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via RESS e-filing – original to follow by courier

Ms. Kirsten Walli, Board Secretary
Ontario Energy Board
2300 Yonge St, 27th Floor
P.O. Box 2319
Toronto, ON M4P 1E4

Dear Ms. Walli:

RE: Toronto Hydro-Electric System Limited (THESL)
Notice of Filing Intentions for 2012 Distribution Rates

Introduction

By way of letter dated March 1, 2011 the Board notified distributors of its expectations concerning the filing of cost-of-service (COS) rate applications for rebasing within the context of incentive regulation (IRM). In that letter, the Board set out a list of distributors from which the Board expected such an application, and furthermore advised distributors not appearing on that list that they should notify the Board as soon as possible, but in no event later than April 29, 2011, of any intention they may have to file a COS application for 2012 distribution rates.

By way of this letter, THESL advises the Board and other stakeholders of its intention to file a non-IRM COS application for 2012 rates. Reasons supporting the need for this approach are set out in detail below.

The Board and intervenors in THESL's current application for 2011 rates are of course aware that the question of the manner of regulation that will apply to the determination of THESL's 2012 rates is a Board-approved, unsettled issue that will go to hearing in the EB-2010-0142 proceeding[1]. THESL does not wish to disturb or depart from the process the Board has already established for determination of that issue, and consequently has filed a copy of this letter in that proceeding so that it will form part of the record in EB-2010-0142.

Prejudice to THESL Arising from the Use of IRM

The imposition of IRM upon THESL for 2012 would effectively freeze THESL's revenue requirement for that year and prejudge evidence that THESL is yet to file pertaining to its continuing need to make significant capital expenditures exceeding depreciation (CEEDs). (The 2011 price cap adjustment for a utility with a median stretch factor was set at 0.18%.) It would also effectively deny recovery by THESL of the revenue requirement related to $120.0 million in capital spending, that is, 50% of CEEDs incurred in 2011, due to the operation of the 'half-year rule'. Such an approach in these circumstances is unjustified and punitive.

In rate applications over the past several years, THESL has consistently presented extensive, detailed evidence concerning the ongoing need for major capital expenditures on its aging distribution system, substantially in excess of annual depreciation cost, for the purpose of infrastructure renewal and the maintenance and improvement of reliability. In its successive decisions the Board has in turn allowed capital expenditures at levels somewhat reduced from those initially requested by THESL, but nevertheless still significantly in excess of depreciation. In the current application, THESL and intervenors have proposed a settlement which provides for capital expenditures of $378.8 million, depreciation of $138.8 million, and CEEDs of some $240.0 million.

Ratebase is the determinant of the capitalization-related components of revenue requirement (i.e., return, PILs, depreciation and interest expense). Ratebase itself can be viewed as a reservoir of investment in the distribution system, with capital expenditures being the primary inflow and depreciation being the primary outflow.

IRM can be well suited to circumstances where depreciation is balanced by capital expenditures so that ratebase remains stable, or grows only slowly. However, in THESL's circumstances there continues to be a demonstrated need for overall capital expenditures to substantially exceed depreciation, now and for a period of many years into the future. As a result of significant CEEDs, ratebase must grow, and consequently so must revenue requirement. IRM is not designed to, and cannot, accommodate significant growth in ratebase and the consequential significant growth in capitalization-related revenue requirement.

[1] Procedural Order No. 2 includes Issue 1.5 which states: "When would it be appropriate for Toronto Hydro to commence filing rate applications under incentive regulation? Is this application an appropriate base case for a future IRM application? If not, why not?"

In contrast to other utilities whose load and customer base is growing and driving capital expenditure needs, most of THESL's capital expenditures are directed to non-revenue producing investments. Since 2005 THESL's load has been declining, on average by more than 1% annually, and customer growth has averaged less than 1% annually. On balance, billing determinants (customers and load) are essentially static for THESL. Stated differently, THESL's capital expenditures do not produce new revenues sufficient to fund those expenditures.

In addition, the Board clearly indicated in EB-2008-0187 Decision (Hydro One Distribution rates, pages 7 through 9) that the Incremental Capital Module was not intended by the Board to be applied to situations of long-term, predictable capital expenditures in excess of depreciation. As a result the existing Incremental Capital Module is inapplicable to THESL's circumstances and does not address the issue of accommodating programmatic CEEDs.

The operation of the half-year rule would also be punitive for THESL if IRM were imposed in 2012, since the 2011 revenue requirement only funds 50% of approved CEEDs in 2011. By 2011 year end, THESL expects to have incurred 100% of approved capital expenditures for that year. Since 2012 revenue requirement would be essentially frozen relative to that for 2011, approximately 50% of 2011 CEEDs or $120.0 million, representing a revenue requirement of approximately $13 million[2], would be unfunded in the 2012 revenue requirement.

It is furthermore the case that not all of the expenditures related to infrastructure renewal can be capitalized. THESL has documented the need for workforce renewal as a result of cresting retirements within its labour force, and new accounting rules reduce the proportion of total project expenditures that can be capitalized. As a result, THESL's operating expenditures are driven significantly by factors other than inflation and this real growth cannot be fully offset or accommodated through productivity growth.

In essence, IRM and cost-of-service both serve as means of setting utility revenue requirements, directly or indirectly. In circumstances where material factors other than inflation and productivity are absent, IRM presents advantages of simplicity and predictability. However, it is unreasonable to expect IRM to accommodate factors that it is not designed to account for, and it is prejudicial to effectively deny the existence of those factors (e.g., significant infrastructure and workforce renewal) by imposing IRM in circumstances where those factors do exist, and which, in THESL's case, are likely to persist for the foreseeable future.

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[2] Assuming a capitalization-related cost rate of 11%

Prejudice to Customers Arising from the Use of IRM

In order to carry on with the necessary renewal of its infrastructure and workforce, THESL requires resources. The only resources THESL can draw on are ultimately those obtained through revenue requirement, since all forms of capital used by THESL must be compensated and THESL has no other material source of earnings.

If IRM is imposed on THESL then it will have no ability to support expenditures in excess of its frozen revenue requirement. In direct consequence of that, THESL would have to reduce 2012 capital expenditures to a level equal to the depreciation component of that revenue requirement. In concrete terms, this would involve a dramatic reduction of capital expenditures from a proposed 2011 level of approximately $380 million to a 2012 level of approximately $150 million. Furthermore, THESL would have to substantially arrest its workforce renewal efforts despite the ongoing aging of that workforce and the inexorable erosion of its human capital.

Such developments would clearly injure customer interests in continuing reliability and service levels provided by the electricity distribution system, both in the near and long terms.

Furthermore the effect of abruptly and artificially curtailing investment in the system would be (among other things) to create even larger costs and hurdles to overcome in the future. Arresting remedial investment in the distribution system (both physical and human capital) does not arrest the ongoing degradation of those physical assets or the erosion of human capital. In fact to do so would set the stage for exactly the kind of 'lumpy', catch-up expenditures that the Board has criticized THESL for in the past (for example, at pages 12-13 of the EB-2007-0680 Decision). Any action which would have the effect of further postponing much needed investment simply exacerbates ongoing reliability concerns and exposes customers to increased reliability and service risks. These outcomes are clearly untoward for all parties concerned.

Even in the event that THESL could continue investing in its system at levels constituting significant CEEDs under IRM, the resulting erosion of THESL's return on equity would lead in short order to an earnings offramp, thereby predictably defeating the purpose of a prolonged period of mechanistic adjustments.

It is instead clearly preferable to meet those requirements in a steady, planned manner rather than by reacting to one emergency after another. Providing a stable, predictable stream of resources to the electricity distribution system is the best way to minimize long run costs and avoid abrupt rate shocks. In circumstances where CEEDs are required and strong pressures for real growth in operating expenditures exist, IRM does not provide a stable flow of resources but instead induces a stair-step pattern of deferred operating and capital expenditures followed by abrupt and possibly severe rate shocks, together with unmanageable peaks in project workload. Neither of these outcomes protects customer interests. Until CEEDs are no longer significant, regular cost-of-service proceedings, or their functional equivalent, provide the greatest degree of rate smoothing in the circumstances that THESL faces.

Regulatory Efficiency

The Board and intervenors achieve substantial efficiencies in the regulation of THESL viewed from a per customer perspective. Considering the list of 24 utilities from which the Board expects a 2012 cost-of-service rebasing application, and using the latest available (2009) Yearbook of Electricity Distributors information, THESL's one cost-of-service proceeding covers 89% of the *combined total* of customers from all 24 of those distributors. If the two major urban utilities on the list are removed, THESL's one cost-of-service proceeding covers 237% of the *combined total* of customers from the remaining 22 distributors. Considering all the distributors listed in the 2009 Yearbook, THESL's 2009 customer base of 689,138 is more than eleven times as large as the average (including THESL) of 60,661. In terms of customer coverage, therefore, one THESL proceeding is more than eleven times more productive than the average proceeding, a fact which should carry significant weight when set against the fact that the costs in dollars and regulatory resources of carrying out any proceeding are largely independent of utility size.

This is further accentuated by the fact that THESL and intervenors have been highly successful in the last two proceedings in reaching settlement on the majority of issues in those proceedings, thereby considerably reducing the most expensive aspect of any proceeding, which is oral hearing time.

Furthermore, on more than one occasion and specifically in THESL's current rate proceeding, the Board has used a THESL application as a 'test case' in setting policy for the entire sector. In the current proceeding for example, the Board has required THESL to produce evidence including two cost allocation studies pertaining to the question of suite metering and the possible establishment of a separate class for multi unit residential buildings. Regardless of the merits of that question, THESL cost-of-service applications have been used by the Board as the venue for consideration of such policy questions and thereby have enabled the Board and intervenors to gain even more policy-setting leverage from THESL's single application.

Even in cases where the issues could be argued to affect only THESL directly, the Board has directed THESL to provide further evidence which could only be dealt with in subsequent cost-of-service applications; for example, with respect to distributed generation in Toronto and the ratemaking consequences of the transfer of streetlighting assets.

Alternatives to the Imposition of IRM

In response to Board Staff interrogatory #9 in the EB-2010-0142 proceeding, THESL outlined how alternatives to both IRM and COS might emerge in the context of the Board's Renewed Regulatory Framework for Electricity initiative. The two approaches outlined there were essentially the multi-year cost of service approach and the 'augmented IRM' approach under which an expanded set of cost drivers would be recognized and applied to revenue requirement directly rather than to rates directly.

Having given further consideration to these questions in the interim THESL is now of the view that a well-defined alternative may emerge in time to be applied to 2013 rates and revenue requirement, and as a result THESL does not at this stage wish to commit to the 3 year cost of service framework that was mentioned in the interrogatory response noted above. Pending further developments in this area THESL anticipates that its 2012 rate application will be for a one year period.

Summary

The imposition of IRM on THESL for the purpose of setting rates in 2012 and the foreseeable future would be unwarranted, unfair, and prejudicial to the interests of customers and THESL, and is not required from the perspective of regulatory efficiency.

Instead, THESL believes that it can work with the Board and intervenors to develop alternative regulatory approaches which can fairly and successfully address the circumstances of both THESL and its customers, while meeting the needs of the Board and intervenors. While annual cost-of-service reviews are demanding on all parties, the Board should encourage development of constructive alternatives to that approach rather than adopting an existing alternative in the form of IRM which is clearly inappropriate for THESL and its customers.

Yours truly,

[Original signed by]

Pankaj Sardana

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cc: Registered Intervenors in EB-2010-0142
J. Mark Rodger, Counsel to THESL