**EB-2016-0255**

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

**AND IN THE MATTER OF** an application by Milton Hydro Distribution Inc. for an Order of Orders determining rates for the distribution of electricity for the period commencing May 1, 2016.

**AND IN THE MATTER OF** Rule 42 of the Rules of Practice and Procedure of the Ontario Energy Board.

# SUBMISSIONS OF THE

# SCHOOL ENERGY COALITION

## A. OVERVIEW

**1.** The Applicant Milton Hydro Distribution Inc. brings this motion to review the Decision and Order of the Ontario Energy Board (the "Board") dated July 28, 2016 in EB-2015-0089 (the "Decision") in the matter of the calculation, allocation and regulatory treatment by the Board of the capital gain on the sale of a property owned by the Applicant, referred to as the "Fifth and Main Property". In the Decision, the Board calculated a capital gain of $505,950, allocated 100% of the benefit of the gain to customers, and for ratemaking purposes treated the gain as a reduction in the cost of the property that replaced it, 200 Chisholm. The Applicant seeks to review each of those three elements of the Decision.

**2.** On September 1, 2016, in Procedural Order #1, the Board determined that the threshold test had been met, and it would hear the matter on the merits by way of written submissions. By letter dated September 15, 2016, the Applicant advised that it did not have any further submissions on its motion. These are the submissions of the School Energy Coalition on the merits of the motion.

## B. BACKGROUND

**3.** The Applicant purchased the Fifth and Main Property from its shareholder, the Town of Milton, in 2009 for a price of $2,218,530[1]. Part of the property was used for outside storage from and after that

[1] The Town bought it the day before from Hydro One for essentially the same price.

time[2]. The intention was that Milton Hydro would build a new head office on that site within 3-5 years, once they had arranged appropriate zoning and acquired certain adjacent land to make the property large enough for their needs[3]. Half of the cost of the Fifth and Main Property was included in rate base under the Board-approved Settlement Agreement in EB-2010-0137. The rationale for that partial inclusion was described in the Agreement as follows:

> *"The removal of $1,109,265 representing 50% of a parcel of land purchased by Milton Hydro in 2009 from the opening capital for the 2010 Bridge Year in order to calculate the 2011 average opening and closing fixed assets. The land will be the site for Milton Hydro's future office/service centre. The Parties agree for the purposes of settlement that only 50% of the parcel of land would be used and useful in the 2011 Test Year."*[4]

**4.** However, Milton Hydro encountered difficulties in achieving their goal, outlined in a letter to the Board January 7, 2014[5]. As a result, in 2015 Milton Hydro purchased 200 Chisholm, and sold the Fifth and Main Property to its affiliate, Milton Energy & Generation Solutions Inc.

5. The sale price for the 2015 sale to the affiliate was $2.4 million, based on a valuation by Colliers that was filed in evidence[6]. The price reflected an increase in value of $181,470[7] over six years, or 8.18%. This works out to a compound annual increase of 1.32% per year, well below inflation[8]. However, the appraisal report had some material ambiguities that put the appraisal result in doubt.

## C. CALCULATION OF THE GAIN

5. In the Decision, the Board concluded that the value of the Fifth and Main Property at the time of the sale to the affiliate was $2,730,000, based on the Board's reading of the appraisal report[9]. This was higher than the $2,400,000 set out as the final conclusion of the appraisal report. The Applicant seeks to overturn this part of the Decision on the basis that it was contrary to the appraisal report.

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[2] Decision, p. 38. The assertion in the Notice of Motion, and in the pre-filed evidence, that the property was acquired in 2008 appears to be incorrect, based on the evidence in EB-2010-0137 (Ex. 2, p. 38) and other internal Milton Hydro evidence. However, nothing appears to turn on that.
[3] Decision, p. 39 and Settlement Agreement in EB-2010-0137. See also EB-2010-0137, Ex. 2, p. 41.
[4] EB-2010-0137 Settlement Agreement, p. 10.
[5] Decision, p. 41 and Exhibit 1, p. 32.
[6] Exhibit 1, Attachment 1-3.
[7] Milton Hydro calculated the actual gain as $175,950 after deducting transaction costs: Interrogatory 4.0-Staff-63.
[8] The sale was actually in December 2015, and the purchase was early 2009, so the period of ownership was actually closer to seven years (which would be a 1.13% per year increase), but in the absence of detailed evidence on this calculation six years is the more conservative basis for the calculation.
[9] This calculates to be a 23.08% over 6 years, or 4.24% per year compounded annually.

6. The appraisal report assumed a selling date of August 5, 2015, and expressed a final opinion, in the cover letter, that the value was $2,400,000. However, the Executive Summary of the actual report describes the property as 6.43 acres having an appraised value of $425,000 per acre, but then incorrectly calculates the result of that multiplication to be $2,400,000. When the two figures are multiplied together, the result is actually $2,732,750. That would make the net gain $508,600 rather than $175,950 as calculated by the Applicant[10].

7. The confusion continued in the body of the appraisal report. For example, the report identifies five comparable sales, with prices per acre ranging from $339,217 to $478,723, and an average price per acre of $433,651[11]. It concludes that the price should be above $339,217 and below $442,213[12], the lowest of the remaining four comparables. It then states that the fair market value range is $400,000 to $450,000 per acre, but follows that with a table (called the "Value Matrix") showing indicative values at $350,000, $375,000, and $400,000 per acre[13]. Each of those values is also multiplied and rounded off incorrectly[14].

8. All of the parties to the proceeding missed these ambiguities and errors of calculation. The Board panel did not. The Board panel not only identified the anomalies, but put its mind to determining the most reasonable value of the property for ratemaking purposes. The Board said:

> *"The appraisal inexplicably presents a chart for values per acre ranging between $350,000 and $400,000 rather than the $400,000 to $450,000 already found to be reasonable. The value of $2.4 million that Milton Hydro has used to derive the capital gain realized on the sale of the land falls well below the $2.73 million value that results from multiplying the appraiser's $425,000 "Rate per Acre" by the area of the parcel consisting of 6.43 acres."*[15]

and later goes on to say:

> *"With respect to the first question, the OEB finds that, for rate-making purposes, the appraisal evidence supports a sale value of $2.73 million for the 6.43 acre parcel rather than the $2.4 million amount presented by Milton Hydro. This sale value is derived by multiplying the $425,000 per acre mid-point of the value range, as determined by the appraiser, by the land area of 6.43 acres."*[16]

[10] The Board in fact rounded off the appraisal figure to $2.73 million, thus increasing the gain by only $330,000, but nothing appears to turn on that.
[11] Appraisal Report, p. 28.
[12] Appraisal Report, p. 33.
[13] Appraisal Report, p. 33.
[14] The report says they were rounded to the nearest $10,000, but it appears that they were likely rounded to the nearest $100,000.
[15] Decision, p. 46.
[16] Decision, p. 54.

9. Not only did the Board identify something that everyone else had missed, but it then delved deeper into the evidence to reach a conclusion on what it really meant. It was faced with an appraisal report that had, essentially, two valuations. It chose the one that made sense to the Board. Faced with imperfect evidence provided by the Applicant, the Board did what it always does when the evidence is not crystal clear: it made a finding of fact based on its assessment of the evidence it did have.

10. This is not a case where the evidence said one thing, and the Board just made a mistake and thought it said something else. In this case, the evidence was not clear, and the Board reached a conclusion based on applying its judgment to that unclear evidence.

11. The Applicant now seeks to file new evidence, after the fact, to "correct" the ambiguities in the evidence it filed in the first place. SEC submits that the Board should not accept this evidence after the fact, for two reasons.

12. First, the Board panel has already made a determination on the facts, and that determination is consistent with a reasonable interpretation of the evidence before it. The Applicant may not agree with it, but it is not wrong or in error.

13. Second, if the new evidence were to be accepted into the record on this review, then given the work of the Board panel in identifying the errors, parties would then have to be afforded an opportunity to test that new evidence. SEC, for example, would want to cross-examine the author of the appraisal report, asking questions like:

a) How is it reasonable for property right next to the 401 in a high growth area to increase by something less than 1.32% per year, i.e. less than inflation, during a 6-7 year period in which real estate prices were rising sharply – and well above inflation – all around the GTA? What were comparable rates of increase in the Milton area during that period? How did the appraiser take this kind of information into account, if at all?

b) Why was the lowest comparable, $339,217, not treated as an outlier, since the other four comparables were grouped together around a narrow range that was 30-40% above the low outlier, and even well above the $425,000 value that the Board used? What steps did the appraiser take to understand why the low value was so different from the other comparables?

c) Why did the final $2.4 million number use a $375,000 per acre standard, which was only 9.5% above the lowest comparable, but 27.7% to 17.9% below the rest of the comparables? How were these differences taken into account?

d) Did the appraiser at any time look at the average of the comparables, $433,651 per acre, and compare it to possible valuations of the subject property? If not, why not?

e) What did each of the successive drafts of the appraisal report say? Was the $425,000 figure a value that was presented to the client Milton Hydro, and then adjusted after feedback? What communications/discussions took place between Milton Hydro and Colliers as to the appropriate value to be included in the appraisal report?[17]

14. The optimal result would have been if the ambiguities in the appraisal report had been spotted by the parties prior to the oral hearing, so that the appraiser could have been cross-examined. However, as with most proceedings before any adjudicator, the process didn't end up being perfect. The Board still has to make a decision based on the evidence before it. The Board did so here, and SEC submits that the Board's conclusion was a reasonable one on the evidence before it. It is not, in our view, appropriate in this case to go back and re-do part of the process because it was not perfect. If that were the scope of motions for review, every decision would ultimately be reviewed, and every process would be re-opened. None of them are perfect.

15. SEC therefore submits that the Board's conclusion on the valuation, and the calculation of the capital gain, were reasonable and should not be altered or vacated.

## D. **ALLOCATION OF 100% TO CUSTOMERS**

16. Milton Hydro's second concern is that only 50% of the Fifth and Main Property was included in rate base in EB-2010-0137 (by agreement with the intervenors, and on approval of the Board), but 100% of the gain was credited to customers. Milton Hydro argues, quite reasonably, that if only 50% was a "regulated asset", only 50% of the gain was a "regulated gain", and should be credited to the ratepayers.

[17] Part of this would also be reference to Interrogatory 1.0-SEC-14, p. 756, where in a presentation to the Relocation Committee by Milton Hydro management in 2014 the Fifth and Main Property is consistently assumed to be worth $2,700,000.

17. SEC disagrees. In our submission, the Board panel exercised its discretion in a reasonable manner in allocating 100% of the gain to the customers.

18. As with the calculation question, the Board panel did not simply misunderstand the evidence. The Board panel was fully aware that only 50% of the Fifth and Main Property was in rate base[18]. However, the Board panel was also aware that the entire property was purchased with the intention of using it for the regulated business[19]. The only reason not all of it was in rate base was that, until some barriers were removed, it was not possible to make all of the property "used and useful" in the interim.

19. In our submission, there are arguments on both sides of the allocation question. On the one hand, the ratepayers have not been getting the use of 100% of this land, but nor have the ratepayers been paying for 100% of the land. If you only pay for a 50% interest in something, then you are only entitled to half of the upside.

20. On the other hand, the sole reason for purchasing the property was to build an office and operations centre on it, which would have taken up all of the property (and more). As originally planned, this should have happened by now. Instead, what happened is that ratepayers paid in rates about $95,000 a year[20] for five years for land that was used for some limited outside storage (overflow from the Lawson site). Thus, the Applicant has a gain on land that was solely purchased for the regulated business, and essentially 100% financed at 4.3% per year by the ratepayers to cover the incremental debt, but on Milton Hydro's argument the shareholder would still have a windfall profit on its sale.

21. We also note that the allocation of the gain is part and parcel of the overall balancing of interests that the Board panel pursued. The Board panel concluded that the entire process of acquiring Chisholm was mishandled, essentially from start to finish, and as a result the ratepayers end up paying for a building that is manifestly inappropriate[21]. While some of the cost of the land and building was disallowed (about $1.4 million), that is largely offset in rates by the Board's decision to deny the $88,000 per year credit to customers that Milton Hydro had proposed. Instead of accepting this as the overall result, the Board quite reasonably said that the Applicant bought the land to be their head office site, and has since replaced it for that purpose with another site, so the entire proceeds should roll over to the cost of the new site.

[18] Decision, p. 39.
[19] Op. cit.
[20] $1.11 million in rate base, at a total cost of capital, including PILs, of about 8.5% per year.
[21] "The selected building is far too large for Milton Hydro's office and operations needs", says the Board at p. 42 of the Decision. The Decision details the numerous ways in which the process was carried out badly.

22. SEC therefore submits that the allocation of 100% to customers was reasonable in the circumstances.

## E. **REGULATORY TREATMENT**

23. The Board panel broke new ground in its treatment of the gain from the sale of the Fifth and Main Property. This was not accidental. The Board specifically considered the ways the gain could be credited to the benefit of the ratepayers, and concluded that reducing the rate base of the replacement property was the fairest and most comprehensive method to do so. In this the Board panel was entirely correct. The fact that the method used is new does not mean that the Board panel made a mistake. It means that they improved on past practice.

24. The Board panel expressed its conclusion on the regulatory treatment as follows:

> *"In this case, where Milton Hydro's purchase of the 200 Chisholm Drive property effectively replaces the Fifth Line and Main Street property, the OEB finds that the appropriate regulatory treatment for the capital gain is to record the entire amount of the gain of almost $506,000 as a credit or reduction to the rate base value of the land at 200 Chisholm Drive.* ***This regulatory treatment is most appropriate where one parcel of property acquired for future use is replaced with another.*** *The appropriateness of this approach is reinforced by the fact that this is the way Milton Hydro treated the capital gain on an assumed sale of the Fifth Line and Main Street property in its internal presentations of own and build options that involved land other than that at Fifth Line and Main Street."*[22] *[emphasis added]*

25. What the Board panel did was, in essence, treat the application of a gain to the cost of a replacement property as being similar to a contribution in aid of construction. All of the money for the replacement property didn't come from the providers of capital (the shareholder or lenders). Some came from another source, the purchaser, so to that extent it should not be included in the capital base on which the providers of capital are paid their return. In a CIAC, a third party such as a developer or government body makes a payment as part of the cost of a capital asset. The Board does not treat that as found money to be paid to the ratepayers. It treats it as a reduction in the investment of capital required for the capital asset. The net cost of the new asset is less. In the same way, where there is a gain on the property that is being replaced, that gain comes from a third party, and effectively reduces the net cost of the new asset.

26. As the Board panel notes, this is exactly how the Applicant viewed the sequence of events as well. In the management presentation on November 14, 2012[23], options for the replacement of Lawson

[22] Decision, p. 55.
[23] Interrogatory 1.0-SEC-14, page 756.

and Fifth and Main with another site were compared on a net basis, after deducting the entire proceeds (including gain) from the Fifth and Main Property. This makes sense. It was an investment decision. The actual amount to be invested was net of those proceeds.

27. The Board panel correctly points out that this is a suitable result where one property is replacing another. This is a continuous process. The Applicant invested $2.218 million in land for a particular purpose. It changed its plans, so chose another property for that purpose, and transferred the value of the old property to the new one. They ended up with a land and building costing $7,300,000. The incremental investment (once the sale price of the land is corrected to $2,730,000) was $4,570,000, so that the total actual cost, before renovations, was $6,788,000 ($2,218,000 plus $4,570,000). That is how much was actually invested by the Applicant in the new head office and operations complex. The remaining $512,000[24] to get to the $7,300,000 price for Chisholm did not come from the Applicant, but from the gain on the sale of Fifth and Main. The effect of the Board panel's regulatory treatment is to include in rate base only the net amount actually invested by the Applicant[25].

28. Thus, Milton Hydro in their motion misses the Board's point entirely. They say that reducing rate base by the amount of the gain means that, after 13 years, they will have paid the entire gain back to ratepayers, but will still have to continue to pay forever. What they fail to note is that, by that argument, after 13 years they should have to remove non-depreciable assets from rate base, because the ratepayers would have paid the full cost. For depreciable assets, where they collect depreciation as well as return, they would have to be removed from rate base after 9 or 10 years. Neither of these is actually right; no more right than saying that they will be overpaying after 13 years of reduced rate base. Return on capital and return of capital are different things. The Board panel understood that. The Milton Hydro motion apparently does not.

29. Milton Hydro also argues that consistency should take precedence over the Board panel's analysis of the appropriate treatment of this gain. SEC disagrees. Consistency is certainly important. However, every Board panel should always be trying to seek a result that optimizes the goals of regulation. Much as distributors are expected to deliver continuous improvement, the same should be true of the Board.

[24] Adjusted to $506,000 to reflect rounding and closing costs.
[25] The further disallowances are separate from this analysis. Some parts of the amount they actually invested were imprudent, and did not provide value to customers. The basis of those rate base reductions is fundamentally different from the exclusion of money that was not actually invested by the Applicant in the first place.

30. Where there is no good reason to implement a new regulatory treatment, SEC agrees that consistency is an important consideration in assessing whether to do so. On the other hand, consistency cannot and should not be used to prevent changes that improve regulatory outcomes. Taken to its logical conclusion, consistency prevents change. In our submission, consistency is a useful concept only where it outweighs the benefits of a proposed change. That is not the case here.

31. In addition we note that the Board panel in this case did not propose that all capital gains be applied to reduce rate base going forward. Rather, the Board panel made clear that where there is a sequence of transactions pursuing the same purpose, gains along the way should be netted out in calculating the net investment by a regulated utility. This is a narrow change, specifically constructed to fit unique circumstances. Instead of being criticized for doing so, the Board panel should be credited with a thoughtful and principled new approach, and an improvement in these special circumstances on the more general approach that the Applicant thinks should be applied.

32. SEC therefore submits that the regulatory treatment by the Board panel is not an error, but an improvement, and should not be overturned.

## F. **CONCLUSION**

33. It is therefore submitted that the three aspects of the Decision challenged by the Applicant were in each case correct and appropriate, and this Board panel should deny the motion on the merits.

34. SEC submits that it has participated responsibly in this motion for review with a view to maximizing its assistance to the Board, and therefore requests that the Board order reimbursement of SEC's reasonably incurred costs for that participation.

All of which is respectfully submitted.
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