date given the practical impossibility of implementing rates on May 1, 2011 (reply submissions are not due until May 2, 2011) and THESL's subsequent billing system conversion (which was scheduled to occur after a May 1st implementation). THESL is particularly concerned with the practical difficulties and associated risk of billing errors associated with attempting to implement new rates in the middle of a major billing system conversion, as was described by Mr. McLorg during Panel 3.

EB-2010-0142 Transcript Volume 2 dated March 30, 2011 at Pages 72-73.

UNSETTLED ISSUES

1. IRM

10. The Board defined Issue 1.5 in Procedural Order No. 2 as follows:

"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?"

11. In Procedural Order No. 2, the Board described its rationale for including Issue 1.5 in this proceeding. On page 4 of the Procedural Order that the Board states "it is appropriate to incorporate this issue to allow parties to explore the full range of approaches available to deal with the longer term issues raised by Toronto Hydro's application." By way of a 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"). Although THESL has never filed an application under the existing Third Generation Incentive Regulation Mechanism ("3GIRM") regime, on March 25, 2011 THESL filed a letter with the Board indicating its intention to file a cost of service application for 2012 distribution rates. This letter was marked as evidence

as Exhibit KH1.2. THESL continues to rely on the evidence set out in this exhibit and the supporting testimony of THESL's Panel 3 regarding this matter.

12. With respect to the first question, THESL submits that for the period until THESL's ratebase stabilizes (i.e., when annual capital expenditures level off and are matched by depreciation), it would not be appropriate for THESL to file rate applications under the existing 3GIRM.

13. Most directly, this is because 3GIRM effectively freezes THESL's revenue requirement during the period between rebasing applications. A static revenue requirement between rebasing years would not be compatible with or compensatory of a significantly increasing ratebase, nor with the goal of providing the greatest practical degree of 'rate smoothing'. THESL submits that it has demonstrated in its past three cost of service rate filings that substantial year-over-year increases in ratebase are and will continue to be a necessity and that it cannot carry out vital infrastructure renewal if capital expenditures are limited to the current level of depreciation.

14. Ratebase, and not yearly capital expenditure, is the driver of the capitalization-related expenses included in revenue requirement. The level of ratebase is principally determined (apart from other minor adjustments) by the balance between capital expenditures, which increase ratebase, and depreciation, which decreases ratebase. So long as capital expenditures exceed depreciation, ratebase must grow. Conversely, when depreciation exceeds capital expenditures, ratebase will decrease.

15. Capitalization-related revenue requirement in any given year is determined by average ratebase, and does not specifically or directly support capital expenditures *per se* undertaken in that year. It is not correct to conclude that rates set on the basis of an approved level of capital expenditures in a given year can continue to be compensatory in the subsequent year if those capital expenditures exceed

depreciation, since if they do, ratebase will have grown and so, therefore, will have revenue requirement.

16. For example, it is not the case that if THESL had approved capital expenditures of $350 million in year one, that the same year one capitalization-related revenue requirement would necessarily continue to support that $350 million level of capital expenditures in year two. That would only be true if ratebase did not change between the two years.

17. Similarly, it is not true that if THESL proposed capital expenditures of $375 million in year two, the 'shortfall' in revenue requirement would be $25 million. The shortfall in capitalization-related revenue requirement between the two years is instead determined by the difference between average ratebase in the two years, which is in turn directly dependent on the amount by which capital expenditures exceed depreciation.

18. The only capital expenditures that can be supported in the subsequent year under a condition of a frozen revenue requirement are those that are just equal to depreciation. In that case, apart from the effects of the half-year rule, ratebase would be static and would be supported by a frozen revenue requirement.

19. In fact, presuming that planned capital expenditures are fully completed, the operation of the half-year rule makes it the case that actual ratebase in the subsequent year is greater than in the base year, by half of the amount by which those capital expenditures exceed depreciation in the base year. As a result, a predictable deficiency in revenue requirement will occur, and the magnitude of that deficiency, under a frozen revenue requirement, will increase directly with the level of capital expenditures exceeding depreciation (CEEDs) in the base year. As set out in Exhibit KH1.2, that deficiency in THESL's case would be approximately $13 million, given the 2011 level of CEEDs.

20. Consequently, when the level of CEEDs is significant, it is not even the case that a frozen revenue requirement in the subsequent year supports the ratebase that then actually exists. THESL submits that this outcome is confiscatory and directly contradicts other express findings of the Board, namely those concerning the weighted average cost of capital and THESL's 2011 approved capital spending. The Board has determined authorized returns to capital (i.e., returns to equity and debt) as well as capital expenditures and depreciation. Given 2011 opening ratebase, the latter two of these determine 2011 year end ratebase, which becomes 2012 opening ratebase. Even supposing that 2012 ratebase remains static (i.e., capital expenditures equal depreciation), the effect of not recognizing the increase in 2012 ratebase is to deny the authorized returns to that incremental ratebase, which is contrary to the Board's other findings noted above.

21. Therefore, with respect to the second question (Is this application an appropriate base case for a future IRM application?), THESL submits that it is not, due first of all to the marked inadequacy of a frozen revenue requirement in circumstances where significant CEEDs are required, and second because the operation of 3GIRM in years between rebasing does not compensate for the approved ratebase that will actually exist at the end of the rebasing year.

22. In essence, the second question takes as a premise the proposition that 3GIRM is appropriate for THESL. Since THESL strongly disputes that premise, it cannot agree that its application for 2011 revenue requirement and rates could then serve as the basis for a ratemaking system that is itself inappropriate for THESL.

23. In response to a question posed by the Board, THESL witnesses clarified on the record that the inadequacy of revenue requirement would occur not in 2011, but rather in subsequent years if 2011 were to be construed as a rebasing year. THESL filed its 2011 application expressly as a non-IRM cost of service application and not as a rebasing application. Furthermore, THESL was able to

settle a large number of issues with the intervenors on this basis, significantly narrowing the scope of issues remaining for the Board to determine in this matter.

EB-2010-0142 Transcript Volume 2 dated March 30, 2011 at Pages 64, Line 13 to Page 67, Line 23.

24. THESL has over the past several years undertaken very strenuous efforts to present cost of service cases to the Board precisely because of its view that it would be irresponsible to neglect the urgent needs for infrastructure and workforce renewal that exist on its system. As a result THESL has consciously foregone the opportunities for greater earnings that by design are offered under an IRM framework. THESL's under-earning in 2009 and 2010 are documented in its Application. In 2009, THESL's actual financial ROE was 6.35% (versus an allowed ROE of 8.01%), and in 2010, on a pro-forma basis, THESL's financial ROE was estimated to be 7.69% (versus an allowed ROE of 9.85%).

Exhibit B1, Tab 6, Schedule 1.
Exhibit B1, Tab 7, Schedule 1.

25. THESL submits that 3GIRM represents a different regulatory framework among all parties, one which THESL has not entered due to its obligations around system renewal. There would be a breach of natural justice and procedural fairness were the Board now to fundamentally change the nature of the relief sought by THESL in its 2011 application, and thereby change the underlying regulatory framework. While THESL expressly denies that a 3GIRM rebasing application would be appropriate in its circumstances, had it known that its application would be treated as one it would have brought a significantly different application, and furthermore would have made significantly different business and operating plans in contemplation of that outcome.

26. For example, THESL would be forced to budget significantly more for reactive maintenance. THESL would also potentially incur program wind-down costs in

order to arrest or substantially slow its infrastructure renewal program. In addition, in order to deal with the half-year rule problem, THESL would have proposed rates to support the full year end rate base for 2011, offset in that year by establishment of a one-year negative rate rider to compensate rate payers for the revenue requirement difference between 2011 average ratebase and 2011 year-end ratebase. Upon expiry of the negative rate rider at the end of the 2011 rate year, the base distribution rates then in effect for 2012 would at least support the actual opening rate base for 2012.

> **EB-2010-0142 Transcript Volume 2 dated March 30, 2011 at Pages 64, Line 13 to Page 67, Line 23.**

27. Were the Board now to treat THESL's <u>actual</u> 2011 application as an application for rebasing, it would deny THESL the right to know the case that it must meet and respond accordingly.

28. THESL had and continues to have a legitimate expectation that its 2011 application would be heard as a stand-alone cost of service application, precisely because it has not had its rates set on an IRM basis for the past three years, has not been within the IRM framework, and could therefore not be 'rebased' as though it were in that framework.

29. The Board itself explicitly reinforced THESL's expectations regarding its 2011 application by giving THESL direction in its EB-2009-0139 Decision (on 2010 rates), wherein it stated at page 29:

> "For the reasons that follow the Board finds that THESL should undertake a cost allocation study related to its provision of suite metering services. The study shall include an analysis of the implications of creating and maintaining a separate rate class for those customers served in this manner. The Board is of the opinion that the potential for cross-

> subsidization is ongoing and that there may be merit in the establishment of a separate rate class for multi unit residential customers that are served directly by THESL through its suite metering provision. This should be filed as part of the next cost of service application, which THESL intends to file later this year, but in any event no later than six months from the date of this Decision. (emphasis added)

30. At pages 34 and 35 of the same Decision, the Board stated:

> "The Board's concern regarding the lack of a robust plan related to DG arose in the context of a rate application. The Board's direction to THESL was to file the product of its direction in this rate setting proceeding. The Board remains of the view that a cost of service proceeding is the most appropriate forum to review the analysis requested.
>
> ...
>
> THESL shall continue its analysis of the incorporation of DG into its Central and Downtown areas. In that regard it shall file a plan concurrent with its filing according to its distribution system planning requirements."

31. In the second passage, the Board goes beyond the 2011 rate year and directs that THESL should file its DG study concurrent with its distribution system planning filing, due in THESL's next case, and expressly states that a cost of service proceeding is the 'most appropriate forum' for its review. The Board would defeat its own direction were it to find that THESL should file on an IRM basis for 2012 rates.

32. Furthermore the Board provided the following direction to utilities in its July 9, 2010 Chapter 3 Filing Requirements for Transmission and Distribution

Applications, at Section 5.0 Specific Exclusions from IRM Applications (emphasis added):

> The IRM application process is intended to streamline the processing of a large volume of rate adjustment applications, and is therefore mechanistic in nature. For this reason, the Board has determined that the IRM process is not the appropriate venue by which a distributor should seek relief on issues which are substantially unique to an individual distributor or more complicated and potentially contentious. The following are examples of specific exclusions from the IRM rate application process:

(a) Smart Meter Cost Recovery Rate Rider;

(b) Rate Harmonization, other than that pursuant to a prior Board decision;

(c) Loss Factor Changes;

(d) Loss Carry Forward Adjustments to PILs/taxes; and

(e) Loss of Customer Load.

33. Due to its size, centrality, system characteristics and policy-forward orientation, THESL regularly seeks relief "on issues which are substantially unique to an individual distributor or more complicated and potentially contentious", often at the express direction of the Board. For example, the potential addition of a separately defined sub-class for Quadlogic-metered customers is an issue that is complicated and contentious and in fact was instigated by a party other than the Board or THESL.

34. Another example illustrating THESL's unique situation for 2012 is the Board's February 11, 2010 Decision to approve the transfer of certain assets that are

properly characterized as distribution assets to THESL, which due to historical circumstances unique to the City of Toronto were considered part of the streetlighting system (EB-2009-0180/0181/0182/0183). In response to a Board request, THESL has since filed additional evidence supporting the transfer of distribution assets. The Board is now reviewing the details of this additional evidence. Once the transfer receives final approval of the Board, THESL will need to address issues of cost allocation, rate design, and rate impacts arising from the asset transfer. THESL intends to address these issues formally in its next (2012) rates case, where these issues can be addressed comprehensively and in context of an overall cost of service application.

35. THESL submits that it is unreasonable to expect that such issues will predictably vanish for three years every fourth year, and agrees with the Board that it is equally unreasonable to deal with those issues within the context of a 'mechanistic' process. Typically these issues have direct revenue requirement and rate implications for Toronto customers, beyond the generic import they have as precedents for the industry.

36. Fundamentally the Board must satisfy itself on the question of whether the electricity distribution system in Toronto requires substantial, continuing reinvestment in order to bring it to an acceptable operating condition and minimize the risk of severely disruptive service outages. THESL submits squarely that it does, and that this has been demonstrated and accepted by the Board and stakeholders in THESL's previous cost of service rate cases. There is no basis in evidence to support the conclusion that the work required is so minimal that it can be supported through depreciation funding alone. While the precise level and pace of reinvestment is a matter for the Board to determine finally in each application, there is a clear need for year-over-year expenditures substantially in excess of depreciation.

37. If the Board accepts this as flowing from the need to "protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service", it must accept that substantial capital expenditures and associated costs arise and must be funded in this effort. It would be a pragmatic contradiction for the Board to accept that the investment must take place to protect the quality of service, and at the same time effectively deny to THESL the revenue requirement resources absolutely required for that purpose.

38. Ultimately it is the Board's judgement that must be exercised to determine the appropriate balance between the pace of system renewal and the risks that that renewal mitigates, and the rate impacts of the associated investment. While THESL is strongly of the view that the pace of renewal must be vigorous and must at least prevent the existing situation from worsening, THESL will manage the resources afforded to it by the Board in the best manner it can. What THESL submits is not open to the Board, acting responsibly, is the imposition of a regulatory regime that does not provide resources corresponding to the Board's assessment of the pace of investment that must be undertaken. THESL submits that the evidence clearly shows that the pace of investment must substantially exceed depreciation, in 2011 and in coming years, and that freezing THESL's revenue requirement for 2012 by imposing 3GIRM would effectively be a finding that significant infrastructure renewal is not required, contrary to evidence that the Board has already accepted.

2. EMERGING REQUIREMENTS

39. In Procedural Order No. 4 issued January 12, 2011, the Board determined that the following three proposed expenditures included by THESL as part of its capital budget will not be eligible for settlement: (i) the energy storage project included under emerging requirements; (ii) the electric vehicle charging infrastructure program included under smart grid as part of emerging requirements; and (iii) the fleet & equipment services expenditures under the general plant category, due to