Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto ON M4P 1E4
Telephone: 416- 481-1967
Facsimile: 416- 440-7656
Toll free: 1-888-632-6273

Commission de l'énergie de l'Ontario
C.P. 2319
27e étage
2300, rue Yonge
Toronto ON M4P 1E4
Téléphone: 416- 481-1967
Télécopieur: 416- 440-7656
Numéro sans frais: 1-888-632-6273

BY E-MAIL

April 14, 2014

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto ON M4P 1E4

Dear Ms. Walli:

RE: BOARD STAFF SUBMISSION
APPLICATIONS BY HYDRO ONE INC. AND NORFOLK POWER DISTRIBUTION INC.
EB-2013-0196, EB-2013-0187 and EB-2013-0198

In accordance with Procedural Order No. 9, please find attached Board staff's submission respecting the above referenced applications.

Yours truly,

Original Signed by

Gona Jaff
Project Advisor
Licensing and Performance Reporting

Attachment

cc: All Parties to the Proceeding

VT INCEPIT FIDELIS SIC PERMANET
Ontario

ONTARIO ENERGY BOARD

Board Staff Submission

APPLICATION BY HYDRO ONE INC. FOR LEAVE TO PURCHASE ALL OF THE ISSUED AND OUTSTANDING SHARES OF NORFOLK POWER INC.

APPLICATION BY NORFOLK POWER DISTRIBUTION INC. SEEKING TO INCLUDE A RATE RIDER IN THE 2013 ONTARIO ENERGY BOARD APPROVED RATE SCHEDULE OF NORFOLK POWER DISTRIBUTION INC. TO GIVE EFFECT TO A 1% REDUCTION RELATIVE TO 2012 BASE ELECTRICITY DELIVERY RATES (EXCLUSIVE OF RATE RIDERS)

APPLICATION BY NORFOLK POWER DISTRIBUTION INC. FOR LEAVE TO TRANSFER ITS DISTRIBUTION SYSTEM TO HYDRO ONE NETWORKS INC.

APPLICATION BY NORFOLK POWER DISTRIBUTION INC. FOR LEAVE TO TRANSFER/ASSIGN ITS ELECTRICITY DISTRIBUTION LICENCE AND RATE ORDER TO HYDRO ONE NETWORKS INC.

EB-2013-0196/ EB-2013-0187/0198

April 14, 2014

INTRODUCTION

Hydro One Networks Inc. (“HONI”) and Norfolk Power Distribution Inc. (“NPDI”), both licensed electricity distributors, and Hydro One Inc., HONI’s parent company, filed related applications dated April 26, 2013 with the Ontario Energy Board (the “Board”). The applications were amended on two occasions and subsequently clarified. The applications, as clarified on January 8, 2014, are as follows:

1. an application by Hydro One Inc. for leave to purchase all of the issued and outstanding shares of Norfolk Power Inc. under section 86(2)(b) of the *Ontario Energy Board Act, 1998* (the “Act”);
2. an application by NPDI seeking to include a rate rider in the 2013 Ontario Energy Board approved rate schedule of NPDI to give effect to a 1% reduction relative to 2012 base electricity delivery rates (exclusive of rate riders) under section 78 of the Act;
3. an application by NPDI for leave to transfer its distribution system to HONI under section 86(1)(a) of the Act; and
4. an application by NPDI for leave to transfer/assign its electricity distribution licence and rate order to HONI under section 18 of the Act.

On February 18, 2014, the Board issued Procedural Order No. 9 in which, among other things, the Board provided an opportunity for the parties in the proceeding to file submissions on the applications. Board staff is hereby filing its submission pursuant to Procedural Order No. 9.

RELEVANT REGULATORY PRINCIPLES

The “No-Harm” Test

The Board’s decision in RP-2005-0018/EB-2005-0234/EB-2005-0254 and EB-2005-0257 (the “Combined Decision”) established the scope of issues that the Board will consider in determining applications for leave to acquire shares or amalgamate (“Merger, Amalgamation, Acquisitions and Divestitures” or “MAAD”) under section 86 of the Act and ruled that the “no harm” test is the relevant test. The “no harm” test is a consideration of whether the proposed transaction would have an adverse effect relative to the status quo in relation to the Board’s statutory objectives. These objectives are set out in section 1 of the Act. According to the no-harm test, if the proposed transaction would have a positive or neutral effect on the attainment of the statutory objectives, then the application should be granted.

Board Report on Rate-Making Associated With Distributor Consolidation

The Board's policy on key rate-making issues that may be associated with consolidation in the electricity distribution sector is set out in a report of the Board titled "Rate-making Associated with Distributor Consolidation" issued July 23, 2007 (the "2007 Report"). The 2007 Report, states that "distributors that apply to the Board for approval of a consolidation transaction may propose to defer the rate rebasing of the consolidated entity for up to five years from the date of closing of the transaction". The 2007 Report also indicates that a "distributor will be required to specify its proposal for rate rebasing as part of the MAAD application". With respect to rate harmonization, the 2007 Report indicates that "the issue of rate harmonization in the context of a consolidation transaction is better examined at the time of rebasing". Nevertheless, the 2007 Report indicates that parties should indicate in the MAAD application "whether they intend to undertake a rate harmonization process after the proposed transaction is completed and, if they do, to provide a description of the plan".

SUBMISSION

The Board's statutory objectives include, among others, protection of the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service, and the promotion of economic efficiency and cost effectiveness. In Board staff's view, as discussed below, the evidence in this proceeding reasonably demonstrates that the proposed transaction will not have an overall adverse effect relative to the status quo in relation to the Board's statutory objectives.

The Purchase Price

The purpose of the applications is to give effect to a share purchase agreement entered into between Hydro One Inc., and the Corporation of the County of Norfolk, the indirect owner of NPDI through Norfolk Power Inc. Subject to necessary approvals, Hydro One Inc. would purchase all of the issued and outstanding shares of Norfolk Power Inc. and within 18 months of the approval of the transaction by the Board, NPDI's distribution assets will be transferred to HONI. According to the application, the negotiated purchase price is $93 million and the net book value of the assets that will be transferred to HONI is approximately $53.9 million. It is HONI's evidence that only the net book value of the assets plus associated working capital will be included in rate base.

With respect to price, the Combined Decision states:

> The Board is of the view that the selling price of a utility is relevant only if the price paid is so high as to create a financial burden on the acquiring company which adversely affects economic viability as any premium paid in excess of the book value of assets is not normally recoverable through rates. This position is in keeping with the "no harm" test.

In its decision on a Motion by the School Energy Coalition in the current proceeding (the "Motion Decision"), the Board stated:

> In applying the "no harm" test, it is not relevant for the Board to consider whether the purchase price of NPI has been set at an appropriate level. The issue for the Board to consider is whether the purchase price is set at a level that would create a financial burden on the acquiring utility and whether any premium in the purchase price finds its way into rates.

HONI's evidence indicates that based on the 2012 audited financial statements, Hydro One Inc. has total assets of $20.8 billion.

In Board staff's view, HONI's evidence demonstrates that the difference between the price paid to acquire the outstanding shares of Norfolk Power Inc. and the book value will not be included in rate base (i.e. the premium above book value paid will not be funded by rate payers). It is also Board staff's position that the premium paid will have no material impact on Hydro One Inc.'s financial viability, considering its financial statements. Therefore, given the findings of the Board in the Combined Decision and the Motion Decision and considering Hydro One Inc.'s financial position, Board staff submits that the reasonableness of the purchase price in this case is not relevant. However, Board staff submits that should the Board approve the transaction, the Board should explicitly state that it is relying on its understanding of HONI's evidence that HONI (or any other party acting under its direction or control) will not in the future make an application to recover any portion of the acquisition premium paid in connection with the transaction.

The position taken by staff in the current proceeding is based on the Board's current policies on MAADs. However, Board staff submits that subsequent to this proceeding, the Board could consider reviewing its policy on MAADs, including the relevance of the purchase price in the context of economic efficiency and cost effectiveness in the distribution sector. In Board staff's view this is particularly important in light of the government's December 2013 Long Term Energy Plan which expects electricity distributors to pursue innovative partnerships and transformative initiatives that will result in savings for electricity ratepayers.

Cost Structure

In the Motion Decision, the Board stated:

> [I]n applying the "no harm" test, it is appropriate for the Board to assess the cost structures which will be introduced as a result of the transfer of NPDI's distribution system and associated licence to HONI in comparison to the cost structures that underpin NPDI's current rates.

Essex Powerlines Corporation, Bluewater Power Distribution Corporation, and Niagara-on-the Lake Hydro Inc. (collectively "EBN"), who filed a combined intervention in this proceeding, pointed out that the 2012 OEB Electricity Yearbook lists HONI's OM&A cost at 439.77/customer whereas Norfolk is at 333.43/customer. In its revised response to EBN interrogatory ("IR") No. 13, HONI stated that the numbers in the 2012 OEB Electricity Yearbook represent system average OM&A costs across HONI's entire service area which includes the largely rural areas of Ontario as well as semi-urban and urban areas and that the cost to serve any given geographic grouping of customers within HONI's service area will differ based on many different factors, including density, tree-cover, geology, and climate. HONI added that its "current OM&A forecast to serve customers in its high and medium density residential rate classes (UR and R1) is considerably lower than the $439.77 "system average". HONI made reference to the "2015 Cost Allocation model output Sheet O1" filed as part of its 2015-2019 distribution rate application currently before the Board (Board proceeding EB-2013-0416) showing that HONI's OM&A cost to serve its high density UR and medium density R1 rate class is $181/customer and $275/customer respectively. Hydro One further stated that the fact that its cost of serving high and medium density residential customers is lower than NPDI's average cost highlights some of the economic efficiencies that result from this transaction.

Board staff submits that HONI's evidence shows that HONI's OM&A cost of serving high and medium density residential customers is lower than NPDI's average OM&A cost of $333.43/customer. Board staff notes that NPDI's average OM&A cost includes the cost of serving some non-residential customers. It should be noted, however, that the application shows that the vast majority of NPDI's customers are residential customers. Board staff also notes that while HONI provided the OM&A forecast to serve customers in its high and medium density residential rate classes, it did not specify which of its density classes is applicable to NPDI customers.

In its revised response to Vulnerable Energy Consumers Coalition IR. No.2, HONI provided a table showing a forecast of the OM&A and capital expenditure savings expected to be realized, from 2014 to 2023, as a result of the proposed transaction compared to the status quo. Three scenarios were presented in the table: low case scenario, medium case scenario and high case scenario. The table presents the following aggregate projected savings under each scenario: low case scenario: $38.5 million, medium case scenario: $48.1 million, and high case scenario: $57.7 million. Board staff notes that HONI's evidence shows considerable savings under all scenarios.

According to the evidence, the following factors, among others, were considered in developing the forecast.

- Contiguity: HONI's service area is contiguous to NPDI's service area and, as a result, HONI expects efficiencies from the proposed transaction through:
  - ability to rationalize local space needs through the elimination or repurposing of duplicate facilities such as service centers. It is HONI's evidence that HONI's plan to move its Dundas Field Business Centre to an existing NPDI facility will allow HONI to leverage the availability of that space and avoid or mitigate the cost for HONI to lease (approximately $60,000 annually), refurbish, or construct required new space;
  - increased efficiency in operating and maintenance work schedules and dispatching of crews over a larger service area. According to HONI, NPDI's direct staff will be transitioned to HONI's Simcoe Operating Centre where they will be part of the resources working within a larger consolidated service area including NPDl's existing service area. HONI's Simcoe Operating Centre is located less than 2 km from the existing NPDI operating centre.
  - efficiency in utilizing work equipment (e.g., trucks and other tools), leading to lower capital replacement needs over time; and
  - rational and efficient planning and development of the distribution system.

- Elimination of redundant administrative and processing functions such as billing, customer care, human resources, and finances.
- Reduction in the number of positions that are currently required to manage and operate NPDI's system. HONI expects to eliminate 30 of the 46 positions currently required to operate NPDI resulting in an expected annual staff savings of approximately $2 million. According to HONI, the Norfolk Power Board of Directors will no longer be necessary resulting in an estimated governance cost savings of $70,000 annually.

- Opportunity to reduce the number of regulatory filings, CDM program administration costs, vehicle fleet and information technology costs, and the use of: external consultants and contractors.
- Ability to offer continued employment within the broader corporation to all affected staff, thereby reducing recruitment, training and development costs and retaining key industry knowledge and expertise.

Considering HONI's evidence relating to the benefits of contiguity and economies of scale, Board staff submits that the proposed transaction can reasonably be expected to result in savings and operational efficiencies. Board staff further submits that should the Board approve the transaction, the Board should require HONI, to file a report with the first rate application that includes costs associated with NPDI's service area, delineating the savings achieved as a result of the proposed transaction. In Board staff's view, this information will be of significant assistance to the Board Panel that will hear that rate application.

Reliability and Quality of Service

It is HONI's evidence that its reliability in its Simcoe Operations area, which consists of the balance of Norfolk County not served by NPDI, is similar to the reliability experienced by NPDI customers. In response to EBN IR No. 10, HONI provided reliability statistics for its feeders within the Norfolk Power area for comparison purposes. It is also HONI's evidence that it can maintain or exceed the current reliability performance by incorporating NPDI into its operating and maintenance program and asset management processes. The "ability to optimize supply to the Village of Delhi" is an example provided by HONI in relation to reliability improvement. HONI specifically stated that "both Hydro One and Norfolk Power own separate 27.6 kV feeders in the area. There is an option to eliminate the radial feed to Delhi, thus improving on reliability". Board staff also notes that HONI plans to retain NPDI's direct staff and transition them to HONI's existing Simcoe Operations Centre to operate as part of the resources working within the expanded service area that includes NPDI's existing service area. As indicated above, HONI's existing Simcoe Operations Centre is located less than 2 km from the existing NPDI operating centre.

Given that HONI's reliability level in its Simcoe Operations area is comparable to NPDI's reliability level and considering HONI's plan to retain the local knowledge by retaining NPDI's direct staff, Board staff submits that HONI can reasonably be expected to maintain the reliability and service level currently provided by NPDI.

Rate Rebasing and Rate Harmonization

Board staff notes that Hydro One has a filed five-year distribution rate application (EB-2013-0416) for rates effective 2015 to 2019. With respect to NPDI's rates, NPDI is seeking a 1% reduction in rates from its 2012 base delivery rates for a period of 5 years from the closing date of the proposed transaction (the "Proposed 1% Rate Reduction"). At the end of the five years, HONI intends to apply under the Board's Incentive Regulation Mechanism to adjust NPDI's rates. HONI seeks to defer rebasing of the consolidated entity until 2020 rates. Board staff submits that the timing of HONI's rebasing proposal is consistent with the 2007 Report referenced above.

With respect to the Proposed 1% Rate Reduction, Board staff notes that HONI's evidence indicates that the cost of the Proposed 1% Rate Reduction will be covered by the synergies associated with the proposed transaction and will not be funded by rate payers. Board staff, therefore, has no objection in this regard.

With respect to rate harmonization, HONI indicated that it will not pursue any form of rate harmonization until 2020. Specifically, HONI's amended evidence indicates that at the time of rebasing (in 2020) HONI may propose to: (i) create new acquired customer rate classes; (ii) move acquired customers to an appropriate HONI rate class existing at that time; or, (iii) some other option. Consistent with the 2007 Report, Board staff submits that the issue of rate harmonization is better examined at the time of rebasing as this is when the consolidated entity would apply for its combined revenue requirement. Board staff submits that in that rates proceeding, specifics of any proposed rate harmonization plan or any other rate proposal from HONI can be fully explored on a record which contains all of the requisite detail.

Transaction Cost

According to HONI, the costs associated with the transactions are estimated to be in the range of $2.5 to $4 million and the cost of the Proposed 1% Rate Reduction is approximately $490,000. It is HONI's evidence that the costs associated with the transactions, including the cost of the Proposed 1% Rate Reduction, will not be funded by ratepayers (i.e. financed through productivity gains associated with the transaction). Board staff submits that should the Board approve the transaction, the Board should explicitly state that it is relying on its understanding of HONI's evidence that HONI (or any other party acting under its direction or control) will not in the future make an application to recover costs arising from the transaction or the Proposed 1% Rate Reduction. Further, Board staff submits that the Board should require HONI to file a report with the first rate application that includes costs associated with NPDI's service area, delineating the actual costs incurred in connection with the proposed transaction. Again, in Board staff's view, this information will be of significant assistance to the Board Panel that will hear that rate application.

US GAAP

HONI requests approval to utilize USGAAP for accounting purposes in relation to NPDI. The evidence indicates that NPDI is proposing to continue NPDI's base rates as set under MIFRS in 2012 for the next 5 years, with a 1% reduction to base rates.

Board staff does not support HONI's request for the use of US GAAP for NPDI for regulatory purposes at this time. Board staff submits that NPDI's regulatory reporting and filing should be consistent with the regulatory accounting basis used to set NPDI's most recent base rates (i.e. MIFRS). This is consistent with the approach adopted by the Board in its July 17, 2012 letter to distributors on regulatory accounting direction in which the Board stated as follows:

> For those distributors that have transitioned to IFRS or whose rates are set based on MIFRS, the Board expects these distributors to conduct regulatory accounting and reporting for 2012 in MIFRS.

Board staff notes that the Board does not prescribe financial reporting for regulated utilities.

Conclusion

Board staff concludes that the evidence in this proceeding reasonably demonstrates that the proposed transaction meets the no-harm test as currently established by the Board. Accordingly, Board staff submits that the application should be approved subject to the following condition:

HONI shall file a report with the first rate application that includes costs associated with NPDI's service area with the Board, delineating:

a. the savings achieved as a result of the proposed transaction; and
b. the actual costs incurred in connection with the proposed transaction.

All of which is respectfully submitted.