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EB-2011-0144
Toronto Hydro Cost of Service Application
Preliminary Issue

Submissions of Energy Probe Research Foundation

November 17, 2011

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1. Energy Probe's understanding of THESL's position on the preliminary issue is that the following principle effects will occur if it is subject to an IRM for the period 2012 -2014:

    a. No additions to ratebase would be allowed during the IRM period
    b. Capital expenditures exceeding depreciation (CEEDs) during the IRM period would not be effectively funded by debt supported in the rates.
    c. THESL's shareholder would not be able to earn its approved return on equity on the CEEDs during the IRM period.
    d. Depreciation associated with CEEDs during the IRM period would not be compensated in the rates.
    e. OM&A expenditure levels would be effectively frozen during the IRM period.
    f. If OM&A actual expenditures exceeded the frozen level, the resulting shortfall would have to be borne by the shareholder.

2. Energy Probe agrees that those effects would occur but submits that the IRM regime as articulated in *The Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors* dated July 14, 2008 fully anticipated them. All distributors including THESL were or should have been aware of those consequences of IRM and planned their business accordingly.

3. THESL's belief that "at present, there are essentially two alternative forms of regulation: the Third Generation Incentive Regulation Mechanism (IRM) and Cost of Service Regulation (COS)" (Preliminary Evidence A1-1-2 page 1 lines 6-8) is a flawed understanding of the Board's regulatory policy for electricity distributors. In

Energy Probes submission, these are two components of a single comprehensive regulatory regime rather than individual options for regulation. All distributors are subject at one time or another to both COS and IRM regulation in accordance with the Board's policy. They are not free to choose the one that most favours them to the exclusion of the other.

4. This concept was clearly articulated by the Board in its EB-2011-0142 Partial Decision & Order dated July 2, 2011 in which it stated:

   "The Board's rate setting policies are not composed of the two separate frameworks that THESL describes. As stated above, the Board has clearly articulated the mechanics of the multi-year rate setting plan and its expectations of distributors. The Board believes that THESL's submissions mischaracterize the Board's rate setting policies and the Board does not accept the construct as described by THESL as a Board sanctioned framework." (pages 9-10).

5. In Energy Probe's submission THESL is currently under IRM whether or not it chooses to accept that situation. This is evidenced by the following excerpt from the Board's EB-2011-0142 Partial Decision & Order dated July 2, 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." (pages 10-11, emphasis added)"

6. The way to demonstrate a need for early rebasing is through the off ramp provisions of the 3GIRM plan described on pages 38-39 of the Report of the Board previously referenced:

"The Board has determined that the 3rd Generation IR plan will include a trigger mechanism with an **annual ROE dead band of ±300 basis points. When a distributor performs outside of this earnings dead band, a regulatory review may be initiated.** In support of this approach, a distributor will be required make a report to the Board no later than 60 days after the company's receipt of its annual audited financial statements, in the event that the distributor falls short of or exceeds its ROE by 300 basis points. The report will be reviewed to determine if further action by the Board is warranted. Any such review would be prospective and could result in modifications to the IR plan, a termination of the IR plan or the continuation of the IR plan."

7. The trigger mechanism referred to in that report is clearly based on historical results and not on forecasted ones. This is evidenced by the fact that to apply for off ramp consideration the distributor must submit a report after it has received its audited financial statements for the year in which it meets the trigger criteria. Therefore, for THESL to use the off ramp it needs to demonstrate that its 2011 performance lies outside of the ROE dead band of 300 basis points.

8. In response to Energy Probe IR#15 on the preliminary issue (R1-2-15) asking what the forecasted end of year 2011 ROE is expected to be, THESL replied that it expected ROE of 9.15%. This shortfall is well below the 300 basis points needed to satisfy the trigger mechanism. Therefore, in Energy Probe's submission, THESL will not meet the trigger conditions for a review by the Board in 2012.

9. THESL's projections of ROE for 2012 – 2014 shown on Table 5 of A1-1-2 page 28 show a decline in forecast ROE starting in 2012 that would exceed the 300 basis points trigger. Energy Probe submits that the analysis presented in that exhibit is based on THESL's projections for those years and not on actual results. Since the off ramp is clearly based on historical results, any analysis based on forecast results is irrelevant for off ramp considerations.

10. THESL states in Exhibit R1, Tab 0, Schedule 1, page 2 that "In essence, the Manner of Regulation evidence addresses the question of whether IRM should appropriately apply to a utility which, as a matter of fact, faces the circumstances and consequential cost pressures discussed in that evidence."

11. At the same time THESL states that it does not regard its circumstances as being unique among the distributors of the province and that its circumstances are reasonably representative of those of a category of distributors who share characteristics that distinguish them from other categories of distributors (Exhibit R1, Tab 1, Schedule 2).

12. Energy Probe takes this to mean that THESL believes that IRM does not work for a category of distributors, including themselves, in the province. In Energy Probe's submission, the Board did not set a policy for some distributors and another policy for others. The Board set one policy and it is clearly intended to apply to everyone.

13. In the EB-2010-0133 Hydro Ottawa Decision dated October 27, 2010, the Board stated that the only issue for it to determine was whether Hydro Ottawa was justified in coming forward in the IRM framework 16 months early. In Energy Probe's submission, the corresponding question for the Board in the current application is whether THESL is justified in coming forward before the first year of the IRM period (2012-2014).

14. The COS application and the figures that show THESL would hit the off ramp in 2012 are based on its current wish list for OM&A and CAPEX. More importantly, the evidence does not demonstrate any action on behalf of THESL to control, reduce or prioritize costs and expenditures in 2012, 2013 or 2014.

15. For the above reasons, Energy Probe submits that THESL is not entitled, under the off ramp provisions of the IRM, to make a COS application for 2012 – 2014 rates. Should it meet the criteria for an off ramp application in 2012, it would be justified in bringing forward an application for relief at that time.

16. In addition to the off ramp provisions of the IRM, the Board has provided further direction to distributors seeking early rebasing. That direction is included in PO#1 of this proceeding and is referenced by THESL in its argument in chief starting at line 24 on page 4 of the transcript volume 3. The relevant excerpt is reproduced below:

> "Should THESL file a cost-of-service application for 2012 rates, the expectations of the Board are clear. As set out in the April 20th, 2010 and March 1st, 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 third-generation IRM plan term."

17. THESL argues that the Board should apply a test of reasonableness to determine whether or not it has met the conditions necessary for early rebasing. In its final argument THESL concludes that it has discharged its burden of proof to the standard of reasonableness and should therefore be permitted a cost of service review.

18. Energy Probe submits that this conclusion is based on a presumption that the evidence on which the application relies accurately represents the actual needs of the company. Since no in depth scrutiny of the evidence, particularly the CAPEX evidence, has been made in this proceeding, the Board would have to take it on faith that the evidence is approximately right to decide in favour of the applicant on the preliminary issue.

19. In Energy Probe's submission there is sufficient doubt that the evidence fairly represents the company's actual needs for the Board to be cautious about assuming anything in that regard.

20. As evidence for this proposition Energy Probe offers two examples from the cross examination record of the company's witness panel.

21. The first concerns replacement of underground cables. This appears in the transcript volume 3 on page 44. Mr. Haines was asked if the company had considered using overhead distribution instead of replacing worn out underground cables with new cables.

22. His reply was essentially that THESL replaces plant on a like for like basis. So if the system is underground then it is replaced with an underground system and if the system is overhead it is replaced with an overhead system.

23. The rationale for this policy appears to be that community expectations govern what THESL does. This is at lines 1-4 on page 45 of the transcript where the witness says:

> "In other words, because of the community issues associated with going from an underground to an overhead, we would tend to change out old equipment with similar equipment."

24. Energy Probe submits that there are at least two important issues associated with this policy that should cause the Board to question it as a basis for large CAPEX investment decisions.

25. The first is that, in the face of rapidly expanding CAPEX needs, the company does not appear to have made a serious effort to reconsider its capital replacement policies in order to mitigate those costs.

26. Undertaking J2.3 was to provide an estimate of the difference in cost between overhead and underground systems. According to the response at lines 12-13, the cost of an overhead system would be about 35% of the comparable underground system.

27. The 10 year program for cable replacement is estimated at lines 8-10 to be about $1.8 billion of which 60% is thought by the company to be replaceable with overhead. That would translate into a program cost of about $1 B of which 65% could be saved by using overhead lines – a savings of $650 M. In Energy Probe's submission that is an investment worthy of a more critical decision making approach than invoking an established policy of replacing like for like.

28. The second issue associated with the like for like policy is that THESL's perception of community issues associated with replacing distribution plant may not be an accurate reflection of how a community actually feels and so might not be a good basis on which to base a replacement policy.

29. In support of this proposition, we have included another excerpt from the witness cross examination transcript page 47. Here, Mr. Haines offered an example of THESL proposing to replace backlot overhead distribution plant in the White Birch neighbourhood to front lot underground distribution. At lines 16-22, Mr. Haines describes THESL's expectation of customer reaction as:

> "And so you would think, from a customer satisfaction perspective, that that would be what I would describe as a no-brainer, that the community would embrace the loss of lines in the backyard over landscaping, swimming pools, et cetera, and that they would see an underground system with transformers buried underground in the front yard as being a positive to the community."

30. In fact, the community response was exactly the opposite of what THESL expected or as Mr. Haines put it at line 23 "The community had a complete uprising over this issue".

31. Energy Probe submits that this example suggests that THESL may not understand what issues are important to customers when their distribution system needs to be replaced. Therefore, relying on its understanding of community issues for its like for like replacement policy, without more exhaustive study, might not result in prudent investment decisions.

32. Energy Probe would also point out in passing that replacing backyard overhead service with front yard underground service appears to be a violation of THESL's own like for like policy. This raises questions about how THESL policies are actually applied in making capital replacement decisions.

33. Energy Probe notes that THESL's reply to undertaking J2.3 contains a rationalization of why underground distribution is preferred to overhead distribution. This rationalization contains a number of statements that raise more questions than they answer.

34. For example, the reliability statistics offered on page 1 and the top of page 2 suggest that overhead distribution is much less reliable than underground. However the comparisons are in the form of ratios ie. Sustained customer interruptions are 2.1 times higher on the overhead system (line 19 page 1). This does not convey a clear picture of whether the interruptions are within acceptable standards nor does it explain why the overhead system is less reliable. Presumably, if these levels of interruptions were not acceptable, THESL would be having a very serious reliability problem given that, according to Mr. Haines, 2/3 of THESL's system is overhead and only 1/3 is underground. (Transcript volume 3 page 47 lines 3-4).

35. Safety is another reason cited for underground distribution and is characterized at lines 6-7 on page 2 as "The increased risk of electrical contact for employees and the public from the overhead system infrastructure as opposed to the underground equivalent". No comment is made about the acceptability of the increased risk of electrical contact for overhead plant nor is any mention made of the contact voltage problems faced by THESL in 2009 which appeared to Energy Probe to be primarily related to underground not overhead plant. There does not appear to be a comparable event on the overhead system that would substantiate the safety issue cited.

36. Another rationalization cites dense forests in many neighbourhoods as precluding overhead distribution as a viable replacement for underground. Again, given that 2/3 of THESL's system is overhead, surely it has already come up with strategies to manage trees in proximity to conductors. In fact, in the main application evidence, THESL describes a program of using insulated aerial cables in forested areas to deal with this very problem. (See D1-9-2 page 14 lines 4-8).

37. In Energy Probe's submission, the rationalization of underground provided in J2.3, interesting as it is, does not offer persuasive reasons why overhead distribution should not be considered as a cheaper alternative to replacing underground cables.

38. If relatively obvious alternatives like replacing underground service with overhead have not been seriously considered by THESL, Energy Probe submits that the CAPEX evidence on which the company relies for its application may not be reliable enough for the Board to make a considered decision on the preliminary issue.

39. And if THESL's replacement polices for residential distribution systems are based on a faulty understanding of community expectations, then its capital investment decision making may not reflect actual needs.

40. Given the magnitude of the dollars involved in just these two examples, Energy Probe submits that the Board cannot just accept the CAPEX evidence as proof that THESL cannot manage its financial needs over the IRM period.

41. However, neither can the Board, in Energy Probe's submission, simply dismiss the evidence and impose an IRM on THESL without more scrutiny than has been applied in this preliminary issue proceeding. To do so would invite an appeal that the decision was unreasonable because it was not based on an adequate review of the evidence.

42. This would appear to put the Board in a difficult position. If it denies the application for cost of service it is vulnerable to an appeal based on an inadequate review of the evidence. If it accepts the application it is forced to conduct a cost of service review contrary to its IRM policy.

43. Energy Probe submits that there is a third choice and that is for the Board to conduct a more thorough review of the CAPEX evidence before making its decision on the preliminary issue.

44. Energy Probe anticipates that there will be objection from THESL for this idea because the Board, having once narrowed the scope of the preliminary hearing, should not, without good reasons, change course and now widen the scope. This could be argued as changing the case to be met by the applicant midway through the proceeding and a potential violation of procedural fairness.

45. However, the two examples cited above on underground cable replacement and THESL's potentially faulty understanding of community expectations that underlie parts of its capital replacement policy are, in Energy Probe's submission, good reasons for the Board to reconsider the narrow scope of the preliminary issue hearing. Moreover, they are evidence that the Board and intervenors were not aware of at the time the scope of the preliminary issue hearing was set. Now that the Board is aware,

Energy Probe submits that the questions raised by these examples is a legitimate basis on which to change the scope of the hearing.

46. Further, Energy Probe submits that the applicant would suffer no prejudice to a more thorough review of its CAPEX budgets at the preliminary issue stage. If the Board were to find through such a review that the budgets were appropriate and supported THESL's application for a COS application, then that review could stand as part of a subsequent COS proceeding. It would not be necessary to revisit the CAPEX evidence.

47. If on the other hand, the Board decided that the CAPEX budgets were not appropriate and did not support a COS application then THESL would have had a thorough hearing on the subject which presumably is what it wants.

48. Therefore, Energy Probe submits that the Board should expand the scope of the preliminary hearing to encompass a full review of the CAPEX budgets proposed by THESL. This should involve the customary steps of interrogatories, intervenor evidence and oral hearing on the evidence.

49. Should the Board decline to conduct an expanded preliminary issue hearing as described, Energy Probe offers two other possible mechanisms for the Board to deal with THESL's situation.

50. Because the bulk of THESL's problems appear to be related to the need to make large CAPEX investments over a significant number of years modification of some of the Board's current policies might assist it in dealing with the company's needs.

51. The criteria used to trigger the Incremental Capital Module could be relaxed to accommodate distributors facing large infrastructure replacement costs.

52. The response to undertaking J2.1 quantifies the capital that THESL expects would fit within the ICM criteria. The numbers are relatively small in relation to the total CAPEX requested in the application.

53. If the Board expanded the types of project that could be included for ICM relief, THESL might be able to use that mechanism for other projects expected to cost significant amounts of money over longer periods of time.

54. However, the rationale for varying from established criteria for ICM would probably strain the Board's original intention that it be reserved for unusual circumstances.

55. For example, many of the direct buried cable replacements in the evidence appear to be the result of premature failure of the cables. The Board could accept this as an unusual circumstance because premature failure was not really expected when the cables were installed. However, premature failure of components is not a rare event in distribution systems and relaxing the standard for ICM in this case would doubtless lead to many applications for relief from other distributors. The incremental capital module would likely lose its effectiveness for unusual events and become an alternative to rebasing applications.

56. Similarly, modification of the criteria for Z factor relief could be used to deal with THESL's CAPEX requirements should the Board find them appropriate.

57. Z factor relief for THESL's CAPEX requirements, though, might be more problematic for the Board than using the ICM mechanism. The Board's stated intentions for Z factor are "The Board expects that any application for a Z-factor will be accompanied by a clear demonstration that the management of the distributor could not have been able to plan and budget for the event". (*The Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors* dated July 14, 2008 page 37).

58. Clearly replacement of aging infrastructure is not an event that management could not have planned and budgeted for, as it constitutes one of the everyday tasks that management undertakes. Modifying the guidelines for Z factor relief would dilute its intended purpose and might invite a flood of applications from distributors for routine capital expenditures. Nonetheless, it is an available tool for the Board to consider for dealing with THESL's needs.

59. In conclusion, Energy Probe submits that THESL is not entitled to a cost of service application until it either meets the off ramp criterium of 300 basis points or demonstrates that it is unable to manage its resources and financial needs during the balance of the IRM period.

60. By its own projections, THESL will not meet the off ramp condition until the end of 2012 so is not eligible to apply for relief under this mechanism until at least 2013.

61. In Energy Probe's submission, THESL has not, in this preliminary issue hearing, demonstrated its inability to manage its resources and finances through the rest of the IRM period principally because the hearing has not resulted in a comprehensive review of the evidence that THESL relies on for that demonstration.

62. Energy Probe submits, for the reasons presented in its argument, the Board should conduct such a comprehensive review of CAPEX requirements prior to making its decision on the preliminary issue.

All of which is respectfully submitted.