EB-2011-0144

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B);

AND IN THE MATTER OF an application by Toronto Hydro-Electric System Limited for an order approving or fixing just and reasonable rates and other charges for the distribution of electricity to be effective May 1, 2012, May 1, 2013, and May 1, 2014.

NOTICE OF MOTION

Toronto Hydro-Electric System Limited ("THESL") will make a motion to the Ontario Energy Board (the "Board") on a date and at a time to be determined by the Board.

PROPOSED METHOD OF HEARING: THESL proposes that the Motion be heard orally.

THE MOTION IS FOR a review of the Board's January 5, 2012 Decision with Reasons and Order on the Preliminary Issue (EB-2011-0144) (the "Decision"), and an Order of the Board:

1. Varying the Decision to allow THESL to recover the revenue requirement associated with $378.8 million in prospective annual capital spending in rates during the Board's Third Generation Incentive Regulation Mechanism regulatory model ("3GIRM") term, which amount was: (i) raised as a new fact by the Board Chair in a letter to Toronto Hydro's Chairman dated January 13, 2012 (the "Board Letter"); (ii) is justified in the evidence on the record before the Board at Exhibit D1 of the Application; and (iii) is consistent with the annual level of capital expenditures ("CAPEX") approved by the Board its Decision and Reasons dated July 7, 2011 in EB-2010-0142 (the "Frozen CAPEX Solution").

2. Varying the Decision to allow THESL to recover in rates the revenue requirement - approximately $14.5 million annually or $44 million over the IRM period - associated with approximately $120 million in historic and approved 2011 CAPEX that is not otherwise reflected in rates under 3GIRM due to the operation of the half-year rule (the "Half-Year Rule Solution"), and is permanently lost by THESL under the 3GIRM model.

3. THESL additionally requests that the hearing of this motion be expedited for reasons of commercial necessity. In particular, the outcome of this motion is a key driver regarding further restructuring actions, including reduction in workforce levels and decisions regarding the capitalization of the corporation.

THE GROUNDS FOR THE MOTION ARE:

4. THESL respectfully submits that the Board's findings raise questions as to the correctness and reasonableness of the Decision, and require the Board's review and relief as set out above, on the following two grounds:

(a) **New Facts Have Arisen and Error in Fact**: The Board Letter raises new facts about the meaning of the Decision because of the following statement:

> "The Board approved levels of capital spending for Toronto Hydro in the range of $350 million in 2010 and $378 million for 2011. The most recent Board decision does not limit Toronto Hydro's capital spending to $140 million in 2012 as suggested in Toronto Hydro media commentary, and does not prevent Toronto Hydro from maintaining its capital budget at these historical levels...if Toronto Hydro brought an application for ICM and if that application was approved by the panel hearing the case, these projects could add $86 million to invest in the utility's infrastructure needs. When this is added to previous spending levels, this could provide Toronto Hydro with a capital program in excess of $450 million for 2012."[1]

The Board Letter has caused considerable uncertainty and ambiguity regarding the meaning and proper interpretation of the Decision because it can be interpreted in two ways.

(i) **Scenario 1:** On the one hand, the Board Letter could be taken to indicate that by the operation of IRM, there <u>is</u> recovery in rates for the revenue requirements stemming from THESL's CAPEX spending at 2011 levels for the years 2012 through 2014 other than through amounts determined by PCI-adjusted depreciation, plus amounts approved under the current

[1] Board Letter, p. 2.

ICM model. In particular, under this scenario, the Board Letter suggests that under 3GIRM for 2012, 2013 and 2014, THESL's 2011 CAPEX would be approved, but effectively frozen, at 2011 levels of $378.8 million per annum, plus any amounts that THESL is able to successfully obtain under an ICM application. If this is correct, THESL submits that the Board should vary the Decision to adopt the Frozen CAPEX Solution proposed in the Board Letter.

(ii) **Scenario 2:** On the other hand, the Board Letter could be taken to indicate that while the Board will only allow in rates an amount of $140 million determined by PCI-adjusted depreciation plus amounts approved under the current ICM model, the Board expects THESL to spend well in excess of the amounts established in rates by the Board. If this is correct, THESL submits that this represents the violation of a fundamental principle of the regulatory compact – that utilities will generally manage and limit spending within Board approved rates because (by operation of statute) utilities have no other sources of revenue – that gives rise to a new factual scenario that neither THESL nor the Board had the opportunity to consider in the Decision. THESL has asked Navigant Consulting to examine the implications of the Board's Letter on THESL in this context (the "Navigant Report"). The Navigant Report, filed as part of this motion, demonstrates that in this scenario, THESL cannot adequately manage its resources and financial needs under IRM. Consequently, the Board erred in fact in the Decision, and the Board should at a minimum adopt the Frozen CAPEX Solution proposed in the Board Letter.

(b) **Error of Mixed Law and Fact**: The Board made an error of mixed law and fact by making the following finding: "The Board does not agree that IRM creates a structural deficit for distributors dealing with replacing aging infrastructure; nor

does it accept that IRM would lead to a breach of the fair return standard."[2] In particular, the Board erred by failing to consider the facts on the record before it to find that the operation of IRM, and in particular the half-year rule, in THESL's circumstances and in light of its now complete 2011 capital expenditures, disallows recognition of and cost recovery for approximately $120 million of Board approved 2011 capital expenditures in ratebase for the balance of the IRM period. This results in an unjustified denial of the actual 2011 costs incurred by THESL to provide distribution services and an unjustified reduction in THESL's fair rate of return on capital for the term of the IRM plan that would impose on THESL a permanent loss of approximately $44 million.[3]

(c) Such further and other grounds as THESL may submit and the Board allow. The detailed grounds for this motion are set out below.

[2] Decision, p. 18.
[3] Navigant Report, p. 12.

BACKGROUND:

5. On August 26, 2011, THESL filed an application with the Board for an order approving or fixing just and reasonable rates and other charges for the distribution of electricity to be effective May 1, 2012, May 1, 2013, and May 1, 2014 pursuant to section 78 of the *Ontario Energy Board Act*, 1998, S.O. 1998, c. 15, Sched. B, as amended (the "Application").

6. On October 4, 2011, the Board issued Procedural Order No. 1 in respect of the Application, in which the Board held that it would consider as a preliminary issue the question of whether THESL's application should be heard or whether it should be dismissed without a hearing (the "Preliminary Issue"), pursuant to the Board's 3GIRM policy with respect to hearing cost of service applications sooner than every four years (referred to by the Board as "early rebasing").

7. On January 5, 2012, the Board issued the Decision in respect of the Preliminary Issue. The Board dismissed the Application, finding that THESL had not met the test set out by the Board to justify a cost of service application for 2012 through 2014 rates.

NEW FACTS HAVE ARISEN AND ERROR IN FACT:

(a) New Facts Have Arisen

8. On January 13, 2012, Ms. Rosemarie Leclair, Chair & CEO of the Board, issued a letter to Mr. Clare Copeland, Chairman of Toronto Hydro Corporation's board of directors. The Board posted the Board Letter on its website.[4]

9. THESL submits the Board Letter raises a question as to the correctness of the Decision that requires the Board's review and the relief as set out above on the basis that new facts have arisen.

10. The Board Letter, written by the Chair & CEO of the OEB, interprets the Decision and its effects and implications on THESL. Ms. Leclair states:

> "I believe that it is important to ensure that the Board's rate-setting processes, **the Board's decision in this case** and the options available to Toronto Hydro are clearly understood by Toronto Hydro and its customers." (emphasis added)

11. Ms. Leclair was not a member of the Board panel that made the Decision. However, in the Board Letter, Ms. Leclair interprets and explains the Decision, the options available to THESL, and sets out the Board's expectations of THESL as a result of the Decision.

12. THESL submits that by issuing the Board Letter, the Board has created considerable uncertainty and ambiguity as to the meaning and proper interpretation of the Decision. THESL submits that the most appropriate means to address this unprecedented circumstance is to give the Board an opportunity to directly address the Board Letter by way of a motion to review the Decision, and to provide regulatory certainty and clarity about the implications of the Decision.

[4] See http://www.ontarioenergyboard.ca/OEB/_Documents/2012EDR/Letter_OEB-Chair-to-Toronto-Hydro_20120113.pdf

(b) The Board Letter Raises Two Distinct Scenarios

13. The ambiguity in the Board Letter serves to create two alternative funding scenarios for THESL's CAPEX for the remainder of the IRM term: being 2012, 2013 and 2014, subject to early rebasing, or THESL meeting the off-ramp. The two scenarios are defined in paragraph 4 above and are discussed further below.

14. In the first scenario, the Board implies that by the operation of IRM, there is recovery in rates for the capital-related costs of THESL's CAPEX for the years 2012 through 2014 other than through amounts determined by PCI-adjusted depreciation, plus amounts approved under the current ICM model. In particular, on this scenario, the Board Letter suggests that for the 2012-2014 period THESL's CAPEX is effectively frozen at THESL's 2011 approved CAPEX levels of $378.8 million per annum, plus any amounts that THESL is able to successfully obtain under an ICM application (described above as the Frozen CAPEX Solution). If this is correct, THESL submits that the Board must vary the Decision to adopt the Frozen CAPEX Solution proposed in the Board Letter to give THESL a fresh CAPEX spending envelope in rates of $378.8 million per year for each of 2012, 2013 and 2014.

15. On the second scenario, the Board Letter could be read to imply that there is no recovery in rates for the capital-related costs of THESL's CAPEX for the years 2012 through 2014, other than amounts determined by the PCI-adjusted depreciation, plus amounts approved under an ICM application.

(i) Scenario I: The Frozen CAPEX Solution

16. It is a fundamental principle of the regulatory compact that, while the Board has the authority to set just and reasonable rates in a manner that protects the public interest, a utility is expected to manage its business within the rates established by the Board.

17. The Supreme Court of Canada explains it this way in *ATCO Gas & Pipelines Ltd. v. Alberta (Energy & Utilities Board)*[5] at para. 4:

> "As in any business venture, public utilities make business decisions, their ultimate goal being to maximize the residual benefits to shareholders. However, the regulator limits the utility's managerial discretion over key decisions, including prices, service offerings and the prudency of plant and equipment investment decisions."

18. This, in general terms, forms the basis of what the Supreme Court calls the "regulatory compact" between a utility and its regulator.

> "These goals have resulted in an economic and social arrangement dubbed the "regulatory compact", which ensures that all customers have access to the utility at a fair price — nothing more. As I will further explain, it does not transfer onto the customers any property right. Under the regulatory compact, the regulated utilities are given exclusive rights to sell their services within a specific area at rates that will provide companies the opportunity to earn a fair return for their investors. In return for this right of exclusivity, utilities assume a duty to adequately and reliably serve all customers in their determined territories, and are required to have their rates and certain operations regulated (see Black, at pp. 356-57; Milner, at p. 101; Atco Ltd., at p. 576; Northwestern Utilities Ltd. v. City of Edmonton, [1929] S.C.R. 186 ("Northwestern 1929"), at pp. 192-93)."[6]

19. Further, the Court held in *BC Electric Railways*[7] that:

> "the obligation to approve rates that will produce a fair return to a utility is absolute".

And in *Union Gas*,[8] the Divisional Court stated that:

> "the provision of the fair return is essential to the preservation of the financial integrity of the applicant which is of mutual concern both to the account and its customers."

20. Under the regulatory compact, it is not open to the Board to, on the one hand, refuse to compensate a company for its costs of providing service (including an opportunity to earn

[5] [2006] 1 S.C.R. 140, 2006 SCC 4.
[6] Ibid. at para. 63.
[7] *British Columbia Railway v. Public Utility Commission of B.C.* [1960] S.C.R. 837 at 848.
[8] *Union Gas Ltd. v. Ontario Energy Board* [1983] 43 O.R. (2d) 489, 1 D.L.R. (4th) 698.

a fair return), but then expect a utility to spend in excess of what it is being compensated for in rates to adequately and reliably serve all customers in their service territory, on the other. This would constitute a violation of the fair return standard.

21. Regardless of the source of financing a utility draws on to fund capital expenditures (debt or equity), a utility has no other source of revenue that it can use to *fund* (as contrasted with *finance*) distribution services other than through Board-approved rates. Just as a utility accepts the regulation of its rates, ratepayers should be expected to pay for the use of the distribution system. The Board must ensure that a utility is justly compensated in accordance with its legal entitlement to recover its costs of providing service, including a fair return.

22. It is in this context that the Frozen CAPEX Solution plausibly arises. In particular, the Board Letter states (on page 2):

> "Under the rate-setting framework set out above, utilities have maintained their annual level of capital spending throughout the IRM period consistent with the level approved in the initial review of revenue requirements. In the Board's view, that is good utility practice and based on our experience, that is how most other utilities in the province manage their capital programs.
>
> The Board approved levels of capital spending for Toronto Hydro in the range of $350 million in 2010 and $378 million for 2011. The most recent Board decision does not limit Toronto Hydro's capital spending to $140 million in 2012, as suggested in Toronto Hydro media commentary, and does not prevent Toronto Hydro from maintaining its capital budget at these historical levels."

23. In other words, the Board Letter suggests that the Board <u>expects</u> THESL to spend approximately $378 million in capital for 2012, an amount that is clearly in excess of the $140 million in capital spending that the Board would allow in rates under the IRM formula (under Scenario 2, as discussed below).[9]

24. The Board Letter goes on to provide that:

> "Additionally, Toronto Hydro can, and has been invited to apply under the Board's incremental capital module to get additional capital funding to meet any

[9] See Navigant Report, Executive Summary (p. 1-2).

> extraordinary requirements. The Board's decision suggests that, based on a preliminary review, certain capital projects contemplated by Toronto Hydro are directly analogous to projects that the Board has previously approved under an ICM for other distributors. In other words, if Toronto Hydro brought an application for an ICM and if that application was approved by the panel hearing the case, these projects could add $86 million to invest in the utility's infrastructure needs. When this is added to previous spending levels, this could provide Toronto Hydro with a capital program in excess of $450 million for 2012."

25. Setting aside the question of ICM funding of $86 million (or more), which THESL acknowledges should be properly addressed through a separate ICM application, the Board Letter again suggests that the Board expects THESL to spend approximately $378 in capital for 2012.

26. Indeed, the reasonability of the Frozen CAPEX Solution is brought into focus when one considers the way in which THESL has made its case to the Board regarding the critical importance of its growing asset-renewal needs since 2006 (including presenting long term capital plans), and how, as a result of the Board-approved settlement of THESL's last two rate cases, the Board has accepted these settlements as being in the public interest, and agreed with THESL regarding both the importance and quantum of THESL's increasing capital renewal. The Board Letter explicitly acknowledges the reasonability of these capital needs:

> "The Board approved levels of capital spending for Toronto Hydro in the range of $350 million in 2010 and $378 million for 2011."

27. In the event that the Board believes that further evidence is required in order to justify varying its Decision to stipulate the Frozen CAPEX Solution, THESL submits that such evidence has already been put before the Board in this proceeding by way of THESL's Application, which forms part of the record in this proceeding. In particular, the relevant capital evidence is contained in section D1 of that Application, including specifically sections D1, Tabs 7 (Schedule 6) through 13 inclusive. As the Preliminary Issue hearing was a motion within the context of that larger Application, THESL submits that it is open

to the Board to consider and take into account to the evidence already before it in varying the Decision to stipulate the Frozen CAPEX Solution.

(i) Scenario 2: No Recovery In Rates Beyond Depreciation Plus ICM

28. The 3GIRM model covers a multi-year period. In the first year of the IRM period, a utility's revenue requirement, and the electricity distribution rates that fund that revenue requirement, are established according to the cost of service ratemaking process. In each subsequent year during the IRM period, a utility's rates are allowed to increase by an amount equal to inflation less a "productivity factor" determined by the Board: this is the PCI-adjustment.[10] However, there is no adjustment of the underlying ratebase which drives more than half of the total revenue requirement, and the PCI-adjustment of rates assumes that ratebase remains effectively static. For that to be so, CAPEX must be (substantially) equal to depreciation.

29. The utility's revenues during the IRM period establish the overall "budget" for utility management. If the utility exceeds this budget, the "excess" will have to come out of return on equity.

30. In short, while the IRM model does not expressly prohibit THESL from spending more than $140 million, any spending in excess of that level (absent ICM funding) is not funded through electricity distribution rates, since those rates are based on the average ratebase in the rebasing year. Absent funding from rates, funding for the capital expenditures can only come from two alternative sources: (a) a reduction in operating expenditures, which could compromise service and reliability; or (b) a reduction in ROE which contravenes the fair rate of return principle. Reliance on increased borrowing could expose the utility to much higher borrowing costs, as well as increase the risks associated with THESL's ability to meet its financial obligations in respect of current outstanding public debentures.

31. THESL submits that under this scenario, the Board Letter represents a dramatic departure from one of the most fundamental principles of the regulatory compact, as discussed above. In particular, the Board Letter appears to suggest that a utility is <u>not</u> expected to

[10] See Navigant Report, p. 8-9. See also p. 5-8 of the Navigant Report regarding the operation of cost of service ratemaking.

manage its business within the confines of the rates established by the Board. Rather, the Board Letter suggests that under IRM, the Board understands and expects that THESL will not recover 100% of its full costs of providing service plus a fair rate of return in rates.

(c) The Navigant Report

32. THESL submits that the Board Letter raises a new factual scenario that directly affects the ability of THESL to adequately manage its resources and financial needs during the remainder of the IRM term which, in turn, raises a question as to the correctness of the Decision.

33. Since the Board Letter was written by the Chair of the Board, THESL can only assume that it reflects the Board's expectations of how THESL should proceed following the Decision. To assist the Board in considering the effects of these alternative factual scenarios on THESL, the company has retained Navigant Consulting to prepare a report in response to the Board Letter which details the implications of the new scenario set out in the Board Letter on THESL under IRM.

34. The Navigant Report provides detailed credible third party expert evidence that demonstrates that under the Board's expected new scenario, THESL cannot adequately manage its resources and financial needs under IRM as it currently exists.

MIXED ERROR OF LAW AND FACT:

35. At page 18 of the Decision, the Board set out its findings regarding the operation of the half-year rule for THESL under the IRM regime:

> "THESL maintained that the planned level of expenditures cannot be accommodated under the 3GIRM framework. THESL asserted that the operation of 3GIRM, and in particular the half-year rule for ratebase additions, results in inadequate return for any capital expenditures in excess of depreciation during IRM years. The company went so far as to suggest that imposition of the IRM model could lead to a breach of the fair return standard.
>
> The Board does not agree that IRM creates a structural deficit for distributors dealing with replacing aging infrastructure; nor does it accept that IRM would lead to a breach of the fair return standard."[11]

36. THESL submits that this finding constitutes a mixed error in law and fact.

(a) The Half-Year Rule Policy

37. The half-year rule first arose in an Ontario rate-making context in the natural-gas sector at a time when gas utilities had annual cost-of-service hearings to set rates. Because the gas utilities were able to return to the Board to establish new rates each year using a full cost-of-service methodology, the half-year rule was equitable and appropriate in this context: it reasonably approximated the average ratebase in place in the test year.

38. However, the half-year rule is problematic when a utility must transition from a cost of service or rebasing test year to IRM, after having made capital investments materially exceeding depreciation. This is so particularly in circumstances where Board-approved capital expenditures greatly exceed depreciation (such as in THESL's circumstances).

39. Specifically, this problematic situation arises when capital expenditures materially exceed depreciation in the test year (year 1, or the rebasing year), because, although test year ratebase is reasonably approximated for the test year, by the end of that test year, ratebase will significantly exceed the average value. That ending value in turn becomes the opening value for ratebase in the subsequent year (year 2, or the first IRM year). Even if

[11] Decision, p. 18.

ratebase does not grow in that subsequent or further years, the difference between opening ratebase in the subsequent year (year 2) and the average ratebase in the test year (year 1) is not recognized and does not attract any revenue requirement under the IRM formula.

40. As a result, a utility in these circumstances is denied cost recovery for a substantial portion of the Board-approved investment it made in the test year (year 1). While at the next rebasing, the utility recovers the capital-related costs of the depreciated amount of the investment, it sustains a permanent loss of: (a) the related depreciation in each year until the next rebasing; and (b) return to debt and equity capital in each year until the next rebasing.

41. This problem is acknowledged in the Board's ICM Decision for Guelph Hydro in EB-2010-0130 (pg. 15):

> "The Board finds that the half-year rule should apply to the MTS-related depreciation and rate base calculations. The Board notes that the Report states, "In calculating the rate relief, the Board has determined not to apply the half-year rule so as not to build in a deficiency for subsequent years in the term of the plan." However, in this case, there are no subsequent years in the plan. Guelph Hydro is filing its rebasing application for 2012 rates and therefore no deficiency will be built into the calculation if the half-year rule is applied."

(b) The Half-Year Rule In THESL's Circumstances[12]

42. In THESL's case, the Board-approved capital expenditures for 2011 in the amount of $378.8 million, compared to depreciation of $138.8 million. Capital expenditures exceeding depreciation were therefore $240 million on an approved basis.[13]

43. By the operation of the half-year rule, this produces approved and actual, but unrecognized, ratebase in the amount of $120 million. In other words, THESL suffers a disallowance of $120 million of approved ratebase in rates for 2012, 2013 and 2014 under IRM (less depreciation over that period), even though those assets were installed

[12] Navigant Report, p. 10-12.
[13] THESL's actual capital expenditures in 2011 were $418.1 million (subject to audit), but THESL requests this relief only with respect to the *Board-approved* capital expenditures.

and being used to provide distribution services to customers at the end of 2011 (the "Approved-But-Unrecognized Ratebase").

44. THESL's foregone capital-related revenue requirement of this amount of Approved-But-Unrecognized Ratebase is approximately $14.5 million annually or $44 million over the IRM period.[14] In short, the operation of the half-year rule in THESL's circumstances results in an unjustified and permanent loss of approximately $44 million dollars over the balance of the IRM term. The result of the Board's policy when applied in THESL's factual circumstances constitutes an unlawful breach of the fair return standard.[15]

(c) The Board's Errors

45. The Board failed to observe the evidence on the quantitative effect of the operation of the half-year rule in THESL's circumstances.

46. However, the Board acknowledged a similar problem in its ICM Guidelines and in its Oakville Hydro ICM Decision in EB-2010-0104 (at pg. 18):

> "The Board notes that in the Report, it was determined that the half-year rule would not apply so as not to build a deficiency for subsequent years in the IRM plan term. Since Oakville Hydro is not scheduled to file a rebasing application until 2014, the Board has determined that the half-year rule will not apply."

47. THESL submits that the operation of the Board's half-year rule under IRM in THESL's circumstances results in an unjustified denial of the actual costs incurred by THESL to provide services and an unjustified reduction in THESL's fair rate of return. This denial of these actual costs cannot be justified with hypothetical arguments about "productivity improvements." The productivity improvement required by the Board is only prospective and is already embodied in the productivity and stretch factors which determine the price cap index adjustment, which in turn applies to the entire revenue requirement. The

[14] Exact amounts to be determined in the context of an application for THESL's 2012 rates.
[15] In Greater Sudbury (EB-2008-0230) the Board stated that: "[t]he Board's policy has established the half-year rule for all electricity distributors and this has been implemented by all distributors in the 2008 and 2009 cost of service proceedings", however the Board was willing to accept a departure from this policy when the factual circumstances merit. Specifically, the Board allowed Greater Sudbury to depart from the application of the half-year rule in respect of its new CIS system.

Approved-But-Unrecognized Ratebase is historical: actual costs already approved and incurred by THESL.

48. In this way, the Board's findings regarding the operation of the half-year rule are contrary to the unchallenged and un-rebutted evidence that was before the Board in the Preliminary Issue hearing,[16] including THESL's evidence regarding Approved-But-Unrecognized Ratebase that:

> "[under IRM] fifty percent of [THESL's] capital invested during rebasing years is not recovered until the next rebasing year (and the opportunity cost of THESL's return and the interim depreciation is lost)"[17]
>
> and
>
> "[what THESL's response to Board Staff Interrogatory 3] shows in a stylized fashion is essentially the effect of the operation of the half-year rule...emanating from the 2012 year, there were $120 million worth of CEEDS that remained unrecognized in the IRM PCI framework."[18]

49. The Board's findings in this regard constitute an error in fact and an error in law.

50. THESL submits that in light of THESL's circumstances and the magnitude of the permanent loss to THESL of approximately $44 million, the Board should depart from its half-year rule policy to adopt the Half-Year Rule Solution. Specifically, the Board should vary the Decision to allow THESL to recover in rates the revenue requirement associated with THESL's Approved-But-Unrecognized Ratebase: $120 million in historic and approved capital spending that is not otherwise reflected in rates under IRM due to the operation of the half-year rule.

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[16] See Exhibit A1, Tab 1, Schedule 2 at p. 27, Witness Statement of Anthony Haines, filed October 31, 2011, Witness Statement of Colin McLorg filed October 31, 2011 (and updated November 1, 2011), Transcript Volume 2, (p. 5, line 8 to p. 8, line 26), Transcript Volume 2 (p. 24, line 16 to p. 25, line 4), and Transcript Volume 2 (p. 58, line 7 to line 27).
[17] Witness Statement of Anthony Haines, filed October 31, 2011 at p. 1
[18] Transcript Volume 2, p. 24, lines 16 to 22.

51. **THE FOLLOWING DOCUMENTARY EVIDENCE** will be used at the hearing of the motion:

(a) The letter dated January 13, 2012 from Ms. Rosmarie Leclair, Chair & CEO of the Ontario Energy Board, to Mr. Clare Copeland, Chairman of Toronto Hydro Corporation, attached to this Notice of Motion as Schedule "1";

(b) The letter dated January 20, 2012 from Mr. Clare Copeland, Chairman of the Toronto Hydro Corporation, to Ms. Rosmarie Leclair, Chair & CEO of the Ontario Energy Board, attached to this Notice of Motion as Schedule "2";

(c) The affidavit and enclosed report of Todd Williams on behalf of Navigant Consulting sworn January 25, 2012, attached to this Notice of Motion as Schedule "3"; and

(d) Such further and other documentary evidence as THESL may submit and the Board allows.

52. THESL brings this motion without prejudice to any other relief THESL may seek in any other forum.

All of which is respectfully submitted this 25th day of January, 2012.

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Schedule “1”

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Rosemarie T. Leclair
Président et Directrice Générale

Ontario

January 13, 2012

Mr. Clare R. Copeland
Chair
Toronto Hydro Corporation
14 Carlton Street
Toronto, ON M5B 1K5

Dear Mr. Copeland

As you know, the Ontario Energy Board recently released its decision on Toronto Hydro's application for rate increases with a cumulative three-year impact of 49%, or $14.43 per month, for a typical consumer (18.7%, or $5.52 per month in 2012; 12%, or $4.20 per month, in 2013; and 12%, or $4.71 per month, in 2014). There has been much discussion in the media about the Board's decision and its impact on Toronto Hydro and its customers.

The Board is mandated to oversee the Province's electricity and natural gas sectors through effective, fair and transparent regulation. In doing so, the Board seeks to protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.

In light of this serious responsibility, I believe that it is important to ensure that the Board's rate-setting processes, the Board's decision in this case and the options available to Toronto Hydro are clearly understood by Toronto Hydro and its customers.

The Board has developed and implemented a multi-year rate setting process, called IRM, to encourage utilities to maximize their efficiency while generating the revenue required to reliably deliver electricity to consumers. The process typically follows a four-year cycle, starting with a comprehensive review of revenue requirements. In the intervening years, the rate setting process provides for inflationary increases adjusted by a productivity measure. In addition, the Board's process also allows adjustments for unforeseen or extraordinary investment if the need arises, the Incremental Capital Module.

This is the rate-setting framework that the Board, in its recent decision, has indicated should be applied to Toronto Hydro.

Under the rate-setting framework set out above, utilities have maintained their annual level of capital spending throughout the IRM period consistent with the level approved in the initial review of revenue requirements. In the Board's view, that is good utility practice and based on our experience, that is how most other utilities in the province manage their capital programs.

The Board approved levels of capital spending for Toronto Hydro in the range of $350 million in 2010 and $378 million for 2011. The most recent Board decision does not limit Toronto Hydro's capital spending to $140 million in 2012, as suggested in Toronto Hydro media commentary, and does not prevent Toronto Hydro from maintaining its capital budget at these historical levels. Additionally, Toronto Hydro can, and has been invited to apply under the Board's incremental capital module to get additional capital funding to meet any extraordinary requirements. The Board's decision suggests that, based on a preliminary review, certain capital projects contemplated by Toronto Hydro are directly analogous to projects that the Board has previously approved under an ICM for other distributors. In other words, if Toronto Hydro brought an application for an ICM and if that application was approved by the panel hearing the case, these projects could add $86 million to invest in the utility's infrastructure needs. When this is added to previous spending levels, this could provide Toronto Hydro with a capital program in excess of $450 million for 2012.

As I noted earlier, the OEB takes its responsibility very seriously. We are mindful of the importance of investing in infrastructure to maintain reliability while ensuring that customer rates remain just and reasonable. The Board's rate-setting framework combined with the incremental capital module is designed to achieve that important balance for consumers.

In its decision, the Board has encouraged Toronto Hydro to apply for an increased capital allowance under the rate-setting framework described above, and we continue to encourage Toronto Hydro to do so. If, however, Toronto Hydro believes that the Board has erred in its decision, there are remedies that it can pursue, either to the Board itself for a review or to the Courts by way of an appeal.

I trust that this information has been of some assistance. The Board looks forward to continuing to work cooperatively with Toronto Hydro to meet its customers' needs going forward.

Regards,

Rosemarie T. Leclair
Chair &CEO

cc : Toronto Hydro Board of Directors
Anthony Haines, President &CEO

Schedule “2”

Toronto Hydro-Electric System Limited
14 Carlton Street
Toronto, Ontario M5B 1K5

Telephone: 416.542.2552
Facsimile: 416.542.2577
torontohydro.com

January 20, 2012

Rosemarie T. Leclair
Chair & CEO
Ontario Energy Board
2300 Yonge Street, 27th floor
Toronto, Ontario
M4P 1E4

Dear Ms. Leclair,

We received your letter dated January 13th. The Board of Directors and management of Toronto Hydro (TH") are also mindful of the importance of investing in infrastructure to maintain reliability while ensuring that customer rates remain just and reasonable. To address our concerns about service reliability while remaining mindful of the impact on rates, the Board of Directors and TH management have been driving to deliver large capital construction programs while increasing efficiency in the organization.

Funding for Capital Expenditures Under the Incentive Regulatory Mechanism:

An independent, qualified third party has verified that the IRM provides TH with approximately $140,000,000 in funding through depreciation for capital programs (plus any additional amounts which may be approved under the OEB's Incremental Capital Module), as compared to the approximately $380,000,000 that was approved by the OEB last year.

System Deterioration and Reliability:

Approximately 40 percent of power outages in Toronto last year were caused by equipment failures and we have not met the OEB's minimum reliability standards for local distribution companies for the past five years. At the request of the OEB, we conducted independent reviews of our equipment assessment methods. Both BIS Consulting LCC and Kinetrics have confirmed that TH's asset condition assessment methodology is industry best practice. In support of our 2009 rate filing, Capgemini found that, when comparing distribution system performance of major cities including those in the G8, TH's distribution system performance is significantly worse than other leading cities in terms of frequency and duration of outages. These studies have supported TH's OEB approved plans in three successive filings over the last five years.

Unique Challenges:

TH is facing several unique challenges. For example, our downtown grid was built in the 50's and 60's using paper insulated lead-sheathed power cables, which was the highest standard at the time. Due to the nature of these cables, a separate, highly skilled workforce

is required to maintain them, and very few utilities use lead cable today. There are only two suppliers of these cables remaining in the world with only one of these in North America. Our cables are aging, present an environmental safety risk, are in short supply, and must be replaced to ensure that we don't compromise the security of supply to downtown Toronto. It will take approximately 20 years to complete this work.

TH also conducts an ongoing contact voltage detection and remediation program. Working with the Electrical Safety Authority on a plan, in 2009 we spent approximately $17,000,000 to assess and repair the end-of-life underground infrastructure. On an ongoing basis, we have been spending $4,000,000 per year to scan city streets nightly. No other utility in Ontario is undertaking such a program.

Growth in Toronto also presents a significant challenge. According to the City of Toronto's Economic Development Committee, there were approximately 163 high-rise buildings under construction in Toronto in October 2011 – more than any other city in North America. In 2015 the City of Toronto is hosting the Pan Am Games, and TH's involvement will be substantial.

Despite the growth in customers and infrastructure demand, our revenues have not grown, principally due to the successful results of energy conservation programs.

Workforce and Productivity:

We continue to make good progress in these areas. Our overall employee headcount is down by 35 percent since the amalgamation of the former Metropolitan Toronto utilities, and the executive ranks have been reduced by 50 percent over the last few years. Mercer Canada Limited, in a report to the Board of Directors has stated:

> "THC has a fair, competitive and effective performance management and compensation program. Compensation levels are well below median market practice and are at risk for delivered results. The systems and processes which support these programs are highly effective, reflect market best practice and have served as a role model for other LDC's in Ontario."

We have made significant productivity gains across the organization. For example, absenteeism at TH is 15 percent below the average of all Canadian public and private sector companies and has improved by 34 percent over the past five years. According to a study done by Gartner, a leading information technology research and advisory company, "Toronto Hydro's total IT spend is 10% (or $4.8M) less than what the peer groups would require on average to support the same workload."

We have just completed our largest annual capital construction program while achieving 2,000,000 hours without a lost time injury in our workforce. This is the best safety record that we have ever achieved and is a 56 percent reduction in injuries since 2007.

As approved by the OEB, we have invested millions of dollars annually in our workforce renewal program. To date we have 120 new apprentices who are being trained in TH's trades school. The trade school is certified by the Ontario Ministry of Colleges and Universities, and is the only one of its kind in Ontario delivered by a local utility. This apprentice program is critical to enabling us to meet the future needs of TH as our aging workforce retires.

Approximately half of our capital construction work is competitively tendered to independent construction companies. The productivity of TH's internal resources has improved and now approximates that of the contractors. Our wrench-time productivity is in the "Industry Leading" category within the power industry as reported by Booz & Company (a leading global management consulting firm).

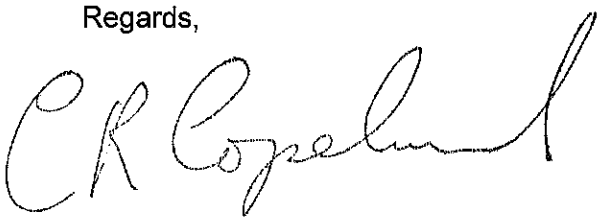
Customer Service:

TH has been a leader amongst local distribution companies in implementing a number of important programs that are aligned with the government's policies on smart meters, time-of-use rates and conservation and demand management programs. Today we have 700,000 customers with smart meters and bill over 650,000 on time-of-use rates. During the implementation of these important programs, call volumes substantially increased. We managed these challenges by deploying cost-effective resource strategies and a variety of communications channels. As a commitment to providing excellent customer service, TH consistently exceeds the OEB's minimum call response requirement.

Toronto Hydro Rates:

Since 2005, TH's distribution rates have remained virtually flat. We are sensitive to the fact that our application, if approved, would result in increases of approximately $5 dollars per month per year for customers. We continue to believe in the need to renew Toronto's end-of-life infrastructure and look forward to an opportunity to present this case to the OEB. In light of the above, we will be filing a request to the OEB to review its decision shortly.

Regards,



Clare R Copeland

Schedule “3”

EB-2011-0144

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B);

AND IN THE MATTER OF an application by Toronto Hydro-Electric System Limited for an order approving or fixing just and reasonable rates and other charges for the distribution of electricity to be effective May 1, 2012, May 1, 2013, and May 1, 2014.

Affidavit of Todd Williams

(sworn January 25, 2012)

I, Todd Williams, in the City of Kingston, Province of Ontario, **MAKE OATH AND SAY**:

1. I am the Managing Director of Navigant Consulting. I therefore have knowledge of the matters to which I depose in this affidavit, unless stated to be on information and belief, in which case I state the source of my information and believe it to be true.

2. I attach to my affidavit as Exhibit "A" a report prepared under my supervision by Navigant Consulting, titled *Impact of the Ontario Energy Board's Incentive Regulation Mechanism on Toronto Hydro*.

3. I attach to my affidavit as Exhibit "B" my curriculum vitae, which I intend to serve as my summary of qualifications in respect of this matter.

4. I make this affidavit in support of THESL's motion for review of the Ontario Energy Board's January 5, 2012 Decision with Reasons and Order on the Preliminary Issue (EB-2011-0144) (the "Decision"), and for no other or improper purpose.

SWORN BEFORE ME
at the City of Toronto,
in the Province of Ontario,
on January 25, 2012.

Original signed by Amanda Klein

Amanda Klein
A Commissioner, etc.

Original signed by Todd Williams

Todd Williams

This is **EXHIBIT "A"** referred to in the Affidavit of

TODD WILLIAMS

Sworn before me this 25th day of January, 2012

Original signed by Amanda Klein

_____

Amanda Klein

A Commissioner, etc. (Province of Ontario)

NAVIGANT

IMPACT OF THE OEB'S INCENTIVE REGULATION MECHANISM ON TORONTO HYDRO

In light of:

1. **The OEB's January 5, 2012 Decision**
2. **The OEB Chair's January 13, 2012 letter to Toronto Hydro**
3. **The Fair Return Standard**

JANUARY 25, 2012

Navigant Consulting Ltd.
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NAVIGANT

Disclaimer: This independent report was prepared by Navigant Consulting Ltd. (Navigant) for Toronto Hydro-Electric System Limited based upon information provided by Toronto Hydro-Electric System Limited and from other sources. Use of this report by any third party for whatever purpose should not, and does not, absolve such third party from using due diligence in verifying the report's contents. Neither Navigant nor any of its subsidiaries or affiliates assume any liability or duty of care to such third parties, and hereby disclaims any such liability.

NAVIGANT

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NAVIGANT

EXECUTIVE SUMMARY

On January 5, 2012, the OEB issued its decision with respect to Toronto Hydro-Electric System Limited's (THESL's) application under EB-2011-0144 stating that the OEB did not support THESL's request to convene a cost of service rate hearing on the grounds that THESL's application did not meet the test for a departure from the OEB's Incentive Regulation Mechanism (IRM). The Board also encouraged THESL to file an IRM rate application for 2012.

In a January 13, 2012 letter to the Chair of the Toronto Hydro Corporation, the Chair and CEO of the OEB stated that:

> *"The Board approved levels of capital spending for Toronto Hydro in the range of $350 million in 2010 and $378 million for 2011. The most recent Board decision … does not prevent Toronto Hydro from maintaining its capital budget at these historical levels."*

Navigant Consulting Ltd. (Navigant) was retained by THESL to explore the impact of the OEB's IRM on THESL in light of: 1) the OEB's January 5, 2012 Decision; 2) the OEB Chair's January 13, 2012 letter to Toronto Hydro; and 3) the Fair Return Standard.

Using data from THESL's approved 2011 rates and applying the OEB's IRM framework, Navigant has concluded that:

1. **The OEB's "Half-Year Rule" results in approximately $121 million of unrecognized rate base at year end 2011 and foregone THESL revenues of approximately $44 million over the remaining years of the IRM.**

   In effect, THESL's depreciation expense, interest expense and return on equity for this unrecognized rate base will not be covered through rates over the IRM period.

2. **THESL faces some very difficult and critical decisions with respect to O&M and capital spending that could impact THESL's access to capital markets and impair the value of the utility.**

   THESL's revenues are expected to increase by 0.7% annually over the remaining years of the IRM period according to the OEB's IRM. Since these revenues will not be built up from THESL's four cost components (O&M expenses, depreciation expense, interest expense and return on equity) as they were in 2011, they do not explicitly "cover" any of THESL's costs per se. Instead, the expected revenues under IRM must be allocated by THESL to these four cost components. Since depreciation and interest expense are largely fixed for the duration of the IRM period, the only cost components that THESL has discretion to adjust are O&M spending and, through its capital spending, return on equity.

3. **If THESL's capital spending continued at the 2011 level of $379 million through 2014, THESL's return on equity would drop steadily to 3.7% by 2014.**

In dollar terms, the total shortfall in THESL's return on equity from 2012 through 2014 would be approximately $131 million. This shortfall would never be recovered in future years since the OEB's rebasing framework that would be applied in 2015 only provides capital recovery for the specific year in question, it does not provide for recovery of any shortfall in return in prior years.

4. **If THESL's capital spending continued at the 2011 level of $379 million through 2014, THESL's O&M expenses would need to decrease by $72 million from THESL's projected 2011 O&M expenses of $238 million to maintain THESL's return on equity at the same 9.2% expected for 2012.**

   This would represent a cumulative reduction in O&M expenses of 30% over the IRM period. Implementing a reduction in O&M expenses to this level would be unrealistic.

5. **If THESL's shortfall due to the Half-Year Rule described in item 1 above were to be addressed, THESL's capital spending would need to decrease from $379 million in 2011 to approximately $140 million in each of 2012, 2013 and 2014 to maintain THESL's return on equity at the same 9.2% expected for 2012.**

   If the shortfall is not addressed, THESL's capital spending would need to decrease to $105 million in each of 2012, 2013 and 2014 to maintain THESL's return on equity at the same 9.2% expected for 2012.

INTRODUCTION AND BACKGROUND

Under Ontario Energy Board (OEB) policy, distributors in Ontario are required to adopt the OEB's Incentive Regulation Mechanism (IRM) unless circumstances exist which preclude the IRM from providing a reasonable outcome.

THESL's current electricity distribution rates in effect for 2011 are the result of a cost of service application EB-2010-0142 filed on August 23, 2010, and a subsequent Ontario Energy Board (OEB or Board) Decision (the "Partial Decision") issued on July 7, 2011.

More recently, THESL filed application EB-2011-0144 on August 26, 2011 establishing rates for three prospective years commencing May 1, 2012 through April 30, 2014. Essentially, this application set out the circumstances precluding IRM from providing a reasonable outcome for THESL.

On January 5, 2012, the OEB issued its decision with respect to THESL's application under EB-2011-0144 stating that the OEB did not support THESL's request to convene a cost of service rate hearing on the grounds that THESL's application did not meet the test for a departure from the OEB's IRM. The Board also encouraged THESL to file both an IRM rate application for 2012 and a separate application to support higher than normal capital spending under the OEB's Incremental Capital Module within the IRM.

On January 13, 2012, Rosemarie Leclair, Chair and CEO of the OEB issued a letter to Clare Copeland, Chair of Toronto Hydro Corporation outlining, among other things, the OEB's rate-setting processes and the options available to THESL. Page 2 of the letter contained the following statement:

> *"The Board approved levels of capital spending for Toronto Hydro in the range of $350 million in 2010 and $378 million for 2011. The most recent Board decision does not limit Toronto Hydro's capital spending to $140 million in 2012, as suggested in Toronto Hydro media commentary, and does not prevent Toronto Hydro from maintaining its capital budget at these historical levels."*

Navigant's Mandate

Navigant was retained by THESL to answer the following questions exploring the impact of the OEB's IRM on THESL in light of: 1) the OEB's January 5, 2012 Decision; 2) the OEB Chair's January 13, 2012 letter to Toronto Hydro; and 3) the Fair Return Standard:

1. How does the OEB's "*Half-Year Rule*" with respect to determination of THESL's 2011 rate base affect THESL over the remaining years of the IRM period?
2. What costs are covered in THESL's projected revenues over the remaining years of the IRM period?

3. Assuming operating costs increase by 0.7% annually, what would THESL's Return on Equity be over the remaining years of the IRM period if its annual capital spending continued at the same $379 million level as approved by the OEB for 2011?
4. Assuming annual capital spending of $379 million, what is the maximum level of operating expenses that would ensure THESL maintains a fair return over the remaining years of the IRM period?
5. Assuming operating costs increase by 0.7% annually, what is the maximum level of capital spending that would ensure THESL maintains a fair return over the remaining years of the IRM period?

THESL's projected return on equity for 2012, based on its rates and spending as approved by the OEB in EB-2010-0142, is 9.2%. For the purposes of this analysis, Navigant has assumed this RoE to be representative of a "fair return on equity", notwithstanding the fact that the OEB's allowable return on equity for regulated utilities is currently 9.58%[1].

In developing its mandate for Navigant, THESL recognized that the OEB's decision and the OEB Chair's letter invited THESL to apply for coverage of some of its capital spending under the OEB's Incremental Capital Module (ICM) within the IRM framework. It does appear that some elements of THESL's projected capital spending, such as "*the Bremner station and contributions to Hydro One Networks Inc. for the Leaside-Birch transmission reinforcement,*" may be eligible for coverage under the ICM as identified by the Board in its decision. At this time, the other THESL projects and their associated capital costs that would be covered under the ICM are highly uncertain. As such, certain of THESL's questions to Navigant simply assume the same level of capital spending by THESL for 2012, 2013 and 2014 as was approved by the OEB in its determination of THESL's 2011 rates.

The next section of this report explains – at a high level – how rates are set for THESL and other utilities. The last section of this report sets out Navigant's answers to THESL's questions.

[1] *Cost of Capital Parameter Updates for 2011 Cost of Service Applications for Rates Effective May 1, 2011*, Ontario Energy Board, March 3, 2011

How are Rates Set and What do they Cover?

Local Distribution Companies (LDCs) are not allowed to set the rates for their distribution services. In Ontario this responsibility lies with the OEB. The OEB approves the distribution rates charged by LDCs according to the rate-making framework established by the OEB.

The OEB's rate-making framework incorporates a process known as ***Cost of Service Ratemaking***. The OEB's framework also incorporates an ***Incentive Regulation Mechanism (IRM).*** Both of these processes are described below.

Cost of Service Ratemaking

Under Cost of Service Ratemaking, the utility's distribution rates are set to allow the utility to 1) recover all reasonable expenses associated with the operation and maintenance of the utility, and 2) earn a reasonable return on their investment. A reasonable return is generally defined as a return which provides the utility with access to capital through the financial markets to enable investments in new utility infrastructure required to serve customers.

These specific costs covered under Cost of Service Ratemaking are:

- Operating and Maintenance (O&M) expense, and
- Capital recovery.

Capital recovery includes three cost components associated with the utility's investments in infrastructure to serve its customers:

- Depreciation expense
- Interest expense, and
- Return on Equity (RoE).

The sum of all these components is referred to as the "Revenue Requirement" of the utility. Essentially, if the utility's revenues in a given year are equal to its Revenue Requirement for that year, then it will cover its cost of providing distribution service for that year.

The equations below define a utility's Revenue Requirement for a specific year:

Revenue Requirement = O&M Expenses + Capital Recovery, or

Revenue Requirement = O&M Expenses + Depreciation Expense + Interest Expense + Return on Equity

The Interest Expense used in calculating the Revenue Requirement is typically calculated as the Weighted Average Cost of Debt ("WACD") on the outstanding bonds and short-term borrowing of the utility.

The Return on Equity is estimated based on the prevailing conditions of the financial markets and seeks to achieve a balance between the utility's need to secure financing from capital

markets and the rates paid by the utility's customers, The return on equity provides a return equal to the economic cost of capital and no economic profit is provided.

The RoE of a regulated utility is a cost similar to O&M expenses. The finding that return on equity is a necessary component of the revenue requirement has been supported in various tribunals including the following quote from Justice Brandeis:

> *In essence, there is no difference between the capital charge and operating expenses, depreciation, and taxes. Each is a part of the current cost of supplying the service; and each should be met from current income. When the capital charges are for interest on long-term bonds, entered into years before the rate hearing and to continue for years thereafter; and it is true also of the economic obligation to pay dividends on stock, preferred or common*[2].

In the OEB's Report of the Board on the Cost of Capital for Ontario's Regulated Utilities, EB-2009-0084 of December 11, 2009, one of the key messages quoted by the Board in regard to the Fair Return Standard (FRS) was as follows:

> *… even though cost of capital may be more difficult to estimate than some other costs, it is a real cost that the utility must be able to recover through its revenues. If the… [Board] does not permit the utility to recover its cost of capital, the utility will be unable to raise new capital or engage in refinancing as it will be unable to offer investors the same rate of return as other investments of similar risk. As well, existing shareholders will insist that retained earnings not be reinvested in the utility*[3].

Cost of Service Ratemaking Example

The following illustrative example demonstrates how these various components are determined and combined to form the Revenue Requirement. Consider an example utility that has a total investment in infrastructure (net of past depreciation) of $1 billion and approved Operating and Maintenance costs of $120 million.

The first step under Cost of Service Ratemaking would be the determination of the utility's Capital Recovery requirement. As described above, this includes depreciation, interest and return on equity. For the example utility, assume that annual depreciation is equal to $60 million. The other two components of the Capital Recovery component are dependent on the level of debt, interest rate and return on equity allowed by the regulator. In this example, assume that debt represents 60% of the total investment, the interest rate on debt is 5% and that the shareholder's equity represents the remaining 40% of the investment. Further, assume that the regulator allows a 9.2% return on equity. Note also that this return on equity

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2 Missouri ex. Rel. Southwest Bell Telephone Company v. Missouri Public Service Commission, 262 U.S. 276, 306 (1923)

3 TransCanada PipeLines Limited v. National Energy Board et al. [2004] F.C.A 149. Para. 12.

is an after-tax amount, so the utility would need to earn slightly more than this before tax to yield the desired after-tax amount. In the example, assume that the income tax rate is equal to 25%.

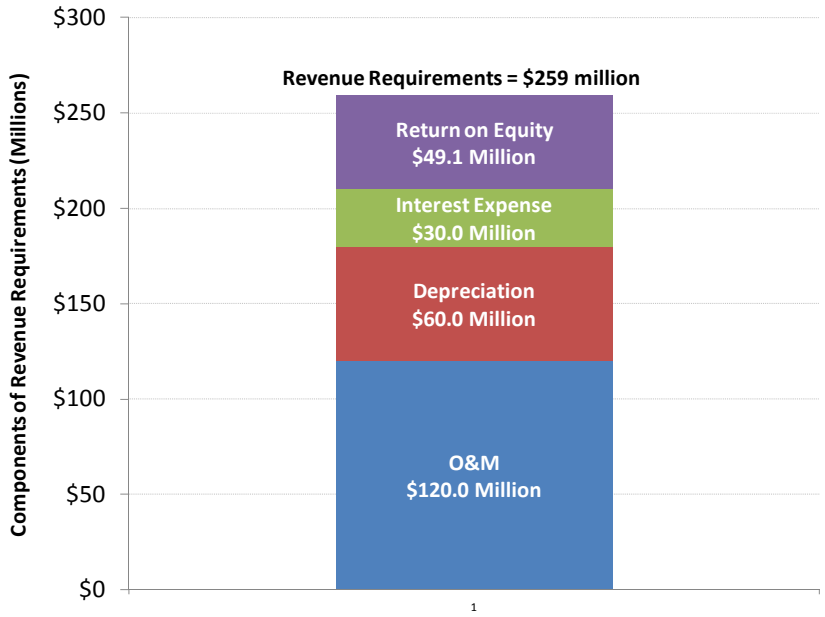
The calculation of interest expense and return on equity is as follows:

Interest expense	**= $1,000 million x 60% x 5%**
	= $600 million x 5%
	= $30 million
Return on Equity	**= $1,000 million x 40% x 9.2%/(1 – 25%)**
	= $400 million x 9.2%/(1 – 25%)
	= $400 million x 12.3%
	= $49.1 million

As a check to ensure the return on equity provides the required return, $49.1 million on a before tax basis would provide $36.8 million ($49.1 million x 75% = $36.8 million) after 25% income tax. For the total shareholder investment of $400 million in the utility's infrastructure, this would be equal to a 9.2% after-tax return ($400 million x 9.2% = $36.8 million).

The sum of these four components (O&M expense, depreciation expense, interest expense and return on equity) are equal to $259.1 million and this would represent the illustrative utility's revenue requirement for that year, broken out as shown in Figure 1:

Figure 1: Breakdown of Illustrative Utility's Revenue Requirement



Three additional and important points to note with regard to Cost of Service Ratemaking are that:

1. **The OEB does not provide money directly to the utility**, rather it sets distribution rates that, based on utility's expected sales to each customer class, allow the utility to collect its revenue requirement from its customers in return for providing distribution service
2. **The utility's revenue requirement does not directly reflect the utility's projected capital spending**. Instead, the revenue requirement includes a capital recovery amount that covers depreciation and the interest on debt and return on equity associated with utility's total investment in infrastructure, often referred to in regulatory parlance as the utility's "rate base".
3. **The Capital Recovery component of the OEB's Cost of Service Framework reflects the average of the utility's rate base at 1) the beginning of the year, and 2) the end of the year.** When rates are set each year according to a Cost of Service framework, the end of year rate base becomes the beginning of year rate base for the following year and this so-called "Half-Year Rule" has limited impact on the utility's capital recovery over time.

   As applied in the "rebasing" year of the OEB's Incentive Regulation Mechanism, described in the following section, any differences between the "average" rate base and the year-end rate base for the initial year created through the "Half-Year Rule" are not reflected in rates in subsequent years.

The Incentive Regulation Mechanism

As discussed, the OEB's rate-making framework also incorporates an ***Incentive Regulation Mechanism (IRM)*** which is designed to provide electricity distributors with an additional incentive to operate efficiently over time. Under Ontario Energy Board (OEB) policy, distributors in Ontario are required to adopt the OEB's Incentive Regulation Mechanism (IRM) unless circumstances exist which preclude the IRM from providing a reasonable outcome.

The IRM covers a multi-year period. In the first year of the IRM period, a utility's revenue requirement, and the rates for the various customer classes that will yield the revenue requirement, are established through a "rebasing" mechanism that is essentially equivalent to the Cost of Service Ratemaking process defined above. As described in the previous section, according to the OEB's Half-Year Rule, the utility's rate base in the first year of the IRM period reflects the average of the utility's rate base at 1) the beginning of the year, and 2) the end of the year.

In each subsequent year during the IRM period, a utility's rates are allowed to increase by an amount equal to inflation less a "productivity factor" determined by the OEB. In a simple example, if the rate of inflation was 1.5% and the productivity factor determined by the OEB was 0.7%, then the utility would be allowed to increase its rates by 0.8% (1.5% - 0.7%).

The utility's revenues during the IRM period establish the overall "budget" for utility management. As described above, this budget covers O&M and capital recovery. If the utility exceeds this budget, the "excess" will reduce the RoE since the other components – depreciation expense and interest expense – are unavoidable. Thus, if a utility cannot meet their budget under IRM, their RoE will suffer. Conversely, if the utility is able to spend less than their "budget", their RoE could increase beyond the level used to establish rates in the rebasing mechanism at the beginning of the IRM process.

At the end of the IRM period, the utility's revenue requirement for the first year of the next IRM period will again be established through rebasing (following the Cost of Service process) and the cycle will repeat itself – with rates in subsequent years allowed to increase by an amount equal to inflation less a productivity factor.

To summarize, in the first (or rebasing) year of the IRM period, the utility rates are established through a rebasing mechanism in which the utility's revenue requirement is set to recover the utility's O&M expense, depreciation expense, interest expense, and return on equity. In subsequent years within the IRM period, rates are allowed to increase by an amount equal to inflation less a productivity factor and the utility's revenues are neither directly related to nor based upon the utility's O&M expense, depreciation expense, interest expense, and RoE in those years.

A consequence of requiring a utility to use the IRM when significant capital spending are required is that the utility will be required to either significantly reduce O&M expenses or suffer a reduction in their RoE.

IMPACT OF THE OEB'S INCENTIVE REGULATION MECHANISM ON TORONTO HYDRO

The specific questions posed by THESL relating to the impact of the OEB's IRM on THESL in light of: 1) the OEB's January 5, 2012 Decision; 2) the OEB Chair's January 13, 2012 letter to Toronto Hydro; and 3) the Fair Rate of Return Standard were:

1. How does the OEB's "*Half-Year Rule*" with respect to determination of THESL's 2011 rate base affect THESL over the remaining years of the IRM period?
2. What costs are covered in THESL's projected revenues over the remaining years of the IRM period?
3. Assuming operating costs increase by 0.7% annually, what would THESL's Return on Equity be over the remaining years of the IRM period if its annual capital spending continued at the same $379 million level as approved by the OEB for 2011?
4. Assuming annual capital spending of $379 million, what is the maximum level of operating expenses that would ensure THESL maintains a fair return over the remaining years of the IRM period?
5. Assuming operating costs increase by 0.7% annually, what is the maximum level of capital spending that would ensure THESL maintains a fair return over the remaining years of the IRM period?

Answers to these questions were developed by Navigant using a simple financial model that reflected THESL's approved 2011 rates and projected costs, rates and revenues for the remainder of the IRM period.

As noted previously, THESL's projected RoE for 2012, based on its rates and spending as approved by the OEB in EB-2010-0142, is 9.2%. Navigant has used this return as representative of a "fair rate of return" in its analysis, notwithstanding the fact that the OEB's allowable RoE for regulated utilities is currently 9.58%.

1) How does the OEB's "*Half-Year Rule*" with respect to determination of THESL's 2011 rate base affect THESL over the remaining years of the IRM period?

According to the OEB's "Half-Year Rule" the Capital Recovery component for the first, or rebasing, year of the IRM period reflects the average of the utility's rate base at 1) the beginning of the year, and 2) the end of the year.

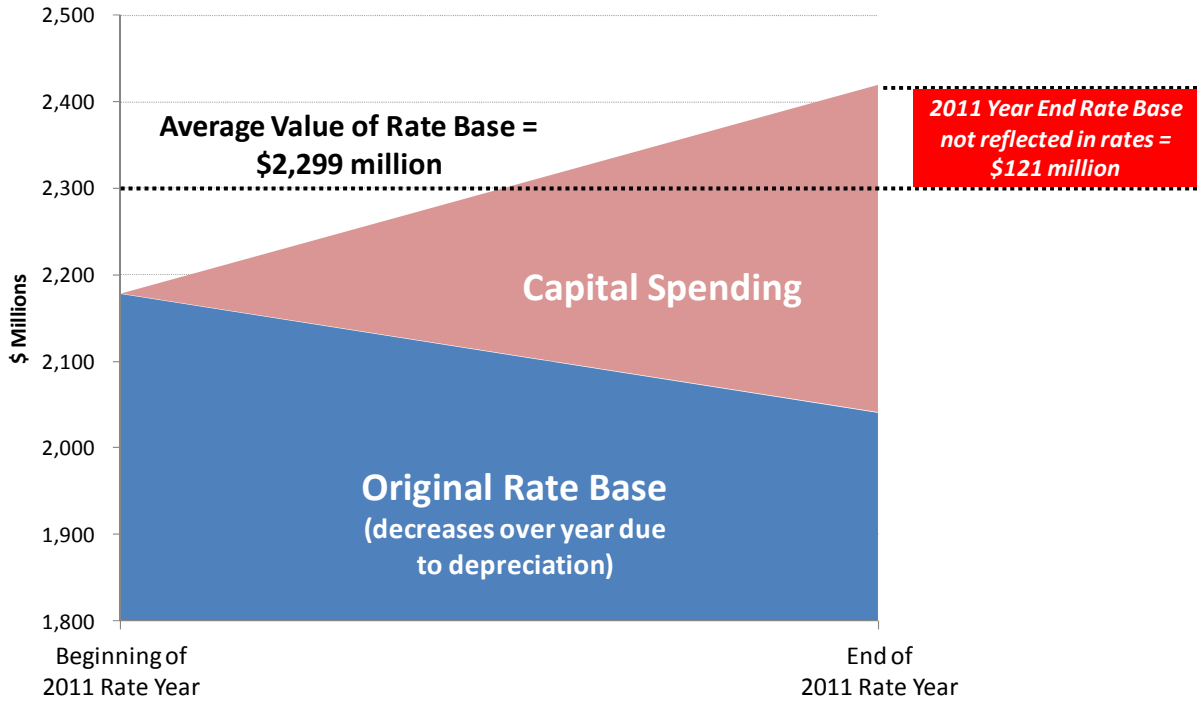
The relevant parameters for determination of THESL's 2011 rate base were:

Rate base at beginning of year	**= $2,178 million**
Forecast depreciation in 2011	**= $137 million**
Projected 2011 capital spending	**= $379 million**
Rate base at year-end	**= $2,420 million ($2,178 million - $137 million + $379 million)**

According to the Half-Year Rule, THESL's average rate base in 2011 was $2,299 million (average of $2,178 million and $2,420 million).

The net effect of depreciation and capital spending on THESL's rate base over 2011 is shown graphically in Figure 2. For simplicity, capital spending is assumed to occur uniformly over the year.

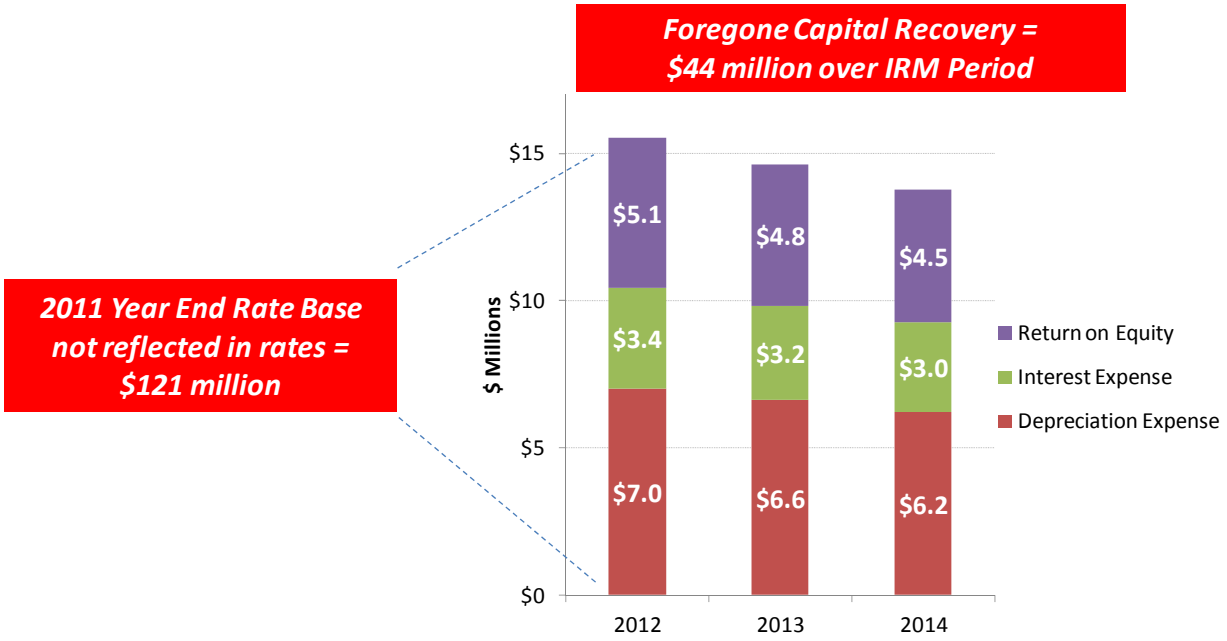
Figure 2: Changes in THESL's Rate Base in 2011



As shown in Figure 2, approximately $121 million of THESL's 2011 year-end rate base is NOT reflected in THESL's 2011 rates. In essence, only half of THESL's 2011 capital spending and depreciation expense were reflected in the rate base for the purpose of calculating THESL's Capital Recovery factor in determining THESL's 2011 rates. Because THESL's 2011 rates form the basis for THESL's 2012, 2013 and 2014 rates under the OEB's IRM, this "unrecognized" rate base has significant implications for THESL.

If this $121 million of unrecognized rate base was subject to Cost of Service Ratemaking over the remaining three years of the IRM period, THESL's Capital Recovery costs would be as shown in Figure 3. As shown, THESL would receive revenues of approximately $15 million each year (declining slightly over the period due to depreciation) over the period. The total value of the Capital Recovery that THESL will not earn – essentially foregone revenue – over the IRM period because of the Half-Year Rule is approximately $44 million. Note that if the 2012 Capital Recovery factor of $15.5 million was subject to the OEB's IRM, the value of the revenue foregone by THESL due to the Half-Year Rule would be slightly higher at just under $47 million.

Figure 3: Foregone Capital Recovery for $121 million of Unrecognized 2011 Rate Base



So, in answer to THESL's question, the OEB's Half-Year Rule results in $121 million of unrecognized rate base at year end 2011. THESL's foregone revenues over the remaining years of the IRM period are $44 million due to this effect and, as a result, THESL's depreciation expense, interest expense and return on equity for this unrecognized rate base will not be covered in revenues over the IRM period. While the implementation of the Half-Year Rule is reasonable for the purpose of establishing rates in a re-basing year (2011 in this case), it has a material impact on THESL's revenues over the remaining years of the IRM period.

The unrecognized rate base will not be recognized until THESL's rates are rebased in 2015. Depending on the level of THESL's 2015 capital spending relative to its 2015 depreciation expense, the same effect may impact THESL's depreciation expense, interest expense and return on equity in the post-2015 IRM period.

2) What costs are covered in THESL's projected revenues over the remaining years of the IRM period?

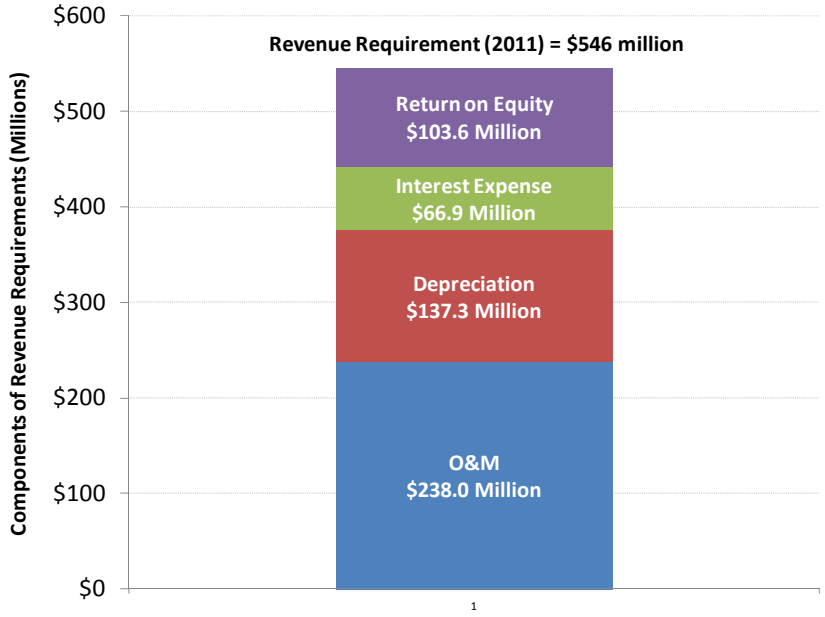
Per the most recent OEB decision, the 2011 rate year would represent the first year of THESL's IRM period. Given this, THESL's 2011 revenue requirement established under the Cost of Service framework will serve as the starting point for THESL's rates (and revenues) under IRM. The key parameters underlying the 2011 rates approved by the OEB are shown in Table 1 below.

Table 1: Key Parameters for THESL's 2011 Rates as Approved by the Ontario Energy Board

Cost Component	2011 Approved ($ Millions)
Capital spending	$379
Operating and Maintenance	$238
Rate Base	$2,298

THESL's forecast revenue for 2011 based on these parameters as approved by the OEB is approximately $546 million. The four components of THESL's revenue requirement for 2011 are shown in Figure 4.

Figure 4: Breakdown of THESL's 2011 Revenue Requirement



In years 2, 3 and 4 of the IRM period corresponding to 2012, 2013 and 2014, THESL's revenue requirement will no longer be based on the summation of these four components according to a Cost of Service framework. Instead, THESL's annual revenue in 2012, 2013 and 2014 will

reflect the rate escalation formula in the IRM framework and will not have any direct relationship with THESL's costs in these years.

As discussed in the previous section, distribution rates are allowed to increase each year within an IRM period by an amount equal to inflation less a productivity factor determined by the OEB. In Navigant's analysis, we have assumed that the maximum allowable annual increase for THESL will be approximately 0.7% (reflecting forecast inflation of 2% less the OEB's productivity factor of 0.72% and the "stretch factor" as applied by the OEB to THESL and other Group III LDCs of 0.6%).

While THESL's customer base has increased slightly in recent years, the average customer electricity usage per customer has declined. These two factors essentially offset one another and, as a result, Navigant has assumed that the expected annual percentage increase in THESL's revenue during the remaining years of the IRM period will be the same 0.7% as projected for rates.

Based on these assumptions, THESL`s expected revenues in 2012, 2013 and 2014 – the remaining years of the IRM period – are shown in the following table.

Table 2: Forecast THESL Revenue through 2014 under IRM

	Rebasing Year	Rates increase each year by CPI minus Productivity Factor		
	2011	2012	2013	2014
Revenue ($ millions)	$546	$550	$553	$557

These revenues ostensibly cover the same four cost components (O&M expense, depreciation expense, interest expense and return on equity) as covered in Cost of Service Ratemaking, but they are not "built-up" from the individual components the same way that THESL's 2011 revenue requirement were developed.

It is important to note that since two of THESL's cost components – depreciation expense and interest expense (the red and green bars respectively in Figure 4) – are largely fixed and unavoidable for the duration of the IRM period, THESL has to allocate the revenue remaining in each year of the IRM period (after covering depreciation and interest expense) between RoE and O&M expenses.

In summary, since THESL's revenues in the remaining years of the IRM period are not built up from the four cost components (O&M expenses, depreciation expense, interest expense and return on equity) as they were in 2011 using the Cost of Service framework, the revenues under IRM do not explicitly "cover" any of THESL's costs per se. The only cost components that THESL has discretion to adjust are O&M spending and, through its capital spending, RoE. Given the expected revenues relative to THESL's (essentially fixed) depreciation and interest expenses over the IRM period, THESL faces some very difficult and critical decisions with

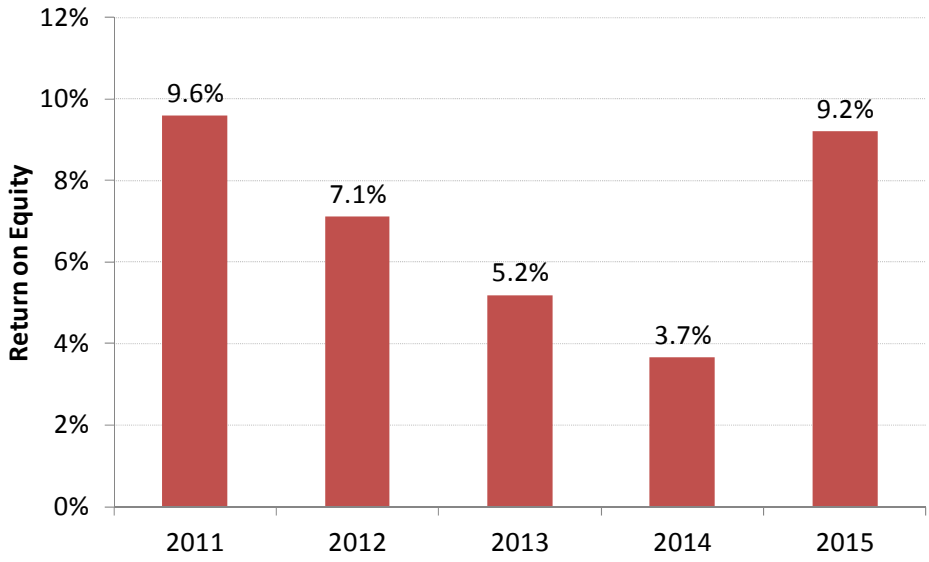
respect to O&M and capital spending that could impact THESL's access to capital markets and impair the value of the utility.

THESL's three remaining questions, answered below, cover the impacts that certain decisions with respect to O&M and capital spending would have on THESL.

3) Assuming operating costs increase by 0.7% annually, what would THESL's Return on Equity be over the remaining years of the IRM period if its annual capital spending continued at the same $379 million level as approved by the OEB for 2011?

The first scenario assumes annual capital spending remains constant at $379 million over the IRM period and that THESL's O&M expenses increase at 0.7% annually (the same rate as THESL's revenues are expected to increase over the IRM period). Figure 5 below illustrates the outcome of this scenario.

Figure 5: Forecast Return on Equity under IRM with Annual Capital Spending of $379 million



After 2011 (the base year in which THESL's rates were established under a Cost of Service framework) the RoE drops steadily to a low of 3.7% in 2014. Note also that this decline in return on equity applies to the entire equity component of THESL's rate base, not just the equity component of THESL's annual capital spending[4]. Such a precipitous decline in return could impact THESL's access to capital markets and impair the value of the utility.

In dollar terms, the total shortfall in the RoE from 2012 through 2014 is approximately $131 million. This shortfall will never be recovered in future years since the OEB's rebasing

[4] Navigant has assumed that 60% of THESL's capital spending is funded through additional debt. This simplifying assumption ignores any potential restrictions on the total level of debt that could be issued by THESL through its existing debt covenants.

framework only provides assurance of capital recovery for the specific year in question, it does not provide for recovery of any shortfall in return in prior years.

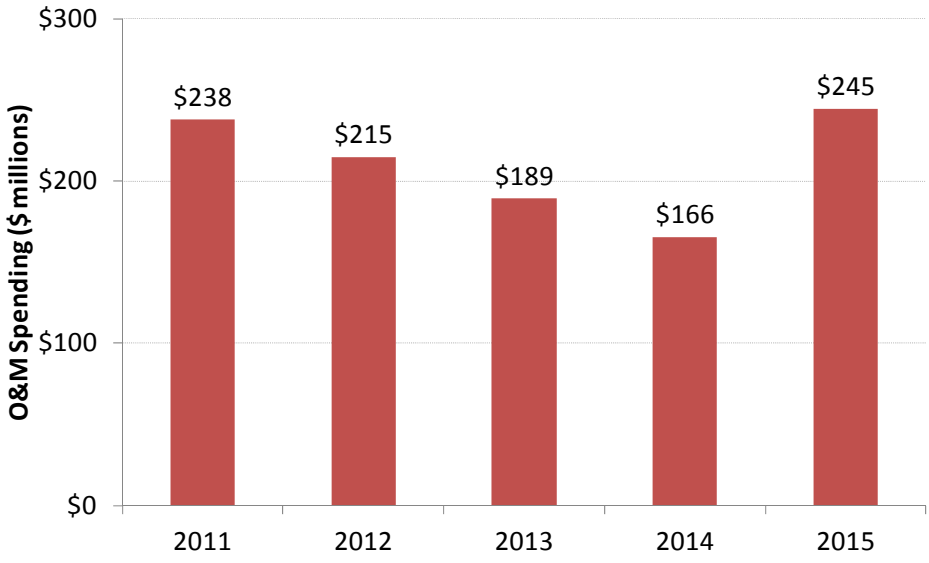
THESL's RoE is forecast to climb back to 9.2% in 2015 when rates are scheduled to be rebased. The 2015 rate increase necessary to provide a 9.2% RoE on THESL's projected 2015 midyear rate base of just under $3.2 billion (up from the 2011 midyear rate base of $2.3 billion) is forecast to be just over 20%.

4) Assuming annual capital spending of $379 million, what is the maximum level of operating expenses that would ensure THESL maintains a fair return over the remaining years of the IRM period?

The next scenario Navigant prepared assumed that capital spending would be maintained at $379 million per year and that O&M expenses would be reduced to a level that would yield the same RoE of 9.2% as expected in 2012.

Figure 6 illustrates that, under this scenario, O&M expenses would need to decrease by 10% to 12% each year to maintain a 9.2% RoE. Over the three year period from 2012 through 2014, THESL's O&M expenses would need to decrease by almost 30%. As in the previous scenario, O&M spending was assumed to increase in 2015 under new rates that would be established through rebasing.

Figure 6: Required O&M to maintain RoE of 9.2% with Annual Capital Spending of $379 million



That such a significant decrease in O&M expenses would be required when revenue is increasing by 0.7% annually appears counter-intuitive, but it is largely driven by the level of projected capital spending relative to THESL's depreciation expense. As THESL's rate base increases over the IRM period, relatively more of THESL's revenue has to be allocated to

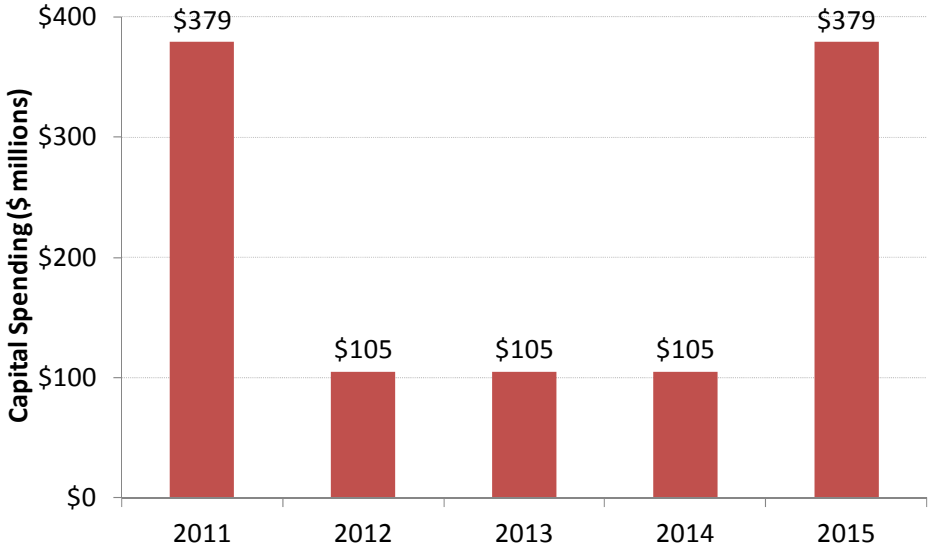
capital recovery and O&M expenses are the only cost component that THESL can adjust to maintain the RoE at 9.2%.

The next scenario explores the opposite allocation – O&M expenses left as projected and capital spending adjusted to maintain the return on equity at 9.2%.

5) Assuming operating costs increase by 0.7% annually, what is the maximum level of capital spending that would ensure THESL maintains a fair return over the remaining years of the IRM period?

The final scenario prepared by Navigant was to determine the level of capital spending in each year of the IRM period in order to achieve an average return on equity of 9.2% while also allowing O&M expenses to increase at 0.7% annually. Figure 7 illustrates the resulting capital budget.

Figure 7: Capital Spending Levels required to maintain a 9.2% Return on Equity



As shown, capital spending levels would have to decrease to $105 million in each of 2012, 2013 and 2014 in order to maintain an average RoE of 9.2% over the IRM period.

The above analysis assumes that THESL's shortfall due to the Half-Year Rule described in the response to question 1 above is not addressed. If THESL's shortfall due to the Half-Year Rule were to be addressed, THESL's capital spending would need to decrease from $379 million in 2011 to approximately $140 million in each of 2012, 2013 and 2014 to maintain THESL's return on equity at the same 9.2% expected for 2012.

Note also that Navigant's analysis simply assumes that the level of capital spending returns to $379 million in 2015 and does not consider any need for any increased capital spending that may be required to "catch up" for any capital spending shortfalls during the 2012 – 2014 period.

Exhibit “B”

CURRICULUM VITAE OF
TODD WILLIAMS

Experience: Navigant Consulting Ltd.

Managing Director
2010 - Present

Director
2008 - 2010

Associate Director
1998 - 2008

Education: Masters of Business Administration
University of Western Ontario, 1990

Bachelor of Science, Engineering Physics
Queen's University, 1983

Memberships: Professional Engineers of Ontario

Experience: Strategic, regulatory, financial and technical support to Ontario electric and gas utilities and their shareholders and Boards of Directors since 1998.

Valuation of utilities under various regulatory frameworks

Supported the City of Barrie in merger negotiations between Barrie Hydro and PowerStream

Regulatory support on various matters to Electricity Distributors Association

Lead Navigant's ongoing support to the Ontario Energy Board for the Regulated Price Plan

Determined benefits of Ontario's Smart Meter Initiative for the Ministry of Energy

Cost allocation for Ontario electricity distribution utility