EB-2013-0147

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch.B, as amended;

AND IN THE MATTER OF an Application by Kitchener Wilmot Hydro Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates for the distribution of electricity commencing January 1, 2014

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

January 20 , 2014

JAY SHEPHERD P.C.
2300 Yonge Street, Suite 806
Toronto, Ontario M1P 3E5

Jay Shepherd
Tel: 416-483-3300
Fax: 416-483-3305
Email: jay.shepherd@canadianenergylawyers.com

Counsel for the School Energy Coalition

TABLE OF CONTENTS

1 INTRODUCTION AND SUMMARY

1.1 *Introduction*

1.1.1 On May 17, 2013 Kitchener-Wilmot Hydro Inc. filed an Application for new distribution rates, effective January 1, 2014. The process included extensive interrogatories, a technical conference, and an ADR that was successful in reaching settlement on all but two issues.

1.1.2 This is the Final Argument of the School Energy Coalition.

1.1.3 The ratepayer groups who intervened in this proceeding have followed their normal practice of working together throughout the hearing to avoid duplication, including discussing issues and exchanging drafts or partial drafts of their final arguments. We have been assisted in preparing this Final Argument by that co-operation amongst parties.

1.1.4 We have organized our submissions under the two headings of the unsettled issues.

1.2 *Summary of Submissions*

1.2.1 This Final Argument contains an analysis of the unsettled issues. The following are SEC's recommendations.

1.2.2 ***Working Capital Allowance***. The working capital allowance should be reduced from 13% as proposed by the Applicant to 9.00%, which is the easily calculated WCA impact of going from bi-monthly to monthly billing of residential and GS<50 customers. The impact of this is a reduction in revenue requirement of $801,200 per year.

1.2.3 In the alternative, SEC proposes that the incremental costs of monthly billing, $401,500 per year, be excluded from the OM&A component of revenue requirement. The Applicant can then implement monthly billing during IRM as a method of improving efficiency, and retain any benefits from that initiative until their next rebasing.

1.2.4 ***OM&A Expenditures.*** While the Applicant is a relatively low cost distributor, the proposal to increase its OM&A spending per customer by 23% from 2008 to 2014 is excessive. In addition to any adjustment related to monthly billing, SEC proposes that OM&A be reduced by $0.9 million, so that the annualized increase in OM&A per customer is reduced from 3.5% to 2.5%, and the overall increase in OM&A from 2010 Actual to 2014 forecast (on an Old CGAAP basis) is reduced from 35% to 24%.

2 WORKING CAPITAL

2.1 *The Issue*

2.1.1 The Applicant proposes to use the Board's default working capital rate of 13%, despite having agreed – and been directed – to do a lead-lag study and file it in this proceeding.

2.1.2 The Applicant has now advised that it plans to move to monthly billing, which will cost more than $400,000 per year, and will have a material effect on its working capital requirements. However, the Applicant still seeks to rely on the Board's default working capital rate, and keep all of the financial benefits of the move to monthly billing for the account of the shareholder.

2.2 *Working Capital Evidence*

2.2.1 ***The WCA Percentage.*** In cross-examination by SEC, the Applicant admitted point blank that it is not offering the Board any evidence at all to support its proposed 13% working capital rate. The exchange is as follows [Tr.1:122]:

> *"MR. SHEPHERD: …Kitchener has proposed a 13 percent working capital allowance calculation; right?*
> *MS. NANNINGA: Correct.*
> *MR. SHEPHERD: Do you have any evidence supporting that, other than Board policy? Any evidence at all?*
> *MS. NANNINGA: Board policy, yes.*
> *MR. SHEPHERD: So if the policy applies to you, then you'll rely on it. If it doesn't apply to you, then there is currently no evidence on the record, that you've provided, anyway, as to what the right number is, is there?*
> *MS. NANNINGA: That is correct."*

2.2.2 Kitchener is not a normal LDC in this respect. Kitchener was directed in its last cost of service proceeding, EB-2009-0267, to carry out a lead-lag study, and base its working capital allowance in this proceeding on the results of that study. The Board said as follows [K1.2, pp. 5-6]:

> *"KW Hydro has proposed to conduct a lead-lag study in the preparation of its next cost of service rebasing application. The Board finds this proposal timely and appropriate;"*

After discussing the possibility that the Board will carry out a "generic proceeding/consultation" on this subject, and directing the Applicant to participate if the Board does so, the Board goes on to say:

> *"The Board expects that KW Hydro will support its cash working capital allowance in its next rebasing application based on the outcomes of this Board-led process or based on the lead/lag study that KW Hydro stated that it would individually undertake."*

2.2.3 The Board did not carry out a generic proceeding or consultation. However, on April 12, 2012 it amended the Filing Requirements [K1.2, p. 7-9] to allow LDCs that had not been ordered to carry out a lead/lag study to use 13% in place of the previous 15% default. As the Applicant had agreed to carry out such a study, and had been directed to do so, this default value did not apply to them.

2.2.4 Further, the Board based its new 13% rate on "the results of WCA studies filed with the Board in the past few years". Those studies were in almost every case based on LDCs with bi-monthly billing. As the Board went on to say in its letter, "**The Board has determined that it is not appropriate for a default value for WCA to be set at a higher level than those resulting from lead/lag studies**" [emphasis added].

2.2.5 Having agreed, and been directed by the Board, to provide empirical evidence in this proceeding as to its working capital requirements, the Applicant is, in our submission, no longer eligible to rely on the Board's default value. That being the case, the Applicant has not met its onus to support its application for a working capital component in its rates.

2.2.6 ***The Impact of Monthly Billing***. Kitchener Wilmot Hydro has decided to go to monthly billing for its general service customers, at an annual cost of $401,500 for additional postage and other costs.

2.2.7 The utility admits that there will be financial savings associated with monthly billing [Tr.1:117]:

> *"MR. SHEPHERD: Would you agree the least likely number for the benefits is zero?*
> *MS. NANNINGA: Yes, I would agree with that. I agree that there are benefits. We just don't necessarily know what they are yet."*

2.2.8 While in cross-examination a number of possible cost savings were discussed, one of the largest and most obvious is a reduction in the "service lag" for working capital purposes. This concept is defined by Navigant Consulting in their report for Horizon Utilities as follows [K1.2, p. 38]:

> *"A Service Lag measures the time from the Company's provision of electricity to a customer to the time the customer's service period ends and the meter is read."*

2.2.9 Navigant notes in the same report that a formula called the "mid-point method" is used to calculate the service lag [K1.2, p. 36, 38]. Essentially, you divide the number of days in the year by the number of billing periods in the year, and divide the result by 2. For all studies that we have seen (including the several in evidence) the results are 30.42 days for customers billed bi-monthly, and 15.21 days for customers billed monthly. This is shown, for example, on the Hydro Ottawa analysis at page 49 of K1.2. The overall service lag for a given LDC will be based on the ratio of customers billed monthly, and customers billed bi-monthly[1].

2.2.10 Energy Probe has correctly set out the formula for the working capital allowance percentage on page 28 of K1.2. The net lag days are calculated and divided by 365. That gives the percentage that should be applied to annual cash spending to determine the amount of working capital required.

2.2.11 The reason this is all important is that the impact of changing the service lag is a simple mathematical calculation. It does not require a lead-lag study. It does not require any difficult assumptions.

2.2.12 A shift from bi-monthly to monthly billing will reduce the service lag from 30.42 days to 15.21 days for those customers affected. If that is 90% of the utility's revenue, then the impact on net lag is 90% * (30.42-15.21) = 13.689 days. When that is divided by 365, you get the impact on the working capital percentage, which is, in this example, a reduction of 3.75%. The remaining elements of the working capital calculation are irrelevant, because all that needs to be determined is the impact of the change itself.

2.2.13 In this case, it would appear from the material filed by the Applicant that they are proposing to move 96% [Tr.1:44-45] of their customers (Residential and GS<50) from bi-monthly to monthly billing. Based on the mid-point methodology described above, the effect of this change is a reduction in the Applicant's working capital required of 4.00%, or a reduction from 13.00% (the Board default) to 9.00%.

2.2.14 The resulting working capital allowance would be $18,759,072, a reduction of $8,337,366. The impact on revenue requirement should be a reduction of $801,200 (WACC of 9.61%, including gross-up for PILs impact).

2.2.15 We note that the Applicant could have – and perhaps should have – carried out a

[1] SEC and other intervenors have consistently taken the position that service lag should be weighted by dollars rather than by customer numbers, but Board decisions have not accepted this position. The Board has used customer number weighting, and so SEC has used that method here. If the weighting were by dollars, the percentage is 83.23% of revenues moved, and the working capital would be $19,863,773 based on the 13% starting point being correct. However, this would represent a change to how the Board calculates the working capital allowance, and would therefore require that the 13% bi-monthly figure also be reviewed to reflect the same change. It would likely have to be reduced by about 0.55% to reflect the dollar weighted basis for service lag. Since the end result is 15.21 service lag days for all Kitchener customers in either case, mathematically the resulting WCA percentage for Kitchener should be the same whether dollar weighting or customer number weighting is used.

lead/lag study specific to Kitchener Wilmot Hydro. That study might have shown a different WCA on the bi-monthly assumption, i.e. something other than the default value of 13%. However, they did not do that, and determined that they would rely on the default value. That being the case, it is the proper starting point for the calculation, producing the 9.00% result.

2.2.16 We also note that, in proposing only a reduction in WCA for this Applicant, SEC is ignoring the many other financial benefits of monthly billing that are likely to arise. Some of those benefits are described in the Util-Assist report for Oakville Hydro, at page 21 of K1.2. While the Applicant says that they do not agree with all of those potential benefits [J1.2], they also admit that they have not done any analysis of the various cost savings they will realize as a result of monthly billing [Tr.1:115, and numerous other places in the transcript].

2.2.17 SEC therefore submits that the Board should reduce the working capital allowance for this Applicant to 9.00%, and reduce the revenue requirement and rates accordingly. In addition, SEC submits that the Board should direct the Applicant to undertake a lead lag study no later than eighteen months after implementing monthly billing, and file that study with the Board in its next following rate application, whether COS or IRM.

2.3 ***Alternative Solution***

2.3.1 SEC's recommendation above stems from the Applicant's decision to include the costs of moving to monthly billing in its revenue requirement for the rebasing year 2014. As a matter of basic principle, if you propose a change, and you want the ratepayers to pay for it, then you must credit the ratepayers with the benefits that arise from the incremental cost. In this case, those benefits are at the very least a reduction in the working capital allowance.

2.3.2 This also could be approached from the IRM paradigm. The Applicant could have said that they were considering a move to monthly billing as one of the cost saving initiatives during IRM. In that case, the Applicant's shareholder would take the cost risk, but would also enjoy the net benefits during IRM. This is, in fact, the essence of the IRM concept. Utilities invest shareholder money in productivity, and for a period of four or five years, depending on the IRM term, the benefits of that productivity show up in improved ROE for the shareholder.

2.3.3 SEC notes that the key here is symmetry. What is funded by the ratepayers should benefit the ratepayers during IRM. What is funded by the shareholder can benefit the shareholder during IRM.

2.3.4 In the current situation, SEC believes that, if the Applicant in its Reply Argument withdrew its $401,500 annual OM&A cost for this change – reducing the OM&A budget accordingly – it would be reasonable for the Board to leave the working capital at 13% and in effect treat the move to monthly billing as an IRM productivity initiative.

2.3.5 However, in the event that the Applicant endorses and takes up this alternative, SEC believes two things should still happen. First, the Applicant should complete its lead/lag study, as it was directed to do so. Second, the Applicant should report at its next rebasing on all impacts of moving to monthly billing, so that they can be properly reflected in rates on rebasing.

3 OM&A EXPENSES

3.1 *Introduction*

3.1.1 SEC believes that the OM&A proposal for this Applicant is too high. However, we are also conscious of the fact that the Applicant is a low cost distributor, and so some component of catchup or other flexibility may be appropriate.

3.2 *Applicant's Proposal*

3.2.1 One of the difficulties with understanding the proposed OM&A budget for any LDC in a time of accounting changes and adjustments is getting numbers that are fairly comparable on an apples to apples basis from year to year.

3.2.2 There appear to be four major adjustments necessary to ensure that past data for the Applicant is set out on a comparable basis to the Test Year:

(a) Smart meter spending that was actually incurred in 2009 through 2011 is all included in 2012 OM&A figures.

(b) The Applicant moved to modified CGAAP in 2012, with an annual impact going forward of $1,692,337.

(c) The years 2009 through 2012 had spending anomalies that make them, in the Applicant's view, non-typical years. (See para. 3.3.2 to 3.3.6 below).

(d) The customer numbers used by the Applicant to calculate OM&A per customer are not the same as their RRR filings, which are the standard customer numbers used by most Ontario LDCs in per customer calculations.

3.2.3 In the case of the first two items, Energy Probe has calculated adjustments and set them out in K1.2, page 71, at lines 43 through 48. SEC accepts those adjustments, and believes that the Applicant has as well [Tr. 1:74].

3.2.4 In the case of the third item, SEC has gone back to 2008, which generally speaking appears to be a pretty typical year. We asked the Applicant about this, and while every year has some unusual aspects to it, 2008 appears to be fairly typical [Tr.1:131]. As a result, in our analyses, we have gone back to 2008 as a baseline.

3.2.5 Finally, for the customer numbers we asked the Applicant to restate their calculations using the RRR numbers, and they did so [J1.7]. We have used the RRR numbers in our calculations, except for 2013 and 2014, which do not yet exist. Therefore, for those two years we have escalated the 2012 RRR number by the percentage increase in number of customers in the Application, i.e. 1.518% for 2013 and a further 1.540% for 2014. We expect that these will be good proxies for the RRR numbers that will be filed later this year, for 2013, and in 2015 for 2014.

3.2.6 With those adjustments and corrections, SEC has prepared the following table setting out the annual OM&A budget on a comparable basis (Old CGAAP), numbers of customers, and OM&A per customer, all for the years 2008-2014 inclusive:

OM&A Per Customer							
	2008	***2009***	***2010***	***2011***	***2012***	***2013***	***2014***
Final as Filed	$12,548,934	$12,203,402	$12,270,957	$13,607,221	$16,827,196	$17,431,075	$18,480,760
Smart Meters Timing		$162,631	$162,424	$406,919	-$731,974		
Subtotal	$12,548,934	$12,366,033	$12,433,381	$14,014,140	$16,095,222	$17,431,075	$18,480,760
Accounting Change					-$1,692,337	-$1,692,337	-$1,692,337
Final - all Old CGAAP	$12,548,934	$12,366,033	$12,433,381	$14,014,140	$14,402,885	$15,738,738	$16,788,423
% Change		-1.46%	0.54%	12.71%	2.77%	9.27%	6.67%
Cumulative Change		-1.46%	-0.92%	11.68%	14.77%	25.42%	33.78%
# of Customers	84,195	85,998	86,611	87,964	89,025	90,376	91,768
OM&A per Customer	$149.05	$143.79	$143.55	$159.32	$161.78	$174.15	$182.94
% Change		-3.52%	-0.17%	10.98%	1.55%	7.64%	5.05%
Cumulative Change		-3.52%	-3.68%	6.89%	8.55%	16.84%	22.74%

3.2.7 By putting the data in one place, on a fairly comparable basis, we can identify certain conclusions that can be drawn:

(a) The overall OM&A budget is proposed to increase from $12.5 million to $16.8 million over six years, a compound annual rate of increase of just over 5.0% per year.

(b) The OM&A per customer is proposed to increase from $149.05 to $182.94 on an Old CGAAP basis, a compound annual rate of increase of 3.5% per year. Thus, even assuming that there are no scale economies arising out of customer growth, OM&A is proposed to increase at more than twice the rate of inflation during these six years.

(c) The adjusted OM&A per customer, while much higher, remains at an above average performance level relative to other Ontario LDCs.

3.2.8 SEC believes that this information allows the Board to identify a reasonable OM&A envelope that will recognize the spending pressures on the Applicant, while encouraging them to remain a low cost distributor. Our analysis and recommendation is below**.**

3.3 *Impact of Past Performance*

3.3.1 There are two aspects of the Applicant's past performance that might be relevant to the Board's consideration of its 2014 OM&A Budget. First, the actual spending in the last rebasing year was significantly lower than the Board-approved amount included in rates. Second, over an extended time the Applicant has provided electricity distribution at cost levels less than most of their peers.

3.3.2 ***Underspending During Previous IRM Period.*** In 2010, the Board approved OM&A of $13.9 million for this Applicant, but they actually spent only $12.3 million. That underspending continued in 2011, for a cumulative underspend of about $2.2 million over those two years. (All calculations in this section are included in the spreadsheet provided to the parties with this Final Argument.)

3.3.3 On the face of it, this would raise the question of whether spending estimates were overstated in the previous rebasing case, which may in turn raise a similar question for this Application.

3.3.4 The Applicant commented on certain anomalies in the OM&A in 2009, 2010 and 2011 [Tr.1:24-25], and SEC cross-examined the Applicant on this point during the hearing [Tr.1:130]. The Board heard the impact of a transformer station project, and then storms, followed by a return to normal spending patterns in 2014.

3.3.5 SEC found those explanations both believable and reasonable, but tested them by looking at total OM&A spending over the 2010-2013 IRM period. If the 2010 Board-approved OM&A per customer is escalated each year by the IRM escalator, and then converted to a total amount of OM&A included in rates, the net result for the four years is $57.1 million (all on an Old CGAAP basis). The actual amount of OM&A spent by the Applicant over that period was $56.6 million, again on an Old CGAAP basis. The difference of 0.9% is relatively small, and is consistent with the Applicant's explanation of the initial underspending.

3.3.6 SEC therefore believes that the underspending relative to the last Board-approved is not sufficiently material to be probative in this proceeding.

3.3.7 ***Low Cost Distributor.*** SEC has argued in the past that LDCs with higher than average levels of OM&A should get approval for less than average increases in those budgets, in order to ensure that they move closer to industry standard cost levels. One of the advantages of the existence of many LDCs in Ontario is that benchmarking is facilitated, and higher cost outliers can be encouraged to contain their costs, thus helping to control increases in the overall cost of electricity distribution in the province.

3.3.8 A second goal that SEC believes the Board should seek is to improve the industry standard level of productivity. The way to do this is to encourage lower cost distributors to retain their industry leading status. The resulting asymmetry – higher cost outliers move downward more than lower cost outliers move upward – can improve overall industry productivity.

3.3.9 That having been said, we recognize that the best performers also may have less "fat" to cut, and so have a greater challenge in reacting to external cost pressures while remaining within the same budget envelope as their less efficient peers.

3.3.10 SEC therefore believes that the Board, in setting top-down levels of reasonable spending for low cost distributors, should adopt a flexible approach. Where the distributor demonstrates good past performance, and specific cost pressures in the future, the Board should respond by allowing cost escalation at a rate slightly higher than less efficient distributors. That rate should still, in our view, encourage the low cost distributor to maintain their superior performance, but can balance that with a somewhat higher level of increase.

3.4 ***Reasonable OM&A Levels***

3.4.1 The last year in which there do not appear to be any material anomalies for the Applicant's OM&A spending is 2008, when the OM&A per customer for Kitchener Wilmot Hydro was $149.05 (calculated on a basis comparable to other LDCs, as described above).

3.4.2 If the Applicant did not start this period as a low cost distributor, SEC would propose that OM&A per customer be allowed to escalate by no more than 2% per year, slightly more than inflation but right around the long term inflation rate. This would produce an OM&A per customer for 2014 of $167.85, and a total OM&A budget of $15.4 million on an Old CGAAP basis, and $17.1 million on an MCGAAP basis. The reduction in OM&A and revenue requirement would therefore be approximately $1.4 million.

3.4.3 We note that, if an OM&A escalator of 2% per annum is used, the resulting annual OM&A figures for 2010 – 2013 total $60.1 million, which is identical to the $60.1 million actually spent by the Applicant on OM&A in those four years. Both figures are Old CGAAP for 2010 and 2011, and MCGAAP for 2012 and 2013. On a comparable basis, therefore, it is clear that over the last IRM period an aggregate annual increase in OM&A per customer of 2% matches what actually took place. (These calculations are included in the spreadsheet provided to the parties and the Board along with this Final Argument.)

3.4.4 SEC believes, however, that the Applicant's status as a low cost distributor should be recognized in any top down calculation. Therefore, SEC proposes that the reasonable level of 2014 OM&A be calculated using a 2.5% escalator on OM&A per customer from 2008 to 2014.

3.4.5 The result of that escalation is an OM&A per customer in 2014 of $172.85 (Old CGAAP basis), which translates into an OM&A budget, on an MCGAAP basis, of $17.6 million in 2014. The resulting reduction in OM&A from the Applicant's proposal would be about $900,000.

3.5 ***Monthly Billing***

3.5.1 As noted in Section 2.3 above, one possible approach to ensuring that the costs and benefits of monthly billing are allocated fairly between the shareholder and the ratepayers is to exclude the incremental costs of monthly billing from the OM&A budget, and allow the Applicant to treat both costs and benefits as an IRM productivity initiative. That is, it would be funded by the shareholder, and during IRM the benefits would accrue to the benefit of the shareholder.

3.5.2 In the event that the Board believes that approach has merit, SEC believes that the result should be a further $400,000 reduction in OM&A, which would reduce the OM&A included in revenue requirement to $17.2 million.

3.6 ***SEC Recommendations***

3.6.1 SEC therefore proposes that the OM&A budget approved by the Board and included in revenue requirement should be $17.6 million, assuming that the WCA is reduced to 9.00% to reflect the impact of monthly billing.

3.6.2 Alternatively, if the WCA is to remain at 13%, SEC submits that the Board should approve an OM&A budget of $17.2 million, by backing out the incremental costs of monthly billing and treating them as a shareholder-funded IRM productivity initiative.

4 OTHER MATTERS

4.1 *Costs*

4.1.1 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

Jay Shepherd
Counsel for the School Energy Coalition