EB-2013-0116

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 Cambridge North Dumfries 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 May 1, 2014

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

May 12 , 2014

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1 INTRODUCTION AND SUMMARY

1.1 *Introduction*

1.1.1 On October 1, 2013 Cambridge and North Dumfries Hydro Inc. filed an Application for new distribution rates, effective May 1, 2014. The process included extensive interrogatories, a technical conference, and an ADR that was successful in reaching settlement on many 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 headings of the unsettled issues.

1.2 *Context*

1.2.1 The Applicant is a utility that is doing a lot of things right:

- ***(a)*** The board of directors brought in top senior executives from other LDCs to lead the company.
- ***(b)*** New management then proceeded in a thoughtful and organized way to ask the question "How can we do this better?"
- ***(c)*** Many new initiatives were identified and are being implemented.

1.2.2 This is all happening within the context of a utility that was already better than average in its productivity relative to other LDCs. Overall costs in 2012, for example, were about a million dollars lower than the predicted level using the Board's econometric model[1].

1.2.3 Further, even with the rates now proposed by the Applicant for 2014 (after the impact of the Settlement), distribution bills would not be wildly out of line compared to the Applicant's natural peers. We have attached as Schedule A to this Final Argument a table showing typical 2014 distribution bills for Cambridge and its peers. All of the information is from the Board's web site.

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[1] As of the period ended in 2012, actual costs average 7% below predicted costs on the Board's model: Tr.1:155.

1.2.4 What our comparison shows is that Cambridge is proposing to go from low cost to average in residential, but remain below average in cost for GS<50. Unfortunately, the cost increases in the Application would move this utility from average to well above average in cost for GS>50 customers (such as most schools).

1.2.5 This context influences SEC's view of the Application, and we believe it should influence the Board's view as well. Utilities that are looking to the future, and seeking to implement improvements that will benefit ratepayers over the long term, should be encouraged to do so.

1.2.6 On the other hand, good is not perfect. An LDC can be moving in the right direction, but still not doing it in the best way, or on the right pace, or with the appropriate level of current costs relative to the customer's preferences. A utility that is a better than average performer doesn't have to become average, or worse. The preferred goal would be for the utility to continue to be a stellar cost performer.

1.2.7 SEC will in these submissions have some criticisms of the spending proposals of the Applicant, and in particular pacing and matching of costs and benefits. Those submissions should not be taken as expressing a negative view of the utility's management, or its strategic direction.

1.3 ***Summary of Submissions***

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

1.3.2 ***OM&A Expenditures.*** SEC has two concerns about the proposed OM&A levels. First, the sudden increase is at a faster pace than is reasonable in the circumstances. Second, the increase is justified by initiatives that will produce benefits during IRM, so that the ratepayers pay for initiatives, but the shareholder reaps the benefits of those investments.

1.3.3 SEC recommends a reduction in OM&A of $1.5 million.

1.3.4 ***Cost of Capital and Interest Revenue.*** Cambridge is caught in an anomaly of the Board's cost of capital methodology. It can maintain much lower debt levels than the Board's deemed equity thickness assumes. This has two results. First, it does not yet need to borrow at current low rates, even though the Board model assumes that they do. This artificially inflates their weighted average interest rate. Second, their cash float is low during periods of capital investment, meaning that the revenues from interest received are lower than would be true under the Board's model.

1.3.5 SEC believes that the company's financing strategy is appropriate, but that Cambridge should not over collect from ratepayers as a result of that strategy. Therefore, we believe that a rate on incremental deemed long term debt of 3.75% should be applied. This reduces the weighted average cost of debt to 4.44%, and revenue requirement by about $400,000.

1.3.6 ***GS>50 Fixed Charge.*** SEC agrees with Board Staff and Energy Probe that the fixed charge for this class should remain at $109.35.

1.3.7 ***Removal Costs.*** SEC agrees that Board Staff's argument on this point – both as it relates to Account 1576 and the 2014 Test Year - is technically correct. With respect to Account 1576, we agree with their position, consistent with VECC and Energy Probe.

1.3.8 However, with respect to the 2014 Test Year, SEC believes it is appropriate for Cambridge to expense removal costs. The company will move to IFRS at some point in the near future, and will have to commence expensing these costs. Given the IRM term, it would appear to us that allowing them to commence expensing these costs now is the most efficient approach. We do support Board Staff's proposal to use the average forecast for the five years, due to the volatile nature of these costs.

2 OM&A EXPENDITURES

2.1 *The Issue*

2.1.1 SEC has two problems with the proposed OM&A budget.

2.1.2 First, the overall increase in both the budget and the FTEs is too high.

2.1.3 Second, the Applicant is (quite wisely) investing in future productivity, but is loading that investment into its rebasing year, resulting in the ratepayers bearing the cost, but the shareholder reaping the benefits.

2.2 *Overall OM&A and FTE Levels*

2.2.1 SEC had the benefit of seeing the Board Staff submissions last week, and drafts of the Energy Probe and VECC submissions on the weekend. All three do useful analyses of the trends in OM&A for this utility over the last several years, and the appropriateness of the proposed levels in the Test Year. In particular, we note the OM&A per Customer table provided by Energy Probe at page 11 of their Final Argument, and the FTE Growth table at page 10 of that same argument.

2.2.2 In keeping with our analysis of the context in Section 1.2 of this Final Argument, SEC believes that the Board should provide a net budget increase to Cambridge. The question is how much. That question can be answered in part by looking at the components of the budget, but it must also be viewed from an objective standpoint, i.e. what is a reasonable overall level.

2.2.3 In this regard, SEC offers a simple analogy. Most residents of Toronto would agree that several new subways would be a great addition to the city, and would improve living standards for many people. If you just stop there, it should be pretty easy to get a consensus.

2.2.4 Of course, you can't stop there. You have to pay for it. If the proposal to build several new subways included a 15% increase in property taxes, how quickly would that consensus evaporate?

2.2.5 For the average person, deciding whether to spend on something that is clearly beneficial is externally limited by the practical realities of one's overall spending levels. Even if the money is available (through loans, credit cards, etc.) and the spending is beneficial, there is a level past which spending on "good things" is no longer a good idea.

2.2.6 The evidence of the Applicant focuses on the benefits of their spending proposals, and for the most part we agree that their proposals are "good things". The level of spending is not unlimited, however, so the Board has to make a determination as to the reasonable total OM&A for a utility in the situation of this Applicant.

2.2.7 We think that the analyses of Energy Probe and VECC provide useful approaches that the Board can use to consider what overall level is appropriate. To those analyses, SEC will add another approach: dollar excess over inflation and growth.

2.2.8 Basically, we take the actual amount needed in OM&A to run the utility in 2010, $10,105,460 (excluding properly taxes)[2], and escalate it by both inflation and growth, less productivity (0.72%) and stretch (0.40% for 2011, 2012, and 2013, and 0.3% for 2014). The resulting escalation over four years is 10.68%, or a compound annual rate of 2.57% per year[3].

2.2.9 All other things being equal, a reasonable budget for 2014 that takes into account inflation, customer growth, productivity, and the impact of IRM would be $11,185,295, i.e. 10.68% greater than 2010 actuals.

2.2.10 SEC agrees that an uplift to this is reasonable in light of the utility's past better than average performance, and their strategic direction.

2.2.11 There is no magic to the amount. It is a judgment call on the part of the Board. In our submission, an uplift in the range of 10-15% would be reasonable. That would result in an OM&A budget for the Test Year, excluding property taxes, and calculated on an Old CGAAP basis, of $12.3 million to $12.9 million. This means a reduction, compared to the proposed OM&A budget of $14.4 million[4] on an Old CGAAP basis, of $1.5 million to $2.1 million.

2.2.12 SEC therefore recommends a reduction in the OM&A component of revenue requirement of $1.5 million.

2.3 ***Assymetrical Productivity Investments***

2.3.1 Both Board Staff and Energy Probe have discussed the fact that the Test Year revenue requirement includes spending for productivity initiatives that will pay off in the future.

2.3.2 SEC carried out an extensive cross-examination on this question[5], and time and again

[2] K1.3, p. 16
[3] Customer growth is 1.80%, 1.07%, 1.84% and 1.84% for the four years, and inflation is 2.30%, 1.90%, 1.50% and 1.70%, i.e. the Board's figures. We note that this calculation was original provided to us by Energy Probe, but we have confirmed its accuracy.
[4] K1.3, p. 16.
[5] For example, Tr.1:138-154,

the Applicant's witnesses admitted that spending today was going to produce material savings down the line. In each case, though, they said that they were not including the benefits of those savings in revenue requirement, because it was premature or because the benefits are hard to estimate.

2.3.3 SEC believes that the purpose of IRM is to incent utilities to invest in productivity, knowing that they will benefit from that investment during the IRM period. On rebasing, the benefits are shifted to the ratepayers, subject to any efficiency carryover mechanism employed by the regulator.

2.3.4 In our view, IRM is not effective if the investments are made by the ratepayers as part of the rebasing budget, while the IRM period benefits accrue to the shareholder. This is not the concept, and it is not fair.

2.3.5 We are not, by the way, suggesting that Test Year OM&A should not include ANY amounts for productivity initiatives. In the normal course, and with or without IRM, utilities should be spending on productivity initiatives every year.

2.3.6 This is about pacing. If the Test Year loads up productivity spending – whether capital or operating – on a pattern dissimilar from past years, then the ratepayers are bearing a disproportionate share of the costs to achieve productivity, but not getting a similar share of the benefits.

2.3.7 SEC is concerned that, if the OM&A budget of the Applicant is allowed to stand, other LDCs will read that as a message from the Board that this mismatch between ratepayers bearing productivity costs, but shareholders getting the IRM benefits, is OK.

2.3.8 We do not propose an additional reduction in OM&A to reflect this issue. In our view, the $1.5 million reduction we have proposed above provides a reasonable EXTRA increase in OM&A, and thus asks the ratepayers to pay their fair share of the Applicant's productivity spending. The Applicant should then continue to invest during IRM.

2.3.9 We note in passing that this would probably be the perfect case for Custom IR. The Custom IR concept allows utilities to identify spending, and the benefits of spending, that do not match the "business as usual" paradigm of most rate-setting. If a utility wants the ratepayers to pay the cost of productivity initiatives, Custom IR would allow the utility to forecast and deliver the benefits of those initiatives to the ratepayers as well.

3 COST OF CAPITAL AND OTHER REVENUES

3.1 *Issue*

3.1.1 This Application brings into focus an anomaly in the way the Board calculates revenue requirement relating to cost of capital.

3.1.2 Because the Board deems a particular capital structure, the amount collected in rates does not have to be the same as the actual cost of capital. The utility is free to finance its assets and working capital in any reasonable and prudent way, and any difference between the deemed cost of capital and the actual cost is for account of the shareholder. This is intended to protect the ratepayers, and in many cases utilities underleverage, resulting in a lower financial ROE than their allowed ROE.

3.1.3 The problem is that two parts of this equation are not done on a deemed basis. The rate deemed paid for long term debt is the weighted average actual interest rate paid. Further, the interest income included as an offset to revenue requirement is based on actual forecast interest received, not the amount that would have been received if the deemed capital structure had been employed.

3.1.4 In this case, these parts of the calculation that use actuals would, if not corrected, result in the Applicant collecting more than its reasonable and prudent costs of capital on either a deemed or an actual basis.

3.1.5 There are two parts to this. The actual interest rate is too high based on the deemed debt. The interest income is too low relative to the deemed capital structure.

3.2 *Cost of Long Term Debt*

3.2.1 The details of this are well described in Energy Probe's Final Argument. Cambridge is underleveraged. In a period of high capital spending, and declining interest rates for long term debt, the result is that the utility does not borrow at current low interest rates. The Board's model assumes that Cambridge does borrow for its capital needs, but not at current interest rates.

3.2.2 The effect of this is that Cambridge assumes it pays 4.96% on its deemed long term debt. Current interest rates are 3.75%. Therefore, even if one assumes that the old debt remains in place at higher interest rates, the new debt would, if the Board's deemed debt level were actually followed, be at 3.75%, and the weighted average cost of debt would be 4.44%.

3.2.3 SEC does not oppose Cambridge's strategy of financing internally for a short period of time, until debt needs reach a sufficient level that low cost external financing can be sourced. While we agree with Energy Probe that management is taking a risk on interest rates, it is not sufficiently obvious to us that this is wrong for us to recommend it be treated as imprudent.

3.2.4 However, we do not believe that a result that assumes they have borrowed this year, and at 4.96%, is a reasonable one. In our view, rates are supposed to be "just and reasonable", and this means, according to the courts, that in a cost of service application the costs must be just and reasonable. If the Board model assumes that a material amount of current debt has been borrowed at higher past interest rates, this is not just and reasonable.

3.2.5 It is therefore submitted that the just and reasonable result is to assume the deemed debt, but assume for calculation purposes that the incremental deemed debt is borrowed at prevailing interest rates, not higher past interest rates. This would reduce revenue requirement by about $400,000.

3.3 ***Interest Revenue***

3.3.1 One impact of financing at the deemed levels, for a utility like Cambridge, would be much higher levels of free cash available to earn interest. This could aveage several million dollars during the Test Year, at an effective interest rate of 1.3%.

3.3.2 As much as we would like to propose that the incremental cash that would result from the deemed debt model was actually being invested, that would appear to us to be a step too far. This is, in our view, a more complex problem, involving things like whether the working capital levels of LDCs are too high (i.e. they don't actually need that much cash on hand), and how the Board's deemed cost of capital model should be applied in practice. SEC believes that the Board should deal with these issues in its next cost of capital review, expected to commence later this year.

4 GS>50 FIXED CHARGE

4.1 *SEC Position*

4.1.1 SEC has reviewed the submissions of Board Staff and Energy Probe, and agrees with both that the fixed charge for GS>50, which is already in excess of the Board's policy guideline, should remain at its current level of $109.35, rather than moving further offside relative to the maximum.

5 REMOVAL COSTS

5.1 *Two Issues*

5.1.1 The two related issues here both revolve around accounting for the cost to remove old assets, either at the end of their useful life, or when they have to be removed before their time.

5.1.2 However, the regulatory issues that arise are different in the two cases.

5.1.3 The first issue is how to account for those costs in 2014 and beyond. That issue is about the application of either Old CGAAP, or IFRS, in 2014, when the Applicant will not move to IFRS until 2015.

5.1.4 The second issue is whether the impact of Cambridge changing in 2012 from adding removal costs to rate base, to charging those costs to operations, should be reflected in Account 1576. That is about whether the Board authorized such an accounting change at the time. If it did not, then going back and capturing those additional operating costs and charging them to ratepayers now would be retroactive ratemaking.

5.2 *Test Year Accounting*

5.2.1 Board Staff argues that, since Cambridge is not implementing IFRS until 2015, they should continue to apply Old CGAAP in 2014, and should do so consistent with the Accounting Procedures Handbook. This means that, instead of charging removal costs to depreciation expense under IFRS, increasing revenue requirement dollar for dollar, the utility charges them to Accumulated Depreciation, affectively adding them to rate base.

5.2.2 SEC does not agree. Cambridge plans to move to IFRS in 2015, and at that time will have to start charging these costs to operating expenses. It will also have to restate its previous year, 2014. The likely result will be that an amount will accumulate over the next five years, to be charged to ratepayers on their subsequent rebasing.

5.2.3 We believe that the Board should take a pragmatic approach, allowing the Applicant to move to this accounting treatment a year early. While this will increase revenue requirement for 2014, it will alleviate a potential buildup of regulatory assets. Further, if Cambridge moves to IFRS in 2015 as planned, the result (once 2014 is restated) is that the financial and accounting records will match.

5.2.4 Board Staff did make a second suggestion, with which SEC agrees. Board Staff noted that removal costs are quite volatile, and while forecast removal costs for 2014 are $716,449, the average for the years 2014-2018 is $472,884. They suggested that the amount to be included in 2014 should be the forecast average over the five year IRM period.

5.2.5 SEC agrees. While our proposal is that this amount, $472,884, should be included in depreciation expense for the Test Year, rather than in rate base, the concept is the same. In fact, it is more common for the Board to use IRM averaging for volatile operating expenses than for volatile additions to rate base.

5.2.6 Therefore, SEC proposes that the 2014 provision for removal costs be reduced from $716,449 to $472,884, but should be included in depreciation expense rather than in rate base.

5.3 ***Account 1576***

5.3.1 In our view, the issue of inclusion of this adjustment since 2012 in Account 1576 is the simpler question. In its letter of July 17, 2012, the Board was clear that it was authorizing changes in depreciation rates and capitalization of overheads to match IFRS treatment. The Board did not authorize changes in the capitalization of removal costs, although it was aware that IFRS would require different treatment than CGAAP. In the same way, the Board did not authorize establishment of AROs or changes in pension accruals, or many other potential IFRS changes. Any utility could seek an accounting order authorizing a change, but there was no blanket approval.

5.3.2 Cambridge made the change without Board approval, and without any applicable deferral or variance account. As a result, it added about a million dollars to operating costs in 2012 and 2013, which amount was not included in the Board-approved rates. The effect was a reduction in rate base as of January 1, 2014 by a like amount.

5.3.3 In our submission, allowing the Applicant to recover past cost increases resulting from an accounting change that was not approved by the Board would be retroactive ratemaking. Whether or not it was a wise choice to make, or the Board would have approved it had the utility asked at the time, is completely irrelevant. In our view, it would be unwise for the Board to open up the retroactive ratemaking door. Utilities should not be allowed to reach back into their IRM period to capture costs that were not included in rates and not covered by any deferral or variance account.

5.3.4 SEC therefore agrees with Board Staff that these amounts should not be included in the calculation of Account 1576. Thankfully, this will not produce a net loss to the utility, because they have confirmed[6] that they can restate their PP&E to include these amounts as if added to rate base at the time. This is, in our submission, the appropriate result.

[6] Tr. 1:113.

6 OTHER MATTERS

6.1 *Costs*

6.1.1 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.

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Jay Shepherd
Counsel for the School Energy Coalition

Comparison of Monthly Distribution Bills - 2014 Rates

Component	*Vol.*	*Cambridge [1]*	*Kitchener [2]*	*Guelph [3]*	*Waterloo [3]*	*Horizon [3]*	*Oakville [4]*	*Burlington [5]*	*Milton [3]*	*Halton Hills [3]*	*Comparator Average*	*Cambridge/ Comparators*
Residential	800											
Monthly Charge		$13.32	$10.50	$14.30	$15.00	$14.92	$14.42	$11.88	$15.21	$12.52	$13.59	
Volumetric		$12.96	$12.96	$13.92	$15.20	$11.76	$12.56	$12.88	$11.36	$9.44	$12.51	
Total		$26.28	$23.46	$28.22	$30.20	$26.68	$26.98	$24.76	$26.57	$21.96	$26.10	0.68%
GS<50	2000											
Monthly Charge		$18.48	$25.76	$15.37	$31.55	$33.21	$34.71	$24.77	$16.19	$27.08	$26.08	
Volumetric		$25.80	$24.80	$25.80	$28.20	$17.20	$30.60	$26.60	$34.40	$16.80	$25.55	
Total		$44.28	$50.56	$41.17	$59.75	$50.41	$65.31	$51.37	$50.59	$43.88	$51.63	-14.24%
GS>50	250											
Monthly Charge		$126.44	$170.00	$166.66	$117.85	$302.77	$118.45	$57.90	$76.87	$76.28	$135.85	
Volumetric		$1,060.73	$1,105.00	$635.50	$1,169.68	$525.03	$1,158.00	$725.55	$640.33	$850.40	$851.18	
Total		$1,187.17	$1,275.00	$802.16	$1,287.53	$827.80	$1,276.45	$783.45	$717.20	$926.68	$987.03	20.28%

Sources

1. ***2.1-SEC-15***
2. ***EB-2013-0147 Revised Draft Rate Order Filed April 21, 2014***
3. ***Board Approved 2014 Rate Orders***
4. ***EB-2013-0159 Settlement Agreement Filed April 17, 2014***
5. ***EB-2013-0115 Settlement Agreement Filed April 28, 2014***