EB-2011-0144

Toronto Hydro-Electric System Limited ("THESL")

Argument-in-Chief

Compendium of Documents

November 14, 2011

Ex. K2.1
A. Haines.

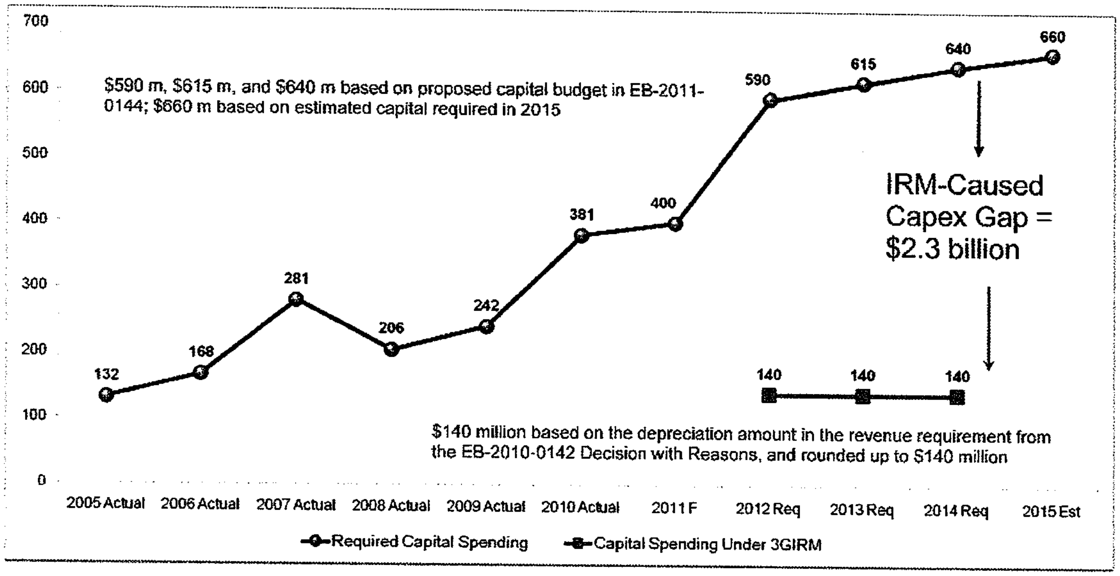

Figure "c"

The consequences of a limit of this nature on THESL's capital spending would also mean that THESL's ability to replace aging infrastructure is completely constrained. Based on today's installed costs, and actual assets in service, THESL estimates that replacement of the entire distribution plant amounts to approximately $12 billion. Even if one simply takes THESL's 2011 approved fixed assets, and applies conservative inflation for the past 30 years, the resulting replacement cost is over $10 billion. In any event, the replacement cost of THESL's assets is a very big number. THESL estimates that the 47% of assets that are either already past their useful life or will be within 10 years (as shown in figure "a") have a replacement cost of over $5 billion. Were THESL only allowed to spend $140 million on <u>total</u> capital (i.e., not just sustaining capital) it would take THESL over 41-years to replace these assets. Further, using the same logic, it would take approximately 97 years to replace the entire distribution plant, which is a completely untenable proposition, but one which is precisely what obtains under IRM for THESL. Given that the average life of THESL's distribution assets is approximately 30 years, not

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multi-year rate setting plan, including the acceptance of THESL's non-conforming applications in the past, the Board considers the April 20, 2010 letter to be a clear and explicit statement of the Board's expectations of distributors on a going forward basis.

Given this clear and direct communication to THESL and other distributors regarding the Board's expectations, the Board does not accept THESL's view that it is reasonable for it to have approached its 2011 application with an expectation that it would also be making a cost of service application in 2012. The Board is not persuaded by THESL's submissions that the Board's stated rate setting policies did not apply to it.

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The Board makes no determination as to what THESL is required to file in its subsequent rate application. It is for THESL to determine the manner in which it chooses to apply for any adjustment to its rates for 2012. The acceptability of the application will be determined by the Board at that time.

The Board notes that THESL is not included in the list of expected cost of service applicants for 2012, as per the letter issued by the Board on March 1, 2011.

Should THESL file a cost of service application for 2012 rates, the expectations of the Board are clear. As set out in the April 20, 2010 and March 1, 2011 letters, a distributor that seeks to have its rates rebased earlier than scheduled must justify, in its cost of service application, why early rebasing is required and why and how the distributor cannot adequately manage its resources and financial needs during the remainder of the 3rd generation IRM plan term.

In its current application, and specifically at Exhibit A1/Tab1/Schedule 2, "The Manner of Regulation for THESL," THESL has provided its reasons and support for making what it characterizes as a cost of service application for electricity distribution rates for the 2012, 2013, and 2014 rate years.

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The Board has determined that it will, in the context of its EB-2010-0142 Decision and the Board's letters of April 20, 2010 and March 1, 2011, and in advance of further procedural steps, consider the question of whether the application filed by THESL is acceptable or whether it should be dismissed (the "Preliminary Issue"). To accomplish this, the Board will allow an initial round of interrogatories by intervenors and Board staff to seek additional information specifically related to the Preliminary Issue and THESL's evidence on the Preliminary Issue at Exhibit A1/Tab 1/Schedule 2. Following THESL filing its responses to these interrogatories, the Board will hear oral submissions from Board staff, intervenors and the applicant on whether THESL's application is justified.

Following its determination on the Preliminary Issue, and if the Board decides to proceed with its consideration of THESL's application, the Board will issue a further Procedural Order to allow for further discovery on the application.

The Board considers it necessary to make provision for the following matters related to this proceeding. The Board may issue further procedural orders from time to time.

THE BOARD ORDERS THAT:

1. Board staff and intervenors shall file with the Board and deliver to Toronto Hydro-Electric System Limited any interrogatories with respect to the Preliminary Issue on or before **Friday October 14, 2011**.
2. Toronto Hydro-Electric System Limited shall file with the Board and deliver to all intervenors any responses to interrogatories filed with respect to the Preliminary Issue on or before **Monday October 24, 2011.**
3. The Board will hear oral submissions related to the Preliminary Issue from Board staff, intervenors and the applicant on **Tuesday November 1, 2011** in the Board's hearing room at 2300 Yonge Street, 25th Floor, Toronto, at 9:30 am. The hearing may continue on **Friday November 4, 2011** if necessary. Parties wishing to file written material related to their oral submissions, such as books of authorities, should do so by **Friday October 28, 2011**.

All filings to the Board must quote the file number, EB-2011-0144, be made through the Board's web portal at https://www.errr.ontarioenergyboard.ca, and consist of two paper copies and one electronic copy in searchable / unrestricted PDF format. Filings must clearly state the sender's name, postal address and telephone number, fax number and

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absence of the special circumstances set out by the Board. Second, the Board finds there is no merit to Norfolk's assertion that acceptance of its proposal for a two year disposition of Group 1 account balances in the 2010 IRM Decision represented an acceptance by the Board that it would be making the cost of service application in 2011. The Board notes that a potential 2011 rebasing was not an issue during the Norfolk 2010 IRM proceeding and, as such, the 2010 IRM Decision was entirely silent on this matter.

Furthermore, the Board notes Norfolk's lower projected financial results for 2011 are not due to loss of load as was the case with Horizon. As stated by the Board in the Early Rebasing Letter, "the Board's rate-setting policies are such that distributors are expected to be able to adequately manage their resources and financial needs during the term of their IRM plan".

Finally, the Board is of the view that all of the extra elements incorporated into Norfolk's application and raised by Norfolk as justification for its early cost of service application can be addressed in the IRM process without undue complexity. The Board notes that other utilities have filed IRM applications that include an Incremental Capital Module ("ICM"), increases in the smart meter funding adder, and deferral account disposition. The Board disagrees with Norfolk's contention that an IRM application that deals with these potential issues is less efficient than a cost of service application.

The Board finds that if Norfolk wishes to file an application for 2011 rates, it should do so based on the 3rd Generation IRM formula. Norfolk is also directed to record the Board and intervenor costs associated with this proceeding (EB-2010-0139) in a sub-account of Account 1508 'Other Regulatory Assets', Sub-account "2011 Cost of Service Proceeding: Board and Intervenor costs" for review and disposition upon Norfolk's filing of its next cost of service application. All other costs incurred by Norfolk in preparing and filing this application must be absorbed within the current revenue envelope. No additional recovery will be allowed.

Cost Awards

The Board may grant cost awards to eligible stakeholders pursuant to its power under section 30 of the *Ontario Energy Board Act, 1998*. The Board will determine eligibility for costs in accordance with its *Practice Direction on Cost Awards*. When determining

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extraordinary capital spending requirements within the IRM framework increases the efficiency opportunities without requiring a full cost of service rebasing review.

As reference to the Board reports above indicate, there was considerable debate during the consultation respecting the appropriate nature of the proposed incremental capital module. In the course of that debate there was a general recognition that the incentive rate mechanism itself accommodated a normal level of capital spending year over year during the term of the incentive rate mechanism. The incremental capital module was intended to address, in a prospective manner, extraordinary spending requirements that were identified during the course of the incentive rate mechanism term.

In its adoption of the incremental capital module as part of the third generation incentive rate mechanism the Board was providing the regulatory flexibility that is required to accommodate unanticipated events that may occur over an extended IRM term. The rapid policy evolution that is currently being experienced in the electricity distribution sector, such as the requirements under the Green Energy Act (Bill 150) may drive capital spending on an array of initiatives that would not typically be considered in a distributor's traditional planning exercise. This evolving policy environment is an example of the envisioned drivers that justified the provision of the regulatory flexibility that the incremental capital module is intended to create.

It should be noted however, that in this application the proposed capital spending was not linked to any anticipated new legislative directives or requirements, in particular those associated with the tabled Green Energy Act; as Hydro One noted, that would be the subject of another application.

In considering Hydro One's application in this case it is apparent that Hydro One has conflated the calculation of the threshold and the eligibility criteria. While the relationship between depreciation expense and capital spending establishes the base materiality threshold, the relationship itself is not the determinative factor in assessing the appropriateness of the use of the incremental capital module. Hydro One has substantially predicated its application on the gap between its depreciation expense and its capital spending plan. In fact what the Board

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requires in considering an application under the incremental capital module is a demonstration that the distributor is facing extraordinary and unanticipated capital spending requirements; i.e. something other than the normal course of business.

The Board's September 2008 Supplementary Report specifically refers to unusual circumstances in giving rise to eligibility under the module. Hydro One's application points to the gap between its depreciation expense and its capital spending as its qualifying characteristic. In fact, as is clear from the evidence in this case, Hydro one has been operating since 2002 with a similar gap between its depreciation expense and its capital spending. The Board does not accept that the terminology "unusual circumstances" can reasonably be applied to this scenario. The Board notes Hydro One's use of the language "capital adjustment mechanism". This terminology, which was uniquely used by Hydro One and which does not appear in either of the Board's reports seems to be a good characterization of the manner in which the module was applied by Hydro One. But in the Board's view it is also indicative of the departure from the intended use of the module that is referred to by the Board as an **incremental** capital spending module.

Accordingly, the Board cannot consider Hydro One's application under the Incremental Capital Module.

However, what is before the Board is a request for rate relief that goes to a large degree to the distributor's plan to continue to serve its existing customers in a safe and reliable manner. Also, Hydro One's application is the first case in which the Board has considered a proposed incremental capital module and Hydro One did not have the benefit of any case-specific Board decision for either Hydro One or any other distributor. Hydro One's misinterpretation of the Board's ICM plan does not invalidate the substance of its application which it filed in good faith. Further, there is a relatively significant gap between Hydro One's apparent capital needs in 2009 and the available funding through rates for these needs. The Board is therefore prepared to consider providing some relief so as to not impair the company's ability to maintain a reliable and safe distribution system..

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in Exhibit..."

Such and such:

"... continuing to spend on capital absent explicit regulatory approvals will lead to negative ratings consequences. Negative ratings consequences would result because the company's leverage ratios would increase to unacceptably high level since the incremental capital would not be in rate base."

It's the last phrase I just want to confirm. So what you're saying is, as I understand it -- or is what you're saying that under an IRM regime there are no additions to rate base during the term of the regime, other than perhaps the first year of that regime, as the spillover from the cost of service year. Is that what you're saying? So effectively that money, those loans -- well, let me just stop there.

There's no in addition to rate base?

MR. COUILLARD: Well, what I'm saying is that if we were to spend the amount of money that is required for the system - in our particular case, for 2012, close to $600 million - we would not have this amount in rates. The only thing we would have in rates is the amount of depreciation, of about $140 million, which creates a significant deficiency for us from a cash flow perspective, which becomes untenable for us, you know, over a couple of years, because, you know, if I don't have that in rates, very quickly I have to leverage -- the company would

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leverage to an unacceptable level and we would breach -- within two years, 24 months, we'll breach our covenant ratio on all our bonds.

What the rating agencies have stated to us, and, actually, everybody -- all the investors we talked to is that if we start to spend above the amount approved by the OEB on either a cost of service or an IRM - I mean, you know, for them it's just whatever you have approved, you have to spend - then there would be some consequences to that, depending on the level.

So, you know, if any given year we go over by $10 million versus the approved level, that is not something that they would see as a significant adverse effect. But in this particular case, we would have 140 million with a need of $600 million. And the rating agencies were quite clear that, you know, their expectation is that we would curtail our spending to the $140 million or otherwise there would be some significant -- some credit rating implication.

MR. BRETT: That's quite helpful. In other words, you're saying that their view of the world is if you start -- any utility that is spending significantly above its approved capital, that is not a good thing from their point of view, and it's going to turn very bad after a certain period of time, I guess is what you're --

MR. COUILLARD: It turns bad very quickly.

MR. HAINES: I wonder if I could add another element to that response.

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opportunity ahead of us.

MR. BUONAGURO: All right. Thank you very much. Those are my questions.

MS. CHAPLIN: Thank you.

We'll take the lunch break now. It's 10 to 1:00. So we'll return in an hour. Thank you.

--- Luncheon recess taken at 12:50 p.m.

--- On resuming at 1:58 p.m.

MS. CHAPLIN: Please be seated.

Unless there are any preliminary matters, I believe you are next, Mr. Shepherd.

CROSS-EXAMINATION BY MR. SHEPHERD

MR. SHEPHERD: Thank you, Madam Chair, and I do not expect to be long. I have five areas I want to cover. And I'm not sure whether this question is for you, Mr. McLorg, or perhaps you, Mr. Haines. I'm not clear yet, and perhaps you could help me with this, whether your argument is that the Board cannot impose IRM on you because -- on Toronto Hydro, because it's legally not entitled to do so - for example, because it would breach the fair return standard - or whether you are say tag the Board should not impose IRM on you because it would have inappropriate consequences or whatever, or both.

Can you tell us which your position is?

MR. RODGER: Well, I wouldn't have Mr. Haines provide a legal opinion or an answer to the legal question, but certainly the other part I think the witness can answer.

MR. SHEPHERD: No, sorry, Madam Chair, I think we're

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hearing. And so that's the saving, if you will, about that efficiency. And it drives productivity improvement, if that's, in fact, correct.

And, of course, as I've described earlier, that productivity improvement assumption is just doing less. It's not actually doing more with less or proportionately less. It really just is a construct of saying, Just spend less.

So we don't think that that's the best way to achieve those objectives. We think that the record shows, and will show in a cost of service proceeding, that there have been significant cost efficiencies and that, you know, just rough math, if it takes $50 million worth of costs to right-size the organization, it's a 30-year payback for the regulatory savings that came from that.

And so I don't see the cost benefit associated with that approach, not to say that there isn't a model out there that can achieve the goals that we've -- you know, that we would all like to achieve together. I think about other places in Europe and other places where, you know, the model tends to be more of a -- I'll call it a cost of service, and then a movement from that cost of service, as opposed to, you know, rebasing, and then backwards; right?

And so there are models I can imagine could be quite effective. But the model we have available to us today is the model, and it results in no cost benefit to the customers. And so -- you know, so all we're left with is cost of service at this point.

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