APPLICATION BY

HYDRO ONE NETWORKS INC.

2010 and 2011 DISTRIBUTION RATES

DECISION WITH REASONS

April 9, 2010

company. Hydro One submitted that many OM&A cost increases took place in 2009 and that this is evidence of the company's commitment to, and the necessity for, these programs.

Hydro One stressed the importance of the vegetation management program and explained the need to move to a shorter cycle to reduce unit costs and outages. It highlighted increased spending from $118 million in 2008 to $136 million in 2009, as an example of a bridge year increase that showed Hydro One's commitment to that program. Hydro One also highlighted lines and maintenance programs which are not discretionary and are a response to higher regulatory standards, principally for PCB regulations.

The following areas were addressed in the submissions:

- Overall OM&A Spending
- Compensation
- Vegetation Management

3.1 OVERALL OM&A SPENDING

PWU supported the proposed level of expenditures and cited the twin requirements of new government-mandated initiatives and the need to maintain an aging system. In PWU's view, reducing costs now would lead inevitably to even higher costs in the future.

Board staff and intervenors identified a number of factors which in their view showed that the OM&A cost increases are excessive: lower inflation and cost escalation factors; trend analysis; benchmark results; and specific spending items.

Board staff and most intervenors noted that updated evidence indicated lower overall inflation and lower distribution cost escalation than in the original application. VECC submitted that based on these updates OM&A is overstated by at least $9.4 million in 2010 and $7.0 million in 2011.

CME submitted that Hydro One's budget should be assessed through three trends or "indicators of reasonableness": total OM&A spending; OM&A cost per customer; and OM&A costs per circuit km. CME noted that OM&A costs have increased by 18.8% between 2008 and 2010 and by 44% between from 2006 and 2011. CME pointed to the

Board's decision in Hydro One's prior distribution rates case which specifically mentioned that past spending is a useful guide in assessing spending proposals. CME noted that OM&A cost per customer has grown by 16% between 2008 and 2010 and by 37% between 2006 and 2011, and that OM&A cost per circuit km has grown by 16% between 2008 and 2010 and by 35% between 2006 and 2011.

Hydro One agreed that historical spending levels are useful information for the Board but submitted that basing future expenditures only on historical norms ignores the reasons and evidence behind the changes. Hydro One argued that it had filed extensive evidence justifying the proposed spending increases and that arbitrary reductions without reference to the evidence should be rejected. With respect to the cost per customer and cost per circuit km trends, Hydro One responded that these measures were not meaningful because the cost increases are due to increased workload, not customer or wire additions. Hydro One cited the PCB regulations and increasing vegetation management spending as independent of either the customer numbers or circuit kilometres.

Board staff and intervenors also pointed to various benchmark results. Board staff submitted that the benchmarking results show that Hydro One has the highest distribution substation O&M expense per installed MVA, and was ranked in the middle-of-the-pack for substation O&M expense per asset. SEC also pointed to benchmarking results which show that Hydro One's OM&A cost per customer in 2010 is $459.50, which is more than double that of many large and complex Ontario utilities. In CCC's view, Hydro One has demonstrated very little in terms of productivity gains because work programs are increasing by 33% and total head is increasing by 37%.

Intervenors were also concerned that Hydro One was not exercising sufficient control over spending increases. SEC acknowledged some key cost drivers, such as PCB regulations, vegetation management needs and the Green Energy Plan spending, but submitted that when customers are being asked to absorb significant cost increases as a result of such key cost drivers, keeping cost increases in other areas to approximately the rate of inflation is a reasonable cost containment measure. SEC submitted that "...companies in a competitive environment facing key cost drivers in certain areas would work to ensure that other areas of spending are either held constant or held to minimal year over increases. Hydro One has done none of that."[3]

[3] SEC Final Argument, p. 17

CCC argued that in light of the pressure related to the Green Energy Plan and related projects, more discretionary projects should have been deferred or scaled back. CCC argued, for example, that the $3 million in 2010 and $4 million in 2011 associated with the head office and GTA space requirements should be viewed as discretionary and should be deferred.

CCC and CME both submitted that Hydro One should be held to a 3% inflationary increase relative to the 2008 Board approved level. CCC estimated this would result in a reduction of about $66 million in each of the test years. SEC recommended an overall OM&A reduction of $18.1 million in 2010.

Board staff recommended a reduction of $33 million in the overall OM&A budget for 2010. The reduction was defined as the half-way point between a 3% inflation scenario and the original OM&A budget. Board staff submitted it was inappropriate to micro-manage Hydro One's activities and recommended that Hydro One should reduce OM&A costs in areas it determines most appropriate. CME agreed with this approach.

Hydro One disagreed with the proposals by Board staff and intervenors to cut OM&A costs based on envelope or index-linked reductions. Hydro One maintained that there was no meaningful criticism or analysis of the underlying causes of the proposed increases and reiterated that the shareholder has borne significant cost increases during the IRM period as a result of the increased work programs, thereby demonstrating that the increased work is necessary. Hydro One maintained that if OM&A is reduced, less work will be accomplished and the performance of the distribution system will be affected.

BOARD FINDINGS

The Board finds that Hydro One's OM&A budget is excessive. Inflation and cost escalation factors are now lower than originally forecast and therefore the budgets are now over-stated on that measure. Second, and more importantly, the various trend measures demonstrate that Hydro One has had limited success in controlling expenditure increases. The Board agrees with Hydro One that these various trends are imperfect measures of reasonableness, but the measures are indicators. Hydro One emphasized that the expenditure increases are not driven by customer numbers or expansion in the circuit kilometres, but by increased workload particularly in the areas of vegetation management, PCB management, and Green Energy Plan related work.

However, if significant incremental work is required in particular areas, then it is the responsibility of the company to manage that in a way that ensures that growth in cost per customer is kept within reasonable levels to ensure ongoing customer affordability. The Board concludes that Hydro One has not been sufficiently successful in controlling the overall growth in spending. The benchmarking results also support the conclusion that Hydro One could and should do better in managing its growth in spending.

In the past, the Board has used different techniques to determine the allowed OM&A. In some cases a detailed line by line examination has resulted in an equally detailed funding prescription from the Board. In other cases the Board has provided the applicant with an overall envelope of funding. In such cases the Board does not stipulate an approved amount of spending for any particular category of spending, but rather leaves to the applicant the freedom to apply that spending according to its own prioritization.

In the Board's view, given Hydro One's capabilities and its complexity, it would not be appropriate to micromanage the utility's operations through a line by line authorization of spending; rather the Board should set an overall envelope and leave the specific allocation of the available funds to Hydro One's judgment and prioritization. In the following two sections of this decision, the Board will provide its observations and findings with respect to compensation and vegetation management. The company should take the Board's guidance on these subjects into account in arriving at its prioritization.

In arriving at the quantum of the envelope approved for OM&A the Board has taken a number of factors into account:

First is the totality of the evidence developed throughout the case. Through the detailed examination which takes place the Board achieves an understanding of the key drivers of utility operations and cost structures. This process also gives the Board the opportunity to assess the overall implications of the company's rate proposals for its customers and includes the opportunity for a variety of interests to express their particular concerns respecting the applicant's rate proposal and operational plans. This is a key element in arriving at a balanced and fair rate decision. The Board's consideration of the specific elements of the application as developed in the evidentiary portion is reflected in our observations and findings under compensation and vegetation management.

Second, the Board has considered the recent rate history of the distribution business. Over the last number of years Hydro One has applied for and received significant increases in the delivery portion of its electricity rates. Since 2004, Hydro One's delivery rates have increased significantly. Between 2004 and 2009 rates for the R1 Class have increased about 28%, whereas inflation has run at about 9%. The increase between 2007 and 2009 has also significantly outpaced inflation. As a result, Hydro One's revenues have exceeded inflation materially. That is not to say that the previous rate decisions have been inordinately generous. Over this period the company has been able to demonstrate a need to improve its customer information systems, maintain its physical plant, and generally manage its operations according to the revenue requirements approved. But the fact remains that customers have experienced increases in the delivery portion of their rates over this period that have significantly outstripped the general inflationary pressure within the economy.

Third, some of these rate increases combined with a recognized need to rationalize and harmonize the rate classes associated with acquired utilities have led to very significant increases in delivery charges for some customers. These increases have been of such a nature that they have been subject to rate mitigation measures, which are continuing.

Fourth, the Board must take into account the overall increase and prospect of further increases in the commodity portion of the bill. While these charges are outside of the control of the applicant, they are no less real for customers. In giving effect to the Board's objective to protect the interests of consumers the Board cannot ignore the overall impacts on customers.

The evidence also reveals another factor that has implications in determining the appropriate quantum of the conventional operations funding envelope. The Province, as part of a global phenomenon, has experienced a significant contraction in economic activity. The resulting demand reductions have two important implications. First, to the extent businesses have curtailed electricity demand or ceased operations, the per unit cost to be covered in delivery charges by the remaining customers will increase. This has an inherently inflationary effect on delivery charges. Second, both companies and individuals are experiencing material challenges in carrying added costs for the delivery of electricity.

Hydro One has maintained that the increases in 2009 borne by the shareholder demonstrate that the expenditures are necessary. In the Board's view, if a company spends more than the amount embedded in rates (whether for a test year or an IRM year), it is not determinative of whether the amounts are reasonable and prudent; nor does it establish the appropriate base for future levels. Management and shareholders make expenditure decisions for a variety of reasons, and the Board must still determine whether the test year forecasts are appropriate in light of all the evidence. Considering all the factors identified above, and in particular the conclusion that Hydro One has not sufficiently controlled its growth in spending, the Board finds that the appropriate quantum of the envelope to accommodate conventional operations should be derived from the year which was most recently examined and approved by the Board. In 2008, the approved level of expenditure was $466 million and the actual level of expenditure was $471 million. These figures are sufficiently close that the Board will derive the allowed level for 2010 and 2011 using the 2008 actual level.

To this initial 2008 level, the Board will apply an annual increase of 5% to derive an allowed OM&A for 2010 of $520 million. For 2011 the Board will apply an increase factor of 3% for an allowed OM&A of $535 million. The escalation factor for 2010 is higher than the rate of inflation. The Board adopts this approach in recognition that the company has statutory obligations, other than those associated with the *Green Energy and Green Economy Act, 2009* (GEA), which it must meet, and the fact that it is preparing itself for an operating environment that is turbulent and to some extent unknown. The escalation factor for 2011 is lower, although still higher than forecast inflation, to reflect that Hydro One itself proposed an even lower level of increase between 2010 and 2011. The Board notes that the approved spending levels are well in excess of the Minimum Level of spending (as explained in the capital expenditure section of this decision) of $476 million for 2010 and $483 million for 2011.

The Board recognizes that accommodating these levels of spending, which are significantly less than that applied for, will require the company to engage in a thoughtful reconsideration of its spending priorities. The Board concludes, however, that given the overall pressures operating within this environment, which are highlighted above, this is the right time for such a recalibration.

3.2 COMPENSATION

Hydro One's total compensation (for the distribution and transmission businesses) is forecast to grow from $566 million in 2008 to $849 million in 2010 and to $934 million by 2011. Headcount is forecast to increase from 6,547 in 2008 to 9,552 in 2010 and to 10,245 in 2011. Hydro One referred to the Mercer/Oliver Wyman Compensation Cost