

**2017 ELECTRICITY TRANSMISSION
REVENUE REQUIREMENT**

Hydro One Sault Ste. Marie LLP

EB-2016-0356

OEB STAFF SUBMISSION

June 22, 2017

INTRODUCTION

By an application dated December 23, 2016, Great Lakes Power Transmission LP (GLPT, now Hydro One Sault Ste. Marie LP, referred to here as Hydro One SSM) filed an application with the Ontario Energy Board (OEB), seeking approval for changes to its electricity transmission revenue requirement, to be effective January 1, 2017.

In its January 14, 2016 Decision and Order in GLPT's 2016 Transmission Rate application¹, the OEB approved GLPT's 2016 revenue requirement of \$39.8M. This was the second year of GLPT's two-year cost of service proceeding approved by the OEB on December 18, 2014.

On October 13, 2016, the OEB approved an application by Hydro One Inc. to purchase all of the issued and outstanding voting securities of GLPT's general partner, Great Lakes Power Transmission Inc.², and accepted Hydro One Inc.'s proposal to defer rebasing for Hydro One SSM for a ten year period. Hydro One SSM was allowed to continue with GLPT's existing revenue requirement and bring forward a separate rate application seeking approval for the elements of a specific revenue cap index framework for the deferral period.

In this application, Hydro One SSM has proposed a revenue cap index for 2017, which results in a proposed base revenue requirement of \$40,533,904. Hydro One SSM also proposes to recover a net deferral and variance account balance of a debit of \$975,219. The resulting requested revenue requirement to be recovered through 2017 Uniform Transmission Rates (UTR) is \$41,509,123. The 2016 Uniform Transmission Rates (UTR) currently in place were declared interim³ until the 2017 UTR are approved. Hydro One SSM has requested a deferral account to record revenue deficiencies from the total approved amount as incurred from January 1, 2017 until the implementation date of rates in this proceeding.

¹ EB-2015-0337

² EB-2016-0050

³ EB-2016-0160 Hydro One Networks Inc. Transmission, November 24, 2016 Oral Hearing Transcript, page 4, lines 12 & 13

This submission is based on the record in this proceeding, which includes Hydro One SSM's application and responses to interrogatories from OEB staff, Schools Energy Coalition, the Vulnerable Energy Consumers Coalition and the Association of Major Power Consumers in Ontario. On June 8, 2017, Hydro One SSM filed its argument in chief, which largely reiterated the positions established in its evidence.

SUBMISSION

Hydro One SSM has proposed an effective date in this application of January 1, 2017. OEB staff notes that the application date of December 23, 2016 would, under normal circumstances, necessitate a later effective date to allow the OEB to process the application. In this case, the form of the application is the result of the OEB's order in Hydro One Inc.'s application for the acquisition of Great Lakes Power Transmission Inc., which was issued on October 13, 2016. Under these circumstances, the filing date constitutes relatively prompt attention to the OEB's Order. OEB staff has no concerns with the requested effective date of January 1, 2017.

Hydro One SSM has stated that it intends to file annual applications during the rebasing deferral period using the proposed revenue cap index, adopting the Hydro One Transmission stretch factor in 2019. It is unclear from Hydro One SSM's evidence whether it intends to update the inflation factor during that time. OEB staff requests clarification of Hydro One's intentions in its reply submission.

In addition to this matter, OEB staff finds it necessary to make submissions on the following three items.

- Hydro One SSM's Proposed Scorecard
- Deferral Account for Forgone Revenue
- Hydro One SSM's Proposed Revenue Cap Framework
- Hydro One SSM's Asset Management Plan

Hydro One SSM's Proposed Scorecard

One of the expected components of this Revenue Cap Index application specified by the OEB was a proposed scorecard, which Hydro One SSM has provided. Hydro One SSM's scorecard contains measures in each of the

performance categories. However, OEB staff notes that the scorecard as filed included neither targets for the performance outcomes listed nor timelines for implementation, and is therefore incomplete.

In response to interrogatories, Hydro One SSM stated that, for nearly all of the performance outcomes, implementation would not be forthcoming until operational integration occurs in 2019. OEB staff submits that, while it is logical to develop longer term performance measurements in conjunction with Hydro One Networks, Hydro One SSM has provided no evidence of its current performance measures. OEB staff submits that this lack of performance measurement is inconsistent with the requirements of an incentive rate-setting application and the OEB's expectations as expressed in its Decision approving the acquisition by Hydro One. OEB staff suggests that Hydro One SSM should be required to provide performance measure metrics for HONI SSM in its next application.

As a result, OEB staff submits that the OEB cannot be adequately informed by Hydro One SSM's scorecard in terms of monitoring Hydro One SSM's performance. OEB staff submits that Hydro One SSM should re-submit a proposal in its 2018 IR application.

Deferral Account for Foregone Revenue

Hydro One SSM has requested approval to establish a sub-account of Account 1574 to capture differences between revenue earned by Hydro One SSM under the interim 2017 UTR (set at the 2016 UTR level and subject to adjustment following the OEB's determination of 2017 revenue requirement applications by rate-regulated transmitters), and the revenues that would have been received under the approved final 2017 UTR. OEB staff submits that Hydro One SSM's request to establish the deferral account is reasonable for the following reasons.

- In its December 29, 2015 Decision and Order in the B2M LP 2015-2019 Transmission Rate application⁴, the OEB stated that a true-up to reflect the actual 2015 revenue requirement needed to be generated. Specifically, the OEB stated:

⁴ EB-2015-0026 B2M LP December 29, 2015, page 10

...the OEB will require B2M LP to calculate the difference between the interim and final 2015 revenues, and refund or recover the difference through an adjustment to the 2016 revenue requirement.

OEB staff submits that the impact of this true-up would generally have the same effect as recording the forgone revenue in a deferral account that would be cleared in a subsequent rate period.

- There are precedents regarding the proposed deferral account. For example:
 - i) In its Decision and Order in GLPT's 2015 Transmission Rate application⁵, the OEB allowed GLPT to record certain forgone revenue in sub-accounts of Account 1574.
 - ii) The OEB approved a deferral account for forgone revenue in the 2016 Hydro One Networks Transmission proceeding⁶. However, the specifics of the deferral account have not been approved at this time.

Hydro One SSM's Proposed Revenue Cap Framework

In its Decision approving the purchase of voting securities of Hydro One SSM, the OEB was specific in the components required of Hydro One SSM in its revenue cap index framework, as follows:

Such an application would be expected to encompass the following components as required by the Transmission Filing requirements: the annual adjustment (expected inflation, productivity, stretch factors) and proposed performance reporting and monitoring (draft scorecard, RRR filings, etc.).⁷

⁵ EB-2014-0238 GLPT December 18, 2014, page 3

⁶ EB-2016-0160 Hydro One Networks Inc. Transmission, November 24, 2016 Oral Hearing Transcript, page 4, lines 15 & 16

⁷⁷ EB-2016-0050, Decision and Order, October 13, 2016

Hydro One SSM has applied for a base 2017 revenue requirement, based on an adjustment of 1.9% to its approved base 2016 revenue requirement. Hydro One SSM has calculated its adjustment factor using expected inflation of 1.9%, a productivity factor of 0% and a stretch factor of 0%. Hydro One SSM proposes to adopt the same annual productivity and stretch factors as Hydro One Transmission, beginning in 2019.

Hydro One SSM states that it will be undertaking a significant review of its operations in conjunction with Hydro One prior to its operational integration, which is expected to begin in 2019. Hydro One SSM states that it “does not expect any significant operational integration steps, or savings, to occur during 2017 or 2018”⁸.

The proposed framework is generally consistent with the framework currently in place for distributors’ Incentive Regulation Mechanism applications. In general, OEB staff has no concerns with the proposed framework, subject to the comments which follow, given that the framework will change by Hydro One SSM’s 2019 application to be consistent with the Hydro One Transmission 2019 application and will only be in effect for at most two years.

The OEB’s experience in incentive regulation for electricity distributors has evolved from 2001 to the establishment of three alternative incentive rate-setting methodologies available to distributors starting in 2014. As a move toward greater adoption of an incentive- and performance-based rate setting framework for transmitters in February 2016, the OEB created two new transmission revenue plan options: the Revenue Cap Index; and Custom IR. This application is based on the Revenue Cap Index methodology. As described in the OEB’s *Filing Requirements for Electricity Transmission Applications* (Filing Requirements), this methodology is analogous to a Price Cap for distributors and includes expectations for the development of an index, as well as productivity and stretch commitments. Although a standardized, formulaic approach has been adopted for distributors’ inflation, productivity and stretch factors as incentive regulation has evolved, no such process has been developed for transmitters. Instead, transmitters are “invited” to propose and substantiate the appropriate

⁸ EB02016-0356, Exhibit 2, Tab 1, Schedule 1, p. 3

method and productivity and stretch commitments for these elements of the adjustment formula⁹.

OEB staff notes that the lack of a formulaic approach for segments of the energy sector other than distribution has not prevented other regulated entities from developing their own approach to incentive regulation. For 2017 to 2021, Ontario Power Generation (OPG) proposed a price cap index rate-making methodology for the company's regulated hydroelectric generation assets, modeled closely on the Price Cap Index set out in the OEB's *Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach* (RRFE). OPG's framework deviates from the Price Cap Index as necessary to incorporate material differences between the distribution and hydroelectric generation segments of the industry. Specifically, the methodology proposed different weighting of the industry input costs in establishing the inflation factor; considered (and rejected) negative growth potential established through an independent Total Factor Productivity (TFP) study; established a productivity factor of 0%; and adopted a stretch factor based on the OEB's 0% to 6% stretch factor range (3% established through the company's hydroelectric benchmarking performance). The OEB has not yet rendered a decision on this methodology. As well, Hydro One Distribution has recently filed a custom IR application¹⁰, which incorporates a revenue cap index. Given the more recent filing of this application, OEB staff has focused on the OPG parameters as comparators in this submission, particularly as it represents an example of an incentive rate-setting mechanism for a non-distributor.

OEB staff appreciates that the timing of this application following the OEB's EB-2016-0050 decision did not allow sufficient opportunity to lay the groundwork for a full revenue cap index as contemplated in the Transmission Filing Requirements. OEB staff submits that further efforts could, and should, be made to address the intent of the Filing Requirements in future applications by Hydro One SSM, as aligned with Hydro One's 2019 transmission application which is intended to propose an incentive rate-setting framework in accordance with the Filing Requirements. Accordingly, OEB staff's observations below are on the components of the IR plan as they may apply to 2017 rates, but the parameters

⁹ Filing Requirements for Electricity Transmission Applications, February 11, 2016, p.1

¹⁰ EB-2017-0049

should be enhanced and aligned with Hydro One's 2019 proposal, including addressing the concerns noted by OEB staff below.

OEB staff will address the three components of the adjustment factor separately.

Inflation Factor

Hydro One SSM has applied an inflation factor of 1.9%, consistent with the inflation factor approved for use by the OEB for distributors in 2017, on the grounds that:

...in the absence of a specific inflation factor established by the OEB for transmitters, it is appropriate for Ontario's transmitters to use the same inflation factor as distributors, recognizing they will share many of the same inputs.¹¹

OEB staff acknowledges that transmitters and distributors share many of the same inputs. However, in establishing the inflation factor, the OEB used a 2-factor Implicit Price Index, which considers that inflation rates for labour and non-labour inputs may differ. The weights for labour and non-labour inputs were established based on a review of the cost shares of medium to large distributors in the province. For distributors, the OEB used weights of 30% for labour, and 70% for non-labour. As noted above, OPG adjusted the weighting of the inputs to reflect the relative shares applicable to the hydroelectric generation industry, applying weighting of 88% to 12% for non-labour and labour, respectively. The resulting proposed inflation factor employed in the OPG formula was 1.8%¹².

OEB staff submits that, while the inputs applicable to transmission and distribution may be largely the same, it may be that the weighting of labour and non-labour inputs may differ between the segments. OEB staff submits that Hydro One SSM's future transmission applications should consider the appropriate weighting of inputs to determine the appropriate inflation factor.

¹¹ EB-2016-0356, Exhibit 4, Tab 1, Schedule 1, p. 1

¹² EB-2016-0152, Exhibit A1, Tab 3, Schedule 2, p. 14

In the absence of a specific review of cost inputs to determine otherwise, OEB staff submits that for the purposes of this application an inflation factor of 1.9% is appropriate.

Productivity Factor

Similar to its logic in developing an inflation factor, Hydro One SSM has adopted the OEB-approved 0% productivity factor established for distributors for 2017. Hydro One SSM again notes the lack of an industry-wide productivity factor developed by the OEB and proposes:

...that the productivity factor used by distributors in Ontario is the most applicable rate to use at this time because until there is more supporting information available, the general assumption is that transmitters' opportunities to realize productivity improvements are not greater than those of distributors.¹³

OEB staff submits that while "the general assumption is that transmitters' opportunities to realize productivity improvements are not greater than those of distributors", the inverse would also be true: that transmitters' opportunities to realize productivity improvements are not *lesser* than those of distributors.

OEB staff agrees that more supporting information is required to determine the appropriate productivity factor for transmitters. Specifically, a total factor productivity (TFP) study should be required for the Ontario transmission business, to determine its unique long run trend in TFP growth. OEB staff notes that a TFP study was conducted and the results considered by OPG in establishing its own productivity proposal of 0%.

While a productivity factor of 0% may well be appropriate for Hydro One SSM, this cannot be established with any certainty until such a TFP study is conducted. Such an undertaking may be onerous for Hydro One SSM to undertake on its own, however it would not be unreasonable for the OEB to require such a study of Hydro One Networks in its 2019 transmission revenue requirement application.

¹³ EB-2016-0356, Exhibit 4, Tab 1, Schedule 1, p. 1

In the absence of a supporting study, OEB staff submits that the use of a productivity factor of 0% for Hydro One SSM for 2017 and 2018 is appropriate.

Stretch Factor

The intent of the stretch factor, as described in the Report of the Board on *Rate Setting Parameters and Benchmarking under the Renewed Regulatory Framework for Electricity Distributors* (EB-2010-0379), is as follows:

The stretch factor component of the X-factor is intended to reflect the incremental [efficiency] gains that distributors are expected to achieve under IR and is a common feature of IR plans. These expected productivity gains can vary by distributor and depend on the efficiency of a given distributor at the outset of the IR plan. Stretch factors are generally lower for distributors that are relatively more efficient.¹⁴

Hydro One SSM has proposed a stretch factor of 0%, for the following reasons:

- The OEB has not approved stretch factors for Ontario transmitters
- Hydro One Networks and Hydro One SSM will be undertaking a review to determine operational synergies to come into effect for 2019, with no significant operational steps to occur before that time
- Hydro One SSM will adopt the stretch factor determined for Hydro One Networks in its 2019 application and it would not be cost effective to determine a stretch factor specific to Hydro One SSM prior to that time
- Hydro One SSM is currently in a 10-year deferred-rebasing period. In accordance with the *Handbook to Electricity Distributor and Transmitter Consolidations*, achieved savings realized during this period are intended for the acquiring shareholder to offset transaction costs and premiums
- Hydro One SSM's operating costs fall below the majority of those of its peers as shown in the benchmarking report filed in this proceeding¹⁵.

OEB staff notes that, while Hydro One SSM's evidence adopts the currently approved inflation factor and productivity factors for distributors, as conditions are

¹⁴ Report of the Board, November 21, 2013, p. 12

¹⁵ EB-2016-0356, Exhibit 3, Tab 1, Schedule 4, Appendix A

likely similar for transmitters and distributors, this does not appear to be the case for the stretch factor.

As discussed below, Hydro One SSM has provided evidence in this proceeding that shows that its total OM&A costs relative to the average of those for a sample of its peers is slightly below the sample average. OEB staff submits that further efficiency gains are possible. Given the recent acquisition by Hydro One, efficiency gains in administration costs in particular could likely be expected. In its application for acquisition of Norfolk Power Distribution Inc., Hydro One submitted that operational savings would come from:

- Elimination of redundant administrative and processing functions
- Scheduling efficiencies
- Elimination of duplicate back office systems
- Savings from the allocation of the costs of the remaining back office systems over a larger customer base
- Reduced Board of Director costs, membership fees for energy associations and regulatory filing expenses
- Using existing systems, processes and corporate shared services within HONI; and consolidation of operating business centres¹⁶.

OEB staff recognizes that a review of operational synergies with Hydro One Networks is forthcoming. However, OEB staff submits that such a forthcoming review is not likely to preclude Hydro One SSM from pursuing efficiency gains prior to that time.

Under these circumstances, OEB staff submits that it would be reasonable to encourage the pursuit of efficiency gains through the application of a stretch factor.

Hydro One SSM states that savings achieved throughout the deferral period are intended for the acquiring shareholder to offset transaction costs and premiums. OEB staff notes that distributors recently acquired by Hydro One, such as Norfolk Power Distribution Inc., Haldimand Power Hydro Inc. and Woodstock Hydro Services Inc. have also been allowed to delay rebasing to offset transaction costs and premiums. In those cases, the maximum allowable delayed rebasing period was five, rather than ten years. For these distributors, Hydro One has applied a

¹⁶ EB-2013-0196/EB-2013-0187/EB-2013-0198, Decision and Order, July 3, 2014

1% reduction to the last rebased rates, as well as a rate freeze over the rebasing deferral period. OEB staff submits that the Revenue Cap Index regime proposed for Hydro One SSM's deferral period, which contains neither a similar 1% reduction, nor a stretch factor, would appear to be generous.

OEB staff agrees that it would not be cost effective to develop a stretch factor specific to Hydro One SSM, and that adopting a similar stretch factor to Hydro One Transmission at the time of its 2019 application would be a logical approach. OEB staff notes that OPG adopted the range applicable for distributors, applying industry specific benchmarking information in its proposed methodology. In the absence of a specific stretch factor for Hydro One SSM, OEB staff submits that the use of the existing range developed for use by distributors and as adopted by OPG (i.e. 0%, .15%, .30%, .45%, .60%) would be reasonable.

Hydro One SSM has provided a benchmarking study to support its claims of operating a cost-efficient utility. The study is based on a sample of 11 transmitters' Operation and Maintenance (O&M) and Administration and General (A&G) costs. As the sample is small and total costs (including capital costs) are not considered, the study is not analogous to that underpinning the derivation of stretch factors for distributors. The data show that Hydro One SSM is below the average of the sample in total OM&A costs. Disaggregating the costs shows that O&M is below average and A&G is above average, which would indicate that Hydro One SSM's results would put them about in the middle of the sample. The results are not so far below average to warrant a stretch factor of 0%, which would apply to a distributor at the lowest end of the cost spectrum. Generally, OEB staff submits that costs in the middle range for distributors would result in a stretch factor of .30%. OEB staff supports this general approach to be used for 2017 and 2018, pending a more rigorous analysis in conjunction with Hydro One Transmission for 2019.

Hydro One SSM's Asset Management Plan

In its Settlement Proposal for 2015 transmission revenue requirement, GLPT agreed to "submit to the Board a more detailed and comprehensive Asset Management plan as part of the GLPT's next rate application"¹⁷. In response to interrogatory 1-SEC-2, Hydro One SSM stated that it was in the process of revising its approach to asset management in conjunction with Hydro One Networks. In its argument-in-chief, Hydro One SSM stated that:

¹⁷ EB-2014-0238, Settlement Proposal, p 11

...any AMP prepared prior to the completion of this exercise would not accurately convey how Hydro One SSM's assets will be managed in the long run.

OEB staff notes that the issue of an asset management plan was not addressed in Hydro One SSM's evidence, however OEB staff notes that Hydro One SSM did submit an asset management plan with its original 2017 revenue requirement application¹⁸. That application was subsequently withdrawn as a result of the OEB decision on Hydro One's acquisition application.

Chapter 2 of the Transmission Filing Requirements states that applicants filing under Custom IR or Revenue Cap will be expected to demonstrate that its planning has been sufficiently robust that the utility will be able to manage within the revenue set, given that actual costs and revenues will vary from forecast¹⁹.

OEB staff submits that, under normal circumstances, the asset management plan should have been filed in this application to satisfy the requirements of the settlement agreement. However, Hydro One SSM has stated that it is undertaking a review to determine operational synergies with Hydro One Networks, which will come into effect in 2019. OEB staff would expect that more evidence in this regard will be available at that time. OEB staff submits that it would be reasonable for Hydro One SSM to file a more enhanced Transmission System Plan (including an Asset Management Plan) in accordance with the Filing Requirements that is in alignment with the Hydro One Transmission System Plan that will be filed in 2019.

All of which is respectfully submitted

¹⁸ EB-2016-0259

¹⁹ Filing Requirements for Electricity Transmission Applications, pgs 2-3