EB-2012-0161

Ontario Energy Board

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 PowerStream Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective January 1, 2013.

ENERGY PROBE RESEARCH FOUNDATION
("ENERGY PROBE")

ARGUMENT

November 13, 2012

POWERSTREAM INC.
2013 RATES

EB-2012-0161

ARGUMENT OF ENERGY PROBE RESEARCH FOUNDATION

A - INTRODUCTION

This is the Argument of the Energy Probe Research Foundation ("Energy Probe") related to the issues that were not completely settled in the setting of 2013 rates for PowerStream Inc. ("PowerStream") to be effective January 1, 2013.

In particular, as set out in the Settlement Agreement dated October 24, 2012, these are issues 2.1 - Is the proposed Rate Base for Test Year 2013 appropriate?; 4.2 - Is the proposed level of the Depreciation/Amortization expense for 2013 appropriate?; 6.1 - Are the proposed Test Year cost of capital parameters appropriate?; and 8.2 - Is the treatment of property, plant and equipment due to the transition to the new accounting standard appropriate?

This Argument has been structured to reflect the above noted issues. Where readily available, Energy Probe has attempted to provide the impact of its submissions on the revenue requirement of PowerStream. However, in order to minimize intervenor time and costs, a comprehensive impact analysis has not been undertaken. If the Board accepts any or all of the Energy Probe submissions, it is assumed that the direct and indirect impacts would be determined by PowerStream and reviewed by intervenors and Board Staff through the associated draft rate order process.

B - SUBMISSIONS

Issue 2.1 - Is the proposed Rate Base for Test Year 2013 appropriate?

Energy Probe submits that the net fixed assets portion of rate base for the 2013 test year should be reduced based on the change in the depreciation methodology adopted by PowerStream beginning with the 2010 historical year relative to the methodology that was used in the last cost of service rebasing proceeding to set 2009 rates.

PowerStream's approved rates were based on the use of the half-year methodology to set 2009 rates (Exhibit J1, Tab 4, Schedule 4.2, Energy Probe Interrogatory #32b). However, as noted in Exhibit D1, Tab 4, Schedule 1, page 1, the historical depreciation amounts for 2010 and 2011 reflect depreciation calculated on a monthly basis based on when the assets are placed into service. The monthly in-service approach is a more accurate way to calculate depreciation in the year in which an asset is put into service (Tr. Vol. 1, pages 55 & 57). Energy Probe agrees that the monthly in-service methodology is more accurate and is preferable to the half-year rule, which is a rough estimate that assumes assets put into service in any given year are put into service at the midpoint of the year.

As shown in Tables 32-1 and 32-2 provided in response to Energy Probe Interrogatory #32 parts (c) and (d), the 2010 actual depreciation expense using the monthly in-service methodology was $48,762,000, while using the half-year methodology would have been $49,512,000. In other words, the change in methodology in 2010 reduced the actual depreciation expense by $750,000 from what it would have been under the half-year rule used to set base rates in 2009. Similarly, the monthly in-service methodology depreciation figure for 2011 (under MIFRS) was $35,499,000 while under the half-year methodology it would have been $36,012,000. This is a further $513,000 reduction in depreciation expense in 2011 due the methodology change in 2010. Over these two years, the depreciation expense was $1,263,000 lower than it would have been if there had been no change in methodology. This reduction in the depreciation expense results, of course, in a higher rate base in the 2013 test year than if the methodology approved in the setting of 2009 rates had been continued over the IRM term.

PowerStream was not able to provide an estimate of the impact on the 2012 depreciation expense of the difference between the monthly in-service and half-year methodologies (Undertaking J1.3). The undertaking response also indicates that PowerStream is not able to calculate the difference between the methodologies prior to 2010 because it does not have the necessary information.

Energy Probe submits that the impact on the 2012 depreciation expense can be estimated based on the 2010 and 2011 data provided in the response to Energy Probe Interrogatory #32. In particular, an analysis of the ratios of the depreciation expense under the monthly in-service methodology to that using the half-year rule shows a consistent difference. In 2010 under CGAAP, this ratio is 0.98485 ($48,762 divided by $49,512). In 2011 under MIFRS the ratio is 0.98575 ($35,499 divided by $36,012). Under CGAAP, the 2011 ratio is 0.98295 ($48,643 divided by $49,487).

Energy Probe submits that the average of the 2010 CGAAP and 2011 MIFRS figures, being 0.98530, is an appropriate estimate of the impact of the change in methodology since both of these years and accounting methodologies (CGAAP in 2010, MIFRS in 2011) are used in calculate the rate base in 2012. This ratio, when applied to the half-year forecast for depreciation in 2012 of $33,918,000 would result in a reduction in the actual depreciation expense that could reasonably be expected to be booked in 2012 of $499,000 ($33,918,000 - $33,918,000 x 0.98530).

As shown in the response to Undertaking J1.4, PowerStream has total in-service additions for 2012 at the end of June that total $33,450,000 and through to the end of September the in-service additions total $45,900,000. Both of these figures exclude any reductions related to contributed capital as the contributed capital is not completed until year end.

As shown in the Exhibit B1, Tab 5, Schedule 5, the continuity schedule for 2012 shows the closure to rate base of $85,391,000, again excluding contributed capital. Based on the figures noted above, only 39% of the forecasted additions to rate base were in-service by the midpoint of 2012, and only 54% were in service by the end of September, which is 75% through the year. In other words, if PowerStream meets the forecast of capital additions closed to rate base in 2012, the depreciation expense under the monthly in-service methodology will again be significantly lower than under the half-year rule methodology.

Energy Probe notes that the *"half-year rule is a tool used for the prediction for the future*", as the Board found in the EB-2010-0136 Decision and Order dated June 23, 2011 for Kingston Hydro Corporation (page 8). In that Decision the Board indicated that the half-year rule was implemented to recognize the fact that not all capital assets are put into service on January 1 of the test year. Energy Probe submits that the same is true for the bridge year.

The half-year rule is appropriate to use for forecasting purposes if it reflects the methodology employed by a distributor for accounting purposes and a more accurate forecast is not available. In the case of PowerStream, neither of these conditions has been met. PowerStream uses a different accounting methodology for recording depreciation that is more accurate than the half-year methodology. It has not reflected this reality in its forecast for regulatory purposes. Further, PowerStream did not provide a forecast based on the methodology it uses for accounting purposes. Energy Probe has provided a reasonable forecast, noted above, based on the historical difference between the methodologies.

Adding the $499,000 difference in 2012 to the $1,263,000 from 2010 and 2011 results in a reduction in rate base at the beginning of the 2013 test year of $1,762,000.

By changing the methodology during the IRM term, PowerStream will effectively recover the cost of assets added to rate base in 2010, 2011 and 2012 twice from ratepayers. Ratepayers have paid for the assets based on the half-year rule methodology. By changing the methodology during the IRM term, PowerStream has increased the test year rate base from what it would otherwise have been. Ratepayers will again pay depreciation on this higher amount, along with a return on capital (both debt and equity) and the associated increase in PILs. Energy Probe submits that this double recovery is neither just nor reasonable and is inappropriate and should be rejected by the Board.

In the Kingston Hydro proceeding noted above, the utility proposed to change its depreciation for regulatory purposes under the IRM period to reflect the half-year rule, despite having base rates set at the beginning of the IRM period that were based on the full-year methodology. In that proceeding the Board stated that:

> *"The Board is in agreement with the arguments of Energy Probe in that full-year amortization was built into the rate base for setting 2006 rates, which were subsequently used as a base for the IRM adjustments each year from 2007 to 2010. Had the half-year rule been used in 2006, rates would have been lower for each of the next four years."* (Decision and Order, page 8)

Energy Probe submits that the same logic applies in this case. Half-year depreciation was built into the rate base for setting 2009 rates, which were subsequently used as a base for the IRM adjustments for each year 2010 through 2012. Use of the monthly in-service methodology for 2010 through 2012 for accounting purposes has resulted in a higher test year rate base than if the methodology used in 2009 rates had been continued over this period.

The complication in this proceeding is that if the Board accepts the submission of Energy Probe and reduces the 2013 test year rate base by $1,762,000, there will be an ongoing difference between the rate base used for regulatory purposes and that calculated from the net book value of the PP&E used by PowerStream for accounting purposes. This effectively would require PowerStream to have two sets of books, one for regulatory purposes (rebasing applications and RRR reporting) and another for accounting purposes.

Energy Probe submits that instead of reducing the test year rate base by $1,762,000 for regulatory purposes, the Board should approve a refund to ratepayers similar to the PP&E deferral account discussed below under Issue 8.2. In other words, the $1,726,000 would be refunded to customers over four years and the return on capital associated with this amount would be removed from the 2013 revenue requirement calculation. This would ensure that ratepayers do not pay twice for the depreciation methodology change in the same manner that the PP&E deferral account ensures that ratepayers do not pay twice as the result of the accounting change from CGAAP to MIFRS.

Issue 4.2 - Is the proposed level of the Depreciation/Amortization expense for 2013 appropriate?

This issue is similar to that described above under Issue 2.1, except that it deals with the forecast of the 2013 test year depreciation expense using a full year methodology and the resulting impact on the test year rate base. Energy Probe submits that the issue here is whether the use of a full year of depreciation for assets that become used and useful in the test year should be included in the test year revenue requirement and, if not, what is the appropriate methodology to use the forecast the test year depreciation figure to be included in the revenue requirement.

a) Full-Year vs. Half-Year

As shown in Table 2 of the October 24, 2012 Settlement Agreement, PowerStream is forecasting a depreciation expense of $36,531,000 to be included in the test year revenue requirement. This forecast is based on a full year of depreciation for additions in the test year (Exhibit D1, Tab 4, Schedule 1, page 1). This increases the depreciation expense by $1,883,000 as compared to the amount calculated under the half-year rule (Undertaking JT1.5). The undertaking response also indicates that if the full year proposal is not approved by the Board, the 2013 revenue requirement would decrease by $2,527,000. This amount constitutes more than 1.5% of the total base revenue requirement, as shown in Table 2 of the Settlement Agreement.

PowerStream has provided the rationale for the use of the full-year methodology in its evidence at Exhibit D1, Tab 4, Schedule 1 where it indicates that the full year depreciation provides a more appropriate level of depreciation expense for the IRM period that will follow this cost of service application in that these additions will attract a full year of depreciation in the subsequent years of the IRM period and provide more adequate funding for capital additions. PowerStream expands on this in the response to

Board Staff Interrogatory #33 at Exhibit J1, Tab 4, Schedule 4.2. In that response PowerStream indicated that the shortfall is further compounded by increased depreciation expense on both additions during the IRM period due to assets being replaced at higher costs than was the case historically and for the cost of new assets placed into service.

Energy Probe notes that Mr. Macdonald indicated that if the Board did not approve the full year depreciation proposal that it would not defer any of the capital expenditures in the test year (Tech. Conf. Tr., page 119) but it might result in the need to defer capital expenditures beyond the test year. In other words, there would be no issue of a lack of adequate funding for capital additions in the test year.

PowerStream is asking the Board to approve a different method for depreciation for accounting purposes and for regulatory purposes in the test year (Tr. Vol. 1, page 41). Mr. Macdonald confirmed that this approach would ask the Board to approve about $1.9 million more from ratepayers in rates than the actual depreciation expense for the test year. Energy Probe submits that this proposal cannot result in test year rates that are either just or reasonable.

The added depreciation expense of about $1.9 million forecast by PowerStream and included in the 2013 revenue requirement is an expense that they admit will not be recorded in the test year. There is no justification for the Board to allow the inclusion of an expense in the revenue requirement when it is known that expense will not take place. The Board would not allow an OM&A expense associated with new positions on staff if the distributor indicated that it was not going to fill those positions in the test year. The Board would not allow a reduction in forecast revenues if the distributor indicated that it was going to earn and collect those revenues in the test year. Both of these are directly comparable to what PowerStream is asking the Board to approve in the setting of just and reasonable rates for 2013.

The PowerStream proposal also suffers from the fact that the difference in depreciation expense, unlike the OM&A and revenue examples given above, has a significant ongoing negative impact on ratepayers in future rate applications. As discussed by Mr. Macdonald and Mr. Shepherd (Tr. Vol. 1, pages 41-43), the actual rate base at the end of the test year will be about $1.9 million higher than forecast because the actual depreciation recorded for accounting purposes will be lower than this amount from that forecast using the full-year approach.

The next rebasing application, which could be for 2014, will reflect this higher rate base in the revenue requirement calculation. Even if the next rebasing application is not until 2017, as suggested by Mr. Macdonald, these assets have long lives and will only be depreciated by a fraction of the $1.9 million. Assuming an average life of 25 years and a corresponding depreciation rate of 4%, this $1.9 million increase in rate base only depreciates by about $76,000 per year. In a 2017 rebasing application, the $1.9 million would depreciate to about $1.6 million. This will be $1.6 million that ratepayers will have to pay depreciation, the return on capital (debt and equity) and PILs on again, after having paid $1.9 million in higher rates in 2013.

In fact, ratepayers will pay this additional $1.9 million in rates in every year under IRM and then pay it again upon rebasing. The total cost to ratepayers under the 2017 rebasing scenario is more than $9 million in total ($1.9 million per year in each of 2013 through 2016, and $1.6 million in depreciation expense over the remainder of the life of the assets) without even taking into consideration the PILs and return on capital costs for 2017 and remaining years of the asset lives.

Energy Probe notes that the current application is for 2013 test year rates. PowerStream admits that this proposal would lead to the collection of $2.527 million more than they require for 2013 in order to earn their allowed return on equity due to the difference in depreciation (and PILs) between their regulatory proposal and their accounting procedures. Energy Probe submits that there is no justification for allowing the PowerStream proposal related to 2013. The Board should not consider the impacts on the revenue requirement beyond the current test year in the current proceeding because that is out of the scope of this proceeding.

b) 2014 vs. 2013

Mr. Macdonald indicated that the use of full-year depreciation in 2013 is not really about 2013. Rather it is about what happens after the rebasing year (Tr. Vol. 1, page 43).

However, should the Board determine that it wishes to look at the impact of the 2013 additions on 2014, then Energy Probe submits that the Board needs to take into consider all of the impacts of the 2013 capital additions to rate base in 2014, not just the impact of the full year of depreciation in 2014 of the 2013 additions.

There are other direct impacts of the 2013 capital additions on the 2014 revenue requirement. These were discussed at pages 43 through 54 of the October 29, 2012 (Volume 1) transcript. As Mr. Barrett agreed, there are many moving parts in this analysis. Unfortunately, the PowerStream proposal only deals with one part of the whole.

As shown in the response to SEC Interrogatory #17, in Table SEC 17-1, the value of the assets that become fully depreciated in 2013 is $12,238,000. This means that the depreciation expense for theses assets included in the 2013 revenue requirement will not exist in 2014 and subsequent years. PowerStream did not provide an estimate of this reduction to the 2014 depreciation expense, but they did do the analysis based on 2009 data. In the response to Board Staff Interrogatory #33 (Exhibit J1, Tab 4, Schedule 4.2) the fully depreciated assets in 2009 had a value of $18,179,992, with an associated depreciation expense of $1,051,460, or an average rate of 5.78%. Applying this rate as an approximation to be used on the $12,238,000 in fully depreciated assets in 2013 results in a reduction in the OM&A expenses of about $700,000. This is clearly an offset the revenue requirement in 2014 based on what happens in 2013.

The response to Undertaking J1.2, distribution revenue would be $1.2 million higher in 2014 as a result of the full-year impact of customer additions in 2013. The 2013 forecast only includes distribution revenues from new customer additions in the test year based on a half-year rule. Energy Probe believes this is appropriate since not all customers added in 2013 would be consuming volumes for the entire year. This is directly comparable to the half-year rule for depreciation. However, if depreciation is based on a full year, then in the view of Energy Probe, so should revenues. In any event, the impact in 2014 of the full year revenues from the customers added in 2013 as a result of the capital expenditures made to connect them in 2013, is an increase in distribution revenues of $1.2 million.

Finally, there is an increase in the capital cost allowance ("CCA") available in 2014 related to the 2013 capital additions. The difference in CCA was estimated to be $2.6 million with an associated reduction in the revenue requirement of about $900,000 (Tr. Vol. 1, page 49).

Taking into account these three additional direct impacts on the revenue requirement for 2014 of the capital additions closed to rate base in 2013 would result in a reduction of about $2.8 million. As a result, if the Board considers that it is appropriate to make an adjustment to the 2013 revenue requirement for the additional $1.9 million in depreciation in 2014 associated with the 2013 capital additions closed to rate base, it must also make an adjustment to the 2013 revenue requirement for the reduction of $2.8 million in direct impacts in 2014 associated with the same 2013 capital additions closed to rate base. To do so otherwise, would be cherry picking at its worst.

c) Half-Year vs. Monthly In-Service

Based on the evidence, Energy Probe believes that the depreciation expense would fall from $36,431,000 calculated using a full year of depreciation to $34,648,000 using the half-year rule. The difference of $1,883,000 is the impact of the difference between the half-year and full-year methodologies noted in the response to Energy Probe Interrogatory #49 and in Undertaking JT1.5.

If the Board agrees with Energy Probe that the full year depreciation methodology should not be included in the 2013 test year revenue requirement, then the question is whether the half-year rule methodology should be applied, or whether the monthly in-service methodology should be used, and if so, what is the appropriate forecast.

For the same reasons noted under Issue 2.1, Energy Probe submits that use of the half-year rule is not appropriate to forecast the depreciation expense in the test year. PowerStream does not use the half-year rule to record depreciation expense for accounting purposes. To use one methodology for regulatory purposes and another for accounting purposes can only be justified if it is not possible to provide a reasonable forecast for the methodology used for accounting purposes. In that case, the use of a different methodology may be appropriate for regulatory purposes.

In the Filing Requirements For Electricity Transmission and Distribution Applications dated June 28, 2012, it is stated at page 32 that:

> *"In particular, the Board's general policy for electricity distribution rate setting is that capital additions would normally attract six months of depreciation expense when they enter service in the test year. This is commonly referred to as the "half-year" rule. The applicant must identify its historical practice and its proposal for the test year. Variances from this "half-year" rule, such as calculating depreciation based on the month that an asset enters service, must be documented with supporting rationale."*

Energy Probe submits that PowerStream has not matched its forecast methodology to match that of its historical practice that it has been using since 2010. Energy Probe also notes that distributors are not prohibited from calculating depreciation based on the month that asset enters service, only that it must documented with supporting rationale.

Energy Probe submits that PowerStream has provided that rationale. Mr. Macdonald indicated that the monthly in-service methodology is more accurate than the half-year rule (Tr. Vol. 1, pages 55 & 57). Energy Probe submits that the use of a methodology which PowerStream believes to be less accurate for regulatory purposes should not be approved by the Board if there is a reasonable forecast available for the more accurate methodology.

Energy Probe further notes that PowerStream has not done any analysis as to whether or not the six month average in-service date is a good estimate for the distributor (Tr. Vol., 1 pages 70-71), and indicated that it was relying on other guidance from the Board.

As noted earlier, in the EB-2010-0136 Decision and Order the Board stated that the half-year rule is a tool used for the prediction for the test year. Energy Probe submits that a more accurate and reasonable tool is available for forecasting purposes. As discussed in Issue 2.1 above, Energy Probe submits that there is a reasonable approach to forecast the depreciation expense under the monthly in-service methodology. This forecast is based on historical ratios for 2010 and 2011 that average 0.98530.

Applying this ratio to the forecast of $34,648,000 using the half-year approach, as calculated above, would result in a further reduction to the depreciation expense of $509,000 ($34,648,000 - $34,648,000 x 0.98530). Energy Probe submits that this is a more reasonable and justifiable forecast for the depreciation expense based on the monthly-in-service methodology than that forecast based on the half-year rule. It is justified on the basis that it actually reflects the methodology used for accounting purposes and is based on the most recent historical ratios available.

Reducing the depreciation expense for the test year would result in a higher rate base and an increase in the revenue requirement related to the cost of capital (debt and equity) and PILs which would partially offset the reduction in the revenue requirement due to the reduction in the depreciation expense.

Issue 6.1 - Are the proposed Test Year cost of capital parameters appropriate?

PowerStream has three promissory notes held by its' shareholders. These notes, which are shown in Table 6.1 of the Settlement Agreement at lines 1, 2 and 12, total approximately $166.1 million, and have a forecasted rate of 5.58%. The issue is whether or not the Board's deemed long term debt rate should be applied to these notes.

Each of the Amended and Restarted Promissory Notes from the three shareholders are shown in the October 12, 2012 letter from PowerStream and the attached Responses to Undertakings.

For the reasons that follow, Energy Probe submits that the Board's deemed long-term rate should apply as a ceiling to the rates used for these three promissory notes. These submissions are based, in at least part, on the EB-2009-0084 Report of the Board on the Cost of Capital for Ontario's Regulated Utilities dated December 11, 2009 (the "EB-2009-0084 Report").

a) Argument-in-Chief

At paragraphs 41 through 43 of the Argument-in-Chief dated November 5, 2012, PowerStream asserts that the continuation of the 5.58% rate for its shareholder Promissory Notes in the test 2012 test year is reasonable and appropriate based on the statement on page 53 of the EB-2009-0084 Report that the Board would rely primarily on the embedded or actual cost for existing long term debt instruments. Energy Probe submits that the Board should reject this assertion.

Immediately following the statement on page 53 of the EB-2009-0084 Report relied upon by PowerStream for its position is a statement that electricity distributors should be motivated to make rational decisions for commercial "arms-length" debt arrangements, even with shareholders or affiliates. As discussed in part (d) below, PowerStream's lack of action on refinancing the shareholder loans when it obtained new financing at substantially lower rates results in higher costs for ratepayers. Energy Probe submits that this shows that PowerStream did not follow the intent of the Board's policy as it did not make a rational decision related to the shareholder debt.

In addition, Energy Probe submits that the shareholder promissory notes are both callable and at a variable rate (see parts (b) and (c) below). The EB-2009-0084 Report clearly states that the deemed long-term debt rate will act as proxy or ceiling for what would be considered to be a market-based rate by the Board in certain circumstances. Those circumstances include debt that has a variable rate (regardless of whether the debt holder is an affiliate or a third-party), and for debt that is callable on demand within the test year.

b) Fixed vs. Variable Rate

The promissory note held by the City of Barrie indicates in Section 2.1 that after December 31, 2009 the interest rate will be resent and adjusted from time to time as agreeable between the City and the Corporation, in order to reflect current market conditions, the deemed interest rate as prescribed by the Ontario Energy Board and the same interest rate for similar debt owed to all shareholders of any successor to the Corporation.

The promissory notes held by the Town of Markham and the City of Vaughn have identical wording with respect to the interest rates. Section 2.4 in both notes states that the interest rate may be adjusted from time to time as agreeable between the Town/City and Amalco (now PowerStream), in order to reflect current market conditions and the deemed interest rate as prescribed by the Ontario Energy Board.

Ms. Young indicated that the notes do not require an adjustment in the rates and that there has never been an adjustment to the rate of 5.58% (Tr. Vol. 1, page 105). However, this only applies to the Town of Markham and City of Vaughn notes as both indicate that the interest rate <u>may</u> be adjusted from time to time. However, Energy Probe notes that the City of Barrie note indicates that the interest rate <u>will</u> be reset and adjusted from time to time, after December 31, 2009.

Energy Probe submits that it is quite clear that each of these three notes does not have a fixed interest rate for the term of the loan. It is equally clear that these notes are all subject to changes in the rates charged. In other words, they are variable rate notes. The sections noted above do not require a rate change, but they do allow a rate change during the term of the notes.

The EB-2009-0084 Report clearly states how the debt rate associated with variable rate loans is to be treated for regulatory purposes. At page 53 of the EB-2009-0084 Report, it is stated that:

> *"For debt that has a variable rate, the deemed long-term debt rate will be a ceiling on the rate allowed for that debt. This applies whether the debt holder is an affiliate or a third-party."*

There is no issue of whether or not the shareholders are properly classified as affiliates since the Board policy applies to affiliates and third-parties. Energy Probe submits that the Board policy with respect to variable rate loans should apply to shareholders as well as to affiliates and third parties.

In the EB-2007-0928 Decision and Order dated October 27, 2008 for Erie Thames Powerlines Corporation, the Board found that the interest rate applicable to variable rate debt held by the shareholder should be 6.1%, consistent with the Board's deemed long term rate. In coming to this conclusion the Board stated (page 23) that:

> *"Interest costs form part of the revenue requirement upon which rates are determined, and it is important that ratepayers are protected from debt arrangements which impose unreasonable costs being recovered in rates. Erie Thames' submission that the municipal debt is not affiliate debt since each municipal shareholder has a 1/7 voting share on ETPC's Board of Directors is not a determinative factor of this finding. <u>The finding is based on what can be considered a reasonable rate irrespective of the legal relationship of the parties</u>."*
>
> *The shareholder debt instrument is subject to rate renegotiation as to the applicable rate at the instance of the debt holder, and has no fixed rate for a fixed term. In the Board's view, this qualifies this instrument as a variable rate loan, subject to the deeming provision of the Report."* (emphasis added)

Energy Probe submits that the same holds true for the shareholder notes in this proceeding. As a result, based on the notes having a variable rate, Energy Probe submits that the Board's deemed long term debt rate should be applied to all three shareholder notes as a ceiling on the allowed interest rate.

<u>c) Callability and Subordination</u>

The Board`s policy with respect to callable loans is found at page 54 of the EB-2009-0084 Report and is reproduced here:

> *"For debt that is callable on demand (within the test year period), the deemed long-term debt rate will be a ceiling on the rate allowed for that debt. Debt that is callable, but not within the period to the end of the test year, will have its debt cost considered as if it is not callable; that is the debt cost will be treated in accordance with other guidelines pertaining to actual, affiliated or variable-rate debt."*

There is no difference in the treatment of callable debt between affiliate or third-party debt.

Energy Probe submits that there is no question that the shareholder notes are callable. Section 3 of all three promissory notes indicates that the shareholders may at any time accelerate payment of all or part of the outstanding Principal by way of written notice to PowerStream no less than 90 days in advance (October 12, 2012 letter and Responses to Undertakings). The question is whether the notes can effectively be called in the test year due to the subordination of the notes described in Section 4.2 of the promissory notes along with Postponement Agreements included in the Responses to Undertakings attached to the October 12, 2012 letter. Energy Probe notes that Section 4.1 under the Subordination heading is not applicable to the 2013 test year since the EDFIN debt has been replaced in 2012.

Sections 4.2 and 4.3 in each of the promissory notes allows the shareholders to subordinate the indebtedness owed to them to debt issued by PowerStream to a financial institution or other third party on such terms as the lender may reasonably request. The shareholders shall execute such documents as may be reasonably required by PowerStream to evidence such subordination. These documents are the Postponement Agreement included in the Undertaking Responses in the October 12, 2012 letter from PowerStream. Ms. Young indicated that all the parties signed this agreement on or around June 26th or June 27th, 2012 (Tr. Vol. 1, pages 77-78).

Energy Probe notes that the Postponement Agreement still allows the shareholders to call all or a portion of their debt with the consent in writing of the Trustee (Section 2 (i)). Ms. Young acknowledged this possibility (Tr. Vol. 1, page 80). Energy Probe submits that this option and possibility effectively means the promissory notes are callable at the request of the shareholders and with permission of the Trustee. There is no evidence on the record of this proceeding that would indicate that such written consent would be withheld.

At the time that the postponement agreement was negotiated with the shareholders and the Trustee (June, 2012), PowerStream did not talk to its shareholders about whether it should get a lower interest rate based on market conditions, or whether the shareholders would like PowerStream to pay them out and allow PowerStream to get cheaper money (Tr. Vol. 1, page 83).

Energy Probe submits that even if the shareholder loans are deemed to not be callable in the test year by the Board, it is not reasonable for PowerStream to retain an above market debt rate at the time that it negotiated the Postponement Agreement in June, 2012. Energy Probe further submits that the Board should direct PowerStream to use the deemed debt rate that was in place at the time the Postponement Agreement was put in place. This was a rate of 4.41%, as set out in the Board's March 2, 2012 letter that set the cost of capital parameter updates for 2012 cost of service applications for rates effective May 1, 2012.

This is consistent with the Board's EB-2010-0136 Decision and Order dated June 23, 2011 for Kingston Hydro Corporation. In that proceeding the Board determined the following (page 41):

> *"Kingston Hydro provided evidence that a resolution of its Board of Directors was made on July 6, 2010 that the affiliated debt would not be callable prior to 2012. The Board would have also expected to be provided with evidence that the holder of the debt was in agreement with this approach. <u>Irrespective, the Board finds that it was not reasonable for Kingston Hydro to retain an above market debt rate at the time it made its resolution on long term affiliated debt. Kingston Hydro should have understood that the affiliated debt rate should have attracted the deemed debt rate that was in place at the time of its resolution</u>. As such, the Board will not approve a debt rate of 7.25% for rate making purposes. Rather, <u>Kingston Hydro is ordered to use 5.87%, the deemed debt rate that was in place at the time of its resolution</u>."* (emphasis added)

Energy Probe submits that the Postponement Agreement is similar to the resolution in the Kingston Hydro application.

If the Board does determine that the shareholder promissory notes are not callable within the test year, then Energy Probe submits that this debt should be treated as variable rate debt, which is consistent with the Board's policy, as noted on page 52 of the EB-2009-0084 Report.

<u>d) Refinancing</u>

Energy Probe notes that PowerStream issued new debt in the amount of $200 million in August, 2012 with a rate of 3.99% (line 3 in Table 6.1 of the Settlement Agreement). This clearly demonstrates that PowerStream was able to attract a significant level of financing at a rate below the Board's deemed long term debt rate of 4.41% that was in effect at the time of the refinancing, as set in the Board's March 2, 2012 letter that set the cost of capital parameter updates for 2012 cost of service applications for rates effective May 1, 2012.

PowerStream did not attempt to refinance the $166.1 million in shareholder loans at the same time it was obtaining the $200 million in new financing in the spring/summer of 2012 (Tr. Vol. 1, pages 79-81). PowerStream indicated that it could not pay off the shareholder loans without the agreement of the note holders.

Further, PowerStream did not approach any of its shareholders to determine if any of them was willing to allow the distributor to pay off all, or a portion, of the outstanding notes (Tr. Vol. 1, pages 83-84). In fact, Mr. Macdonald indicated that PowerStream did not develop a strategy with their shareholders about disposing of their debt and that no discussions took place with the shareholders.

Energy Probe submits that this lack of action of the part of PowerStream and its shareholders should not result in ratepayers paying a higher cost of debt than could have been obtained from true arms-length third parties. As the Board noted in the EB-2007-0928 Decision quoted above, interest costs form part of the revenue requirement upon which rates are determined and it is important that ratepayers are protected from debt arrangements which impose unreasonable costs being recovered in rates.

Energy Probe submits that by failing to even discuss the issue of the shareholder debt payment, PowerStream has imposed higher interest costs on ratepayers than is either necessary or reasonable. As a result, it is submitted that the Board should consider imposing a rate of 3.99% on the $166.1 million of shareholder notes, the same rate that PowerStream negotiated for the $200 million of debt issued in August, 2012.

If the Board does not believe this is an appropriate rate, then it is submitted that the Board`s deemed long term debt rate should apply.

e) Conclusion

In the EB-2009-0084 Report, at page 53, the Board stated that it:

> *"is of the view that electricity distribution utilities should be motivated to make rational decisions for commercial "arms-length" debt arrangements, even with shareholders or affiliates."*

Energy Probe submits that PowerStream has not met this criteria. If the Board determines that the shareholder promissory notes are callable within the test year, or are variable rate notes, then it is clear that the Board's deemed long-term debt rate should apply as a ceiling on the rates charged for these notes.

If the Board determines that these notes are neither callable nor variable rate loans, then Energy Probe submits that the Board should still apply the deemed long term debt rate as a ceiling on the rates used for calculation of the revenue requirement because PowerStream did not attempt to renegotiate a lower rate on the promissory notes to reflect current market conditions when it obtained new and replacement financing for other loans (EDFIN) in 2012. Neither did PowerStream discuss with its shareholders the option of paying out the loans and obtaining lower cost financing as it did with the EDFIN loan. In other words, PowerStream did not take the necessary steps to make a rational decision related to the shareholder notes.

Issue 8.2 - Is the treatment of property, plant and equipment due to the transition to the new accounting standard appropriate?

The issue here is whether or not the difference in construction work-in-progress ("CWIP") should be included in the calculation of the amount to be cleared in the PP&E account.

PowerStream has calculated the total amount to be refunded to ratepayers to be $2.387 million, based on total PP&E amounts that include not only rate base, but also the difference in CWIP under CGAAP and MIFRS at the end of 2012. Excluding the impact on CWIP, the amount to be refunded to ratepayers based solely on the difference in rate base at the end of 2012 is $9.571 million. The difference between these figures, $7.184 million, is the difference in CWIP at the end of 2012 between CGAAP and MIFRS. These figures are all shown in Table JT1.4-2 in the Responses to Undertakings attached to PowerStream's October 12, 2012 letter.

a) CWIP or No CWIP

Energy Probe has had the opportunity to review the submissions of Board Staff, dated November 12, 2012, related to this issue. In general, Energy Probe supports those submissions which were broken down into two sub-issues.

Energy Probe supports the Board Staff submission related to the first sub-issue that PowerStream's interpretation of the Addendum Report with respect to the rate base PP&E calculations is incorrect and that PowerStream's approach with respect inclusion of CWIP and its associated overhead costs in rate base PP&E is a departure from the Board policy and should, therefore, be disallowed.

With respect to the second sub-issue as identified by Board Staff in their submissions, Energy Probe agrees with the analysis and submissions of Staff. In particular, Energy Probe submits that the Board should consider the transitional costs associated with the difference in CWIP that is related to the changes in PowerStream's capitalization and burden/overhead allocation due to the adoption of MIFRS as an out-of-period cost.

Where Energy Probe diverges from the submissions of Board Staff is related to whether or not the principle of retroactive rate making is invoked. Energy Probe is a strong supporter of the principle of no retroactive rate making. In this instance, however, Energy Probe does not believe that the CWIP difference is retroactive rate making.

The difference in CWIP as a result of changing from CGAAP to MIFRS does not appear to be fundamentally different than the changes in OM&A and depreciation expenses that also are the direct result of changing from CGAAP to MIFRS. These changes are tracked through the change in rate base and are included in the PP&E account. The resulting clearance of this difference to ratepayers is not considered retroactive rate making. Similarly, the difference in CWIP does not appear, at least to Energy Probe, to be retroactive rate making.

The Board Staff submission sets out two options with respect to the recovery of the CWIP difference. Option 1 was that the Board should deny PowerStream's request. Energy Probe does not support this option for the reasons set out above. The intent of the Board's policy on the transition from CGAAP to MIFRS is to keep both ratepayers and the utilities whole. Denying recovery of the cost would not do this.

Energy Probe does support Option 2 that would see the Board approve the recovery of the one-time costs either in part or in full. Energy Probe submits that impact on PowerStream in 2012 is material.

Energy Probe does not see any merit in the justifications put forward by Board Staff for the partial recovery option. Energy Probe submits that full recovery (subject to submissions in part (b) below) should be allowed in order to keep PowerStream whole.

b) CWIP Impact

If the Board determines that the PP&E account should reflect the difference in CWIP at the end of the 2012 as a result of the change from CGAAP to MIFRS, or that this difference, or some portion of it, should be recovered from ratepayers through another mechanism, then Energy Probe submits that it should be the after-tax impact of this difference that is recovered from ratepayers.

The problem, as described by PowerStream, is that with the transition to MIFRS from CGAAP there is an increase in costs that cannot be applied to capital and they end up increasing OM&A (Tr. Vol. 1, page 28). In effect, the $7.184 million noted above, becomes an OM&A expense and never gets into rate base (Tr. Vol. 1, page 31).

If this is the case, then the 2012 financial statements would reflect $7.184 million in OM&A costs that would not be recorded as such under CGAAP. This would reduce the taxable income by this same amount.

Since the intent of the Board's policy is to keep both ratepayers and distributors whole as a result of the accounting change, it is clear that the increase in OM&A costs should be reduced by the associated reduction in PILs costs.

Based on a marginal tax rate of 26.5% (Exhibit J1, Tab 4, Schedule 4.3, Energy Probe Interrogatory #33), the increase in the OM&A costs in 2012 would result in a reduction in 2012 PILs of $1.904 million. Energy Probe submits that the resulting net cost of $5.28 is the appropriate amount that should be recovered from ratepayers if the Board determines that all the difference is to be recovered from ratepayers since this is the net cost to PowerStream of the increased OM&A expense.

Energy Probe further submits that the clearance of the CWIP related amount should be kept separate from the PP&E account as is currently defined by the Board's policy. In particular, a separate deferral account should be set up for the CWIP amount. Recovery should be over the same period as the PP&E account is cleared. Unlike the PP&E account, Energy Probe submits that the approved interest rate for all deferral and variance accounts should be applied to this amount and factored into the recovery.

c) Return on Rate Base Only

If the Board determines that the PP&E account should reflect the difference in rate base at the end of the 2012 as well as the recovery for the CWIP difference at the end of 2012, then Energy Probe submits that only the rate base related portion of the account should be reflected in the reduction in the return on rate base.

In particular, as shown in the Attachment to Exhibit JT1.4, the difference in rate base between CGAAP and MIFRS at the end of 2012 is $9.571 million. This figure is the result of a decrease in depreciation expense of $25.899 million, partially offset by a reduction of $16.328 million in the amount capitalized. The $9.571 million difference is shown in Table JT1.4-2 in the Responses to Undertakings that is attached to the October 12, 2012 letter from PowerStream. This is the net book value of the PP&E included in rate base.

The increase in rate base of $9.571 million has been built into the 2013 revenue requirement, and consistent with the Board policy as stated in the EB-2008-0408 Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment dated June 13, 2011, Energy Probe submits that this is the amount that should be used to calculate the reduction in the return on rate base for the 2013 test year.

The recovery related to CWIP, whether or a pre-tax or aft-tax basis, does not form part of the difference in the rate base that flows through into the test year revenue requirement. Rather, the CWIP difference is a one-time impact on expenses in 2012 and does not affect rate base in 2013 and subsequent years. As a result, Energy Probe submits that it should not be reflected in the amount by which the cost of capital associated with rate base needs to be adjusted in order to keep ratepayers whole from the transition from CGAAP to MIFRS. This appears to be the same conclusion that Board Staff arrived at on page 15 of their Submission.

As noted in part (b) above, Energy Probe recommends the creation of a separate account to deal with the disposition of the CWIP amount from the PP&E account that deals with rate base differences. This would simplify the different treatment of the amounts that is being recommended by Energy Probe.

C - COSTS

Energy Probe requests that it be awarded 100% of its reasonably incurred costs. Energy Probe has attempted to minimize its time on this application, while at the same time ensuring a thorough review.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

November 13, 2012

Randy Aiken
Consultant to Energy Probe