VINCENT J. DEROSE
T 613.787.3589
vderose@blg.com

Borden Ladner Gervais LLP
World Exchange Plaza
100 Queen St, Suite 1300
Ottawa, ON, Canada K1P 1J9
T 613.237.5160
F 613.230.8842
blg.com

Borden Ladner Gervais

By electronic filing

October 15, 2014

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

Dear Ms Walli,

Hydro One Networks Inc. ("Hydro One") 2015 to 2019 Distribution Application	
Board File No.:	**EB-2013-0416**
Our File No.:	**339583-000171**

Please find enclosed the Written Argument of Canadian Manufacturers & Exporters ("CME") in the above-noted proceeding.

Yours very truly,

Vincent J. DeRose

enclosure
c. Susan Frank and Erin Henderson (Hydro One)
Intervenors EB-2013-0416
Paul Clipsham and Ian Shaw (CME)

OTT01: 6589716: v1

EB-2013-0416

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

AND IN THE MATTER OF an application filed by Hydro One Networks Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective January 1, 2015, each year to December 13, 2019.

ARGUMENT OF
CANADIAN MANUFACTURERS & EXPORTERS ("CME")

October 15, 2014

Peter C.P. Thompson, Q.C.
Vincent J. DeRose
Emma Blanchard
Borden Ladner Gervais LLP
World Exchange Plaza
100 Queen Street
Suite 1300
Ottawa, ON K1P 1J9

Counsel for CME

INDEX

1. INTRODUCTION

1. Hydro One Networks Inc. ("**HONI**") has proposed a rate-setting framework for the 5 year period commencing January 1, 2015. Its proposal is based on forecast revenue requirements for each of the years 2015 to 2019. HONI is seeking approval for revenue requirements of $1,415 million in 2015, $1,523 million in 2016, $1,578 million in 2017, $1,615 million in 2018 and $1,660 million in 2019. When compared to the 2011 revenue requirement approved by the Board in HONI's 2010 and 2011 rate application (EB-2009-0096), which resulted in the approval of a revenue requirement of $1,148.9, these represent very significant increases.

2. While HONI states that its application is submitted under the Custom Incentive Regulation ("**Custom IR**") rate setting option established by the Board in the 2012 Renewed Regulatory Framework for Electricity Distributors ("**RRFE**"), it characterizes its Custom IR application as a "Custom Cost of Service" application.

3. The Board has recognized the limitations of the cost of service approach to rate setting in terms of incenting companies to continuously seek efficiencies in their businesses.[1] These shortcomings have operated as a catalyst driving the evolution of alternative approaches to rate setting now reflected in the RRFE which are performance and incentive-based. The result is a regulatory compact with a stronger market-like paradigm that imposes additional productivity and efficiency expectations on the company.[2]

4. We submit that HONI's characterization of its application is inherently contradictory and reflects a refusal to accept the principal which is at the core of the RRFE being the need to shift the focus of rate regulation from utility cost to value for customers. This can only be accomplished by creating incentives for the implementation of sustainable efficiency improvements and structuring rates to ensure that ratepayers share the benefits of these efficiencies.

---

[1] Natural Gas Regulation in Ontario: A Renewed Policy Framework on the Ontario Energy Board Natural Gas Forum, March 30, 2005 at p.18.

[2] Board Staff Submissions at p.15.

5. An effective incentive mechanism is one which rewards utilities who perform to a level which meets or exceeds best in class standards or benchmarks used in the derivation of incentive-based rates and which ensures that rewards do not flow to utilities that fail to meet such standards or benchmarks.

6. At a high level, we submit that HONI's proposed framework is deficient because a number of essential components of any Custom IR plan are absent:

(i) First, HONI has not provided robust benchmarking that the Board can rely upon in order to evaluate the reasonableness of the forecasts which underpin the proposed "Custom Cost of Service" application.

(ii) Second, HONI does not propose an annual adjustment mechanism designed to drive efficiencies through a productivity factor and a stretch factor.

(iii) Finally, HONI has not included an Earnings Sharing Mechanism ("**ESM**").

7. The foregoing deficiencies are compounded by HONI's resolution not to strive for improvements in reliability or service levels but instead to continue to perform at the lowest quartile amongst electrical utilities and by HONI's suggestion that it is entitled to reinvest any savings into this fourth quartile performing utility rather than sharing the benefits of any such savings with ratepayers.[3]

8. In our submission, the cumulative effect of HONI's selective approach to Custom IR places the ratepayers at a significant risk which warrants intervention by the Board. As a result, in these submissions we urge the Board to bring HONI's application back into line with the core principles of the RRFE and to refocus the proposed rate regulation framework on value for customers by creating incentives and ratepayer protections in the form of an aggressive stretch factor and an ESM, and by disallowing certain capital expenditures which are demonstrably out of line with both industry practice and with HONI's historical level of investment.

9. In finalizing these submissions, we have greatly benefitted from the detailed submissions provided by Board Staff on October 7, 2014 and from a draft provided to us by the Association of Major Power Consumers in Ontario ("**AMPCO**").

---

[3] Transcript Volume 2 at p.93.

2. THE NEED FOR STRONG EFFICIENCY INCENTIVES UNDER THE RENEWED REGULATORY FRAMEWORK FOR ELECTRICITY

10. We agree with Board Staff that a major shortcoming of HONI's proposed plan is the absence of external productivity and efficiency components comparable to an X factor.[4] This is a common feature of incentive rate setting and a core requirement of all three rate-setting approaches contained in the RRFE Report:

> ***"To ensure that the benefits from greater efficiency are appropriately shared throughout the rate-setting term between the distributor/shareholder and the distributor's customers, the expected benefit will be taken into account in establishing the rate adjustment mechanisms applicable to each rate method through the X factor.*** [5]

11. The inclusion of an annual adjustment mechanism which is decoupled from year-over-year changes in a particular utility's forecast of revenues and costs reflects the "fundamental shift from the historical cost of service regulation"[6] mandated by the Board. It is intended to drive efficiencies and ultimately produce benefits for customers by incenting regulated utilities to adopt approaches similar to those of competitive cost minimizing and profit maximizing companies which plan their expenditures in a manner which will enable them to keep pace with their peers.[7]

12. Far from providing the external inputs fundamental to incentive rate setting, HONI's proposed plan is entirely self-referential. Its proposed pacing and prioritization of capital investments is unsupported by any external benchmarking while the inclusion of "embedded productivity" commitments is the antithesis of the required external productivity and efficiency components.

13. Our submissions regarding the amendments to HONI's proposed regulatory framework which are required to ensure value to customers consistent with the RRFE follow herein.

---

4 Board Staff Submissions at p.8.
5 RRFE at p.12.
6 RRFE p.10.
7 RRFE pp.10 and 11.

2.1. The Need for a Total Factor Productivity Measure

14. As discussed above, an X factor includes both a productivity component and a stretch factor.[8] The productivity component is the external benchmark which all distributors are expected to achieve. It should be derived from objective, data-based analysis that is transparent and replicable. To this end, productivity factors are typically measured using estimates of the Total Factor Productivity ("**TFP**") growth of the regulated industry.[9]

15. HONI has elected not to include a TFP analysis in its application, or any other external evidence supporting a productivity component, that can be relied upon in establishing an X factor. The absence of this information presents a significant challenge to the Board in developing an X factor that can be applied to the HONI application to ensure that the risks and benefits are appropriately shared between the utility and ratepayers over the next 5 years.

16. We agree with Board Staff's recommendation that HONI be ordered to carry out a productivity analysis over the next 5 years which is comparable to that used by the Board to estimate industry productivity. This will establish an empirical baseline for HONI's performance on a going-forward basis, as well as providing an empirical foundation for HONI's next application in 2019.

17. While the requirement for future productivity analysis will address the productivity component of the X factor for 2019 and beyond, it will not address the need to ensure an appropriate sharing of risks and benefits for the years 2015 to 2019. To this end, we are recommending the implementation of an aggressive stretch factor. The appropriateness of imposing a stretch factor on HONI's proposed plan is addressed in detail below.

2.2. Proposed Annual Savings Have Been Exaggerated

18. HONI states that savings "embedded" in its application justify its failure to include an external productivity factor and stretch factor in its proposed rate setting framework.

8 RRFE at p.17.
9 Board Staff Submissions at p.8.

According to HONI, these "embedded" savings total $728.8 Million[10] over the period between 2014 and 2019.

19. We submit that the quantum of savings cited by HONI is overstated and reflects a fundamental misreading of the concept of productivity as it relates to incentive regulation.

20. In the first place, we note that $90.8 Million of the savings identified by HONI relate to 2014 and therefore fall outside the ambit of the application currently before the Board.

21. More significantly, however, we submit that the only savings which are relevant to a productivity analysis are those which are incremental to savings resulting from efficiencies achieved in past years. Put another way, we submit that savings achieved from projects developed and implemented prior to the 5 year term should not be included in the productivity analysis.

22. HONI acknowledges that a large portion of its embedded productivity includes savings that were generated prior to 2015.[11] In point of fact, as indicated by Board Staff, the incremental savings or "greenfield efforts" included in HONI's plan are de minimis[12] compared to savings claimed by HONI which are derived from work previously undertaken.

23. Table 2 at page 13 of the Board Staff Submission sets out the total annual savings claimed by HONI for the years 2015 to 2019, compared to the incremental or new savings for each of those years. That table demonstrates that while HONI is claiming annual savings of $638M for the years 2015 to 2019, only $40.8M of those claimed savings are incremental to savings from continuous improvements launched or achieved prior to 2015. In addition, the amount of incremental savings declines over the 5 year period such that the forecast incremental savings for 2019 is only $200,000.00.

24. When determining whether to impose a stretch factor, and if so, the appropriate stretch factor to apply, we urge the Board to confirm that the productivity savings embedded in HONI's forecast are $40.8M (as set out by Board Staff) and not the

10 Table 2 of Exhibit A, Tab 19, Schedule 1.
11 Transcript Volume 4, p.15.
12 Board Staff Submissions at p.13.

amounts described by HONI which have been overstated as a result of the inclusion projects developed and implemented prior to the 5 year term.

2.3. The Need for a Stretch Factor

25. HONI argues that the savings they have identified in their application, in terms of productivity, substitute for an X factor and provide for adequate sharing of risks and benefits[13]. With respect, we disagree.

26. As set out above, the annual savings that HONI has built into its forecast costs are almost entirely driven by efficiencies which have been implemented and achieved in years prior to 2015 to 2019. The "embedded productivity" contained in HONI's forecasts, which Board Staff has estimated at $40.8M over the 5 year term, does not support a conclusion that HONI will be continuously seeking efficiencies in their business. This is demonstrated most starkly by the fact that the forecast of incremental savings for 2019 are only $200,000.00.

27. In response to Board Staff Interrogatory No. 11[14], HONI took the position that its forecasted productivity savings are "ambitious" and that it does not expect to achieve additional efficiency gains over the 5 year term. We do not view incremental savings of $40.8M over a 5 year period, and in particular, incremental savings as low as $200,000.00 in the last year, as "ambitious productivity savings".

28. We submit that HONI's application exhibits minimal productivity in terms of efficiency savings over the 5 year period and as a result, we support Board Staff's proposal to include a stretch factor.

29. Board Staff has recommended a 1% stretch factor which could either apply to the years 2016 to 2019, or, alternatively, begin to apply immediately in 2015 for the full 5 years of the Plan. We believe that there is no reason why the stretch factor should not apply to all 5 years. For this reason, we urge the Board to impose a stretch factor which commences in 2015 and continues through 2019.

30. While we support Board Staff's proposed stretch factor in principle, we submit that a more aggressive stretch factor is necessary in this case to compensate for the

---

13 Transcript Volume 1, pp.85-86.
14 Exhibit I, Tab 2.02.

absence of an external productivity component which could be derived from external benchmarking or from a TFP analysis. We are therefore recommending that a 2% stretch factor be applied over the five year term of the plan. Based on Board Staff's estimates[15], the impact of a 2% stretch factor for the entire 5 years would be approximately $460Million.

2.4. The Need for an Earnings Sharing Mechanism

31. HONI acknowledged in cross-examination that they heard from customers that they were interested in a potential for earnings sharing. Despite the obligation to consider customer feedback and preferences, HONI has consistently rejected such requests[16]. We submit that, particularly in the absence of meaningful benchmarking, the Board should require HONI to implement an ESM.

32. HONI's position is that an ESM is not required because:

- HONI's smoothing proposal is an alternative to an ESM;
- HONI has a history of under-earning, and therefore, the ESM is unnecessary[17]; and
- The ESM is a complicated calculation that HONI should not have to undertake.

33. We submit that none of the above constitutes reasonable grounds for the Board to reject the application of an ESM to HONI's proposed rate setting framework. We address each of HONI's stated objections to the imposition of an ESM as follows:

(a) Rate Smoothing and ESM are Not Incompatible

34. In cross examination HONI confirmed that its smoothing proposal is a mitigation tool[18]. Such a mitigation tool does not replace the protection afforded to ratepayers from an ESM.

35. We submit that rate smoothing and an ESM are not mutually exclusive. Their respective purposes are completely different. Rate smoothing is a mechanism that the

---

15 Board Staff Submissions at p.20.
16 Transcript Volume 2, p.92.
17 Transcript Volume 2, p.90.
18 Transcript Volume 2, p.91.

Board uses to maintain rate stability, or to manage rate shock that can occur from very large one-time rate increases. An ESM, on the other hand, is a mechanism that the Board uses to ensure that productivity or efficiency gains, which result in over-earnings by the utility, are appropriately shared with ratepayers.

(b) Historic Under-earning Reflects A Policy of Reinvesting Efficiency Savings and Should Not Preclude ESM

36. According to HONI, because it has not demonstrated a historic problem of overearning in the distribution business, they should not be required to implement an ESM.[19] While we acknowledge that historically there have been no overearnings in HONI's distribution business,[20] we submit that rather than reflecting an inability to develop efficiencies, this results from HONI's stated policy of redirecting efficiency savings into additional work.[21]

37. In our submission, a policy of applying efficiency savings to increase the pace of capital projects is incompatible with a regulatory framework which requires applicants to submit for approval by the Board forecasted capital expenditures supported by detailed planning of capital spending. The pace of capital spending which is ultimately approved by this Board should be maintained and all gains should be immediately shared with ratepayers.

38. Our concerns about the proposed reinvestment of efficiency savings were echoed by the Board during the oral hearing of HONI's application:

> ***MS. HARE: I have a few questions, all in areas that have been well-explored by the other parties, but the first area I want to ask about is this whole issue of reinvesting savings from any productivity achievements versus earnings sharing.***
>
> ***I appreciate, Ms. Frank, that you have given us cautions about, the probability of overearning due to productivity is very low, given your past history, but nevertheless, what I am trying to understand is, given that you put forward budgets for OM&A and capital that are needed to maintain system reliability and to improve customer***

19 Transcript Volume 2, p.93.
20 Exhibit 1, Tab 6.03, Schedule 6.
21 Transcript Volume 2, p.91.

> ***service, you've already included enough money to do that. So why do you think, because there's extra money, that reinvesting is a good thing, as opposed to – you've obviously prioritized your projects. I know there is always lots of work to do. But those projects presumably could have waited till years 2 or 3 or 4, and you're moving them up because you would theoretically have the extra money.*** [22]

39. We submit that HONI should not be permitted to "re-invest savings." Any other finding would permit HONI to unilaterally accelerate the pace of its capital spending regardless of this Board's decision. All efficiencies should result in earnings sharing rather than an acceleration of capital spending.

(c) Difficulties Associated with ESM Calculations

40. HONI has raised concerns about the complexity of calculating the ESM. HONI's position is that an ESM should be rejected because it will take more effort and cost to measure, and as a result also introduces the potential for disagreement on how it is measured.[23]

41. HONI confirmed, however, that an ESM calculation could be undertaken. The description of how an earnings sharing mechanism could be done, if required by the Board, is set out at Undertaking J2.4.

42. As the Board has recognized in the recent Enbridge Gas Distribution Inc. ("**EGD**") Multi-year Custom IR Plan proceeding (EB-2012-0459), an ESM is a tool which provides for benefit sharing between ratepayers and shareholders if the company earns more than its allowed return during the IR term. We submit that an ESM in a form similar to that approved by the Board for EGD should be imposed on HONI's 5 year plan. Specifically, the ESM should include the following 3 components:

(a) Under-earnings: If HONI's return is less than the allowed ROE ("Return on Equity"), the under-earnings will be borne entirely by HONI's shareholders;

---

22 Transcript Volume 2, pp.113-114.

23 Transcript Volume 2, p.94.

(b) A "dead-band": If the return is less than 100 basis points above the allowed ROE, then ratepayers receive no benefit and all of the extra earnings will flow to HONI's shareholders; and

(c) A sharing ratio above the "dead-band": If the return is more than 100 basis points above the allowed ROE, the extra earnings will be shared 50/50 between ratepayers and shareholders.

43. An ESM on the above basis will provide a performance incentive to HONI while at the same time ensuring that ratepayers share in the benefits of that performance. This is particularly the case if the Board accepts our position that HONI should not be permitted to "re-invest" efficiency gains in further capital spending. The model of the ESM which the Board approved for EGD would achieve this goal..

2.5. Adjustments to Plan

44. HONI is proposing three categories of adjustments which it states are intended to protect it and its customers against "unexpected results in the operation of the plan.[24]" While we believe that the absence of an X factor constitutes a significant deficiency in HONI's plan, we are generally in agreement with the other annual adjustments proposed and with the proposed materiality threshold for unforeseeable events (the "**Z-Factor**"), the only exception being that we share Board Staff's concern that the proposed customization of "off-ramps" unduly alters the risk sharing between HONI and its customers.[25]

2.5.1. Annual Adjustments

45. We have reviewed the annual plan adjustments proposed by HONI together with Board Staff's recommendations in this regard. Our comments on these adjustments follow.

Cost of Capital

46. Under the Board's most recent Cost of Capital parameters, an annual update to HONI's Cost of Capital, for each of the 5 years of the proposed Plan, is appropriate. In

[24] Exhibit A, Tab 4, Sch. 1, p.3.
[25] Board Staff Submissions, p.21.

arriving at this conclusion, we have taken guidance from the fact that the Board has recently approved an annual update to Cost of Capital for Enbridge Gas Distribution Inc. in its 2014 to 2018 Rate Application (EB-2012-0459). In the interests of consistency, we do not oppose a similar approval being issued for HONI.

Working Capital

47. We have reviewed Board Staff's Submissions on Working Capital. Board Staff has recommended that the Working Capital allowance be fixed in 2015 for the entire 5 year term of the Plan. The basis for this recommendation is that reasonable forecasts can be made of the commodity costs and, as such, there is no reason to add additional complexity to this Plan through an annual update of the Working Capital. In the interests of avoiding unnecessary complexity, we adopt Board Staff's recommendations regarding Working Capital.

Clearance of Variance Accounts

48. We agree with Board Staff's recommendation that the RSVA, the 2014 Smart Grid Account, the Tax Rate Changes Account, and the Pension Cost Differential Account be cleared annually in order to avoid the accumulation of large balances that would need to be cleared at the end of the 5 year Plan, and which, in turn, could cause rate instability.

2.5.2. Off-Ramps

49. Board Staff have recommended that the Board not approve HONI's request to add two additional off-ramps for industry re-structuring or major changes to HONI's service territory. We agree that the Board's existing policies, and in particular, the provision of a mechanism for a regulatory review to be initiated if a distributor performs outside of a 300 basis points earnings dead-band or its performance erodes to unacceptable levels, will provide sufficient protection for HONI and that the proposed customization of off-ramps unduly alters the allocation of risk as between the company and the ratepayers established in the RRFE.

2.5.3. Regulatory Treatment of Unforeseen Events

50. HONI has requested that the Board approve a higher materiality threshold for the regulatory treatment of unforeseen events. As Board Staff points out[26], the higher materiality threshold will result in the transfer of risks from customers to the company, and also brings the threshold in line with the materiality's threshold of 0.5% that applies to a significant portion of Ontario's distributors with revenues greater than $10M. For these reasons, we support HONI's proposed regulatory treatment for unforeseen events.

2.6. Benchmarking

51. Undertaking a meaningful comparison with other utility companies through benchmarking is critical to providing the Board with a basis for assessing the reasonableness of forecasts underpinning a Custom IR application.[27] It also provides a useful tool for directing continuous improvement in distributor performance by assisting the Board in assessing distributor investment plans and in determining appropriate cost levels in rates associated with those plans.[28]

52. In the Memorandum of Agreement ("MOA") between HONI and the Province of Ontario, HONI agreed that it would target its performance to be in the top quartile of private and publicly owned utilities in North America. Specifically, subsection 2 of section G, under the heading "Performance Expectations", reads as follows:

> ***G. Performance Expectations:***
>
> ***[...]HOI will annually establish three to five year performance targets for operating and financial results as well as major project execution. Key measures are to be agreed upon with the Minister of Energy and the Minister of Finance. HOI will benchmark its performance on these measures against the performance of other utilities, including international utilities where information is available. On these measures, Hydro One will target performance to be in the top quartile of***

[26] Board Staff Submissions, p.24.
[27] RRFE at p.13.
[28] RRFE at p.60.

> ***private and publicly-owned utilities in North America.*** **[Emphasis added]**[29]

53. HONI has not provided external benchmarking that the Board and ratepayers can rely upon in assessing the reasonableness of its forecasts. Specifically, HONI has not undertaken a total cost benchmarking study, a capital costs benchmarking study or an overall OM&A benchmarking study.[30]

54. When asked what benchmarking studies, if any, HONI is planning to carry out over the five-year term of its proposed plan, HONI confirmed that it does not have any specific plans at this time for benchmarking. Only if the Board ordered that benchmarking occur, would HONI undertake benchmarking.[31] In light of the RRFE, this is not an acceptable position.

55. With respect to the benchmarking requirements set out in the MOA, when asked whether HONI was benchmarking its performance of those measures against other utilities, including international utilities, the witnesses could only offer that HONI participates in various associations such as the Canadian Electric Association and the Edison Electric Association. We submit that participation with such associations does not equate to participation in external benchmarking studies particularly where those associations are no longer undertaking benchmarking within their membership.

56. We submit that HONI's failure to deliver benchmarking evidence in support of its application is unacceptable in light of the RRFE and HONI's commitments under the MOA.

57. In the absence of any total cost or productivity benchmarking supplied by HONI, we submit that the Board should have regard to the benchmarking results contained in the Pacific Economics Group Research, LLC's ("**PEG**") report of July 2011 entitled "Empirical Research in support of Incentive Rate-Setting: 2013 Benchmarking Update".

58. According to the PEG report, HONI is the second least efficient distributor in Ontario. The only distributor that is less efficient than HONI is Algoma Hydro.[32]

---

29 CME Compendium, Exhibit K2.1, Tab 1, p.3.
30 Transcript Volume 1, pp.32-33.
31 Transcript Volume 1, p.91.
32 Transcript Volume 1, p.41.

59. HONI readily acknowledges its poor ranking relative to private and publicly-owned utilities in North America and confirms that it remains in the 4th quartile and has no expectation of improving the reliability for the distribution business over the term of the proposed Custom Cost of Service plan.[33]

60. We agree with Board Staff's submission that HONI should be directed to carry out total cost benchmarking studies, in consultation with stakeholders over the next five years to establish an empirical baseline for HONI's performance and to provide an empirical foundation for HONI's next application.

61. Given the significant increases in the revenue requirement proposed by HONI for the next five years, however, further consequences should flow from HONI's overt refusal to provide information which should form a cornerstone of the Board's oversight of this electricity distributor. We submit that HONI's refusal to undertake benchmarking as required by the RRFE, its poor performance relative to its peers as demonstrated by the PEG report and its willingness to entrench itself at the 4th quartile all provide further justification for the stretch factor which we recommend in Section 2.3 of these Submissions.

3. RATE BASE AND CAPITAL INVESTMENT

62. HONI proposes significant increases in capital spending compared to past years. While percentage increases were not calculated by HONI, in order to demonstrate the order of magnitude of the proposed capital spending increase, both Board Staff and AMPCO have compared historical capital spending over the 2009-2014 period with proposed capital spending over the 2015-2019 for certain key investments[34] including:

(i) **Pole Replacements:** Percentage increase – between 64% and 66% from approximately $323 Million over the historical period to approximately $530Million over the forecast period.

[33] Transcript Volume 1, p.38.
[34] Board Staff Submissions at p.45; AMPCO submissions (final pagination not available at time of drafting).

(ii) **<u>Station Refurbishments:</u>** Percentage Increase - approximately 220% from $63.4 Million over the historical period to $203.3 Million over the forecast period.

63. HONI states that the "extensive capital investment necessary….is the essential factor underlying this application"[35] and that "the primary reason behind any increase in revenue requirement over the test period can be found in the company's capital program."[36]

64. As indicated by HONI's Senior Vice President, Engineering and Construction, these significant increased capital expenditures are not intended to deliver any form of improvement in the reliability which HONI provides to its customers but are justified on the basis of the condition of HONI's assets:

> ***MR. WINTERS: … we do need to increase spend in certain areas in order to keep the reliability at the same levels as they are today, rather than degrade.***
>
> ….
>
> ***MR. WINTERS: … you look at the demographics of our assets and that's really based on age, or it's been of the equipment being at end-of-life and really condition assessment, a combination of those.***
>
> ***And based on the current state of our assets, yes, we need to make these additional investments in order to maintain the current levels of reliability.***

65. Given the foregoing, we submit that it was incumbent on HONI to demonstrate that the that the level of investment which HONI proposes is appropriately aligned with the actual condition of its assets and to provide quantitative information on expected reliability performance in relation to stations interruptions. As indicated by Board Staff[37], the evidence advanced by HONI fails to accomplish either of these objectives.

66. In fact, based on an extensive review of evidence which HONI submitted in EB-2009-0096 together with the evidence in this hearing, AMPCO has demonstrated that

---

[35] HONI Closing Argument, Transcript Volume 8, p.8.
[36] HONI Closing Argument, Transcript Volume 8, p.13.
[37] Board Staff Submissions at pp.42 and 43.

notwithstanding HONI's expectation that the failure trend will increase over the next five years, failure rates are trending lower over the 2004-2008 and the 2009 to 2013 period and interruptions are steadily declining.[38]

67. AMPCO also questions the use of pole age as a proxy for asset condition, noting that there is no justification given for the proposed substantial departure from the asset management approach which HONI applied to pole replacement between 2009 and 2014.[39]

68. The lack of clear evidence demonstrating the need for significant increased capital spending is further compounded by the absence of a third party review of the proposed investment strategy or any benchmarking evidence which would shed light on industry standards or best practices in this area.

69. While we agree with Board Staff's recommendation that HONI be directed to undertake benchmarking relating to lifecycle costs in the industry[40] and that a third party review of the asset investment planning and prioritization process be undertaken and presented as evidence in HONI's next rate hearing, in our submission this is insufficient for the purposes of this application given the magnitude of the proposed spending increases and in the context of a multi-year Custom IR plan.

70. We note that Board Staff indicated that it "considered recommending to the Board the denial of recovery of some of the proposed spending for the poles and stations programs [but that] the record in staff's view is insufficient to allow a recommendation for reduction to be made that is not to some degree arbitrary."[41]

71. In our submission, AMPCO has proposed a reasoned and logical basis for targeted reductions to HONI's proposed capital expenditures. As a result, we adopt recommended methodology contained in AMPCO's submissions, namely:

(i) That an average unit cost of $7,298 /pole (being an average of HONI's unit cost for pole replacements over the period between 2010 and 2014) be applied to an accomplishment level of 11,000 poles (being the

38 AMPCO Submissions (page references not available at time of drafting).
39 AMPCO Submissions (page references not available at time of drafting).
40 Board Staff Submissions at pp.46 and 47.
41 Board Staff Submissions at p.45.

accomplishment level proposed by HONI for 2013 and 2014) resulting in a decrease in capital expenditures of approximately $112 Million (from $503Million to $418 Million); and,

(ii) That the spending on station refurbishments be maintained at the 2014 level reflecting the declining trend in station failures described above resulting in a total reduction in capital spending of $131 Million over the 2015-2019 period.

3.1. Overhead Capitalization Rate

72. We understand that the use of American generally accepted accounting principles ("**US GAAP**") in place of international financial reporting standards ("**IFRS**") was approved by the Board in EB-2011-0399 and as a result we accept that for the purposes of this application, the use of capitalization rates which may only be acceptable under US GAAP is appropriate.

73. Notwithstanding the foregoing, we also submit that in future proceedings it will be important that the Board have before it information which will allow the Board to appreciate any material differences that may result in higher capitalization under US GAAP than under IFRS.

74. We adopt the submission of Board Staff that HONI should be required to include in its next cost based application an additional capitalization study based on IFRS principles which can be read in conjunction with HONI's financial statements in order to highlight any material differences which would result from the preparation of the financial statements under IFRS as opposed to under US GAAP.

4. DISTRIBUTION SYSTEM PLAN

75. Our submissions regarding HONI's distribution system plan as it relates to capital expenditures are contained in Section 3 above. In all other respects, we support Board Staff's recommendations regarding the need for a consolidated plan, the need for greater clarity with respect to the planning and prioritization of capital expenditures, and recommendations for future reporting and filings.

5. OPERATIONS, MAINTENANCE AND ADMINISTRATION COSTS

5.1. Vegetation Management

76. HONI forecasts expenditures in its Vegetation Management Program of $814 Million between 2015 and 2019. This represents a 22% increase over the 2010-2014 expenditure in Vegetation Management of $668 Million.[42]

77. We have had an opportunity to review AMPCO's submissions with respect to this aspect of HONI's application and we agree that the proposed cost increase appears to be founded in poor and declining productivity over time rather than being the result higher unit costs produced by HONI' s current longer clearing cycle and more difficult clearing work as argued by HONI in its closing argument.[43] In support of this position, we would emphasize the following:

- In EB-2009-0096, the Board received a Vegetation Management Study commissioned by HONI and concluded that "vegetation management is one of the areas where expenditure reductions should be achievable" and that "the evidence also suggests that [HONI's] efficiency level for this activity could be enhanced whatever the cycle length." [44]
- A 2012 Vegetation Management Benchmark study (the "**2012 Vegetation Management Study**"), which was provided by HONI in response to an undertaking given during the Oral Hearing, concluded that :
    - [HONI's] cost per tree treated is $83/tree in comparison to the average of $53/tree and the next lowest cost peer company of $73/tree;
    - [HONI's] cost per labour hour for distribution routine maintenance was the highest of all utilities at $86/hr;
    - ...[HONI's] cost per pole mile is 57% higher ($2,026 to $1,290) when adjusted for overhead vs. underground miles ...which implies a cost difference of approximately $44m based on the total overhead pole miles for [HONI];
    - [HONI's] cost per customer is $102, which is nearly 2.5 times greater than the next lowest cost peer company of $44 and significantly higher than the median cost per customer of $16.22; and,

---

[42] J4.9
[43] HONI Closing Argument at pg. 12.
[44] EB-2009-0096 at pg. 19.

- Although [HONI] serves an extensive territory, 69% of lines are accessible by roads or passable terrain, which is equal to the average of the utilities benchmarked in the report*. This implies that the cost disadvantage is not likely a result of more difficult terrain or line locations. [45]

78. In addition to the above, as demonstrated by AMPCO, a review of HONI's unit cost productivity with respect to vegetation management since 2008 demonstrates a decline in HONI's unit cost productivity in this area over time.

79. We agree with AMPCO's submission that the number of interruptions is not the best outcome metric for evaluating productivity with respect to vegetation management and that a unit cost metric is a better determinant of value for money for ratepayers and is more likely to operate as an incentive to improve efficiency.

80. We submit that the results of the 2012 Vegetation Management Study demonstrate that as was the case in 2009, vegetation management remains an area where expenditure reductions should be achievable and where HONI's efficiency level could be enhanced.

81. As a result, we adopt the proposal advanced by AMPCO that the level of vegetation management should not be accelerated to 14,250 km in 2016 and 2017 but rather should be set at the eight year cycle of 12,750km and that a rate of $7,336/km, being an average the unit rate in dollars per kilometer achieved by HONI over the 2009 top 2013 period, should be applied to this forecast.

82. Under AMPCO's proposal, the proposed expenditures for 2015 to 2019 related to vegetation management would be reduced by $72.3M. We submit that in the circumstances described above, this level of reduction is appropriate.

5.2. Compensation and Staffing

83. Compensation costs are one of the central drivers to HONI's overall OM&A costs. As set out at page 54 of Board Staff's Submissions, HONI's total wage increases represent 6.5% over the 5 Year Plan.

---

[45] Exhibit K2.1, CME Compendium – at Tab. 4. Pg. 33. Conclusions of Utility Vegetation Management Benchmark & Industry Intelligence : 2011-2012 Distribution CN Utility Benchmark Survey Analysis Preliminary Report are reproduced at pg. 33 of the KPMG Ministry of Energy Assessment of Organizational and Structural Opportunities at Hydro One, February 28, 2013.

84. This Board has historically been critical of HONI's compensation costs. In EB-2008-0272, the Board stated as follows:

> ***"The Board concludes that it is appropriate to disallow some compensation costs because these costs are substantially above those of other comparable companies and the company has failed to demonstrate that productivity levels off-set the situation."***

85. In EB-2009-0036, the Board went on to observe:

> ***"Hydro One has shown (for the categories presented) that it has controlled wage escalation better than some of the other Ontario Hydro successor companies. However, compensation costs remain excessive in comparison to market indicators. The evidence indicates that Hydro One's main competition for labour comes from within Ontario and the Board regulates most of those other entities. It would be unacceptable for the Board to, in effect, fuel that wage competition by incorporating ever rising wage levels (over and above market-related levels) into rates."***

86. In EB-2010-0002, the Board was again critical of HONI's compensation costs:

> ***"The Board also shares intervenors' concerns that Hydro One's compensation costs are still 17% above the market median and that proposed increases in head counts are excessive. Central to this problem is the lack of any measurable increases in productivity. In its previous decision, the Board indicated that it did not accept that the productivity portion of the Mercer Study could be relied upon. The Board still finds this to be so."***

87. In short, since 2008 three things have remained true: 1) HONI's compensation costs are below the median, 2) the Board has been critical of HONI's excessive compensation costs, and 3) this has resulted in the Board imposing reductions of HONI's OM&A.

88. In this case, HONI has filed an updated Mercer Compensation Study. That study concludes that HONI's total compensation was 10% below the market median in 2013. While this is an improvement from the 2008 Mercer Study that concluded HONI's overall weighted average was 17% off market median, it is still indicative of poor performance

and there continues to be a lack of any measurable increases in productivity. In our submission, HONI should not be rewarded for improving its compensation benchmarking by 7% when it still remains below the median.

89. At Undertaking J3.12, HONI calculated the total amount of compensation that would be payable if it was at the median in 2014. That Undertaking confirms that the distribution OM&A portion of payable is $15.38M, per year, or over market median per year. We urge the Board to reduce HONI's OM&A by this amount for each year of the 5 Year Term in order to bring HONI's compensation costs within the market median. This would result in a reduction of $76.9M over the 5 Year Term.

5.3. Pensions and Other Post-Employment and Post-Retirement Benefits ("OPEBs")

90. We do not take issue with the Pension and OPEP costs for which HONI has requested approval for recovery in this application. As Board Staff observes, these costs are supported under the current policy environment.

91. That said, we remain very concerned about the sustainability of HONI's pension plan. In this regard, we have included the Report on the Sustainability of Electricity Sector Pension Plans to the Minister of Finance dated March 18, 2013 in the CME Compendium at Tab 7 of Exhibit K2.1.

92. The Special Advisor made the following observation at page 20 of that Report:

> ***"However, the plans are far from sustainable: they have a high total cost, volatile/unpredictable contribution rates, have yet to incorporate new actuarial mortality assumptions and no flexibility to absorb the effect of future adverse events."***

93. He then went on to further recommend as follows:

> ***"It is critical that the plans build flexibility into their structure so that they are able to accommodate shocks in the future. Because so much of the pension liability is already accrued, and changes can only affect future service, benefit changes that provide flexibility must be adopted sooner rather than later to have a meaningful impact."***

94. Furthermore, in the "Conclusions and Recommendations" of the Report, the Special Advisor expressly recommended that employer/employee contribution move to the target of 50/50 on an agreed time line. He also observed that the government has suggested 5 years to reach the target which would appear to be a reasonable phase-in period.

95. In light of the fact that HONI's proposed term is 5 years, we believe it is appropriate for the Board to direct that there be detailed reporting, on an annual basis, with respect to the on-going sustainability of HONI's pension plan. HONI should be directed to report on all changes that have a material impact on its pension plan, as well as on-going improvements which either HONI is implementing unilaterally, or, that the government is more broadly directing.

96. In asking the Board to impose this level of reporting, we are cognizant of Board Staff's submission that further investigation of the need for and the types of possible set aside mechanisms is necessary, as well as HONI's suggestion that a generic proceeding would be the appropriate venue for the Board to consider issues around pensions and OPEPs. The fact that these issues may be addressed in a generic policy proceeding is not, in our view, a reason to not direct HONI to provide the annual reporting set out above. If such annual reporting becomes redundant because of a generic policy proceeding, then the Board can order HONI to no longer report on an annual basis at that time.

6. COST ALLOCATION AND RATE DESIGN

97. Subject to comments on possible rate shock, set out below, we do not take issue with HONI's review of its customer rate classification to ensure that all customers were properly classified in accordance with its Board approved density-based rate classes or with its rate class reclassification policy.

98. With respect to cost allocation and revenue to cost ratios, we also acknowledge that HONI's current proposal is a significant move to aligning all revenue to cost ratios. In principle, this is something that HONI should continue to move towards.

99. That said, we are concerned that the overall changes to cost allocation and rate design, largely driven by the changes in revenue to cost ratios, will result in very large increases to a number of customers.

100. For this reason, we support Board Staff's recommendation to phase-in the larger increases in revenue to cost ratios over a number of years to reduce the initial high rate increases. While the long term goal should be to properly adjust the revenue to cost ratios, it should not be done in a manner that potentially results in rate shock for some customers.

101. Even for those rate classes whose overall increase is not, on its face, particularly large, there may exist outlier customers who face percentage increases well in excess of 10%. Exhibit J6.1, Attachment 1 sets out the percentage increases assuming an unsmooth revenue requirement. We submit that assessing the percentage increases without smoothing will allow the Board to assess, with the greatest accuracy, the extent to which some customers will be affected by the proposed changes.

102. As the Board will note, the change in distribution bill for the GSe rate class is as high as 26.9%, for the UGe rate class is as high as 54.1%, the GSd rate class is as high as 21.5% and the UGd rate class is as high as 25.1%. These are obviously very significant increases.

103. We submit that the Board should consider implementing a rate mitigation process for those customers who are facing large increases as a result of the rate design and cost allocation changes. We are particularly concerned about individual customers in these rate classes who are facing the highest percentage increases. By phasing the changes in over time, the Board can ensure that the drastic changes are mitigated.

7. COSTS

104. CME requests that it be awarded 100% of its reasonably incurred costs in connection with this matter.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 15th day of October, 2014.

Peter C.P. Thompson, QC
Vincent J. DeRose
Emma Blanchard
Counsel for CME

OTT01: 6586722: v5