NORTON ROSE

Barristers & Solicitors / Patent & Trade-mark Agents

Norton Rose Canada LLP
Royal Bank Plaza, South Tower, Suite 3800
200 Bay Street, P.O. Box 84
Toronto, Ontario M5J 2Z4 CANADA

F: +1 416.216.3930
nortonrose.com

On January 1, 2012, Macleod Dixon joined
Norton Rose OR to create Norton Rose Canada.

April 25, 2012

Sent By Courier

Kirsten Walli
Board Secretary
Ontario Energy Board
Suite 2700
2300 Yonge Street
Toronto, ON M4P 1E4

Your reference EB-2011-0271	Direct line +1 (416) 216-2311
Our reference 01005480-0015	Email richard.king@nortonrose.com

Dear Ms. Walli:

Halton Hills Hydro Inc. ("HHH") (EB-2011-0271)

Please find enclosed HHH's Reply Argument in the above-referenced matter. The Reply Argument is also being filed on the Board's RESS system, and served on all parties to the proceeding.

Yours very truly,

Original signed on behalf of

Richard King

RK/mnm

Enclosure

Cop(y/ies) to: All Intervenors in EB-2011-0271
Art Skidmore (HHH)
David Smelsky (HHH)

DOCSTOR: 2412185\1

EB-2011-0271

ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an application by Halton Hills Hydro Inc. for an Order or Orders approving or fixing just and reasonable rates and other charges for the distribution of electricity as of May 1, 2012.

HALTON HILLS HYDRO INC.
REPLY ARGUMENT

April 25, 2012

Norton Rose Canada LLP
200 Bay Street, Suite 3800
Royal Bank Plaza, South Tower
Toronto, Ontario M5J 2Z4

Richard J. King
(416) 216-2311
(416) 216-3930
richard.king@nortonrose.com

A. INTRODUCTION

1. This Reply Argument responds to the submissions of Board Staff and intervenors (Energy Probe, VECC and SEC) in respect of the five unsettled issues in HHH's 2012 distribution rate application. These issues are:

- inclusion of the Green Energy Initiative ("GEI") in capital expenditures for the test year (and the consequent impacts on depreciation, cost of capital, etc.);
- the appropriate amortization period for HHH's property, plant and equipment ("PPE") account;
- the clearance of HHH's deferral and variance account ("DVA") amounts;
- the long-term debt rate to be utilized in calculating HHH's cost of capital; and,
- the appropriate operations, maintenance and administration ("OM&A") expenses to be included in HHH's test year.

2. This Reply Argument is organized on an issue-by-issue basis.

B. CONTEXT FOR UNRESOLVED ISSUES

3. Before addressing the specific submissions of Board Staff and intervenors on the unsettled issues, both SEC and Energy Probe took issue with HHH's submission (in its Argument-in-Chief) that what HHH was asking for in respect of the unresolved issues is quite modest in terms of ultimate rate impacts. SEC and Energy Probe suggest that by making this submission, HHH is suggesting that every rate case should automatically result in a rate increase. That is not the case.

4. HHH believes that contextualizing the rate impacts of unresolved matters should be of significant importance to the Board, given that ultimately the Board's jurisdiction in all rate proceedings is to set just and reasonable rates (subsection 78(3), *Ontario Energy Board Act, 1998*). Case law has interpreted this to mean rates that are reasonable to both the utility and the consumer (*Northwestern Utilities, Ltd. V. Edmonton*, [1929] 2 D.L.R. 4 (SCC)). The Board's jurisdiction could not be broader – it is entirely up to the Board to determine how to satisfy itself that resultant rates are just and reasonable in any particular case. There is no prescribed methodology for how the Board is to make its determination.

5. Given this, HHH thinks it is entirely reasonable for the Board to understand whether the resolution of issues in a proceeding could increase rates by 20% or (as in this case) have virtually no impact on rates. The primary statutory imperative for the Board in these matters is bottom-line rates. Understanding the potential of any unresolved issues to affect bottom-line rates must form the contextual backdrop for the Board's consideration of those issues.

6. As noted in its Argument-in-Chief, HHH's test year revenue deficiency now stands at $79,360, which is based on HHH being fully successful on the unresolved issues – in other words, the Board approving:

- HHH utilizing the Board's deemed long-term debt rate;
- the inclusion of the full $6,274,021 OM&A costs in HHH's test year;
- the inclusion of the Green Energy Initiative in HHH's test year capital expenditures;
- a 20-year amortization period for HHH's PPE account; and,
- the clearance of the DVA amounts over two years.

7. If the Board denies or reduces any of these five items, HHH's modest revenue deficiency would be further reduced. In other words, the outcome of this proceeding will result in the status quo in terms of rates. Moreover, HHH's rates are currently at the low end of the spectrum when compared to rates of other distributors proximal to HHH, and other predominantly rural utilities.

8. Each of the five unresolved issues is addressed more specifically below.

C. GREEN ENERGY INITIATIVE

(a) Positions of the Parties

9. Board Staff and intervenors do not support HHH's proposal to include the Green Energy Initiative project in its test year capital expenditures. There are two qualifiers to this:

- SEC supports a dramatically scaled-down Green Energy Initiative that is one-tenth the size of HHH's proposed project (i.e., 140 units); and
- Energy Probe offers three alternatives for the Board to consider, including: (i) a scaled-down project of 100 units; (ii) installation of 140 units annually over a number of years; or (iii) the full installation of the proposed 1,400 units, with a deferral account that records an increase in revenue requirement equal to the cost savings to ratepayers over the 20 year life of the installations.

10. Intervenors and Board Staff argue that HHH has failed to provide sufficient evidence to the Board to demonstrate that the benefits of the Green Energy Initiative outweigh the costs.

11. In HHH's view, intervenors and Board Staff have failed to acknowledge any benefits from the Green Energy Initiative other than quantifiable, financial

benefits. Nor have intervenors and Board Staff allowed for the utility to enjoy any benefit of the doubt or presumption of management good faith with respect to this project when it comes to HHH's evaluation of these non-financial, non-quantifiable benefits.

12. In HHH's view, there is sufficient experience with this technology, and sufficient evidence on the record in this proceeding, to indicate that the Green Energy Initiative represents a prudent distribution investment.

(b) Law Related to Capital Expenditures by Utilities

13. In evaluating capital expenditures by utilities, the prudent investment standard has been consistently approved by Courts and utility regulators. Under this rule, there is a presumption on the part of the regulator that a utility's expenditures are reasonable and made in good faith. The presumption arises from a very practical consideration – namely, that in the absence of such a presumption, the utility would theoretically have the burden of positively proving, with specific factual evidence, that every cost element in a rate case was reasonable.

14. The classic statement of the prudent investment standard is found in the *Southwestern Bell* case, and has been consistently recognized by utility regulators across North America:

> Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown.
>
> *Missouri ex. rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276 (1923) (U.S.S.C.) at 289 ("Southwestern Bell").

15. Intervenors can rebut the presumption of management good faith by establishing a prima facie case that calls into question the reasonableness of the utility's proposed expenditures. At that point, the burden shifts to the utility to adduce additional evidence to show that the expenditure is reasonable under the

circumstances known to the utility at the time the capital expenditure decision is made.

> Ontario Energy Board, Decision with Reasons, RP-2001-0029, *Union Gas Distribution Rates 2001-2002*, paras. 2.34 and 2.35

16. The Board has stated in past cases that the presumption of management good faith enjoyed by a utility can be rebutted by showing, *inter alia*:

- that the outcome of the investment decision was or would be "unreasonably adverse" to customers; or

- that the utility's conduct is or was inconsistent with industry practices at the time.

> Ontario Energy Board, Decisions with Reasons, RP-2001-0032, *Enbridge Gas Distribution Rates 2002*, paras. 3.12.1 to 3.12.5.

> Burns, R., *Security-Related Cost Recovery in Utility Network Industries*, (Columbus, Ohio: National Regulatory Research Institute, 2003), at 6.

Will the Green Energy Initiative Be "Unreasonably Adverse" to Customers?

17. In this case, HHH is strongly of the view that the Green Energy Initiative will not only not be "unreasonably adverse" to HHH's customers, but will in fact provide net benefits to its customers. Not all of these benefits will be financial, and not all financial benefits are precisely quantifiable.

18. Intervenors and Board Staff have, in their submissions, virtually ignored or attributed zero value to those benefits from the Green Energy Initiative that are not purely financial (or cannot be quantified financially with sufficient accuracy). In HHH's view, that is entirely inconsistent with how the Board does (and should) make determinations regarding utility cost items. Indeed, not all capital expenditures by distributors provide notable financial benefits for ratepayers. Decisions about capital expenditures are made for a variety of reasons –

including reliability, future planning considerations, operational efficiency, etc. HHH is proposing the Green Energy Initiative because it believes that on balance, ratepayers will be better off after implementation of the Green Energy Initiative than before.

19. HHH has provided evidence to show that the **quantifiable financial** benefits are $35,495 annually (EProbe IR#19). This amount does not include a number of **non-financial** and **non-quantifiable financial** benefits. These include:

- Non-Financial Benefits to Ratepayers: Increased reliability, voltage stabilization, improved monitoring of system (i.e., monitoring operation and health of grid, reliability alerts, remote sensing of voltage quality and power flows), platform for future smart grid opportunities, improved public awareness about electricity usage/renewable production, reduced generation emissions, etc.

- Non-Quantifiable, Financial Benefits to Ratepayers: Value of emission reduction credits, value of any improved response times to specific problems as a result of better real-time information, etc.

(Exhibit 2, Tab 3, Schedule 7 and Undertaking J1.5.)

20. The annual revenue requirement increase associated with the Green Energy Initiative (using a CCA of 8%) varies between $54,412 and $101,822 (EProbe Argument, Appendix B). HHH's view is that the non-financial and non-quantifiable benefits to ratepayers (when taken together with the estimated quantifiable financial benefits of $35,495, and the benefits to the utility noted below) makes the Green Energy Initiative a prudent investment. It should also be noted that the $35,495 is merely a best estimate of quantifiable costs.

21. HHH submits that in addition to an assessment of the benefits and costs to ratepayers of the Green Energy Initiative, an appropriate, comprehensive

analysis of the Green Energy Initiative should consider the benefits to the utility. These benefits relate primarily to improved ability to monitor reliability and improved to operational efficiency. The Green Energy Initiative will allow HHH to respond more quickly and efficiently to specific problems because of the improved information offered by the systems. In addition, the Green Energy Initiative will provide more general benefits in terms of improved asset management, by being able to provide more timely information about the health of distribution assets. The return on equity provided to HHH as a result of this project is immaterial – varying from $10,308 to $40,923 annually over the 20 year project timeline.

<u>Is the Green Energy Initiative Inconsistent with Current Industry Practice?</u>

22. Intervenors and Board Staff unfairly attempt to portray the Green Energy Initiative as an unproven, poorly understood renewable generation project that is better suited to a small pilot project until the equipment and its benefits are better understood. This is not the case. HHH understands the technology, has observed a pilot project of the technology on HHH's distribution system, had discussions with other utilities where the technology is being utilized, and given careful consideration to the scale of project that might be appropriate for HHH.

23. The Green Energy Initiative is not, contrary to the submissions of Board Staff and intervenors, simply a renewable generation project. Nor is it a technology that must be constrained to a "pilot project" scale. No better evidence of this exists than the fact that other jurisdictions have permitted distribution utilities to carry out identical projects on a far greater scale. As noted in HHH's Argument-in-Chief, the New Jersey Board of Public Utilities approved the installation (and rate-basing) of 135,000 units by the Public Service Electric and Gas Company (the public utility in New Jersey). This is a distribution company capital project, included in rate base. It is appropriately classified as a distribution project given the broad distribution benefits associated with the project. In contrast, renewable

generation projects are aimed first and foremost at maximizing and being compensated for generation output, with any other benefits of connecting such projects being unintentional and merely incidental. Projects such as the Green Energy Initiative are multi-purpose projects that use the generation component to provide other, more material operational benefits to the distributor.

24. Approving the capital expenditure associated with the Green Energy Initiative is not inconsistent with current industry practice.

25. HHH notes that the Board has disallowed other "green" capital projects recently proposed by Ontario distributors. As pointed out in our Argument-in-Chief, these have been initiatives where the connection to the utility's core function of distribution has been tenuous (e.g., electric vehicle programs proposed by utilities). The Green Energy Initiative, on the other hand, is meant to support HHH's core function of electricity distribution.

26. In paragraph 40 of its submission, VECC praises HHH for its "entrepreneurial spirit and corporate culture with a social conscience". Indeed, there has been much talk in recent months and years about promoting innovation across Ontario's electricity sector. This Green Energy Initiative is just such an effort. Moreover, it is well within the realms of what a distributor should be considering. It is not a project outside the scope of distribution utilities, and is in line with all of the provincial objectives related to a smart, green electricity sector.

(c) Net Present Value of Green Energy Initiative

27. Board staff submits that the Green Energy Initiative should be rejected on the grounds that it is not financially feasible, based on a net present value calculation.

28. HHH submits that the Green Energy Initiative is no different than many other capital investments. In some cases such as customer connections, customer

contributions are made to ensure a project is revenue neutral. In other cases of general system upgrades, no customer contribution is required—the work is done by existing customers because the benefits accrue to the system as a whole. That is the case with the Green Energy Initiative—it will provide general benefits to the system (and all customers). It has the unique feature of actually generating qualifiable financial benefits (which most system upgrades do not) to offset the cost. Consequently, the viability of this system-wide project is not to be judged solely on the basis of an NPV calculation. HHH is requesting that the Green Energy Initiative be evaluated on the same rate-making principles as approved by the Board in the Partial Settlement Agreement. None of the capital projects in Partial Settlement Agreement were subject to net present value analysis and it would be unfair to evaluate this single project based on a net present value analysis.

(d) Tax Treatment of Green Energy Initiative Capital Expenditures

29. HHH is proposing the Green Energy Initiative not as an experimental project but a viable capital project with benefits to the ratepayers and to the utility. This investment aligns with the CCA class for distribution assets with a CCA rate of eight percent, and generally reflects the useful life of the assets.

30. The Green Energy Initiative proposed by HHH does not match the provisions of the accelerated CCA rates for Class 43.2—property provided for efficient and renewable energy generation equipment. The accelerated CCA for Class 43.2 is designed to encourage the efficient use of fossil fuels and increased use of renewable and alternate energy sources that will ultimately have an expected positive impact on the environment. HHH's Green Energy Initiative is not a generation project – it is a distribution project that has a generation component to provide other operational benefits to the distributor and ratepayers.

(e) Summary of HHH's Submission

31. HHH is proposing the Green Energy Initiative after careful consideration of the results from its own pilot project, discussing the technology with jurisdictions where the technology is more broadly employed, and an analysis of the costs and benefits (quantitative and qualitative) of the project. Not every utility capital expenditure should require an independent study as a pre-condition to such expenditure, which is what Board Staff and intervenors seem to want. Moreover, in the case of the Green Energy Initiative, the non-financial benefits and non-quantifiable financial benefits will always be qualitative, and will vary with circumstances. No further study will be able to quantify these benefits (historically or on a forecast basis). How does one quantify the benefits from improved knowledge about system operations? How does one forecast the benefits from being able to pinpoint a system failure which allows for quicker and more efficient utility response to a problem? What will the future value of verified emission credits be?

32. HHH has also sought to be reasonable in its scaling of this project, and believes that an installation of 1,400 units represents a reasonable project scope. It does not, as noted in the testimony of Mr. Skidmore, represent anywhere near the full potential for this technology within HHH's distribution system (Hearing Transcript, p.47, lines 21 to 26). HHH considered the scope of potential deployment, the project costs and potential benefits, and determined that a 1,400 unit project was the most appropriate.

33. The scaled-down alternatives put forward by SEC and Energy Probe have no evidentiary underpinning – they are numbers picked out of thin air.

34. For all of the reasons noted above, HHH submits that its Green Energy Initiative should be approved as proposed. Neither Board Staff nor intervenors have shown that management's judgment as to the prudence of the planned capital

expenditure is either unreasonably adverse to customers or inconsistent with current industry practice. HHH's proposal to bring forward this project has been studied via a pilot project and collaborative information exchange with other utilities, and provides significant benefits to ratepayers and the utility.

D. PPE AND DVA ACCOUNTS

(a) Introduction

35. In HHH's view an inordinate amount of time has been spent (in interrogatories, cross-examination and argument) on the issue of the appropriate amortization period for HHH's PPE account. By now, the Board, Board Staff and parties to this proceeding have a full understanding of the positions and arguments being asserted. Consequently, HHH does not propose to spend a great amount of time in this Reply Argument adding to an already thorough record.

36. There is, obviously, not as complete a record with respect to the issue of the quantum of the amount in the PPE account, given that HHH only updated this amount (from $1,462,823 to $836,717) on March 21, 2012. To be clear, it was not HHH's desire or intent to have a late update to its evidence on this point. However, the fact of the matter is that following the technical conference and before the oral hearing, HHH was in the process of its year-end audit with KPMG and during this process the amount in this account was updated, and the update was material. When that was completed, HHH had a choice – it could either ignore that update and proceed with oral cross-examination before the Panel on information it new to be false, or it could update the number to the true number. The only real option was to update the number on the record, regardless of how unpopular a late evidentiary update would be.

37. The quantum and amortization period of the PPE account is discussed immediately below.

(b) Quantum of the PPE Account

38. With respect to the quantum of the PPE Account, intervenors in this proceeding have relied on the argument of Energy Probe on this issue. Consequently, this part of our Reply Argument responds to the Energy Probe submissions.

39. Energy Probe asks for further support for the updated PPE amount of $836,717, and specifically to explain the change to HHH's depreciation expense for 2011 (reflected in the table at p. 9 of Energy Probe's argument).

40. As noted at the commencement of the oral hearing, HHH noted that the PPE amount changes as a result of HHH finalizing its 2011 capital expenditures and depreciation during its year-end audit process with KPMG.

41. As noted in EProbe IR#38(c), HHH established a depreciation model to facilitate the implementation to IFRS. The rates were not changed in the model, but the overall depreciation expense is slightly lower. Further, at the oral hearing, it was noted that the change was a result of finalizing the 2011 fixed assets section of the audit file and the correction of a formulaic error.

(c) Amortization Period for PPE Account

42. As the Board knows, HHH is proposing to amortize its PPE deferral account over a period of 20 years. This approach would result in annual reductions in HHH's revenue requirement over the next twenty years in the following amounts:

- $92,415 in Years 1 through 4;
- $82,040 in Years 5 through 8;
- $71,665 in Years 9 through 12;
- $61,290 in Years 13 through 16; and

- $50,914 in Years 17 through 20.

43. Board Staff and intervenors have all submitted that an appropriate amortization period for the PPE account is four years.

44. HHH's position with respect to the submissions of Board Staff and the intervenors is that they all proceed from a fundamentally flawed premise – namely that a four year period is the "default" amortization period that a utility must "rebut", or show exceptional circumstances as to why it should be allowed an amortization period different than four years.

45. This is a fundamentally flawed premise to start from because it is in direct contradiction of Board policy.

46. The Board has no prescribed, "standard" or "default" amortization period that distributors must utilize. Rather, the Board has stated that it "will determine the period of time for amortization [of the PPE deferral account] on a case-by-case basis and will be guided primarily by such considerations as the **impact on rates**, **implications of any other IFRS transition matters** and any **requirements for rate mitigation**" (see *Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment*, EB-2008-0408, June 13, 2011, p. 32) (emphasis added).

47. A four year amortization period is not the default amortization period. If the Board had wanted to establish a prescribed amortization period it would have. It didn't. Yet all of the submissions of Board Staff and intervenors proceed on this assumption of defaulting to a four-year amortization period.

48. HHH submits that in the circumstances of this case, a 20 year amortization period is more appropriate (given the criteria set out by the Board), for the following reasons:

- The rate impact of a longer amortization period is less volatile (i.e., smoother). An amortization period of 20 years would have an effective reduction in rates of 0.4% (for 20 years) whereas amortizing the PPE deferral account over four years would effectively reduce rates by 2% per year (for four years).

- The rate impacts of this proceeding will be minimal, so there is no need for a shorter amortization period in order to mitigate or offset rate increases associated with this rate application.

- A shorter amortization period would have a material impact on HHH's cash flow and revenues, which can be moderated or "smoothed" if a longer amortization period is utilized. As noted in its Argument-in-Chief, HHH's submission is that an accounting change should not have any material impact on either utility revenue or customer rates. Consequently, HHH's submission is that a longer amortization period for the PPE account is more appropriate for both utilities and ratepayers.

- The PPE deferral account is meant to return to ratepayers increased rates attributable to an accounting change. This increase in rates will be sustained well beyond four years. Given this, it seems suitable to amortize the PPE deferral account over a longer period. A short amortization period such as four years would not achieve the same intergenerational equity – only HHH's customers in the next four years would receive rate mitigation.

- A 20 year amortization period aligns with the useful lives of the distribution assets.

49. In terms of the other DVA accounts, Board Staff approved of HHH's proposal to clear the DVA accounts over two years. Energy Probe argues that if the Board

approves a 20 year amortization period for the PPE account, then the DVA account clearance period should be extended to two years. Given the rate impacts associated with this rate application, HHH believes that a four-year clearance period is unnecessary.

50. Consequently, HHH proposes to recover he DVA balances totalling $627,940 over two years (i.e., $313,970 annually), which HHH submits is reasonable.

E. LONG-TERM DEBT

(a) Positions of the Parties

51. HHH is proposing that its long-term debt rate be set at the deemed debt rate of 4.41%. Intervenors suggest that the rate should be set at 3.85% and Board Staff suggests the rate be set at 3.96%.

(b) Existing and Future Loans

52. Promissory Note: At present, HHH considers its Promissory Note held by the Town of Halton Hills to be the long-term debt of the utility. As noted in its Argument-in-Chief, the terms of the Promissory Note are flexible:

- the rate of interest is at the discretion of the Town (prescribed by the Town Treasurer from time to time); and,
- to provide protection to the utility and its ratepayers from the Town's discretion, HHH has the ability to prepay the Promissory Note in full at any time without notice or penalty.

53. Traditionally, the debt rate on the Promissory Note has mirrored the Board's deemed rate. This is not an unusual form of financing arrangement for Ontario distributors, in part because having the shareholder as the main corporate debt holder offers the utility flexibility than might not be the case with a third party

lender (as well as avoidance of transaction and administrative costs). For 2012, the debt rate on the note will be set at the Board's deemed rate of 4.41%. The current amount of debt outstanding under the Promissory Note is $16,141,970.

54. Smart Meter Loan: HHH also has a loan with TD Commercial Bank that was established to finance the utility's smart meter capital expenditures. The amount of that loan outstanding as of December 31, 2011 was $3,943,430. The loan has a one-year term (expiring this August 2012) and an interest rate of prime plus 1.4%.

55. Contrary to the submissions of Energy Probe (EProbe Argument, p. 18), HHH's loan with TD Commercial Bank is not a long-term loan. While the agreement with TD is a multi-year agreement, the agreement covers three separate loan facilities (two of which relate to smart meters). The second of these is not mandatory – it may be taken up "at the Borrower's option".. So Energy Probe is incorrect when it says that the current one-year smart meter loan is the last year of a loan of a multi-year loan agreement. It is a separate one-year loan.

56. Test Year Loan: During the test year, HHH anticipates seeking $5,000,000 in financing for capital expenditures starting in 2012. At this point in time, HHH has not determined how it will obtain this financing. The only specific criteria associated with this financing is that HHH would seek a loan facility that could be drawn down in tranches to correspond with HHH's capital program (Hearing Transcript, p.39). HHH has not selected a lender or term for that loan (contrary to Energy Probe's submission, which states that "it is reasonable to expect that HHH will have a 5 year term on the $5 million loan"). In HHH's view, there is no basis for any such assumption. Consequently, there is no basis for then further assuming an interest rate (Energy Probe uses 2.52% based on an Infrastructure Ontario 5-year rate).

57. HHH is aware of the requirement in EB-2009-0084 (*Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* dated December 11, 2009, p. 53) to "in a forward test year, forecast the amount and cost of new long-term debt to be obtained during the test year." However, HHH has at this point no good basis for forecasting the term or rate associated with this debt, and in any event, HHH is of the view that it may not be long-term debt. Further, It is noteworthy that HHH's expectation as to the quantum of the loan amount is based on inclusion of the $1.4 million expenditure on the Green Energy Initiative, which is subject to Board determination in this proceeding. Intervenors fail to mention this in their submissions – on the one hand, they argue for the inclusion of $5 million in HHH's long-term debt at a low rate, while on the other they are asking the Board to disallow $1.4 million of that $5 million.

58. In HHH's view, there is too much uncertainty surrounding the parameters of any $5 million test year financing to forecast with much accuracy the $5 million anticipated loan (including whether the financing will be long- or short-term). HHH does not expect to be in a good position to forecast its test year loan parameters until its audited financials are prepared and the decision in this case is rendered. It will then have a better financial picture of the utility upon which to base financing decisions.

(c) Issues to Consider

59. The disposition of this issue by the Board raises two basic issues: First, what should be considered long-term debt by the Board for the purposes of rate-setting. Second, in setting the debt rate for a utility in a re-basing application, what type of risks should be borne by a utility in terms of debt rate exposure. The two issues are not unrelated.

60. With respect to the first issue (i.e., what constitutes long-term debt), HHH submits that there are a number of considerations – the actual term of the loan

(the conventional definition of long-term debt is any loan or financing in excess of one year), the life of the assets underpinning the loan, and whether the loan is general corporate loan or asset-specific.

61. HHH's approach to financing its assets is not unusual for an Ontario distributor. The Promissory Note to the Town consists of its general corporate long-term financing. The rate for this general corporate debt is set at the Board's deemed debt rate. From time-to-time, HHH may look to third-party financing for discrete capital expenditures. This practice is consistent with the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* (EB-2009-0084) dated December 11, 2009. As the record in this proceeding shows, HHH has periodically made inquiries with both Infrastructure Ontario and commercial banks (primarily Toronto-Dominion ("TD") Bank). From HHH's inquiries, it is clear that Infrastructure Ontario is interested in new projects or asset purchases rather than general corporate debt.

62. At present, HHH is not proposing to change its approach to financing – long-term debt will continue to be provided by the Town and from time-to-time specific capital expenditures may be funded via discrete loans of no greater than one-year. Where those loans cease to be favourable (either in terms of rate or terms/conditions), HHH will terminate those third-party loans and cover the amount off with their general corporate loan.

63. Very recent inquiries with TD Bank about replacing HHH's corporate long-term debt resulted in a quote of 5.16% (Hearing Transcript, p. 45, line 21), <u>which is greater than</u> the 4.41% deemed rate set by the Board.

64. With respect to the anticipated $5 million loan to be taken out in the test year, HHH has indicated that it will consider all possible financing options. It is unclear at this point, where the financing will be placed, and the associated terms, conditions and rates. Infrastructure Ontario's current posted rates vary from

2.58% (five year) to 4.26% (forty year) (utilizing the link provided in EProbe IR #62(c)).

65. It is difficult to forecast interest rates, but as stated in its Argument-in-Chief, it is HHH's expectation that current interest rates will rise in the short- to medium-term. This ties in to the second issue noted above – namely, whether a utility should bear the risk of debt rate risk.

66. HHH submits that the question of whether a utility should bear debt rate risk should be decided on a case-by-case basis, depending upon the make-up of the utility's debt, ability of the utility to obtain lower rates, and predictability of any test year loan terms.

67. In HHH's case, its general long-term corporate debt is held by its shareholder and set at the Board-deemed rate. Infrastructure Ontario seems uninterested in general corporate debt, and a recent quote from a commercial bank for general corporate debt was higher than the deemed rate (5.16% versus 4.41%). HHH is not large enough to be rated by a rating agency, so has fewer financing options than larger utilities. And finally, although the plan is to borrow $5 million during the test year, there is still $1.4 million of test year capital expenditures at issue, and interest rates are anticipated by HHH to rise. Given such uncertainty, HHH submits that utilizing the Board deemed debt rate is the most reasonable and predictable, and puts no unnecessary risk on the utility. The deemed debt rate is a reasonable rate – and ratepayers cannot be said to be adversely affected by utilizing the deemed rate. In terms of balancing the debt rate risk to the utility versus the risk of ratepayers "overpaying" for debt, the circumstances of HHH's situation suggest that the most reasonable approach is to utilize the Board deemed rate.

F. OM&A

(a) Positions of the Parties

68. There is a huge disparity between what HHH, Board Staff and intervenors consider to be the appropriate 2012 OM&A expenses for HHH, as shown by the following table:

	Proposed 2012 OM&A (CGAAP)	Proposed 2012 OM&A (MIFRS)
HHH	**$5,987,400**	**$6,274,021**
Board Staff	---	$6,099,021
SEC	$5,124,500	---
Energy Probe	$5.25 to 5.5 million	---
VECC	$6,166,810 to $6,348,510	---

69. Given that Board Staff and intervenors each take a different approach to the issue of an appropriate test year OM&A expense, this section of HHH's Reply Argument will address each approach separately.

70. Generally, however, Board Staff and intervenors have come at the issue from different perspectives:

- starting with HHH's proposed OM&A and proposing reductions after scrutinizing OM&A line items (Board Staff's approach);
- starting with HHH's 2008 Board-approved OM&A and then making both formulaic adjustments (e.g., inflation) and specific adjustments (e.g., smart meter FTEs) (VECC's approach);
- starting with HHH's lowest actual OM&A expense figure during the previous IRM period (i.e., 2010) and applying a percentage increase taken from another Board proceeding (EB-2011-0054) (SEC's approach); and,

- starting with HHH's last actual OM&A expense figure (also 2010) and applying a percentage increase from another Board proceeding (EB-2010-0259)(Energy Probe's approach).

71. Each approach is discussed in turn below. However, HHH submits that only Board Staff's approach complies with the jurisprudence on this point (as noted in paras. 13 to 16 above. The law is clear—utilities enjoy the presumption of management good faith in forecasting their costs; they do not bear the burden of proving every cost item. Only if a party to a rate proceeding rebuts that presumption of management good faith for a cost item does the utility then have the burden of proving that cost item. Consequently, the case law dictates that the starting point for any cost analysis has to be the utility's good faith forecast of its test year expenditures. Intervenors are then free to challenge expenditures as being excessive or unnecessary, and it then becomes the utility's burden to justify that expense.

72. Using a historic year as the basis for rate-setting in 2012 is inconsistent with this jurisprudence. Historic years can be used as a benchmark to assess management's test year OM&A budget, but its only purpose is to rebut the presumption of management good faith in relation to certain OM&A items and require further justification from the utility on such items. Ultimately, in order to be consistent with the rate regulation case law, the Board must use HHH's 2012 forecast as the starting point for the determination of appropriate OM&A costs. To do otherwise would fail to provide HHH with any presumption of management good faith.

(b) Board Staff Approach

73. Board Staff appears to be supportive of an overall 2012 OM&A expense of approximately $6.1 million. This is $175,000 less than the HHH's request for $6,274,021 in OM&A costs (MIFRS, inclusive of property taxes).

74. The $175,000 reduction proposed by Board Staff is based on Board Staff's view that HHH has given itself too wide a safety margin in its 2012 budget with respect to smart meter OM&A. According to the Board, HHH's smart meter OM&A should be expected to ease (i.e., decrease) during the IRM period. On this issue, HHH considers its test year smart meter forecast to be well-founded. HHH is fully implemented on smart meters, and has actual OM&A expenses that it has used to forecast the annual incremental OM&A costs associated with smart meters.

75. With respect to Board Staff's specific breakdown of the $327,710 in smart meter costs, HHH would point out that of that amount, $195,210 is for staffing (which Board Staff does not object to), $76,000 is for communications and $56,500 is other costs including new Wide-Area Network (WAN), and maintenance and security fees. The meter reading expenses for 2012 is $71,840 (and not $206, 840). The latter number included the $135,000 MDMR fee, which has been removed. The $71,840 cost is comprised of $56,500 in "other costs" noted above, plus meter reading and support costs of $15,340.

76. Board Staff accepts HHH's increased tree trimming expenditures on the basis that the costs are confirmed by an independent evaluation of the matter.

77. Board Staff also accepts HHH's MIFRS transition costs, since these costs are beyond the control of HHH.

78. With respect to wages and benefits, Board Staff has asked for specific clarification on a few points (all relating to whether certain costs are one-time in the test year, or sustained over the IRM term), as set out below:

- "*Board staff notes that one of the new hires is in anticipation of a retirement. It is unclear to Board staff whether an overlap exists in 2012 that would not be sustained during HHH's upcoming IRM plan*". <u>HHH's Response</u>: The reference here is to the hiring of an Apprentice Metering

Technician. This is a sustained costs as the training of an apprentice is a minimum four year process and will continue through the IRM period. The Apprentice Metering Technician has been hired.

- "*Board staff suggests that HHH should address in its reply submission whether certain costs expected in the test year will be sustained throughout the IRM period, or alternatively whether some of them might be unusual development or catch-up items whose costs should be averaged over more than one year. These items that would benefit from further justification in the test year include the cost of engineering work (hearing transcript p. 71), and actuarial costs for post-employment benefit calculations, contract negotiations and a risk management program (all references to the hearing transcript p. 76).*" <u>HHH's Response</u>: The page 71 transcript reference is in relation to Account 5050 and 5055 (which for the test year are forecasted at $208,434 and $102,000, respectively. These 2012 figures are higher than the 2011 figures because of the re-allocation of costs between accounts (as noted at Hearing Transcript p. 71, line 21 and p. 73, line 8). These are sustaining costs. The page 76 transcript references are in relation to Account 5630 (Outside Services) which was $54,000 in 2011 and $117,000 in 2012. The amounts in this Account were far higher in 2008 ($293,492), 2009 ($163,690) and 2010 ($123,089). The cost drivers in 2012 are general corporate development (e.g., training in customer service, environmental stewardship, health and wellness, etc.), audit and legal, risk management, employee relations (e.g., employee safety training, grievances, bargaining, etc.), and post-employment benefit costs. All costs are sustained throughout the IRM period.

(c) VECC Approach

79. As noted above, VECC's approach to HHH's OM&A analysis starts with HHH's 2008 Board-approved OM&A and then makes both formulaic adjustments (e.g., inflation) and specific adjustments (e.g., smart meter FTEs), supported by arguments. At the end of the analysis, VECC concludes that the appropriate 2012 OM&A for HHH is between $5.4 million and $5.6 million (MIFRS). However, there is an addition error in VECC's numbers (specifically, the 2008 Board-approved OM&A) which when corrected results in VECC proposing a 2012 OM&A expenditure in excess of that being requested by HHH.

80. A summary of VECC's analysis (with the correction noted) is set out below. It tracks the table at para. 27 of VECC's submission.

Starting Point (2008 OM&A)		
--VECC Submission, Table at para. 3 --corrected	$4,085,000 $5,124,000	$4,085,000 $5,124,000
Adjustments	**Low**	**High**
Inflation Adjustment (10-12%)	$408,500	$490,200
Customer Growth Adjustment (6.3%)	$257,355	$257,355
Productivity Factor Adjustment (2.3%)	$93,955	$93.955
Incremental FTEs due to Smart Meters	$100,000	$200,000
Other Incremental Smart Meter Costs	$77,000	$77,000
Property Tax	$106,000	$106,000
Total Adjustments	**$1,042,810**	**$1,224,510**
2012 OM&A (CGAAP – Corrected)	**$6,166,810**	**$6,348,510**

81. VECC's starting point OM&A was simply an addition error made in the table at para. 3 of VECC's submission. If one corrects the addition error and starts with the correct 2008 Board-approved OM&A, then makes what VECC considers to be reasonable adjustments for inflation, customer growth, productivity, smart meter expenses and property tax, one ends up with an OM&A for the test year that is greater than what HHH is proposing.

(d) SEC Approach

82. SEC's approach to HHH's OM&A is completely arbitrary.

83. SEC's argument is that HHH has consistently underspent on its OM&A during the IRM term to the benefit of HHH's shareholder, and that these gains should be sustained and not disappear upon re-basing. In other words, SEC alleges that HHH is "gaming" the rate-setting process.

84. As a result, SEC is proposing to establish HHH's test year OM&A budget by taking HHH's lowest actual annual OM&A expense during the IRM term (which for HHH is 2010) and increasing that amount by 14.5% for 2012. The rationale for the 14.5%, according to SEC, is that it is the percentage increase (over 2010) awarded to Hydro Ottawa in its 2012 cost-of-service application. According to SEC, this is an appropriate percentage because Hydro Ottawa has also underspent on OM&A during the IRM term, and as a result "the similar spending pattern for the two utilities suggests that a similar overall response from the Board may be appropriate."

85. There are a few points to make here related to HHH's lower OM&A costs during the IRM term, as well as the appropriateness of using Hydro Ottawa as a precedent for setting HHH's OM&A budget.

86. First, HHH's lower OM&A costs during the IRM term are not evidence of HHH "gaming" the rate-setting system to the benefit of HHH's shareholder. HHH manages its business using its best judgment on a daily basis. Its daily management decisions and activities are made in order to run the utility's business—not thinking about what costs can be eliminated today but re-claimed in a future re-basing year.

87. Moreover, there is no evidence that that is what occurred in HHH's most recent IRM period. As noted by the testimony of Mr. Skidmore, the utility underwent

significant organizational change during the IRM period, much of it at the executive and senior managerial level. This accounts for the drop in the number of full-time employees through 2009 and 2010. Now that the organizational change is complete, HHH is in the process of hiring to fill certain positions (as part of succession planning, filling needed roles, and taking on new responsibilities such as smart meters). Three new full-time employees were added this year (2011), which brings the number of full-time employees at the end of 2011 to one more than at HHH's last re-basing.

88. The second point relates to SEC's reliance on the Board's decision in Hydro Ottawa's rate case as a proxy or precedent for setting HHH's 2012 OM&A. In HHH's view, that approach is completely arbitrary. It does not take into account any evidence about what comprises HHH's OM&A costs (historic and forecast) and the factors driving changes in those costs. Setting HHH's test year OM&A on the basis of a formula from another utility's rate case would amount to making a decision without taking into account the evidence before it.

89. HHH has adduced a significant amount of evidence through the course of this proceeding in order to support its request for an OM&A expense level of $6,274,021 (MIFRS). There are four key OM&A cost drivers associated with this amount, none of which are extraordinary or unreasonable:

- Wages and Benefits: As noted above, and in Mr. Skidmore's testimony (Hearing Transcript, p. 68, lines 26 to 28), HHH is in the process of adding additional employees over 2011 and 2012 in part to meet new regulatory requirements, and fill positions left vacant as a result of the significant organizational changes at HHH during 2009 and 2010. In the test year, HHH is planning to add one management position and three unionized positions – a senior engineering technician, an advanced metering infrastructure (AMI) coordinator, and an apprentice metering technician (Hearing Transcript, p. 68, lines 1 through 16). These increased FTE numbers, coupled with a 3% annual wage increase with HHH's unionized workforce drives the cost increases in wages and benefits. HHH submits that the net addition of five new employees over the four-year period from 2008 to 2012 is not unreasonable, particularly in light of HHH's significant growth, and increased operational burdens related to provincial initiatives in the areas of conservation, smart meters and renewable generation connection.

- Tree Trimming Costs: HHH's increased tree-trimming costs were forecasted based on an independent evaluation of HHH's system by an independent arborist. HHH's standard line clearance program in the past few years have failed to keep pace with abnormally high tree growth, excessive disease and die-back of mature trees in recent years. As a result, HHH is proposing a more aggressive tree-trimming program, the work and costs of which will be averaged over the next four years. These are necessary expenses, driven by factors beyond HHH's control.

- Smart Meter Costs: With respect to smart meter OM&A costs, these are driven by regulatory changes beyond HHH's control.

- MIFRS Transition Costs: With respect to MIFRS transition costs, these are also driven by regulatory changes beyond HHH's control.

90. Further on this point, SEC's proposal to start with the actual 2010 OM&A expenditures and then increase it by 14.2% to establish a 2012 forecast in accordance with the Hydro Ottawa decision is not even what transpired in the Hydro Ottawa case. Ultimately the Board looked at the evidence and concluded:

> The intervenors have submitted that the OM&A envelope for the test year should be in the range of $57.7 M to $59.244 M, largely based on comparisons with other proceedings. The Board considers the comparisons to other proceedings to be informative and in some instances where a record is lacking in detail it becomes a very important element to consider. The Board has been able to base its

> determinations primarily on the record before it in this proceeding and finds that Hydro Ottawa has provided sound rationale for most of its requirements.

91. In the end, the Board did not set Hydro Ottawa's OM&A budget by starting with its lowest annual OM&A figure during the IRM term and increasing that by 14.2%. Instead, the Board based Hydro Ottawa's approved OM&A expenditures on the evidence filed, and ultimately set an envelope OM&A that it deemed sufficient (based on a 2.5% year over year escalation of 2008 approved levels, notwithstanding lower actual expenditure levels during the IRM period).

92. SEC's approach would result in HHH's OM&A in 2012 to be set at the same level as the 2008 Board-approved amount ($5.124 million on CGAAP).

93. Consequently, HHH is of the view that SEC's methodology for arriving at an appropriate OM&A figure for the 2012 test year is arbitrary, insufficient and without any evidentiary basis.

(e) Energy Probe Approach

94. Energy Probe's approach is virtually identical to that of SEC. It is based on taking the last year of OM&A actuals for HHH and increasing it by 10%. To that amount, Energy Probe adds $327,710 of incremental smart meter costs to get a "lower limit" OM&A figure of $5.25 million. The addition of the tree trimming costs ($250,000) forms the "upper limit" OM&A figure proposed by HHH of $5.5 million, although Energy Probe is not supportive of the tree trimming costs being borne solely by ratepayers.

95. Like SEC, Energy Probe derives its methodology from another utility's rate case (EB-2010-0132, Hydro One Brampton Networks Inc.). For the same reasons as those noted above in relation to SEC's reliance on the Hydro Ottawa's rate case, HHH believes that setting HHH's OM&A expenditures on the basis of another utility's circumstances is arbitrary and without any basis in evidence.

96. With respect to the argument about tree trimming, Energy Probe's arguments are echoed by other intervenors (notably SEC). Essentially the argument is that HHH's shareholder profited by underspending on tree trimming during the IRM term and now (as a result of such underspending) the tree trimming amount being included in OM&A costs are higher than they otherwise would be. In other words, had HHH properly spent on tree trimming during the IRM term, then the costs of tree trimming to be included in HHH's base rates for 2012 would be lower.

97. That is not, however, what the record shows. First, there is no indication that HHH "underspent" on tree trimming. HHH's spending on tree trimming has been relatively flat over the past number of years (approximately $100,000, as per Undertaking J1.6) and there is no indication that the amount incorporated into HHH's rates for 2008 varies from this amount. Indeed, the amount in Account 5135 (Overhead Distribution Lines and Feeders – Rights of Way) shows $99,000 in the Board-approved amount (see Exh. 4, Tab 1, Sch. 1, Table 4-2). Second, HHH has acted entirely prudently on the issue of tree trimming. As noted in the independent arborists report, the region has been subject to abnormally high tree growth, along with excessive disease and die-back of mature trees in recent years. When HHH observed this during the IRM term, it did two things: (a) it called in an independent certified arborist to evaluate the system; and (b) it increased its tree trimming budget during the IRM term from $76,885 in 2009 to $120,317 in 2010 and to $147,000 in 2011 (Undertaking J1.6 and Hearing Transcript, p.72, lines 23 to 28). The actual spending indicates recognition on the part of HHH that more trimming was being required, coupled with the hiring of an independent arborist in early 2011 to complete an evaluation.

(f) Summary

98. As noted, HHH submits that the Board has before it ample evidence to fully support its requested OM&A expenses for the test year. In large part, the

increase to OM&A are driven by four items, two of which are beyond the utility's control (MIFRS transition and smart meter), one of which has been supported by an independent study (tree trimming) and one of which is reflective of increased company staffing needs based on a variety of factors.

99. In its Argument-in-Chief, HHH set out three tables (repeated below) to demonstrate the reasonableness of its global OM&A, for the Board's reference. These tables are not meant to be used as a basis for setting the OM&A budget, but rather as a reference or comparator for the Board's consideration as to the reasonableness of HHH's forecasted test year amount.

100. Table 1 starts with the 2008 Board approved OM&A (in CGAAP), assumes an annual increase in OM&A of 3%, and then adds the cost increases for tree trimming and MIFRS transition. The result is a revenue requirement of $6,303,728, which is comparable to the OM&A being applied for by HHH.

Table 1			
			Reference
2008 Board Approved OM&A		5,124,000	Table 4-1 Exhibit 4/Tab1/Schedule 1, page 2
3 percent annual increase			
2009 – 3%	153,720	5,277,720	
2010 – 3%	158,332	5,436,052	
2011 – 3%	163,082	5,599,133	
2012 – 3%	167,974	5,767,107	
Additional requirement - 2012			
Tree trimming	250,000	6,017,107	
Transitioning to MIFRS	286,621	6,303,728	EProbe IR #35
	1,386,147		
		$6,303,728	

101. Table 2 takes the average of the actual and estimated OM&A expenses for 2008 through 2011 ($4,684,691 CGAAP), and then adds the costs associated with the four cost drivers (increased wages and benefits, increased tree trimming, smart metering costs, and MIFRS transition costs). The result is an OM&A in the test year of $6,034,022, which is comparable to HHH's requested OM&A.

Table 2		
		Reference
Average of 2008-2011 Actual		
2008	5,111,058	Table 4-1 Exhibit 4/Tab1/Schedule 1 page 2
2009	4,436,426	Table 4-1 Exhibit 4/Tab1/Schedule 1 page 2
2010	4,386,371	Table 4-1 Exhibit 4/Tab1/Schedule 1 page 2
2011	4,804,910	Table 4-1 Exhibit 4/Tab1/Schedule 1 page 2
Average	4,684,691	
Tree trimming	250,000	
IFRS	286,621	EProbe IR #35
Smart metering	327,710	$462,710 less $135,000MDMR
Increase Staffing	200,000	
2012 Union Increase/Benefit increase	285,000	
(120,000+80,000 (OMERS)+25,000+60,000 (health))		
	$6,034,022	

102. Table 3 is a variation on Table 2, and utilizes as a starting point the 2011 estimated bridge year OM&A instead of the four year average. Again, the result is an OM&A in the test year that is comparable to HHH's request.

Table 3		
2011 Bridge	4,804,910	Table 4-1 Exhibit 4/Tab1/Schedule 1 page 2
Tree trimming	250,000	
IFRS	286,621	2012 only - refer to EP IR#33(b) - Nov16,2011
Smart metering	327,710	$462,710 less $135,000MDMR
Increase Staffing	200,000	
2012 Union Increase/Benefit increase	285,000	
(120,000+80,000 (omers)+25,000+60,000 (health))		
	$6,154,241	

G. CONCLUSION

103. For all of these reasons, HHH requests that the Board approve:

- the inclusion of the Green Energy Initiative ("GEI") in capital expenditures for the test year;
- a 20-year amortization period for HHH's property, plant and equipment ("PPE") account;
- the clearance of HHH's deferral and variance account ("DVA") amounts over 24 months;
- the use of the Board's long-term debt rate in calculating HHH's cost of capital; and,
- the inclusion of $6,274,021 in OM&A expenses in HHH's test year revenue requirement.

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

HALTON HILLS HYDRO INC.

Original signed on behalf of

By its Counsel, Norton Rose Canada LLP
Per: Richard J. King