Ontario

ONTARIO ENERGY BOARD

STAFF SUBMISSION

2008 ELECTRICITY DISTRIBUTION RATES

Chatham-Kent Hydro Inc.

EB-2007-0881

February 8, 2008

INTRODUCTION

On November 1, 2007, Chatham-Kent Hydro Inc. ("CKH") submitted an application based on the 2008 Incentive Regulation Mechanism ("IRM") seeking approval for changes to the rates that CKH charges for electricity distribution, to be effective May 1, 2008. CKH also requested approval for a Z-factor adjustment associated with the recovery of bad debt, the completion of its rate harmonization plan, and new smart meter rate adders. The purpose of this document is to provide the Ontario Energy Board (the "Board") with the submissions of Board staff after its review of the evidence submitted by CKH.

Z-FACTOR ADJUSTMENT

Background

The *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* (the "Board Report") states that:

> "Under cap mechanisms (price or revenue), contingencies need to be built into the regulatory regime to provide the flexibility to recognize extraordinary events outside the control of distributor management. These are called Z-factors (…) For 2nd Generation IRM, the Board will limit reliance on Z-factors to well-defined and well-justified cases only – specifically, Z-factors will be limited to changes in tax rules and to natural disasters."

CKH's Z-factor request is for the recovery of $200,000 resulting from "a few significant bad debt accounts."

Discussion and Submission

In response to a staff interrogatory, CKH provides three main arguments in support of establishing a Z-factor for bad debt at this time. First, CKH states that a precedent was set in the Decision in proceeding EB-2004-0527 where the Board allowed Oakville Hydro Electric Distribution Inc. ("Oakville") to recover revenues that were to be foregone as a result of one large customer significantly reducing its demand. Staff notes that this case occurred prior to the establishment of the second generation IRM. Staff also notes that while CKH's bad debt request is a one-time event of $200,000, Oakville's request related to on-going annual distribution revenue foregone of $1.261 million, or an annual under-recovery of approximately 4% of its total distribution revenue. In its EB-2004-0527 Amended Reasons for Decision, the Board stated that:

> "The Board acknowledges that the Board approved rates include compensation to the utility for the risk of business losses. However, the Board finds that it is appropriate to reallocate revenue responsibility because the loss that would otherwise be incurred is material, beyond the control of the utility and beyond a reasonable level of business loss."

While CKH indicated that the materiality threshold of 0.2% of total distribution expenses was exceeded, staff notes that out of the total Z-factor claim of $200,000, about $9,500 is attributable to un-recovered distribution revenue. Since CKH did not propose to recover the going-forward foregone distribution revenue of about $9,500, staff questions if that this amount would be material to CKH.

Second, CKH claims that electricity distributors should be "made whole for commodity, transmission, and IESO charges." About $190,500 of the $200,000 requested by CKH relates to those non-distribution revenue charges. Staff notes that in the Decision and Order in the RP-2005-0020/EB-2005-0391 proceeding, where Milton Hydro Distribution Inc. requested recoveries for bad debt, the Board stated that:

> "The Board notes that a portion of the loss was associated with the commodity. However, the Board reminds Milton Hydro that electricity

> distribution companies have their rates set based on a number of cost factors including the compensation for business risk. Even though there is no explicit risk premium associated with the commodity element, the overall premium is sufficient to provide adequate compensation to Milton's shareholders."

Third, CKH asserts that in the June 4, 2007, staff discussion paper entitled *Electricity Distributors and Management of Customer Commodity Payment Default Risk* ("Discussion Paper"), staff "acknowledged outstanding issues surrounding the distributors' ability to manage customer default risk and the tools available to them to do so." In CKH's view, "At least until these issues have been resolved, the Board should allow Z factors for such losses." Staff notes that there was no acknowledgement made by staff that there were any outstanding issues surrounding the distributors' ability to manage customer default risk or issues surrounding the tools available to them to do so. In fact, staff wrote that "The question remains as to whether the existing measures are generally considered adequate or whether implementation by the Board of additional measures might be warranted."

Staff also notes that the Discussion Paper lists prior applications to the Board by electricity distributors for bad debt recovery and highlights that they were all denied. One example is the Amended Decision and Order in the RP-2005-0020/EB-2005-0402 proceeding where the Board stated that, as part of its reasons to deny Oshawa PUC Networks Inc.'s request, "The Board also wishes to avoid reducing the incentive to aggressively manage bad debt levels." The Discussion Paper also described risk mitigation measures under the Board's authority, which includes the calibration of bad debt through a rebasing application, increasing the billing frequency, and security deposits.

Staff notes that Rideau St. Lawrence Distribution Inc. lost its largest volumetric customer to insolvency in 2006, a factor that contributed to its decision to self-nominate for rate-rebasing in 2008. CKH self-nominated to be rate-rebased in 2010.

Finally, staff is unclear on whether the amount claimed is net of any security deposits it may have received from the three defaulting customers or if CKH expects to receive funds from any settlement resulting from the bankruptcy, or through the sale of those claims to a third party.

RATE HARMONIZATION

Background

CKH consists of 11 service areas that amalgamated in December 1997. In the 2006 EDR rate case (RP-2005-0020/EB-2005-0350), the Board reviewed and approved CKH's rate harmonization proposal stating that rate harmonization will remove distinctions between customers based on historic service areas and will not create undue customer rate impacts.

The Board also approved the second of the three-year rate harmonization plan that CKH submitted as part of its 2007 IRM rate application (EB-2007-0517, EB-2007-0109). The Board found that the rate harmonization application was in accordance with the proposal approved in the 2006 EDR rate case. CKH is now applying for the third and last year of its rate harmonization plan, which entails the harmonization of the residential rates and the harmonization of the General Service 50 to 4,999 kW Time of Use rates in the Blenheim and Chatham service areas.

Under CKH's revised application, a residential customer consuming 1,000 kWh per month would experience an approximate change in the electricity bill ranging from a decrease of 2.7% for a customer in the Wallaceburg service area to an increase of 5.2% for a customer in the Blenheim service area. Based on the consumption profiles submitted by CKH, no rate class would experience a total bill impact greater than 10% under this revised application. These bill impacts exclude the effect of CKH's proposed adjustment to retail transmission service rates.

Discussion and Submission

Board staff has reviewed CKH's rate harmonization application and has found it to be in accordance with the methodology approved in the 2006 EDR rate case.

In response to a staff interrogatory regarding the possibility that a total bill impact greater than 10% could be experienced for certain consumption profiles by consumers in the Blenheim General Service 50 to 4,999 kW Time of Use ("GS TOU") rate class, CKH wrote that it now wishes to withdraw its request to harmonize the rates of the GS TOU rate class. CKH also indicated in their response that there is only one customer in this rate class and that "they will close the plant and move all production to an affiliate plant in the United States, this process has already begun." CKH further added that "this rate class is being grandfathered from the previous regulatory regime and will not be used for any new customers."

Given the submission by CKH regarding the status of the customer in Blenheim and the fact that the rates will not be made available to any new customer, staff submits that CKH's proposal to retain the two GS TOU rates within Blenheim and Chatham would help minimize rate fluctuation over time. This is due to the fact that the harmonization of the two GS TOU rates would result in a decrease of the Chatham GS TOU rates at this time, only to revert back to rates based only on the Chatham GS TOU customers at rebasing (assuming that there will be no customers in the Blenheim GS TOU left).

With regard to the residential rate harmonization, Board staff notes that CKH appears to have deducted an incorrect amount for the volumetric conservation and demand management rate rider on the sheet called "Harmonized Rate" of the revised IRM model CKH submitted on January 18, 2008. This error, if confirmed, affects the calculation of the proposed harmonized residential volumetric charge. Staff asks the applicant to comment on this issue.

SMART METER

Background

In the 2006 rate setting proceedings, a number of distributors indicated that they might have difficulty implementing the announced smart meter installations targets without financial assistance. To address this need, the Board provided advanced funding in the form of a smart meter rate adder. However, the Board indicated that the rate adders are not set to guarantee cost recovery, nor are they set at a level that is deemed to be prudent. This prudence review is to be undertaken at a later date, as explained below. As well as providing advance funding, the use of the rate adders was an attempt to phase in the impact that might arise if the cost of the smart meters were brought into rate base all at once in a future year. Rate adders are to be removed once smart meter asset balances are included in approved rate base and their costs incorporated into a re-based revenue requirement.

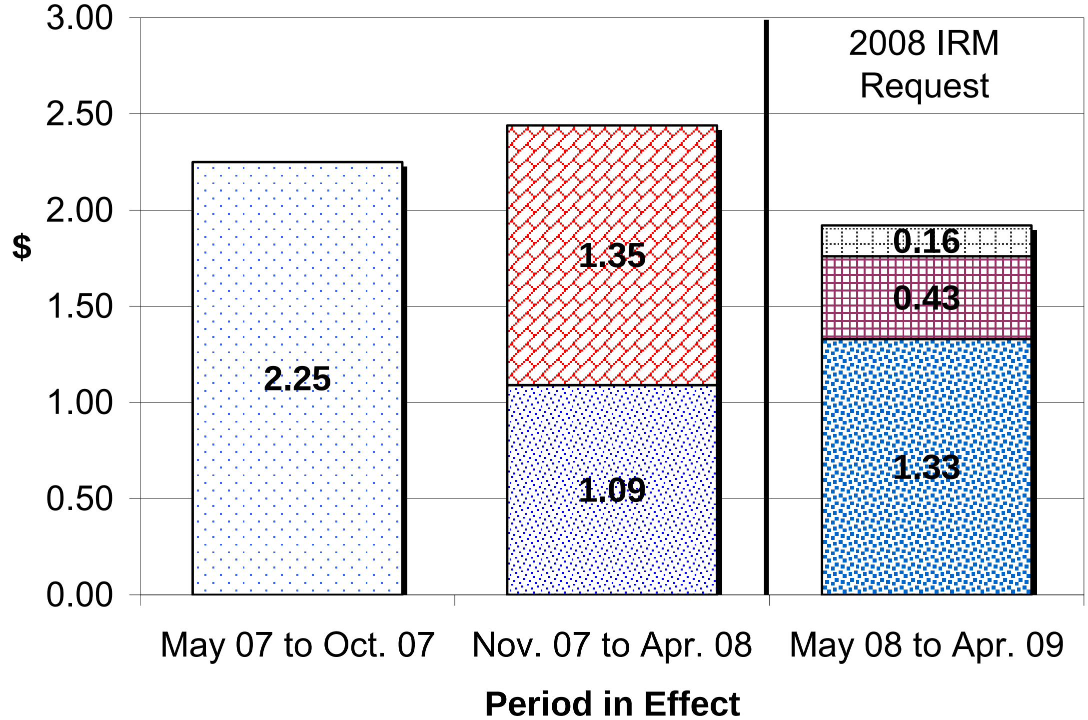
Following its Decision on certain generic 2006 EDR issues, the Board also established variance accounts to capture the amounts recovered through the rate adders and the revenue requirement associated with smart meters. Once a prudence review has been conducted by the Board, the net amounts accumulated in the variance accounts are disposed of through a rate rider. In the intervening period between the expiry date of the rate rider and the time of re-basing, the revenue requirement associated with these Board approved smart metering costs is captured in a new rate adder (permanent capital adjustment). Upon re-basing, a typical approach would be to include the approved smart meter expenditures adjusted for depreciation in rate base and adjust the revenue requirement accordingly. The rate adder would then no longer be necessary.

CKH is one of the licensed distributors authorized by Ontario Regulation 427/06 to conduct discretionary metering activities. In its EB-2007-0517 and EB-2007-0109 Decision and Order dated April 12, 2007, the Board approved CKH’s request for a smart meter rate adder of $2.25 per metered customer per month (MC/month) effective May 1, 2007. Following the EB-2007-0063 and EB-2007-0517 Rate Order dated October 26, 2007, the Board approved a one – year rate rider of $1.35/MC/month to dispose of the variance between the amounts recovered through the rate adder up to October 31, 2007, and the Board approved smart metering costs up to April 30, 2007. A new rate adder of $1.09/MC/month was also implemented effective November 1, 2007, to fund planned smart meter installations from May 1 to December 31, 2007.

CKH is now applying to recover through a rate adder (permanent capital adjustment) the 2008 revenue requirement associated with the Board approved smart metering costs up to April 30, 2007. This proposed rate adder amounts to $1.33/MC/month and would be in effect throughout the 2008 rate year. CKH also proposes, effective May 1, 2008, the establishment of two new one-year rate adders totalling $0.59/MC/month ($0.43/MC/month related to residential installations made between May 1, 2007, and December 31, 2007, and $0.16/MC/month associated with general service installation made up to September 30, 2007). If approved, CKH's total monthly service charge for smart meters would decrease to $1.92/MC/month from the current $2.44/MC/month. Figure 1 shows staff's depiction of the elements described above.

Staff notes that CKH has reflected in its application the termination, effective May 1, 2008, of the existing $1.35/MC/month rate rider and the $1.09/MC/month rate adder.

Figure 1: Monthly Smart Meter Charge per Metered Customer



Rate Rider

True-up of residential costs approved up to Apr. 07

Rate Adder

Funding for first part of planned 2007 Installations

Funding for remainder of planned 2007 installations

Proposed for general service installations made up to Sept. 07

Proposed for residential installations made between May 07 and Dec. 07

Proposed permanent capital adjustment for installations made up to Apr. 07

Discussion and Submission

New rate adder (permanent capital adjustment) of $1.33/MC/month

Staff notes that the proposed rate adder of $1.33/MC/month was calculated using the computer model filed by CKH in the EB-2007-0063 and EB-2007-0517 proceeding, and is meant to recover the 2008 revenue requirement associated with the Board approved smart metering costs up to April 30, 2007.

In its Decision with Reasons for EB-2007-0063, the Board stated that:

> "For those applicants that are not part of the first tranche of cost of service applications, the incentive rate mechanism process will recognize the costs approved in this Decision. This will allow distributors to include costs related to minimum functionality, as approved in this Decision, in their incentive rate adjustment."

It is staff's understanding that monies collected through this rate adder would be a return on and of capital for the capital expenditures approved in EB-2007-0063. As such, it is Board staff's understanding that these monies would not be recorded in a variance account.

New Rate Adder of $0.43/ MC/month

CKH is applying for two new one-year rate adders: one for residential smart meters installed between May 1, 2007, and December 31, 2007, ($0.43/MC/month); and the other for smart meters installed up to the September 30, 2007, for general service customers with a demand less than 50 kW and general service customer with a demand greater than 50 kW ($0.16/MC/month). Those rate adders were calculated using the computer model used in the EB-2007-0063 and EB-2007-0517 proceeding.

Through an interrogatory response, CKH clarified that it is not asking that a prudence review of the costs underpinning the calculation of the proposed new rate adders be conducted in this proceeding. Staff understands that CKH intends to “apply for final recovery of costs incurred for all installed meters at April 30, 2008,” at a later date.

Board staff notes that the funding that CKH is requesting with regard to the installation of residential smart meters (i.e., the $0.43/MC/month rate adder) has already been provided through the $1.09/MC/month rate adder that became effective on November 1, 2007. Staff’s understanding is based on the fact that the amounts and smart meter installation projections used for the calculation of both the $1.09/MC/month rate adder and the requested $0.43/MC/month rate adder are the same, except for the exclusion of $43,738 in incremental operating spending in CKH’s proposed $0.43/MC/month rate adder. In addition, the model identifies these amounts as pertaining to 2007 rather than calculating the revenue requirement on these installations for 2008. Board staff asks CKH to confirm this point. Nonetheless, this does not change staff’s observation below.

The applicant is asked to comment on the option of maintaining the existing $1.09/MC/month rate adder in place for the 2008 rate year, since CKH has not requested in its application any amount for a 2008 return on and of capital for the residential smart meter installations made between May 1, 2007, and December 31, 2007. While those expenses have not been approved yet, the applicant is asked to comment on whether it is appropriate, for rate stability, to provide relief for their associated costs up until a decision is made on those installations. The continuation of the $1.09/MC/month rate adder would provide continued funding for CKH’s smart meter program, which will be subject to a prudence review in a later proceeding.

Staff notes that while the existing $1.09/MC/month rate adder relates to 10,948 residential installations, the proposed rate adder of $1.33/MC/month (permanent capital adjustment) relates the installation of 17,052 residential smart meters. Board staff also notes that CKH did not request any funding for their planned 2008 installation of 209 smart meters for customers with a demand less than 50 kW and 424 smart meters for customers with a demand greater than 50 kW. The $1.09/MC/month rate adder could also be seen as providing funding for some or all of those activities.

Alternatively, Board staff notes that the smart meter models filed by CKH also calculated a rate adder of $0.85/MC/month to recover the 2008 revenue requirement associated with the residential installations made between May 1, 2007, and December 31, 2007. The applicant is asked to comment on the option of approving this rate adder. Staff notes that the transitional adjustment to the capital structure has not been made for the calculation of this rate adder. Staff further notes that approving this rate adder would not provide additional funding for the planned general service installations in 2008, nor a recovery for a 2008 revenue requirement on general service installations made to date.

<u>New Rate Adder of $0.16/MC/month</u>

The funding sought through the one-year $0.16/MC/month rate adder totals $60,609 and relates to a return equivalent to a return on rate base for installations made up to September 2007: 431 smart meters for General Service Less Than 50 kW customers and 271 smart meters for General Service Greater Than 50 kW customers.

CKH stated in response to a Board staff interrogatory that the costs associated with it are within minimum functionality set out in Ontario Regulation 425/06. Board staff notes that Ontario Regulation 425/06 prescribes the criteria and requirements for meters for “residential and small general service consumers” to be those specified in the document entitled “Functional Specification for An Advanced Metering Infrastructure — Version 2.” That document states that “This Specification sets the required minimum level of functionality for AMI in the Province of Ontario for residential and small general service consumers where the metering of demand is not required.” Board staff notes that the only customer classes where the metering of demand is not required are the Residential class and the General Service Less Than 50 kW class.

Board staff notes that in EB-2007-0063, Toronto Hydro-Electric System Limited agreed that the meters for 560 general service customers exceeded the minimum functionality in that these meters were to be used for billing of demand. The Board stated that it explicitly did not find "that the costs associated with these meters fall into the minimum functionality costs." Nonetheless, the Board determined that those costs could be recovered, but that the approval of these costs was "ancillary to the smart meter decision."

RETAIL TRANSMISSION SERVICE RATES ADJUSTMENT

Background

In its letter dated October 29, 2007, the Board directed each distributor to propose an adjustment to their retail transmission rates (RTR) and disposition of the associated variance account balances in its 2008 Cost of Service or Incentive Rate Mechanism application, as applicable.

CKH proposes to reduce its RTR — Network Service Rates by 13.0% and its RTR — Line and Transformation Connection Service Rates by 27.0% for all its rate classes.

Discussion and Submission

To derive their proposed RTR adjustments, CKH determined their annual wholesale transmission network and connection costs based on 2006 data and the Board rate order dated October 17, 2007 (EB-2007-0759). These adjusted wholesale transmission network and connection costs were subsequently compared to revenue generated through existing retail transmission rates for the 2006 calendar year period to determine cost/revenue ratios for network and connection. The calculated cost/revenue ratios for network and connection were then applied to existing retail network and connection rates to derive the proposed adjustments to retail network and connection rates.

While CKH is partly embedded within Hydro One Networks Inc. (“Hydro One”), CKH assumed for the purpose of the derivation of the RTR adjustments that Hydro One, as a host distributor, will be charging rates equivalent to the new wholesale transmission rates.

All of which is respectfully submitted.