EB-2016-0160

ONTARIO ENERGY BOARD

IN THE MATTER OF *the Ontario Energy Board Act, 1998* ("Act");

AND IN THE MATTER OF an Application by Hydro One Networks Inc. for an order or orders made pursuant to section 78 of the Act approving electricity transmission revenue requirement and related changes to the Uniform Transmission Rates beginning January 1, 2017 and January 1, 2018.

SUBMISSIONS OF ENERGY PROBE RESEARCH FOUNDATION ("ENERGY PROBE")

February 1, 2017

HYDRO ONE NETWORKS INC.
2017 – 2018 TRANSMISSION RATES APPLICATION EB-2016-0160
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1. Executive Summary

1.1 For Energy Probe, the two key aspects of Hydro One's 2017-2018 transmission rate application are the aggressive capital spending program the company has proposed and the significant increase in executive compensation and incentives. Energy Probe largely supports the capital components of the application, but offers a number of suggestions and considerations for the Board in regards to compensation.

1.2 The justification for the major increase in capital spending, according to Hydro One, is to "reduce the reliability risk" of its transmission assets and, in the process, mitigate the risk -- and cost -- of future blackouts and interruptions. As addressed below, Hydro One does not expect its investments to actually reduce or improve service to its customers. In total, Hydro One is proposing to spend $1,076.1 million in 2017 and $1,122.2 million in 2018 on its capital program. While Energy Probe largely supports Hydro One's capital spending budget, we have also proposed an alternative for the Board to consider that would, marginally, lower its sustaining capital budget.

1.3 Although Hydro One is proposing that the Ontario Energy Board ("Board) approve above-inflation -- amounting to double-digit increases from 2015 -- increases to its capital budget over the next two years, it's not proposing any service improvements for its customers. In fact, it's explicitly arguing against any such promises. Energy Probe has significant concerns on this disconnect. Nonetheless, Energy Probe recognizes that the company is undergoing significant change under new management. Over the next two years, Hydro One's new management has the opportunity to show the Board that it's capable of executing its capital plan, improving productivity, finding efficiencies and, ultimately, providing a higher quality service to its customers. While we have concerns on Hydro One's refusal to guarantee better reliability, we believe there are ample areas for the Board and the company's shareholders to hold management to account for its performance over the next two years as it moves to incentive-based regulation.

1.4 Many of the company's largest customers have repeatedly told the company that reliability is their number one concern (tied with rates). These customers admitted -- at a Hydro One-led customer survey -- they would be willing to pay more to improve or, in the worst case, maintain current levels of reliability. Yet, as noted above, Hydro One has repeatedly stressed that it can't promise either one of those outcomes, even with annual, greater-than-inflation increases on budgets to upgrade and update its transmission assets. Hydro One maintains that in a majority of cases, reliability is out of its control no matter how much it spends on upgrading the grid. Energy Probe believes that the company's proposal to spend more to "reduce reliability risk", but then argue against any real, tangible performance improvements, is concerning and the opposite of what a private,

competitive company would offer.

1.5 Hydro One has repeatedly stressed that the new management group brought in after the partial privatization of the company will transform Hydro One into a "best-in-class, customer-centric, commercial utility."[1] Yet, again, nowhere in its strategy is the company proposing improved service (less and shorter service interruptions) for its customers. Rather, it's tabled a new analytical model -- the reliability risk model -- that will, over the next two years, show a slight decrease in the "risk" of service disruptions, not actual disruptions. Energy Probe questions how a transformation of a company promising the same level of service, yet charging higher rates, could be considered an improvement for the company's customers. Again, we acknowledge the Hydro One is being led by a new management team and changes take time, but we would expect a "customer-centric" utility not to shy away from promising better service.

1.6 Between 2012-2016 Hydro One failed to meet its in-service addition targets -- meaning it was unable to actually spend all of its Board-approved capital budget. Given the company's past history, Energy Probe is concerned about the company's proposal to, not only increase its capital budget for 2017-2018, but continue to do so through 2021, given its poor performance in the past. But, as described later, Energy Probe supports Hydro One's proposal to increasingly link management compensation to a variety of performance targets, notably in-service additions. Going forward, both the Board and Hydro One's customers will be able to clearly see whether the company's new management is capable of correcting past deficiencies in regards to executing capital programs (in-service additions). If it fails to demonstrably show improvement, both the Board and Hydro One's shareholders can take management to task as it moves to incentive-based regulation and five-year applications.

1.7 Hydro One's customer consultation, while welcome, was a flawed exercise. Similar to customer consultation exercises done by other utilities, Hydro One presented a number of dire figures on the health of its assets and then asked those customers "how much more should we spend?" Energy Probe understands that the Board has increasingly called for more customer consultation, yet we question the worth of this consultation, given that the figures Hydro One presented were, in our opinion, misleading and the company admitted that it didn't learn anything new from its customers as a result of the customer consultation. Energy Probe is surprised that Hydro One's new management didn't look, and expect, tougher criticism from its customers, given the company's track record under public ownership.

1.8 Hydro One's overall compensation continues to be too high compared to its sector peers, according to its own benchmarking studies. The company's unionized workforce, for example, is still paid about 10% more than its benchmarked peer groups, while overtime continues to be paid at an above-market rate of 200%. Ratepayers should not be

[1] AIC page 15.

on the hook for compensation levels that are above the benchmarked peer groups. Accordingly, the proposed 2017 and 2018 OM&A costs related to compensation should be reduced by, according to Energy Probe's estimate, $80 million annually -- with $20 million of that reduction being allocated to the transmission business. Energy Probe hopes that, based on our detailed recommendations, Hydro One will provide appropriate estimates in its reply argument. Nonetheless, Energy Probe supports the company's push to tie management compensation to performance targets. We also note that in the 2017 and 2018 test years, it should be assumed that Hydro One -- for regulatory purposes -- is still likely to be 70% publicly-owned. Therefore, there should be a modified transition of executive and management compensation towards investor-owned pay structures (Union, Enbridge etc.).

1.9 Hydro One's transmission scorecard is a work in progress and should be accepted for the current rate application, with certain caveats. However, Hydro One has not made a case for the use of the Reliability and Cost Efficiency (RCE) metric and the Board should place zero weight on this. As well, the executive and non-unionized short-term incentive scorecards do not appropriately reflect customer outcomes or the current ownership of Hydro One -- 70% publicly owned -- and should be redesigned with expert input as soon as possible. In regards to Hydro One's productivity claims, the company should be directed to provide a full accounting of these savings -- in 2017 and 2018 -- when it comes before the Board with its 2019 rates application. Hydro One should specifically address any steps taken to improve labour productivity and any savings it produces.

1.10 Recommendation: Energy Probe, largely, supports Hydro One's application for 2017-2018 transmission rates in regards to capital spending. Hydro One has proposed an ambitious, in our opinion, capital spending budget that the company hopes will address the demographic "bulge" of its assets. Throughout the proceeding, no party disagreed with Hydro One's assessment, though some parties feel the company should "pace" its investments to avoid rate increases in a time of rising public concern over hydro bills.[2] Yet, part of the reason for the current proposal for rate hikes is that Hydro One deferred work in the past in an effort to mitigate rate hikes. As well, Hydro One was required by legislation to pursue capital projects that supported renewable energy and other environmental policies implemented by Queen's Park. We don't see any time in near future that would qualify as a "good" time for rate hikes. Alternately, Energy Probe has proposed a slightly "smoothed " approach to capital spending (Section 3.9) that the Board may consider.

1.11 Recommendation: Energy Probe believes that the company's move to increasingly tie non-union compensation to performance targets is a key step in pushing the company towards greater efficiencies and improved reliability. That said, Hydro One's proposal for short-term and long-term compensation incentives is, in some cases, inappropriate

[2] Board Staff's final argument

considering that the company is still largely public and it's asking for money in rates before the incentives have been achieved. Energy Probe proposes that the Board establish a deferral account for the STIP portions of incentive compensation, while denying other portions altogether. Putting a portion of incentive **compensation in a deferral account gives the company a two-year window to prove to the** Board and its customers that it can complete what it proposes to do in terms of improved performance (on both the capital and operating sides of its business).

2. What Hydro One is Proposing in Terms of Capital Spending

2.1 At the heart of Hydro One's 2017-2018 transmission rate application is an aggressive capital spending program that will see the company spend $1,076.1 million in 2017 and $1122.2 million in 2018 on various capital investments. The majority of that money will be spent on what the company calls sustaining activities, which it has in the past defined as work needed to "to refurbish or replace" assets at their "end of life"[3] and, in this application, has updated that description to include work that mitigates "reliability risk" and maintains "first quartile reliability."[4] In its application, Hydro One expects to spend $776.8 million in 2017 and $842.1 million in 2018 on sustaining work, or 72% and 75% of its total capital spend, respectively.[5] In contrast, in 2012 sustaining capital investment accounted for 50% of Hydro One's entire capital program.

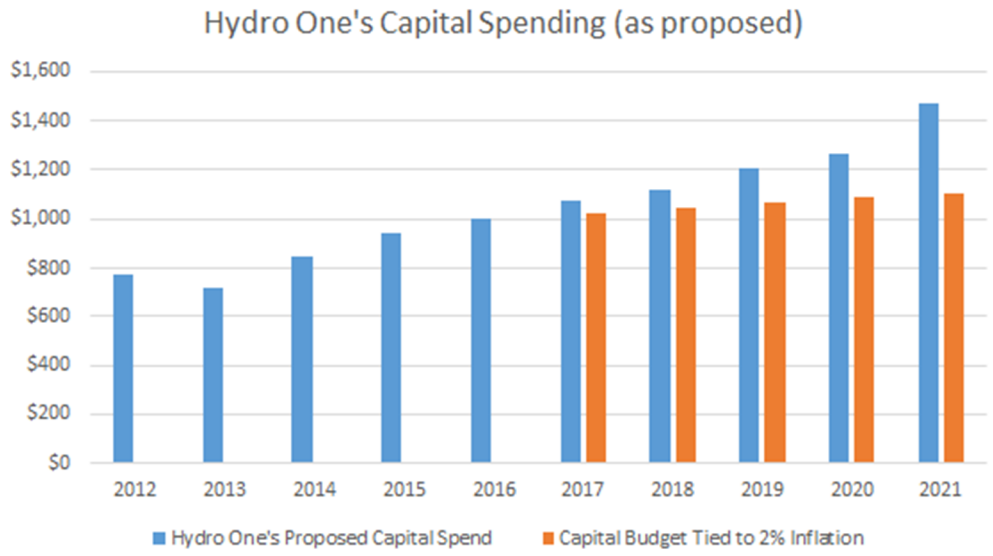
2.2 The increase in capital spending isn't a short-term trend, according to the company's 2017-2018 rates application. Hydro One is forecasting that its capital spending will continue to increase in the years following its current application. By 2021, the company expects to spend $1,474.9 on its overall capital program and $1,118.1 million on its sustaining program, or about 76% of its total capital program. Even after 2021, Hydro One is signaling that "significant sustainment capital investment" will be needed as far out as 2030.[6] The increases are well above inflation forecasts.

[3] EB-2012-0031, Exhibit D1 Tab 3 Schedule 2, Page 1 of 74

[4] EB-2016-0160, Exhibit B1, Tab 3, Schedule 2, Page 1 of 43

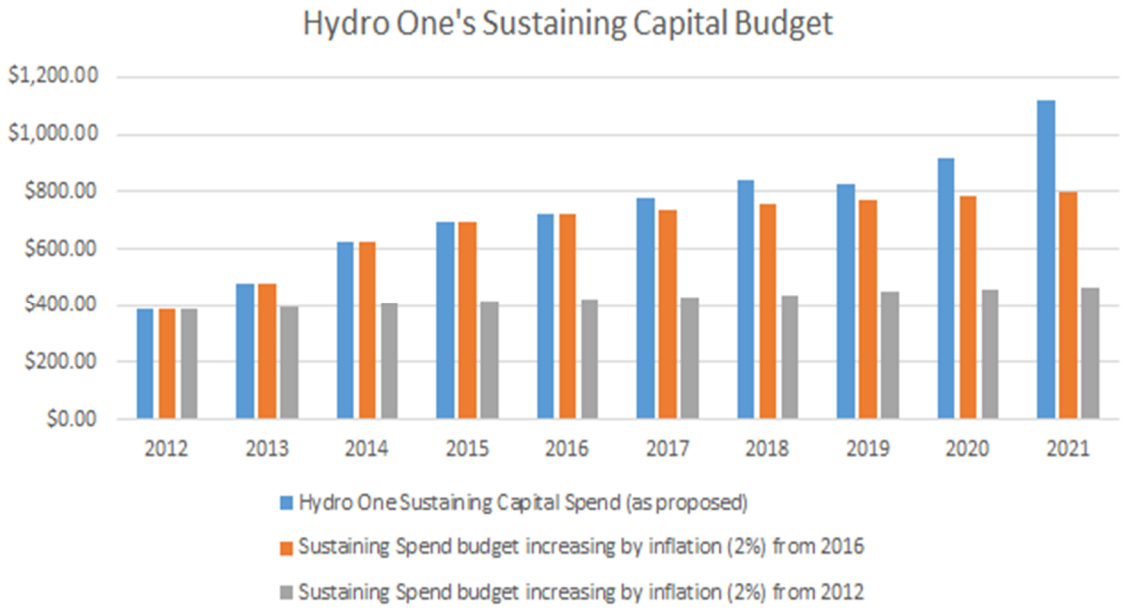
[5] EB-2016-0160, Exhibit A, Tab 3, Schedule 1, Page 13 of 25

[6] OEB Staff Interrogatory #67



2.3 The increase in capital spending from previous years is material in Energy Probe's opinion and is a sizable chunk of the tens of billions of dollars that will be spent on electricity assets over the next decade. Compared to 2012, it's clear that Hydro One's new vision for the company involves a much more aggressive capital program than it has proposed in previous applications. The company admitted as much in the oral hearing (and is detailed in 2.5).[7] From 2012 to 2021, Hydro One will increase its annual capital investment spending by 90%, or 10% annually on a smoothed basis. Sustaining spending will increase by 187% over that time, or nearly 21% annually. While Hydro One has downplayed the bill impacts of its application, highlighting the 0.1% and 0.2% total bill impact in 2017 and 2018, respectively, those figures mask the material increases on spending that the company is proposing. If that capital spend program is compared to inflation-adjusted increases over that time, the increase becomes even more material. Placing those increases against inflation shows just how dramatic the ramp up in spending is.

[7] Transcript Volume 1, page 60-65



2.4 While the capital program is just one component of Hydro One's overall revenue requirement, it's the most significant driver going forward. Operating costs, for example, are declining over the 2017-2018 period and will be lower than in 2012 -- though part of that decline is a result of more operating costs being push to the capital budget and other exogenous factors (pensions).[8] In Hydro One's previous transmission application, the annual rate increases were 1.1% in 2015 and 1.7% in 2016.[9] In its current application, the company's plan requires rate increases that are more than double those amounts -- 2.6% in 2017 and 4.8% in 2018. Based on Hydro One's forecasts, we expect similar, if not higher, rate increases from 2019 onwards.

2.5 Hydro One's application also "resets" its capital spending forecasts compared to previous applications. For example, in its last rate application, Hydro One forecast that its total capital spending program in 2017 and 2018 would be $847.8 million and $838.8 million, respectively. In its current application, those figures have increased to $1,076.1 million and $1122.2 million for 2017 and 2018. In percentage terms, Hydro One's forecast for 2017 and 2018 capital spending has increased by 27% and 34%. Going forward, the company forecast in its last application that capital spending would hit $831.4 million in 2019[10], but has now revised that figure higher to $1207.5 million -- an increase of more than 45%. As noted by other parties, these increases are coming during a period of heightened concern over soaring costs in the electricity sector.

[8] EB-2016-0160, Exhibit A, Tab 3, Schedule 1, Page 18 of 25, Table 9
[9] 2014-09-16, EB-2014-0140, Section II, Page 3 of 27
[10] 2014-06-27, Exhibit A, Tab 16, Schedule 8, Page 4 of 4

3. Is the Increased Capital Spending Needed and What is the Role of the Reliability Risk Model?

3.1 As has been noted in numerous previous transmission rate applications, Hydro One faces an aging set of assets.[11] Contrary to claims from the province that it "made critical infrastructure upgrades to ensure system reliability,"[12] Hydro One has not made significant progress in tackling the demographic "bulge" of its assets. Hydro One, in fact, admits to deferring investments in the past, by utilizing its assets "as fully as possible, without prematurely replacing them", allowing for "smaller rate increases", while noting that that deferral was "to the benefit of the rate payer, not a detriment."[13] Energy Probe believes those "benefits" flowed to past ratepayers at the expense of current and future ratepayers. Nonetheless, eventually these assets age to the point where they need to be replaced and the company now thinks it has reached that point.

3.2 The most notable difference in this application compared to previous ones is that Hydro One is now relying on, and presenting to the Board, what it calls a "reliability risk" model to provide a better view on how its overall investment decisions impact the health of its assets going forward. Using a set of hazard curves, this model attempts to quantify the increase in risks under various investment strategies. Under the proposed capital spending program, Hydro One's reliability risk model shows that the *relative change in risk* decreases by 2% over the next two years. That's not to say interruptions to customers will decrease by 2%, but simply that the risk of its assets failing and causing interruptions decreases by 2%. In terms of specific assets, transformers, for example, will see the "relative risk" rating of the entire asset class decrease -- a falling number is a trend in the right direction -- from 1.694% to 1.535%.[14] Hydro One, in short, is attempting to quantify to the Board and its customers the risk of further deferring capital investments.

3.3 The reliability model, according to Hydro One, addresses "confusion" from customers over the company's claims that many of its assets are operating past their "estimated service life" and other "end of life" concepts. Energy Probe questions whether -- outside of a small group of large, sophisticated customers -- many of its customers are clear on the distinction of lowering the risk of a blackout and actually ensuring fewer blackouts occur between 2017 and 2018. That said, Energy Probe believes the model may prove useful in highlighting to the Board, Hydro One's

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[11] See, for example: Exhibit B1, Tab 2, Schedule 4, Attachment 1, Page 3 of 6, figure 2 ; Exhibit B1, Tab 2, Schedule 6, Page 5 of 66, figure 2; Exhibit B1, Tab 2, Schedule 6, Page 13 of 66, figure 7; Exhibit B1, Tab 2, Schedule 6, Page 32 of 66, figure 20

[12] https://news.ontario.ca/opo/en/2016/09/keeping-clean-reliable-electricity-affordable-and-lowering-peoples-bills.html

[13] CCC Interrogatory #2

[14] Board Staff IR #15

customers and its shareholders, the potential future risks of relying on aging equipment in an effort to keep rate increases minimal.

3.4 Yet, Energy Probe believes the reliability risk model has shortcomings. The most important, from the perspective of Hydro One's large and small customers, is that the model doesn't actually provide any concrete evidence that the company's current investment plan will provide better service (fewer and less lengthy blackouts). This is an important distinction. When pressed on this issue -- by many parties and on numerous panels -- Hydro One responded that while it might "expect" reliability to improve, it "can't guarantee it."[15] The company was clear that "in spite of making all of these investments and reducing reliability risk, if you have a year where the weather is particularly abnormal and bad, that your SAIDI performance would show poor."[16] And, finally, Hydro One admitted that it doesn't even know if the figures spit out from the model -- and that underpin much of its application -- are "reflective of what we expect to occur" in the real world.[17] In short, the company has presented the reliability risk to both customers and the Board as a central component to its increased capital spending program, but can't be sure if its reliability risk metrics will either reduce interruptions or at all match what happens in the real world. It also said that it couldn't "back test" the model to see how well it would have predicted current levels of reliability.

3.5 Reliability risk model aside, no party in the hearing presented evidence that Hydro One's assessment of its assets was incorrect or that the company could, over the long-run, avoid making the investments laid out in its application before the Board (see the description of the insulator problem).[18] At best, parties could argue -- as Board Staff did in its final argument -- that Hydro One could "spread out" or "pace" these investments over a longer period. When asked if the Board were to reduce Hydro One's proposed sustaining capital budget, the company responded that the condition and age of its assets would continue to deteriorate and the work would simply "be deferred."[19] In fact, according to Hydro One, if that work were to be deferred and the assets had to be fixed or replaced in a "corrective manner", the cost to ratepayers in doing so is higher than if done according to an overall plan[20]. As far as we can tell, no party questioned that statement or provided contrary evidence. Energy Probe is concerned that calls to "smooth" the company's capital spending plan don't actually help ratepayers in the long run and may, in fact, be worse for them. While the company's assets may continue to operate beyond their useful life and the risk metrics ascertained from the reliability risk model may not occur, that appears to be little more than a game of regulatory Russian Roulette. Furthermore, given the significant investments that will be occurring in the

[15] Transcript Volume 1, page 149-150, as well as Transcript Volume 3, page 44

[16] Transcript volume 2, page 129

[17] Transcript Volume 5, page 122

[18] Transcript Volume 5 page 164

[19] Transcript Volume 2, page 8

[20] Transcript volume 2, page 9

electricity sector over the next decade -- most notably two nuclear refurbishments -- Energy Probe fails to see when would be the "right" time for Hydro One to undertake the capital investments needed to modernize its assets. There's never a "good" time for rate increases.

3.6 Furthermore, one reason why in recent years Hydro One may not have made necessary investments to replace its aging assets is that it was required by legislation to spend hundreds of millions of dollars on both connecting renewable generators to the grid and other costs related to the shuttering of the province's remaining coal plants. Energy Probe calculates those costs amount to more than $500 million between 2009-2012.[21]

3.7 Provincial policies aside, Hydro One has consistently earned above the Board's approved Return on Equity (ROE) between 2012-2015[22], while knowing full well that its assets were aging and deteriorating. We fully understand that utilities can earn above the Board-approved ROE by controlling costs -- this is, in fact, part reason there is a band around the Board-approved ROE. But we question whether it was appropriate for Hydro One's shareholder to keep those "excess" earnings when it knew that its assets were deteriorating. We would hardly describe that as a responsible way to manage the province's transmission assets.

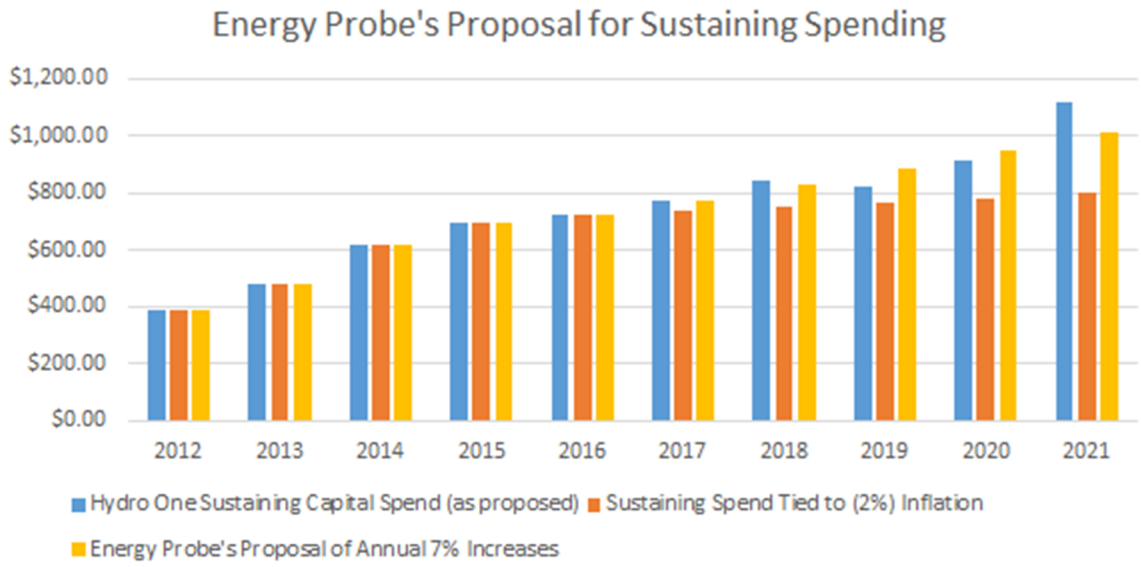
3.8 Recommendation: Energy Probe believes the Board should approve Hydro One's proposed capital spending plan for 2017-2018 for two reasons. First, it's clear that the work needs to be done -- no party in the proceeding, as highlighted in Hydro One's argument-in-chief, questioned whether that was the case. While some parties believe that Hydro One could adjust the "timing" or "pacing" of those investments -- and, as detailed below, whether Hydro One is actually capable of completing the work as planned (we share those concerns) -- it's not clear that such a policy would, in the long-run, be of net benefit to ratepayers. More simply, the costs of deferring the work could end up being greater than those detailed in the application, according to Hydro One's evidence. Secondly, Hydro One has in the past been required by legislation to spend significant amounts of money on projects and assets that it wouldn't otherwise have done. Energy Probe questions the logic of denying the company the opportunity of "playing catch up" when it's clear that its asset base is aging and the risk of those assets failing is increasing.

3.9 Recommendation: Alternately, we propose a plan that would marginally trim Hydro One's capital plan, but still allow the company to address its aging asset base. In percentage terms, Hydro One is proposing to increase its sustaining capital budget by 9.34% annually between 2017-2021. In 2017 to 2018 the increase is, on average, 7.34%. Energy Probe proposes that the Board approve a sustaining capital

[21] EP Interrogatory #1

[22] BOMA Interrogatory #30

budget increase of 7% annually in 2017 and 2018 (and for the remaining years in the company's forecast). Doing so would lower the sustaining budget from the proposed $776.8 million in 2017 to $775 million and from $842 million in 2018 to $829.25 million. Collectively, our proposal lowers the sustaining budget over 2017-2018 by around $14.5 million. Going forward, to 2021, our proposal, while still allowing Hydro One to increase its annual sustaining budget, lowers the 2021 figure to around $1,015 million from Hydro One's forecast of $1,118 million. We believe our proposal allows Hydro One to address its aging assets, while also cutting some spending due to our concerns with the reliability risk model and customer engagement.



4. Is Hydro One Capable of Getting The Projects Done On Time?

4.1 Hydro One has struggled in the past to meet its Board-approved In-Service Additions (ISAs). Some years it's significantly under the Board-approved amounts, while other years, it's significantly over. As detailed in AMPCO interrogatory #47, Hydro One put into service $305 million less in capital additions then the Board-approved between 2012 and 2016. Energy Probe is concerned that the company has presented a significant increase in capital spending, part of which is needed because the company was unable to meet its in-service plans of previous applications.

4.2 As part of the last settlement agreement, there is an asymmetric variance account, which ensures that if Hydro One underspends, that money is returned to ratepayers. Energy Probe's concern is that if Hydro One is unable to meet its capital spending requirements, which according to the company's own evidence is needed to mitigate the risk of more blackouts and interruptions, it doesn't eliminate the need for the spending, it

just defers it.

4.3 Considering that Hydro One has actually missed its total In-Service Additions between 2012-2016 by $305 million, part of its significant increase in capital spending going forward may have been mitigated had it met its Board-approved plans. While the asymmetric variance account ensures that any "underspend" is returned to ratepayers, it may actually "hurt" ratepayers in the long-run as it means Hydro One is not actually addressing its "bulge" in aging assets. The company simply reapplies for that spending in its next application.

5. Customer Engagement Misleading In Numerous Ways

5.1 Recommendation: It's hard to see the value in Hydro One's customer consultation exercise for two reasons and, as such, we think the Board should give it little consideration. First, many of the charts and figures the company put before those being surveyed were misleading and presented a doomsday scenario. Second, Hydro One excluded LDC end customers from the sessions even though they account for 92% of the company's revenue. Energy Probe welcomes Hydro One's push to pursue greater dialogue with its customers, but we question the value of this particular consultation, given the information presented and the timing between the sessions -- we agree with Board Staff's concern on this point[23] -- and Hydro One's application.

5.2 Many of the figures and charts presented by Hydro One and Ipsos Reid in the customer consultation sessions were misleading. For example, in its presentation, Hydro One told those being surveyed that equipment outages "caused by failure or necessary repairs/replacements" increased by 300% from 2011-2015. What that figure doesn't tell its customers is that in 2011 the company was largely pursuing development capital programs in order to meet the province's renewable and clean energy policies and that, while these investments may carry a "large cost", the "requirement for outages on the network for that new element are... much smaller [than sustaining projects]."[24] As the company moved, from 2012 onwards, to a capital spending program that focussed more on sustaining projects, it experienced greater interruptions simply due to the nature of the work being completed. The 300% increase was largely a result of a work program that focussed more on upgrading Hydro One's assets -- which, by its nature involved taking some assets out of service -- than a grid more prone to failure. Comparing the number of equipment outages in 2011 to 2015 when the company was pursuing two completely different capital programs is an apples-to-oranges comparison.

5.3 Following that 300% figure comes another dramatic figure. Hydro One then tells its customers that risk of being placed in a single-circuit system has increased by around 400%. But Hydro One provides no firm figures for the number of times or incidences

[23] Board Staff Argument, page 13

[24] Transcript volume 4, page 10

when customers that are normally on a multi-circuit service are temporarily switched to a single circuit system and then experience some sort of outage or interruption because of that switch. The number could be zero or it could be in the thousands. The 400% figure is dramatic, but there's no evidence that it actually resulted in any service interruptions for Hydro One's customers. The fact that 70% of Hydro One's transmission network is "redundant" and on multi-circuit system (southern Ontario is largely a multi-circuit system) simply means that it can use that redundancy to its benefit and upgrade its assets while ensuring the lights say on. The 400% figure provides little evidence that Hydro One's aging assets are leading to more interruptions for its customers.

5.4 Hydro One's own reliability data suggests that -- leaving aside its concept of reliability risk -- the number of service interruptions in recent years has, in many cases, actually improved. On Hydro One's "proposed transmission regulatory scorecard", two of the three metrics (SAIFI-S and SAIFI-M) decline (show improvement) from 2011 to 2015. The other metric, SAIDI, shows an improvement from 2011 to 2014, but then jumps higher (gets worse) in 2015.[25] Nowhere in Hydro One's scorecard does it show a steady decline in reliability metrics between 2011 through 2015, although that's exactly what Hydro One led those being surveyed to believe. When asked whether it was true that Hydro One's reliability metrics have improved over the last five years, the company said it "agreed" with that statement, later adding that reliability had "moderately improved the last couple of years."[26] That's a much different story that what the company told the surveyed customers. We should note that the scorecard figures that show, for the most part, an improvement in reliability figures, are tied to compensation.

5.5 Hydro One's data from the CEA composite also shows that reliability -- on all metrics -- has steadily improved from 2006 to 2015 and, apart from one outlier in Figure 10, have remained fairly constant since 2011.[27] Hydro One simply replied that those are "lagging indicators" and it wants to make sure that performance is maintained going forward and, as such, the "levels of investment that were necessary to achieve that level of performance in the past must be adjusted as a result of the current condition of our assets in order that those levels be maintained."[28] Energy Probe notes that telling customers equipment outages have increased by 300%, as it did in its consultation, and then later telling the Board that it needs more money to maintain its past performance, which has been improving, are two very different stories.

5.6 Even in Hydro One's own presentation to customers ("Overall Transmission Reliability Has Remained Flat"), it's clear that the utility's reliability metrics aren't nearly as drastically bad as the company first described. Between 2006 and 2015, both the SAIDI and SAIFI metrics declined.

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[25] EB-2016-0160, Exhibit B2-1-1, Attachment 1, Page 2 of 2

[26] Transcript Volume 3, page 185

[27] EB-2016-0160, Exhibit B1, Tab 1, Schedule 3, Page 23 and 24

[28] Transcript Volume 1, page 71

5.7 It's clear that Hydro One kicked off its customer consultation session with dramatic figures -- the 300% and 400% cited above -- in an effort to create a crisis scenario. But those figures don't match up with the company's own figures presented in this application, which show that, in many cases, reliability hasn't gotten worse (it's improved, although not dramatically) and, compared to other utilities in Canada,[29] Hydro One isn't a negative statistical outlier, at least in regards to customers on its multi-circuit system.

5.8 Energy Probe agrees with many of Board Staff's criticisms of Hydro One's customer engagement activities. Notably, we take particular issue with the "zero" scenario that Hydro One presented to customers. The company told its customers that a "zero" scenario -- which, in fact, was simply a continuation of historical rate increases -- would increase reliability risk by about 20%. Yet, Hydro One's sustainment spending -- which has the largest impact on reliability -- had been increasing by about 20% annually between 2012-2016[30]. Nowhere in its presentation did it present that information to its customers. Energy Probe believes that information would have been very pertinent to customers when determining what rate impacts would be tolerable while maintaining reliability.

5.9 We also support Board Staff's comment that Hydro One should have made a stronger effort to hear from end-users other than directly connected transmission customers and LDCs[31]. As noted early in the oral hearing, LDC customers account for 92% of Hydro One's transmission revenues. While Hydro One believes that LDCs will represent the views of their customers, distributors largely pass on transmission costs and may have a different opinion on what rate increases are tolerable. LDC customers are also much more sensitive to rate hikes and would likely have offered much different responses that transmission-connected customers who are more concerned with reliability.

6. Operating Maintenance and Administration Costs (OM&A)

Cost of Overtime

6.1 Although the hourly cost of overtime, *which is driven by negotiated labour contracts,* was higher than the peer group, Hydro One's overtime usage, as a percent of total hours, was consistent with other companies in the peer group. However, under the existing labour agreements, it means that additional hours *begin at double-time pay, rather than time and a half.*

[29] See the CEA data referenced above

[30] See our graphs in Section 2 as evidence of those increases

[31] Board Staff Argument, page 13

6.2 Hydro One's overtime costs are generally higher than the other reporting companies, meaning it could realize significant benefits by minimising overtime.[32] For example, overtime costs amounted to $85.7 million in 2015 and $59.2 million in 2016 (partial year).[33] Undertaking TCJ.12 shows overtime costs of $85.7 million in 2015 and $59.2 million in 2016 (partial year). For regular employees, overtime is paid at two times the hourly rate. In addition to regular employees, casual and contract employees are also paid overtime.

6.3 Recommendation: There is no clear evidence explaining who is responsible for deciding the size of overtime costs that are eventually built-in to final budgets to ensure that in-service additions (ISAs) are completed on time. Given the size of the capital budget, combined with the projected reductions in the permanent work force and the ISA performance scorecards, there is likely to be increasing pressure to rely on overtime hours to ensure ISA targets are completed on time. Hydro One has not provided any evidence detailing specific plans to reduce overtime costs to meet industry norms, as identified in the Navigant Report.

6.4 Recommendation: Hydro One needs to explain its budget assumptions on overtime hours and costs that will be needed to meet its ISA performance targets. It should also detail the consequence -- both in its operations scorecard and for the company as a whole -- if it misses those forecasts.

7. Scorecards, KPIs, RCE and Productivity

Scorecards and KPIs

7.1 Hydro One sets out the context for its Transmission Scorecard in its AIC:[34]

> Hydro One will continue to evaluate and refine those metrics on an ongoing basis.[35] Once the metrics have been appropriately considered and refined, Hydro One will consider publicly including and reporting these as against targets. Until then, Hydro One intends to track and trend its metrics while providing targets for compensation purposes for one year forward.[36]

7.2 Hydro One has chosen a variety of metrics to measure the impact of cost saving strategies associated with implementing industry best practices and other strategic initiatives. It says that these metrics are based on the four concepts in the RRFE and the associated guidelines that have been used by LDCs for several years.

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[32] Exhibit I Tab 11 Schedule 14: Exhibit B2Tab 2Schedule 1Pages 29-30 of Navigant Report
[33] Undertaking TCJ.12
[34] AIC, page 54
[35] Exhibit I, Tab 1, Schedule 92, Page 1.
[36] Ibid 19

7.3 Hydro One also states that significant focus was placed on the selection of KPIs in an effort to measure productivity in a number of areas, ranging from the deployment of capital, the execution of operations, as well as maintenance and administrative activities.[37] The goal, according to the company, is to evaluate its progress on realizing cost efficiencies and greater customer value. While developing its transmission scorecard, Hydro One re-evaluated the use of KPIs to improve performance and efficiencies across the organization. It also developed more robust KPIs in order to facilitate performance management. Metrics were chosen for the transmission scorecard to meet the criteria of being relevant, objective, measurable and actionable.

7.4 Hydro One's transmission scorecard commitments are detailed in the 22 KPIs used in the proposed transmission scorecard, and the additional tier 2 and tier 3 KPIs that have developed to augment the metrics in the scorecard. There are 3 KPIs included in the scorecard to address productivity and cost efficiencies.[38]

7.5 Recommendation: Hydro One's transmission scorecard is a work in progress and should be accepted for the two years of the application, but with the caveat that company investigate benchmarking more of its metrics, particularly more macro metrics. Energy Probe agrees with Board Staff[39] that Hydro One should consider a metric that looks at costs per unit. Hydro One strongly opposes such a metric, saying that, eventually, the company would "want to use these metrics to compare among other transmitters" and doing so, it believes, would be inappropriate. Regardless of how Hydro One compares to other utilities -- although we welcome that comparison -- it's important to see if Hydro One is capable of finding real efficiencies that lower end costs for customers. Customers -- and the Board -- may find that an overriding metric, such as costs per MWh, would be highly informative. Many customers may not care about the hundreds of line items that make up the company's rate application, but would be curious to know if the company's management is able to find efficiencies that, ultimately, lower costs for consumers. For example, using Hydro One's proposed revenue requirement and load forecast, we can see that the cost per MWh delivered is increasing by 4.75% in 2018 from the previous year.

Year	Revenue Requirement	Load Forecast (MWh)	Cost per MWh
2016	$1,480,700,000	20,233	$73,182
2017	$1,487,400,000	20,373	$73,008
2018	$1,558,400,000	20,378	$76,475

[37] Exhibit I-1-104
[38] Exhibit K1.4: Presentation Day, Slide 35
[39] Board Staff Final Argument, page 22

Reliability and Cost Efficiency RCE Metrics

7.6 Hydro One admits that its proposed Reliability and Cost Efficiency (RCE) metric shouldn't be "taken in isolation."[40] The reason, as pointed out at the oral hearing, is that the RCE metric will show "improvement" simply by increasing the company's gross asset value. As Hydro One increases its capital spending -- and, in the process, it's gross asset value -- over the next two to five years, all else being equal, the RCE metric will improve. Energy Probe questions the value of a metric that shows improvement simply by increasing the value of your assets through more greater capital spending.

7.7 Furthermore, the RCE metric deals with the number of outages, but not the duration. It is linked to one reliability metric (SAIFI), but not the other (SAIDI), yet the company has proposed outcomes that require improvements in both.

7.8 Recommendation: The Board should reject the RCE metric. If the Board is interested in the RCE metric, it should direct Hydro One to further investigate the merits of it and, in the meantime, the company should place zero weight on the RCE in scoring its performance scorecards.

Productivity

7.9 As detailed in Hydro One's AIC, the company embarked on an exhaustive review in an effort to find greater productivity opportunities. This initiative was described by Mr. Vels in the hearing[41] as follows:

> "… the new board and management, including myself, decided that it was appropriate to undertake a detailed review of the organization at that time with several goals in mind that would potentially enhance the draft business plan and result in an improved transmission rate application. These goals included an exhaustive review of the potential for further productivity and efficiency over and above what was included in the draft business plan, a customer consultation process, preparation of a comprehensive OEB scorecard, and
>
> improved analytics relating to the risk underlying the transmission reliability assumptions."

[40] Transcript Volume 1, page 148

[41] **Transcript Volume 1, Page 17,**

7.10 The key areas where productivity savings were expected to be found were:[42]

- More effective procurement programs, including investments in new processes and tools
- Reductions in administrative expenditures through improved processes and optimization of internal staff skills
- Rationalization of Hydro One's IT spending.
- Improved field efficiency through more effective work planning
- Improved execution through the consolidation of stations work.

7.11 Exhibit I-9-13 sets out examples of where Hydro One claims it has built productivity savings into its 2017 and 2018 budgets. Examples related to budgeted saving estimates for four purchase categories, include:

- (i) equipment rentals;
- (ii) general hardware;
- (iii) construction services; and
- (iv) construction materials;

The estimated budgeted savings just from these four purchase categories are $6.01 million in 2017 and $9.14 million in 2018.

7.12 In undertaking TCJ1.17, Hydro One sets out the OM&A related savings that are currently built into its investment plan:

- procurement OM&A savings of $2.1 and $2.8 million in 2017 and 2018,respectively
- procurement capital savings of $11.2 and $21.4 million in 2017 and 2018, respectively
- OM&A savings from the information solutions division of $3.4 million and $4.5 million in 2017 and 2018, respectively
- OM&A savings from stations of $2.9 million and $3.5 million in 2017 and 2018, respectively

7.13 Hydro One claims it has already built OM&A savings into its application that amount to $8.4 million in 2017 and $10.8 million in 2018. Capital savings built into the application amount to $11.2 million in 2017 and $21.4 million in 2018.[43] Hydro One claims these estimates are conservative and do not include the positive effect of lower pension costs -- since these were not defined as productivity savings. They also don't include expected savings in other areas, such as the significant future avoided costs

[42] TCJ 1,17
[43] TCJ1.17

stemming from the tower coating program and the avoided costs associated with integrated stations replacement.

7.14 Productivity improvements require more than just increasing the output per unit of labour or capital, but also that the cost of inputs -- labour and material -- is reduced. Hydro One is making headway on using new technology and lowering its supply chain procurement costs but, in our view, is doing less than it should on improving labour productivity. We note that over 2015-2018, total base pay per employee is increasing by 7% for regular employees, 3% for casual/temp and 3.8% overall. In our view, it is key that Hydro One reduce the rate of increases to the average pay per regular employee and, at the same time, reduce the number of work units.

7.15 The other key labour productivity improvement would see Hydro One actually reduce overtime costs. Energy Probe believes that the best way to do that would be to reduce standard overtime rates to 150% of the job rate (excluding weekends and holidays). As noted earlier, other utilities in the Navigant Benchmarking Peer Group[44] have adopted such measures. Hydro One remains an outlier in this respect.

7.16 In regards to productivity savings, Hydro One is not directly accountable through rates, but rather indirectly through scorecards and KPIs.

7.17 Recommendation: The Board should direct Hydro One to provide full accounting for the claimed 2017 and 2018 productivity savings in its next rate application. It should also address actions taken to improve labour productivity and related savings going forward.

8. OM&A Expenditures

[44] **Ibid Ref 17**

Description	2012	2013	2014	Historic 2015	Bridge 2016	Test 2017	Test 2018
Sustainment	204.7	221.0	228.6	233.6	227.5	241.2	238.5
Development	8.4	8.6	7.5	6.1	5.3	4.8	5.0
Operations	54.8	56.7	56.6	59.0	60.0	61.3	62.1
Customer Care	4.4	5.3	5.4	5.1	4.1	4.0	3.9
Common Corporate Costs and Other OM&A	80.7	75.8	37.2	73.9	72.3	49.9	47.5
Taxes Other Than Income Taxes	62.1	21.2	64.1	63.9	62.9	63.6	64.3
Pension Adjustment*	-	-	-	-	-	-11.0	-8.0
B2M LP Adjustment*	-	-	-	-	-	-0.8	-2.1
Total	**415.2**	**388.4**	**399.5**	**441.6**	**432.1**	**413.1**	**411.2**
Capitalization	106.9	109.3	124.3	116.9	122.0	133.2	134.7
Gross OM&A, pre-capitalization	**522.1**	**497.7**	**523.8**	**558.5**	**554.1**	**546.3**	**545.9**

8.1 In every year but 2015, Hydro One has spent less than the OM&A amount allowed to be recovered in rates.[45] In 2012, it underspent by $12.1 million, for 2013 it was $11.6 million (adjusted by the unforeseen tax refund), for 2014 it was $50.3 million, for 2015 it overspent by $10.4 million and in 2016 it again underspent by $4.7 million. In total, Hydro One underspent by $68.3 million over 5 years, an amount that ratepayers have funded through rates, but was apparently not actually needed by Hydro One.

8.2 Meanwhile, as noted earlier, between 2012-2015 Hydro One's ROE exceeded the allowed return by 2.99%, 4.29%, 3.76% and 1.63%, respectively.[46] For 2016, the current estimate for ROE is 2.5% the approved amount. As noted in Board Staff's argument, under-spending on OM&A over that 5-year period is a major contributor to the over-earnings. While it has been regulators' practice under IRM to allow utilities to keep the savings, under cost-of-service this is not part of the regulatory compact.

8.3 Recommendation: Consistent historical under-spending of OM&A by Hydro One under cost-of-service regulation -- and over-earning relative to the allowed ROE -- requires an adjustment of the claimed OM&A envelope for the 2017 and 2018 test years. We recommend a reduction of 3% based on the 5-year average historic under-spending. This would be $15 million per year. This recommended reduction is a general OM&A reduction, as opposed to other specific Energy Probe reductions.

[45] Exhibit I-13-25

[46] Exhibit I Tab 2 Schedule 30

9. Common Corporate Functions and Services

Exhibit I
Tab 4
Schedule 12
Page 2 of 3

Table 1: CCF&S Costs ($ Millions)

Description	Historic Years				Bridge Year	Test Years		TX Allocation	
	2012	2013	2014	2015	2016	2017	2018	2017	2018
Corporate Management	5.0	4.9	5.5	12.5	23.4	22.3	22.1	7.2	7.1
Value Growth					5.9	4.2	4.2	0.0	0.0
Corporate Donations					1.1	1.1	1.1	0.0	0.0
Investor Relations					1.8	1.0	1.0	0.0	0.0
Corporate Management (excluding 3 groups above)					14.5	16.0	15.7	7.2	7.1
Finance	35.2	41.9	40.0	39.1	42.1	41.0	38.6	21.9	19.4
Human Resources	9.9	11.1	12.8	13.6	16.2	14.8	14.2	7.6	7.3
Corporate Communications & Services	11.3	15.0	19.5	17.3	17.5	17.3	19.4	8.7	9.9
General Counsel and Secretariat	8.8	9.6	8.7	8.6	10.3	10.4	10.5	5.5	5.6
Regulatory Affairs	20.6	20.6	23.0	24.1	26.4	25.4	26.0	9.6	9.8
Security Management	3.1	3.4	3.5	4.2	5.1	4.7	4.8	2.2	2.3
Internal Audit	3.5	3.4	3.6	4.2	6.2	6.3	6.4	3.3	3.4
Real Estate & Facilities	54.6	54.1	53.6	60.0	60.1	59.6	60.7	32.2	32.7
Total CCF&S Costs	**152.0**	**164.0**	**170.3**	**183.6**	**207.3**	**201.8**	**202.6**	**98.3**	**97.5**

9.1 The above exhibit excludes non-regulatory costs and does not include all common costs. Another $150 million of costs are directly allocated to work programs -- planning, IT management, project control.[47] The total figure is $325 million, which amounts to about 55% of OM&A costs. As can be seen from the exhibit above, common corporate costs continue to increase disproportionately relative to customer growth and loads served by both the company's transmission and distribution businesses.

Corporate Management Costs

9.2 Corporate management costs are increasing by $10 million annually.[48] Corporate management costs allocated to the transmission business were $4 million in 2016, increasing to $7.2 million in 2017 and $7.1 million in 2018. One of the drivers of this increase is executive compensation.

[47] Exhibit I Tab11 Schedule 32

[48] **C1/Tab3/Sch1 and Exhibit ITab4 Schedule 12 (Table 1)**

9.3 Board of Director costs are also increasing, beginning in 2016 and again into 2017 and 2018.[49] Hydro One's CFO noted that this increase is "not a reflection of the fact that it's a public company. It's a reflection of the level of management that is required to run the company."[50]

Outsourcing: Inergi and BGIS

9.4 In an effort to mitigate cost increases, Hydro One is relying on outsourcing. By the end of the test years, Hydro One will -- over the previous decade -- have outsourced major administrative functions to Inergi, a subsidiary of Cap Gemini,[51]at a cost of $158 million annually, with $33.5 million of that amount allocated to the transmission business. More recently, Hydro One has outsourced facilities management to Brookfield Global Integrated Solutions (BGIS) at a cost of $28.8 million annually. The main features of the Inergi contract include:

- An ECA cost inflator
- Productivity
- Setting and measuring performance targets.
- Shared savings

9.5 Exhibit TCJ 2.21 and BS IRR Exhibit I Schedule 118, Attachment 1 address, at a high level, the Inergi performance targets. Exhibit C1, Tab 3 Schedule 2, Page 3 indicates that the Inergi agreement also provides for optional benchmarking reviews of fees by an independent third party. The cost of that review is borne equally by Hydro One and Inergi. The third party analyst is selected from a predetermined list included in the Inergi agreement. The new agreement allows for continued competitive benchmarking cycles, but without restrictions on when the benchmarking can take place. Hydro One is not totally clear on the triggers and process for this third party review and the process for this. It has never invoked this provision.

9.6 The BGIS 10-year contract is for $28.8 million per year and covers several services previously performed in-house by Hydro One. Hydro One claims that it will save $80 million over the term of the contract.[52] Performance is monitored against KPIs monthly. The overall performance reported for 2016 was within the stated targets.[53]

[49] **Exhibit I Tab13 Schedule 18**
[50] **Transcript Vol 2, p.144**
[51] **Exhibit C1Tab 3 Schedule 2 Pages 3 and 12 and Appendix B Table 1**
[52] Exhibit I Tab13 Schedule 16
[53] Exhibit I Tab 1 Schedule 120

9.7 Increases in corporate management costs related to executive compensation and the Board of Directors are a direct result of the new post-IPO Hydro One management model. The company claims that the new model requires a higher level of management. Yet, Hydro One is still transitioning from a public- to investor-owned utility. Hydro One is still 70% publicly-owned and may be so for some time. More directly, these costs are excessive and cannot be accepted based on aspirations of improved performance that stem from the privatization of the utility.

9.8 As we elaborate under the executive compensation and long-term incentive plan (LTIP) sections, the increased corporate management costs are not related to providing better value to transmission customers in 2017 and 2018. Therefore, these costs should not be borne by those customers, but rather by the shareholder and removed from 2017 and 2018 rates.

9.9 In regards to outsourcing, Hydro One confirmed there are no direct financial consequences to Inergi if the five performance measures shown in the referenced exhibit are not met.[54] Given the emphasis by Hydro One on productivity improvements in 2017 and 2018, it is crucial that outsourced functions performed by Inergi and BGIS, which comprise almost 50% of common corporate costs (OM&A), are benchmarked and that aggressive targets for productivity improvements are put in place.

9.10 Recommendation: The Board should find the increased corporate management costs in 2017 and 2018 are not related to providing better value to transmission customers in the test tears. Therefore, they should not be borne by those customers, but rather by the shareholder and removed from rates in 2017 and 2018.

9.11 Recommendation: The Board should direct Hydro One to benchmark its outsourcing contracts, preferably before the next application, and provide specific productivity improvements and incentive/rewards for these contracts. In addition, Hydro One notes that outsourcing to BGIS is now an affiliate contract. This requires additional justifications under the provisions of the Affiliate Relations Code. Accordingly, Hydro One should provide the necessary evidence in its next application (the Distribution Revenue Requirement for 2018-...).

[54] Ibid

10. Compensation

Representation	2013	2014	2015	2016	2017	2018
PWU Reg	360,796,279	370,778,651	368,449,119	384,766,692	388,118,070	387,145,503
SOCIETY Reg	137,310,153	148,807,143	148,539,224	145,544,065	145,551,630	142,615,374
MCP Reg	82,939,240	81,578,789	84,289,003	92,403,449	97,211,160	101,517,699
Total Regular	581,045,672	601,164,583	601,277,346	622,714,206	630,880,860	631,278,575
Total Compensation	719,976,414	757,299,121	751,352,945	787,652,865	807,633,194	813,743,318

Note: the difference between total compensation $ and total regular compensation $ is the compensation for temporary and casual employees.

Hydro One's total payroll -- transmission and distribution -- continues to increase at a rate above inflation.[55][56] After a decline in 2015, the increase for 2016 is 4.8% and, proposed for 2017 and 2018, is 2.5% and 7.5%, respectively. In total, over three years, the increase amounts to 8.3%. This increase includes payroll for casual and other non-regular employees that amounts to about $150 million in 2015 and increases to $182 million in 2018 -- an increase of 21.5%

The reasons for this change, as they relate to Hydro One's transmission application, appear to be

- significant increases in executive and management positions.
- a reduced permanent regular workforce
- Increased individual compensation for all full time employees, including STIP, LTIP and Share Plans.
- Overtime paid at 200% of the base rate
- Increased use of casual and temporary workers

Compensation is the primary component and major driver of OM&A costs between 2016-2018., Energy Probe will address compensation and payroll in nine sub-sections:

[55] Exhibit I Tab 11, Schedule 28 part d)

[56] Exhibit I-06-060

10.1 Compensation Philosophy for Executives
10.2 Compensation Benchmarking and Peer Groups
10.3 Senior Executive Compensation
10.4 Executive Compensation and Productivity
10.5 Executive and Non-Unionized (Bands 2-4) Compensation
10.6 Management Non-Unionized (Bands 5-10) Compensation
10.7 Society and Union Compensation
10.8 Casual, Temporary and Non-Regular Staff
10.9 Proposed STIP Scorecards

The issue of pensions and OPEBs will be briefly discussed, but will largely be left to other parties to address.

10.1 Compensation Philosophy for Executives

10.1.1 Hydro One sets out its compensation philosophy in its AIC. A significant portion of management compensation is variable and dependent on performance. Hydro One states that both Long-Term Incentive Plans (LTIP) and Short-Term Incentive Plans (STIP) have been included in compensation packages to align with competitive markets and incentivize improvement. These variable aspects of total compensation are also aligned with Hydro One's proposed transmission scorecard and the principles of the RRFE.

10.1.2 Hydro One is telling the Board that its compensation policy is now (and should be) aligned with other investor-owned companies, including OEB-regulated companies like Union Gas and Enbridge Gas Distribution. This statement and supporting evidence is misleading and should not be accepted for these reasons:

- Union Gas Limited and Enbridge Gas Distribution gas utilities are integrated transmission and distribution companies that are 100% investor-owned
- Hydro One is still 70% publically owned and there is nothing to suggest that it will move to a majority investor-owned company over 2017-2018.
- Union and Enbridge Total Direct Compensation (TDC or "compensation") plans -- including STIP and LTIP -- have been reviewed in detail by the Board.
- Hydro One executive compensation plans are purely *aspirational.* There is no track record for either the STIP (one-year outlook) and LTIP (3-year outlook)
- The OEB has found in many Decisions that Hydro One's compensation benchmark should at P50 (the median) of its peer group. (see below)

10.1.3 Recommendation: We will discuss and propose alternative compensation approaches for management that are fairer to the both the company and its ratepayers. Given Hydro One is still majority publicly-owned, the Board should not fully accept Hydro One's proposed compensation policy and approach for 2017 and 2018.

10.2 Compensation Benchmarking and Peer Groups

10.2.1 In the 2013 Mercer Report, the 3 groups that **were** benchmarked included only two executives in the non-represented/management group -- the top rates and regulatory affairs executive and financial director. These are the same as the prior studies. The new 2016 Mercer compensation benchmarking report does not include total compensation benchmarking for other executives in bands 1-4 in the non-represented/management group. There were no benchmarking studies filed in prior cases for the senior executive group. The senior executive positions (CEO and CFO) for this application were benchmarked in the Hugesson report done for the Hydro One Board.

10.2.2 The compensation benchmarking for bands 1-4 (top level) and MCP for bands 5-10 were also dealt with in the two Towers Watson reports.[57] All told, there are *4 separate* benchmarking reports for executive and management compensation.

10.2.3 At the Technical Conference, there was a discussion about the continuity and comparability of Mercer Peer Groups with Mr. McDonell[58]

> MR. McDONELL: Correct. One of the things we have been doing and directed by the Board here *was to try and be consistent, so we can show trending within the total compensation that Mercer provided.*
>
> So by and large the peer group will be the same from the previous three studies. *Now, we have tried to add a couple of other peer groups just to provide a little bit more data, but by and large it would be the same peer groups for MCP, PW, and Society jobs.*

10.2.4 As noted earlier, Mercer benchmarks non-unionized (MCP), Society and Union positions. Only two executive positions are included. The new Mercer Benchmarking Report[59] shows:

Relative to *Median P50*

Non Represented (Mgt)	**1.02 or 2% over P50**
Professionals (Society)	**1.11 or 11% over P50**
Power Workers (PWU)	**1.16 or 16% over P50**
Overall	**1.14 or 14% over P50**

[57] Exhibits I Tab 6 Schedules 57 Attachments 2 and 3

[58] TC Transcript Volume 2 Pages 12-13 PAGE 14

[59] **Exhibit 9.8 Mercer Slide Deck Preliminary Results Pages 12 and 18**

Relative to *Market Average*

Non Represented (Mgt)	**0.98 or 2% below Avg.**
Professionals (Society)	**1.06 or 6% over Avg.**
Power Workers (PWU)	**1.10 or 10% over Avg.**
Overall	**1.08 or 8% over Avg**

10.2.5 Mercer estimated that the dollar difference between the weighted average total compensation for Hydro One employees and the P50 median for its peers included in the study amounted to $71 million annually. Hydro One allocates 17.6%, or $12.5 million of that amount, to the transmission business.

10.2.6 Relative to 2013, the Mercer report indicates that compensation for these three groups (excluding management) are further away from the Peer Group P50 median. Worse still, this doesn't even consider new STIP (for management) or lump sum payments for the Employee Option Share Plan (EOSP), since these were not in place in 2016.

10.2.7 A key issue is determining *the appropriate benchmark* for regulatory purposes. In the EB-2013-0416/EB-2014-0247 Board Decision Page 24:

> *Hydro One did not provide sufficient evidence in support of its proposed compensation spending. The company did not demonstrate that the market requires the level of compensation proposed in order to attract and retain the necessary employees. In the absence of such evidence the OEB will use the market median as a reference point for the percentage of compensation costs that will be included in the rates paid by Hydro One's customers.*
>
> *While the OEB recognizes the progress that Hydro One has made over the last few years in getting closer to the market median, the OEB does not find that it is fair that ratepayers pay for a 10% premium over the market median. The OEB, however, will not disallow the entire 10% premium. Rather, the OEB will require efficiency from Hydro One by disallowing half of that amount from the revenue requirement, or $7.7 million per year, each year for 2015, 2016 and 2017. The OEB still expects Hydro One to accomplish the work programs as outlined. In addition, the OEB directs Hydro One, in its next rates application, to file a compensation study similar to the one filed in this proceeding so that the OEB can continue to benchmark Hydro One's compensation against that paid by comparable companies.*[60]

[60] Extract from the Board Decision in EB-2013-0416/EB2014/0247 page 24

10.2.8 As well as requiring a new benchmarking study, the Decision laid out two key elements. First, that ratepayers should not pay a premium for compensation. Secondly, since Hydro One was above the median, the Board made a disallowance equivalent to a revenue requirement reduction of $7.7 million in compensation each year. These findings relate to Hydro One Networks (Corporate) and would encompass both the distribution and transmission businesses.

10.2.9 Recommendation: The Board should find that, based on the Mercer Study, Hydro One's compensation remains above the market median for most benchmarked positions. Therefore, it should reduce overall OM&A allocated to the transmission business by the excess amount estimated by Mercer, which totals $17 million out of $71 million

10.3 Senior Executive Compensation CEO and CFO

10.3.1 Effective June 4, 2015, the BPSAA[61] is no longer applicable to Hydro One. In addition, as of June 4, 2015, the Broader Public Sector Executive Compensation Act, 2014 (Ontario) (the "BPSECA"), legislation, which would otherwise have applied to Hydro One in the place of the BPSAA, also does not apply to Hydro One. Hydro One's Chief Executive Officer and Chief Financial Officer were retained after the BPSAA ceased to apply to the company and their compensation arrangements reflect Hydro One's proposed new approach to executive compensation.

10.3.1 Since 2013, the number of Hydro One executive positions has increased from 16 to 24 and total compensation will rise from $6.5 million to $19.56 million in 2018. The transmission business' share of compensation has risen from $3.8 million to $4.6 million from 2013-2016 and is projected to grow to $8.3 million in 2018, including $5.2 million in incentives.[62] In 2014, Hydro One's CEO pay amounted to $745,208, including benefits, and Hydro One's CFO was paid $521,635, including benefits.

			MCP - Executive (MCP Bands 1-4)			
Year	TOTAL WAGES	Base Pay	Short Term Incentive	Long Term Incentive	Other Allowances	TX Allocation
2013	3,819,831	2,692,652	951,635	NA	175,544	55%
2014	3,598,757	2,645,729	715,466	NA	237,562	57%
2015	4,471,294	3,051,486	1,000,500	NA	419,308	58%
2016	4,646,716	2,790,537	1,183,868	575,850	96,461	52%
2017	6,582,265	2,846,348	1,465,703	2,171,824	98,390	52%
2018	8,269,726	2,862,728	1,526,873	3,779,768	100,358	52%

[61] Broader Public Sector Accountability Act (Ontario)

[62] EP IR #29 and Transcript Undertaking 10.5

10.3.2 Hydro One indicates that the reason the new CEO and CFO positions attract higher compensation than the former CEO and CFO is the need for a different skill set.[63]

10.3.3 Hugessen Consulting was engaged by the Hydro Board to undertake a competitive market assessment for the new CEO and CFO appointments. Given certain challenges in benchmarking the CEO and CFO positions, Hugessen considered and benchmarked these positions against a few comparator groups.

10.3.4 The Hydro One Board approved 2016 compensation for the top two executive positions is:[64]

	CEO	**CFO**	**% Base Pay**	
Base Salary	**$850,000**	**$500,000**	**-**	**-**
Target STIP	**$765,000**	**$300,000**	**90**	**60**
Target LTIP	**$2,385,000**	**$700,000**	**280**	**140**
TOTAL TDC	**$4,000,000**	**$1,500,000**		

10.3.5 There are four specific senior executive compensation issues that we will address:

- The appropriateness and comparability of the peer groups used for compensation benchmarks for the CEO and CFO positions
- The use a P75 rather than a P50 benchmark
- The implications for compensation of the transitional ownership structure of Hydro One relative to other regulated utilities.
- We will also comment on the proposed STIP and LTIP.

10.3.6 Hydro One's consultants have used ***three*** peer groups to benchmark total compensation for the CEO and CFO positions. Mr. Soare of Hugessen provided a detailed explanation of how this benchmarking came about.[65] In sum, Hydro One's Board of Directors retained Hugessen directly. Hugessen then provided a CEO and CFO compensation philosophy and a peer group made up of eight utilities. This benchmarking was later used by Hydro One human resources as part of the IPO in late 2015.

10.3.7 For continuity, Towers Watson adopted this as one peer group, but then, after discussions with Hydro One in August 2015, expanded this group to a larger 21-member peer group for their report. Compared to the Hugesson peer group -- or the Mercer peer group -- a much lower proportion of the Towers Watson peer group are rate regulated utilities.

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[63] Exhibit I, Tab 1, Schedule 1

[64] Exhibit I Tab 11 Schedule 23 c), d)

[65] Transcript Volume 8 Pages 127

10.3.8 Our view is that the peer group chosen by Hugesson to benchmark CEO and CFO compensation was appropriate for market comparison purposes. It was also adopted by Hydro One for the IPO. The expanded 21-member peer group is not appropriate, as many of these companies are not rate-regulated. The Board should reject this peer group in favour of the eight-utility peer group since Hydro One failed to provide compelling evidence on why these, predominantly, non-rate regulated utilities are a better comparison when it comes to compensation, particularly for the top executives.

10.3.8 As to Hydro One's argument regarding insufficient benchmarks in the 8 utility peer group, Energy Probe notes that the accepted Mercer peer group includes many of these mid-management positions. Furthermore, Mr. Soare confirmed that the Hugesson-recommended mid-case that influenced the initial CEO and CFO compensation was based on a *P75* 8-utility peer group benchmark.[66]

10.3.9 As noted above, Towers Watson (Mr. Resch) confirmed that the Towers Watson CEO and CFO compensation study used both the IPO 8-utility peer group, as well as the proposed expanded new 21-company executive peer group.[67] Mr. Resch confirmed that Hydro One's compensation philosophy states that they target the 50th percentile[68].

> MR. RESCH: Yes, the organization -- so Hydro One's compensation philosophy states that they target the 50th percentile.
> DR. HIGGIN: Right. So if we were using at the utility group, that would have been the lower numbers that are shown here for the utility peer group, correct?
> MR. RESCH: The 50th percentile for the utility peer group, yes, is lower than the 50th percentile for the executive peer group.
> DR. HIGGIN: Right. So, for example, for the CEO, it's 500,000 less a year if you use the utility peer group and P 50?
> MR. RESCH: If -- yes.
> DR. HIGGIN: And the same for CFO. It's 200,000 a year less for CFO if you used the utility peer group, correct?
> MR. RESCH: Yes.

10.3.10 Mr. Resch confirmed, in this exchange, that the result of this change from the 8-utility peer group to a 21-member executive peer group by Towers Watson was:

- the CEO and CFO compensation at P50 for 2016, using the 8-member IPO utility peer group, would have been: $3.6 million and $1.3 million, respectively
- Using the new 21-member executive peer group at P50 the compensation increased to $4 million for CEO and $1.5 million for CFO, respectively.

[66] Transcript Volume 8 Pages 125/126
[67] Transcript Volume 9 Pages 126/127
[68] Transcript Volume 9 Pages 130.131

10.3.11 Recommendation: Energy Probe submits that, for regulatory purposes, Hydro One's executive compensation should be benchmarked at P50 of the 8-utility Hugesson peer group, with a potential *ceiling* of $3.5 million for the CEO and $1.6 million for the CFO. We also accept that on top of base pay, appropriate STIPs should be recoverable in rates (see specific comments about STIP Scorecard below during 2017 and 2018).

10.3.12 Recommendation: However, we submit that during the transition from a public utility to an investor-owned utility, Hydro One's LTIP awards should be based on a ***post*** rather than ***prospective*** basis. In other words, based on actual performance and subject to further review by the Board. Cost recovery should be deferred until the next case. Although not currently before the Board, this recommendation also applies to Hydro One's distribution business.

10.3.13 The reasons for this recommendation are three-fold:

- Hydro One is transitioning from a regulated public-owned utility to an investor-owned utility. Yet, unlike other private utilities regulated by the Board, such as Union and Enbridge, Hydro One is 70% publicly-owned There is no evidence on the record when the full transition to a private utility will be complete.
- It is our understanding that the current LTIP targets cover three years, 2016-2018, and accordingly the LTIP pay award should be based on performance over that period and not recovered prospectively in rates.
- Union and Enbridge have performance continuity to inform their test year LTIP plans and awards. Hydro One does not.

10.3.14 Furthermore, we suggest that pay equity/fairness between crown-owned electricity peers -- such as the OPA and IESO -- should be taken into account when considering Hydro One's executive compensation, specifically the LTIP portion. Granting a (potentially) 285% LTIP bonus for Hydro One senior executives is in our view inappropriate, given that Hydro One is still a majority publically-owned utility. It also creates unnecessary executive compensation pressures across the electricity sector.

10.3.15 Recommendation: For regulatory purposes, the Board should accept the proposed senior executive base pay and, in principle, an STIP for 2017 and 2018 at the P50 Hugesson benchmarks. That amounts to base pay of $850,000 and STIP of up to $765,000 for the CEO and base pay of $500,000 and STIP of up to $300,000 for the CFO.

10.3.16 Recommendation: The current STIP scorecard is not based on customer outcomes as required by the RRFE and should be redesigned. Accordingly until this is done, the 2017 and 2018 STIP award costs should not be recovered from ratepayers in

rates and should be deferred using a deferral account. Hydro One should provide evidence on the new STIP scorecard when seeking recovery of the STIP costs and clearance of the deferral account.

10.3.17 Recommendation: The LTIP component of compensation is excessive and based on Hydro One being a private investor-owned utility. Its structure should be re-examined by Hydro One and consideration by the Board deferred until 2019. Hydro One should provide appropriate evidence to support the regulatory LTIP awards in the next rate case. This recommendation also applies to Hydro One's distribution business.

10.4 Executive Compensation and Productivity

10.4.1 In its AIC[69] Hydro One links retaining the new CEO and CFO to pension savings of $3.5 million between 2015 and 2017[70], as well as a $15-million decrease in revenue in 2016, which will be refunded to ratepayers through the pension cost variance deferral account in future rate applications.[71]

10.4.2 Energy Probe submits the Board should totally reject the merit of Hydro One's linking of increased executive compensation to the pension re-evaluation directed by the CFO, which Hydro One reiterates in its AIC is not a productivity outcome.

10.4.3 Periodic (2-3 years) actuarial valuations are required and are part of the OEB regulatory framework. The current review was "off cycle", but the evaluation would have been required in the next rates case. The fact that the valuation indicated a projected surplus is not surprising, due to demographic and market changes. This is not a productivity improvement and its timing is not linked to the hiring of the new CFO.

10.4.4 Recommendation: Hydro One needs to demonstrate real productivity improvements as a result of steps taken by the CEO and CFO in order to support an award of the LTIP. This is why Energy Probe has recommended post-performance evaluation and deferral of recovery of these costs.

10.5 Executive and MCP (Bands 2-4) Compensation

10.5.1 The Towers Watson study for the second level executive group used both the eight-utility peer group and the expanded 21-member executive peer group.[72] The result was that Hydro One's executive compensation in 2016 was at ~P25 of each peer group -- due to no LTIP -- and should be increased to P75. This would result in the

[69] AIC, page 60-61
[70] Exhibit I-4-12
[71] TCJ1.8
[72] Exhibit I-06-057-02 Pages 5 -6

recommended changes in total compensation:[73]

	3rd-5th highest paid	Band 3	Band 4
Market P50	$1,285,000	$735,000	$463,000
Hydro One	$548,000	$365,000	$285,000

10.5.2 Towers Watson does not specifically link the difference in Hydro One compensation to a specific amount of LTIP, but does note this is the major difference. Towers Watson says the following:

> **Transition / implementation**
> The Executive Peer Group can be considered somewhat
> **aspirational,** representing the future growth of the organization and its requisite talent needs.
> Compensation levels for current incumbents do not immediately need to be aligned with the market 50th percentile and can be transitioned over time (e.g., 1 to 3 years) depending on the incumbent and the pace of organizational change.
> Experienced new hires may need to be positioned closer to the market 50th percentile upon hire

10.5.3 Recommendation: Towers Watson is recommending the benchmark for the 3rd-5th executives and bands 2-4 be P50 of the executive peer group during a two- to three-year transitional period. Since the major "aspirational" component of compensation is LTIP, we submit that this recommendation from Towers Watson supports our position on LTIP; mainly, that *it should not be awarded on pre-test year basis, but rather on a post-basis and any recovery of costs deferred until a review by Hydro One in time for its next rate application.*

10.5.4 Recommendation: However, we do not support the use of the Towers Watson executive peer group as the appropriate benchmark for bands 5-10. As we submitted for the CEO and CFO, the benchmark should be P50 of the 8-utility peer group used by Hugesson and by Hydro One for the IPO. In addition, it is clear that the 8-utility peer group more closely compares to the Mercer Peer Group.

10.6 Management Non-Unionized (Bands 5-10) Compensation

10.6.1 Hydro One engaged Towers Watson to complete a competitive market assessment of its total rewards package for its management compensation plan (MCP) employees (588 incumbents).[74]The Towers Watson analysis was based on Hydro One's current organizational structure and responsibilities. Towers Watson indicated it will need to be refreshed, as it transitions to an autonomous publicly-traded company. As such, use of this data and any program changes it informs should be paced with the evolution of the organization. The Towers Watson benchmark review focuses on non-executive roles (Bands 5-10). A review of executive roles is underway and will be provided separately. The market research was conducted on a segmented basis

[73] Exhibit I-06-057-02 Pages 5 -6

[74] I-06-057 Attachment-03

10.6.2 Towers Watson indicated that, consistent with Hydro One's compensation philosophy, roles are benchmarked against comparator organizations that best represent the underlying skill sets required. The two segments identified for benchmarking purposes include core operational and support segments, with each representing 50% of the band 5-10 population and 77% of Hydro One's incumbents are in roles covered by this review.

		Base Salary			Total Target Cash (TTC)			Total Direct Compensation (TDC)		
Band	# Hydro One Benchmarked Incumbents	Avg. Hydro One	Avg. P50	% +- P50 Base Salary	Avg. Hydro One	Avg. P50	% +- P50 TTC	Avg. Hydro One	Avg. P50	% +- P50 TDC
Band 5 *(Director)*	49	$167	$150	*11%*	$204	$183	*12%*	$204	$191	*7%*
Band 6 *(Mgr/Prof)*	118	$135	$129	*5%*	$155	$142	*9%*	$155	$142	*9%*
Band 7 *(Mgr/Prof)*	229	$117	$107	*10%*	$130	$116	*12%*	$130	$116	*12%*
Band 8 *(Admin)*	19	$74	$68	*9%*	$80	$73	*9%*	$80	$73	*9%*
Band 9 *(Admin)*	35	$64	$61	*6%*	$69	$65	*7%*	$69	$65	*7%*
Band 10 *(Admin)*	3	$55	$50	*10%*	$57	$52	*8%*	$57	$52	*8%*
Weighted Average	453	$121	$112	8%	$137	$124	11%	$137	$125	10%

10.6.3 On an aggregate basis, Hydro One's position to market is aligned "at" or slightly above market median, with above market variances attributable largely to the support segment. This is consistent with the findings of the Mercer Report.

10.6.4 In regards to pension and OPEBs, Towers Watson finds that Hydro One is above the market median for pensions and savings, but at or below market median for OPEBs.

10.6.5 Recommendation: As we submitted earlier, with respect to the results of the Mercer Report, the Towers Watson report shows, again, that the compensation for Hydro One's MCP employees in bands 5-10 is above the P50 median of the peer groups. TCJ 1.6 shows the premium for these bands may be $6.3 million. As the Board has previously determined, we submit that Hydro One must not recover the premium above market from ratepayers. This will require Hydro One, in its Reply Argument, to provide a compensation payroll deduction calculation for 2017 and 2018 based on the Mercer and the Towers Watson groups at P50. It should provide this to the Board together with an estimate of the amount to be allocated to its transmission business.

10.6.6 Recommendation: Given that Hydro One has moved in the opposite direction from its market peers, 100% of the premium should be disallowed and a reduction made in the OM&A component of the 2017 and 2018 revenue requirement.

10.6.7 Recommendation: Based on the Towers Watson Report for bands 5-10 that shows Hydro One is above market (P50), and given the fact that the disallowance of half of the market premium in the last rates case has not resulted in corrective action, 100% of the above market premium identified by Towers Watson for these positions should be disallowed. Hydro One should calculate this amount and provide it in its reply argument. It should also be reconciled with the Mercer estimate of $71 million. There should be an appropriate reduction in 2017 and 2018 OM&A costs and an appropriate allocation of the disallowance to Hydro One's transmission and distribution businesses.

10.7 Society and Union Compensation

10.7.1 The compensation for Hydro One's Society and Union employees is the result of collective bargaining. Hydro One addresses the 2015 agreement in its AIC, indicating that the most recent round of collective bargaining with PWU and the Society resulted in significant gains in three areas:

- Base wage increases below inflation (e.g.1.27% for 2017), which is also below market
- Lump sum payments, thereby reducing overall compensation costs (lump sum payments do not impact other benefits).[75]
- Employee Share Ownership Plan (ESOP) -- "ownership" type compensation in the form of share grants and employee share ownership opportunities, thereby engaging employees and aligning their interests with Hydro One's goals and success.[76]

10.7.2 The costs of the ESOP to Hydro One are estimated to be $3,540,302 in 2017 and $4,745,181 in 2018, for both the PWU and Society.[77]

10.7.3 Hydro One's overall payroll for the Society and Union in 2017 appears to increase at 1.27% i.e. below inflation.[78] However, as indicated by Mercer and Towers Watson, Hydro One's compensation is still above P50 of the benchmark peer group. Furthermore, this benchmark does not include lump sum payments, or the costs to Hydro One of the ESOP.

10.7.4 Hydro One contends that the lump sum payments and ESOP are part of the package negotiated with the Society and Union in 2015. This may be true, but the offset in reduced payroll and average pay for 2017 and 2018 is not in evidence. Hydro One agreed in examination that for executive and MCP bands there was no offset.[79] Ratepayers are still faced with ongoing increases in payroll and above market compensation.

10.7.5 We submit the ESOP reflects the "private investor-owned utility" compensation philosophy. Yet, Hydro One has not provided the Board with any evidence that such a scheme for unionized employees is part of total compensation for its Mercer Benchmark Peer Group -- in which Hydro One's Union and Society compensation is above P50. In

[75] Exhibit C1, Tab 4, Schedule 1, Page 14.
[76] Exhibit I, Tab 1, Schedule 128
[77] Ibid 43
[78] Form 2K and I-06-060
[79] Exhibit I Tab 11 Schedule 26 b)

addition, it is unclear why new employees do not have the same rights, subject to service requirements[80].

10.7.6 Hydro One has provided the Board with a difficult regulatory issue. It has not supported its ESOP proposal by benchmarking, but claims ESOP was part of the deal in the 2015 collective bargaining and is an offset to higher base pay.

10.7.7 Recommendation: For regulatory purposes, compensation for both Society and Union employees in rates should be at the median of the Mercer peer group. Hydro One should also provide the Board with an adjustment to OM&A, which should be reconciled with the $75 million premium estimated by Mercer, and appropriately allocated to transmission and distribution businesses.

10.7.8 Recommendation: Hydro One has not provided compelling evidence of the offsets or benefits to the ESOP grants. Since both Society and Union compensation is already above the P50 benchmark, the Board should disallow the recovery of the ESOP costs in rates in 2017 and 2018. This would adjust OM&A costs amounting to $3.5 million in 2017 and $4.7 million in 2018.

10.8 Casual, Temporary and Non-Regular Staff

10.8.1 Hydro One employs a large number of casual, non-regular staff that perform about 57% of the transmission work program.[81] Hydro One was asked about the use of, and savings from, the use of casual non-regular staff. [82]Hydro One responded that it is obligated through collective agreements to assign work to the various union's based on their work jurisdiction entitlements. Since there are no options to assign work to another union, there are no savings.

10.8.2 As indicated earlier, casual and non-regular employee and payroll will increase by 21.5% over the period 2016-2018. Hydro One has confirmed there is no direct benefit or lower cost by using more non-union labour to deliver work programs, as the work must be assigned to Union and Society employees.

11. Proposed Executive/MCP STIP Scorecards

[80] Transcript Vol 10 Page 12
[81] Exhibit C1 Tab 4 Schedule 1, p. 22
[82] Exhibit I Tab1 Schedule 127

Execution and Performance

June 2016 Hydro One Team Scorecard

Strategic Objectives	Definition	Measure	Year-to-Date			Full Year	
			Actual	Budget	Last Year	Budget	Target
Safety (10%)	Recordable Incidents	Incidents per 200,000 hours	1.3	1.6	1.8	1.6	1.5
Customer (25%)	Tx Satisfaction Note 1	% satisfied of total surveyed	n/a	n/a	n/a	80%	82%
	Dx Satisfaction	% satisfied of total surveyed	68%	73%	70%	73%	75%
	Tx Customer Commitments	% of commitments kept made to Tx Customers	90%	74%	n/a	74%	81%
	Dx Customer IT Enablement	Provide Customers tools and technology (3 projects initiated)	Note 2	Note 2	n/a	2	3
Net Income (40%)	Net Income to Common Shareholders	$M	360	381	359	Note 3	Note 3
Work Program (25%)	Dx Pole Replacement	# of Poles	8,273	6,404	7,334	12,000	12,600
	Dx Line Clearing	KM Controlled	5,952	5,207	5,669	11,000	12,100
	Tx In Service Capital	$M	230	266	225	+3% or -5%	910
	Dx In Service Capital	$M	294	313	288	+3% or -3%	622

Note 1: The Tx Satisfaction survey results will be received in Q3
Note 2: We are on track to deliver three projects this year to benefit communication and interaction with customers
Note 3: As we are a public company, we cannot communicate full year net income budgets widely

▶ 34

11.1 Hydro One indicates that for the executive employees (Bands 3-4 and lower), the STIP scorecard was put in place in 2016[83] and a modified version will apply to the 2017-2018 rate years. The STIP template applies to bands 3-4 and/or lower bands. The senior executives (bands 1-2) have a different version that has different content and weighting[84].

11.2 There are two important customer-related metrics and weightings in the scorecards. First, the 25% weighting for "customers" and, for transmission specifically, the percent of net income with a 40% weighting. with a score of $360 million compared to target $381 million. The outcome of this metric is net income to common shareholders.

11.3 Recommendation: The proposed weightings in the scorecard, in our view, are inappropriate for regulatory -- as opposed to internal -- purposes. The KPIs should be directly related to outcomes that are directly relevant to customers, including end-use

[83] Presentation Day Hydro Slide Deck Page 34

[84] Undertaking Exhibit J1.02

customers. For example, the 40% net income metric has no relevance to ratepayers.

11.4 Recommendation: The STIP scorecards for all executives should be redesigned to reflect categories and weightings that relate to customer outcomes and, importantly, recognize the ownership status of Hydro One. This redesign should be completed for the next rates application. Hydro One may want to consider filing this for its upcoming distribution application.

Costs

Energy Probe has participated fully in all aspects of the Proceeding. However, while cooperating with other intervenors in the interest of efficiency, it has focused its efforts in certain key areas.

For these reasons, we request that Energy Probe be reimbursed for 100% of its legitimately incurred costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

Brady Yauch MSc, MA, Consultant to Energy Probe

Roger M.R. Higgin PhD.; MBA: P. Eng. SPA Inc.- Consultants to Energy Probe

12. Summary of Energy Probe Recommendations (with Paragraph References).

Overall

1.10 Recommendation: Energy Probe, largely, supports Hydro One's application for 2017-2018 transmission rates in regards to capital spending. Hydro One has proposed an ambitious, in our opinion, capital spending budget that the company hopes will address the demographic "bulge" of its assets. Throughout the proceeding, no party disagreed with Hydro One's assessment, though some parties feel the company should "pace" its investments to avoid rate increases in a time of rising public concern over hydro bills.[85] Yet, part of the reason for the current proposal for rate hikes is that Hydro One deferred work in the past in an effort to mitigate rate hikes. As well, Hydro One was required by legislation to pursue capital projects that supported renewable energy and other environmental policies implemented by Queen's Park. We don't see any time in near future that would qualify as a "good" time for rate hikes. Alternately, Energy Probe has proposed a slightly "smoothed " approach to capital spending (Section 3.9) that the Board may consider.

1.11 Recommendation: Energy Probe believes that the company's move to increasingly tie non-union compensation to performance targets is a key step in pushing the company towards greater efficiencies and improved reliability. That said, Hydro One's proposal for short-term and long-term compensation incentives is, in some cases, inappropriate considering that the company is still largely public and it's asking for money in rates before the incentives have been achieved. Energy Probe proposes that the Board establish a deferral account for the STIP portions of incentive compensation, while denying other portions altogether. Putting a portion of incentive **compensation in a deferral account gives the company a two-year window to prove to the** Board and its customers that it can complete what it proposes to do in terms of improved performance (on both the capital and operating sides of its business).

Capital Plan

3.8 Recommendation: Energy Probe believes the Board should approve Hydro One's proposed capital spending plan for 2017-2018 for two reasons. First, it's clear that the work needs to be done -- no party in the proceeding, as highlighted in Hydro One's argument-in-chief, questioned whether that was the case. While some parties believe that Hydro One could adjust the "timing" or "pacing" of those investments -- and, as detailed below, whether Hydro One is actually capable of completing the work as planned (we share those concerns) -- it's not clear that such a policy would, in the long-run, be of net benefit to ratepayers. More simply, the costs of deferring the work could end up being greater than those detailed in the application, according to Hydro One's evidence. Secondly, Hydro One has in the past been required by legislation to spend

[85] Board Staff's final argument

significant amounts of money on projects and assets that it wouldn't otherwise have done. Energy Probe questions the logic of denying the company the opportunity of "playing catch up" when it's clear that its asset base is aging and the risk of those assets failing is increasing.

3.9 Recommendation: Alternately, we propose a plan that would marginally trim Hydro One's capital plan, but still allow the company to address its aging asset base. In percentage terms, Hydro One is proposing to increase its sustaining capital budget by 9.34% annually between 2017-2021. In 2017 to 2018 the increase is, on average, 7.34%. Energy Probe proposes that the Board approve a sustaining capital budget increase of 7% annually in 2017 and 2018 (and for the remaining years in the company's forecast). Doing so would lower the sustaining budget from the proposed $776.8 million in 2017 to $775 million and from $842 million in 2018 to $829.25 million. Collectively, our proposal lowers the sustaining budget over 2017-2018 by around $14.5 million. Going forward, to 2021, our proposal, while still allowing Hydro One to increase its annual sustaining budget, lowers the 2021 figure to around $1,015 million from Hydro One's forecast of $1,118 million. We believe our proposal allows Hydro One to address its aging assets, while also cutting some spending due to our concerns with the reliability risk model and customer engagement.

Customer Consultation

5.1 Recommendation: It's hard to see the value in Hydro One's customer consultation exercise for two reasons and, as such, we think the Board should give it little consideration. First, many of the charts and figures the company put before those being surveyed were misleading and presented a doomsday scenario. Second, Hydro One excluded LDC end customers from the sessions even though they account for 92% of the company's revenue. Energy Probe welcomes Hydro One's push to pursue greater dialogue with its customers, but we question the value of this particular consultation, given the information presented and the timing between the sessions -- we agree with Board Staff's concern on this point [**insert reference here**] -- and Hydro One's application.

Capital Plan Implementation

6.3 Recommendation: There is no clear evidence explaining who is responsible for deciding the size of overtime costs that are eventually built-in to final budgets to ensure that in-service additions (ISAs) are completed on time. Given the size of the capital budget, combined with the projected reductions in the permanent work force and the ISA performance scorecards, there is likely to be increasing pressure to rely on overtime hours to ensure ISA targets are completed on time. Hydro One has not provided any evidence detailing specific plans to reduce overtime costs to meet industry norms, as identified in the Navigant Report.

6.4 Recommendation: Hydro One needs to explain its budget assumptions on overtime hours and costs that will be needed to meet its ISA performance targets. It should also detail the consequence -- both in its operations scorecard and for the company as a whole -- if it misses those forecasts.

Transmission Scorecard and Metrics

7.5 Recommendation: Hydro One's transmission scorecard is a work in progress and should be accepted for the two years of the application, but with the caveat that company investigate benchmarking more of its metrics, particularly more macro metrics. Energy Probe agrees with Board Staff[86] that Hydro One should consider a metric that looks at costs per unit. Hydro One strongly opposes such a metric, saying that, eventually, the company would "want to use these metrics to compare among other transmitters" and doing so, it believes, would be inappropriate. Regardless of how Hydro One compares to other utilities -- although we welcome that comparison -- it's important to see if Hydro One is capable of finding real efficiencies that lower end costs for customers. Customers -- and the Board -- may find that an overriding metric, such as costs per MWh, would be highly informative. Many customers may not care about the hundreds of line items that make up the company's rate application, but would be curious to know if the company's management is able to find efficiencies that, ultimately, lower costs for consumers. For example, using Hydro One's proposed revenue requirement and load forecast, we can see that the cost per MWh delivered is increasing by 4.75% in 2018 from the previous year.

7.8 Recommendation: The Board should reject the RCE metric. If the Board is interested in the RCE metric, it should direct Hydro One to further investigate the merits of it and, in the meantime, the company should place zero weight on the RCE in scoring its performance scorecards.

Productivity

7.17 Recommendation: The Board should direct Hydro One to provide full accounting for the claimed 2017 and 2018 productivity savings in its next rate application. It should also address actions taken to improve labour productivity and related savings going forward.

OM&A Expense

8.3 Recommendation: Consistent historical under-spending of OM&A by Hydro One under cost-of-service regulation -- and over-earning relative to the allowed ROE -- requires an adjustment of the claimed OM&A envelope for the 2017 and 2018 test years. We recommend a reduction of 3% based on the 5-year average historic under-spending. This would be $15 million per year. This recommended reduction is a general OM&A

[86] Board Staff Final Argument, page 22

reduction, as opposed to other specific Energy Probe reductions.

Corporate Management Costs

9.10 Recommendation: The Board should find the increased corporate management costs in 2017 and 2018 are not related to providing better value to transmission customers in the test tears. Therefore, they should not be borne by those customers, but rather by the shareholder and removed from rates in 2017 and 2018.

Outsourcing: Inergi and BGIS

9.11 Recommendation: The Board should direct Hydro One to benchmark its outsourcing contracts, preferably before the next application, and provide specific productivity improvements and incentive/rewards for these contracts. In addition, Hydro One notes that outsourcing to BGIS is now an affiliate contract. This requires additional justifications under the provisions of the Affiliate Relations Code. Accordingly, Hydro One should provide the necessary evidence in its next application (the Distribution Revenue Requirement for 2018-...).

Compensation

10.1.3 Recommendation: We will discuss and propose alternative compensation approaches for management that are fairer to the both the company and its ratepayers. Given Hydro One is still majority publicly-owned, the Board should not fully accept Hydro One's proposed compensation policy and approach for 2017 and 2018.

10.2 Compensation Benchmarking and Peer Groups

10.2.9 Recommendation: The Board should find that, based on the Mercer Study, Hydro One's compensation remains above the market median for most benchmarked positions. Therefore, it should reduce overall OM&A allocated to the transmission business by the excess amount estimated by Mercer, which totals $17 million out of $71 million

Senior Executive/MCP TDC

10.3.11 Recommendation: Energy Probe submits that, for regulatory purposes, Hydro One's executive compensation should be benchmarked at P50 of the 8-utility Hugesson peer group, with a potential *ceiling* of $3.5 million for the CEO and $1.6 million for the CFO. We also accept that on top of base pay, appropriate STIPs should be recoverable in rates (see specific comments about STIP Scorecard below during 2017 and 2018).

10.3.12 Recommendation: However, we submit that during the transition from a public utility to an investor-owned utility, Hydro One's LTIP awards should be based on a *post*

rather than ***prospective*** basis. In other words, based on actual performance and subject to further review by the Board. Cost recovery should be deferred until the next case. Although not currently before the Board, this recommendation also applies to Hydro One's distribution business.

10.3.15 Recommendation: For regulatory purposes, the Board should accept the proposed senior executive base pay and, in principle, an STIP for 2017 and 2018 at the P50 Hugesson benchmarks. That amounts to base pay of $850,000 and STIP of up to $765,000 for the CEO and base pay of $500,000 and STIP of up to $300,000 for the CFO.

10.3.16 Recommendation: The current STIP scorecard is not based on customer outcomes as required by the RRFE and should be redesigned. Accordingly until this is done, the 2017 and 2018 STIP award costs should not be recovered from ratepayers in rates and should be deferred using a deferral account. Hydro One should provide evidence on the new STIP scorecard when seeking recovery of the STIP costs and clearance of the deferral account.

10.3.17 Recommendation: The LTIP component of compensation is excessive and based on Hydro One being a private investor-owned utility. Its structure should be re-examined by Hydro One and consideration by the Board deferred until 2019. Hydro One should provide appropriate evidence to support the regulatory LTIP awards in the next rate case. This recommendation also applies to Hydro One's distribution business.

Executive Compensation and Productivity

10.4.4 Recommendation: Hydro One needs to demonstrate real productivity improvements as a result of steps taken by the CEO and CFO in order to support an award of the LTIP. This is why Energy Probe has recommended post-performance evaluation and deferral of recovery of these costs.

MCP Compensation

10.5.3 Recommendation: Towers Watson is recommending the benchmark for the 3rd-5th executives and bands 2-4 be P50 of the executive peer group during a two- to three-year transitional period. Since the major "aspirational" component of compensation is LTIP, we submit that this recommendation from Towers Watson supports our position on LTIP; mainly, that *it should not be awarded on pre-test year basis, but rather on a post-basis and any recovery of costs deferred until a review by Hydro One in time for its next rate application.*

10.5.4 Recommendation: However, we do not support the use of the Towers Watson executive peer group as the appropriate benchmark for bands 5-10. As we submitted for the CEO and CFO, the benchmark should be P50 of the 8-utility peer group used by

Hugesson and by Hydro One for the IPO. In addition, it is clear that the 8-utility peer group more closely compares to the Mercer Peer Group.

10.6.5 Recommendation: As we submitted earlier, with respect to the results of the Mercer Report, the Towers Watson report shows, again, that the compensation for Hydro One's MCP employees in bands 5-10 is above the P50 median of the peer groups. TCJ 1.6 shows the premium for these bands may be $6.3 million. As the Board has previously determined, we submit that Hydro One must not recover the premium above market from ratepayers. This will require Hydro One, in its Reply Argument, to provide a compensation payroll deduction calculation for 2017 and 2018 based on the Mercer and the Towers Watson groups at P50. It should provide this to the Board together with an estimate of the amount to be allocated to its transmission business.

10.6.5 Recommendation: As we submitted earlier, with respect to the results of the Mercer Report, the Towers Watson report shows, again, that the compensation for Hydro One's MCP employees in bands 5-10 is above the P50 median of the peer groups. TCJ 1.6 shows the premium for these bands may be $6.3 million. As the Board has previously determined, we submit that Hydro One must not recover the premium above market from ratepayers. This will require Hydro One, in its Reply Argument, to provide a compensation payroll deduction calculation for 2017 and 2018 based on the Mercer and the Towers Watson groups at P50. It should provide this to the Board together with an estimate of the amount to be allocated to its transmission business.

10.6.6 Recommendation: Given that Hydro One has moved in the opposite direction from its market peers, 100% of the premium should be disallowed and a reduction made in the OM&A component of the 2017 and 2018 revenue requirement.

10.6.7 Recommendation: Based on the Towers Watson Report for bands 5-10 that shows Hydro One is above market (P50), and given the fact that the disallowance of half of the market premium in the last rates case has not resulted in corrective action, 100% of the above market premium identified by Towers Watson for these positions should be disallowed. Hydro One should calculate this amount and provide it in its reply argument. It should also be reconciled with the Mercer estimate of $71 million. There should be an appropriate reduction in 2017 and 2018 OM&A costs and an appropriate allocation of the disallowance to Hydro One's transmission and distribution businesses.

10.7.8 Recommendation: Hydro One has not provided compelling evidence of the offsets or benefits to the ESOP grants. Since both Society and Union compensation is already above the P50 benchmark, the Board should disallow the recovery of the ESOP costs in rates in 2017 and 2018. This would adjust OM&A costs amounting to $3.5 million in 2017 and $4.7 million in 2018.

STIP-Pay for Performance

11.3 Recommendation: The proposed weightings in the scorecard, in our view, are inappropriate for regulatory -- as opposed to internal -- purposes. The KPIs should be directly related to outcomes that are directly relevant to customers, including end-use customers. For example, the 40% net income metric has no relevance to ratepayers.

11.4 Recommendation: The STIP scorecards for all executives should be redesigned to reflect categories and weightings that relate to customer outcomes and, importantly, recognize the ownership status of Hydro One. This redesign should be completed for the next rates application. Hydro One may want to consider filing this for its upcoming distribution application.

APPENDIX A

A. How these Matters came Before the Board

The Application

Hydro One Networks Inc. ("Hydro One" or the "Company") applied under Section 78 of the
Ontario Energy Board Act, 1998 in proceeding EB-2016-0160 for approval of the revenue
requirement, use of certain regulatory accounts, and rates for the transmission of electricity for a two year period, effective January 1, 2017 ("Application").
In this Application, Hydro One requests approval of:

- rates revenue requirements of $1,487.4 million for 2017 and $1,558.4 for 2018[87];
- charge determinants by rate pools for developing Uniform Transmission Rates[88];
- its proposed performance scorecard ("Transmission Scorecard")[89];
- continuation of certain regulatory accounts[90]; and
- disposition of certain regulatory accounts with a net credit balance of $95.6 million
  effective January 2017.

Context for Application

In November 2015, Hydro One's shareholder completed the necessary steps to sell 15% of the outstanding common shares in its parent company, Hydro One Limited ("HOL")[91]. Hydro One states:

> *"This was a formative step which resulted in significant and fundamental changes to the affairs of the company. Hydro One is transitioning from an entirely Crown-owned corporation into one which is more commercially oriented; that is, has greater focus on customers, greater corporate accountability for performance outcomes, and company-wide increase in productivity and efficiency"*.

Hydro One states the Application seeks to become fully aligned with the Ontario Energy Board's ("OEB" or "Board") ratemaking expectations now described in the Board's Handbook to Utility Rate Applications (the "Handbook") including the principles and objectives of the OEB's Renewed Regulatory Framework for Electricity ("RRFE").

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[87] Exhibit K6.3, Update to Exhibit A, Tab 3, Schedule 1, Page 1
[88] Exhibit K6.3, Page 1.
[89] Exhibit B2, Tab 1, Schedule 1, Attachment 1, Page 2.
[90] Exhibit K6.3, Pages 22-23.
[91] Exhibit J.11.10. The total issuance of shares to the public is now approximately 29%, as discussed in Transcript Volume 1, Page 43, Line 20 to Page 44, Line 1.