

BY EMAIL and RESS

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Ontario Energy Board 2300 Yonge Street 27th Floor Toronto, Ontario M4P 1E4 June 30, 2017 Our File: EB20160356

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2016-0356 - Hydro One Sault St. Marie 2017 Rev. Requirement SEC Submissions

We are counsel to the School Energy Coalition ("SEC"). Pursuant to Procedural Order No.2, this is SEC's submissions regarding the application by Hydro One Sault St. Marie LP ("Hydro One SSM"), formerly, Great Lakes Power Transmission ("GLPT"), for approval of its 2017 transmission revenue requirement, which will included in the calculation of the Uniform Transmission Rates ("UTR"). SEC submissions are focused on the major components of the application.

Rate Adjustment

Hydro One SSM has proposed to calculate its 2017 revenue requirement by way of adjustment to its approved 2016 revenue requirement, which is consistent with the Board's decision in the Hydro One Inc. - GLPT MAAD application ("HONI SSM MAAD Decision").¹ In that decision, the Board directed that any adjustment to its revenue requirement be way of way of a revenue cap index methodology consistent with the Board's Transmission Filing Requirements.² Specifically, the annual adjustment should include expected inflation, productivity, and a stretch factor.³

SEC provides comments on each element of Hydro One SSM revenue cap index methodology.

Inflation. Hydro One SSM has proposed an annual inflation factor of 1.9%, consistent with the Board's stated inflation factor for distributors for 2017. SEC agrees with Board Staff's analysis in its submissions that this may or may not be appropriate for a transmitter since the weighting of labour to non-labour is likely to differ for distributors. Since there is no industry average weighting on the record, SEC does not know if the weighting would lead to a higher or lower ratio of labour to non-labour inputs. The Board should require Hydro One to provide information for its 2018 rate adjustment application regarding a transmission specific inflation factor. Considering, Hydro One transmission will be required to undertake a similar study for its 2019 application, the information could be made available a year earlier for the Hydro One SSM application.

¹ Ex.1-1-1, p.2; Argument-in-Chief, p.3

² Decision and Order (Hydro One - GLPT MAAD - EB-2016-0050), October 13 2016, p.18-19 ³ Ibid

Productivity Factor. Hydro One SSM has proposed a 0% productivity factor, consistent with the number the Board has approved for distributor incentive rate-setting applications. SEC recognizes there is no industry-wide productivity factor approved by the Board for transmission, but contrary to Hydro One SSM's position, there is no "general assumption that transmitters' opportunities to realize productivity improvements are no greater than distributors".⁴ When asked for the basis of its conclusion, Hydro One SSM had no answer except to repeat that that is the Board's productivity for distributors.⁵ The truth is Hydro One SSM simply does not know if transmitter's opportunities to realize productivity improvements are greater, less or equal to that of distributors, since no Total Factor Productivity ("TFP") study has been undertaken

SEC submits that for this year it is reasonable for Hydro One SSM to use the Board's productivity factor for distributors in its revenue readjustment adjustment. But similar to SEC's comment on inflation, for its next adjustment, Hydro One SSM should use the results of the Hydro One transmission TFP analysis it is required to do for its 2019 application.

Stretch Factor. Hydro One SSM has proposed a stretch factor of 0% on the basis that it is operating under the Board's rate-making policy for consolidation, and on the basis of the benchmarking information it has provided undertaken by First Quartile Consulting.⁶ SEC submits neither of those rationales stand up to scrutiny The Board should set Hydro One SSM's stretch factor for 2017 at 0.6%.

The Board has approved numerous applications for consolidation under its *Rate-Making Associated with Distributor Consolidation* policy and the *Handbook to Electricity Distributor and Transmitter Consolidation.*⁷, as well as subsequent applications for rate adjustment during the deferred rebasing period. Consistent with Board policy, those adjustments included stretch factor that would otherwise have been applicable if it had not consolidated. There is no 'stretch factor holiday' during the deferred rebasing period, as Hydro One SSM appears to be seeking. To do so would be explicitly contrary to the Board's decision in the Hydro One SSM MAAD Decision. The deferred rebasing period does allow the acquiring utility shareholder to offset its costs, but that is by allowing it to postpone when it must rebase (i.e. when it must pass all the operational savings on to its customers).

First Quartile Consulting benchmarking results do not demonstrate that Hydro One SSM is in the first quintile (or even quartile) to warrant a stretch factor of 0%, consistent with the Board's IRM framework for electricity distributors. For a number of reasons the, First Quartile Consulting benchmarking is fundamentally flawed, and thus should not be used to set Hydro One's stretch factor, especially that of 0%. This is for at least the following reasons:

 OM&A Costs Only. The benchmarking information undertaken by First Quartile consulting is restricted to OM&A spending only. Hydro One SSM has provided no benchmarking information regarding any other aspect of its revenue requirement. OM&A accounted for no more than 28% of its annual revenue requirement in each year since 2012.⁸ Hydro One SSM readily admits that it did not ask First Quartile Consulting to review Board policies and

⁴ Ex.4-1-1, p.1

⁵ 4-SEC-5

⁶ Argument-in-Chief, para. 9

⁷ Report of the Board: Rate-Making Associated with Distributor Consolidation (EB-2014-0138), March 26 2015

⁸ 3-SEC-4(d)

decisions to determine based on the benchmarking information what the appropriate stretch factor would be.⁹

- Results Do Not Show Top Cohort Performance. Even using the flawed OM&A spending results, the information does not even support Hydro One SSM's contention that it has provided top level cost performance. In fact, in none of the benchmarking metrics is Hydro One SSM in the top quintile or quartile. When asked in interrogatory 4-SEC-6, where in the benchmarking report does it show Hydro One SSM's results warrant a stretch factor of zero, it pointed to the O&M per asset metric where it was "slightly outside of (higher than the first quartile cost level), and OM&A per Asset where it is "between the first and second quartile cost value". ¹⁰ Neither reflect top cohort performance which would warrant a zero stretch factor consistent with the Board's IRM framework for distributors. When the information is presented on a quintile basis, which allows for comparison to the five stretch factors assigned for distributors, on the most compressive metrics OM&A per asset, Hydro One SSM falls in between the average and 2nd quintile, with its performance closer to average in 2016. ¹¹
- Flawed Methodology First Quartile Consulting's denominator for most of its metrics is Gross Asset value. The intent of using gross asset value is to normalize for transmitter size.¹² As SEC discussed at length in its Final Argument in Hydro One Transmission's most recent rate application (excerpts attached)¹³, the problem with using gross asset value is that benchmarking performance is then driven by how expensive a utility's system is. A more expensive system will actually result in lower costs, all other things being equal, whereas less expensive system, all other things being equal, will result in worse performance. This is a fundamentally flawed benchmarking methodology that does not provide a true indicator of Hydro One SSM's cost performance compared to any peers.
- Peer Group. The benchmarking sample size is also very small and do not appear to be very reflective of the conditions Hydro One SSM faces. There are only 11 other companies included in the peer group, and none in Canada or the northeastern United States.¹⁴ Further, none are transmission only companies, similar to HONI SSM has been.¹⁵ No meaningful stretch factor can be derived from this peer group.

Hydro One SSM has the burden of providing evidence to justify an appropriate stretch factor. It has failed to do so, even though it could have easily obtained total cost benchmarking information through First Quartile Consulting. The Board should not extrapolate a stretch factor based on a flawed study that shows at best Hydro One SSM preforms *slightly* better than average for a subset of its costs that reflect *less* than 30% of its revenue requirement.

⁹ 4-SEC-7

¹⁰ 4-SEC-6

¹¹ 3-SEC-4(e), Figure 1

¹² Ex. 3-1-4, Appendix A, p.5

¹³ EB-2016-0160, SEC Final Argument, p.19-22 (See Appendix)

¹⁴ Ex.3-1-4, Appendix A, p.8

¹⁵ Ibid

The Board should set Hydro One SSM's stretch factor at 0.6% as a result. It has provided no information to show that is not the appropriate stretch factor for Hydro One SSM's entire revenue requirement.

Based on a 0.6% stretch factor, the Board should reduce the requested 2017 revenue requirement by \$238,668.¹⁶

Effective Date

Hydro One SSM is seeking an effective date of its approved revenue requirement for January 1, 2017. Since the 2017 UTRs have been declared interim based on the 2016 approved rate, Hydro One is seeking a deferral account to capture the foregone revenue from January 1st, until the 2017 UTR is set. SEC submits the Board should set Hydro One SSM's revenue requirement effective date as the date a final decision is rendered in this proceeding. The Board should only approve a deferral account to capture foregone revenue from the date of the Board's decision in this proceeding, and the setting of any final 2017 UTR.

Hydro One SSM filed its application in December 2016. The Board has consistently found that "In cases where utilities have not filed their applications in time to have rates in place prior to the effective date, the Board's practice has typically been to not allow the utility to retrospectively recover the amounts from the period where the interim order was in effect".¹⁷ The fact that it did not get a merger decision until October 13, 2016 is irrelevant. It was its shareholders decision to consolidate with Hydro One Inc. and file a MAADs application when it did which has the obvious consequence of a fall 2016 decision. Their actions were clearly entirely in control of the Applicant, not the Board, or its ratepayers.

Deferral and Variance Account Disposition

Hydro One SSM is requesting disposition of various deferral and variance account balances over a 12 month period. SEC specifically takes issue with one account, the In-Service Addition Net Cumulative Asymmetrical Variance Account.

As detailed in Hydro One SSM's own evidence at Exhibit 5, Tab 1, Schedule 2, in GLPT's 2015-16 settlement proposal, the Board approved creation of an asymmetrical variance account to track the difference between the revenue requirement of the approved and actual in-service additions over those two years (called the In-Service Addition Net Cumulative Asymmetrical Variance Account). If the cumulative amount of in-service additions during 2015 and 2016 was less than the cumulative Board-approved amount, then the revenue requirement impact of the shortfall would be entered in the variance account. Hydro One SSM has recorded zero in that account and so is not proposing to dispose of any amount.¹⁸

In response to interrogatories, Hydro One SSM provided the approved and actual in-service additions for both 2015 and 2016¹⁹, and has recognized it underspent by \$927,185 over those two years.²⁰ Hydro One SSM should have recorded the revenue requirement impact of that amount, and sought disposition. It appears it did not do so since at the time of filing its application, before the end of 2016, due to the cumulative nature of the account, it forecast to make up the 2015 difference in

¹⁶ 4-SEC-8

¹⁷ See for example, *Decision with Reasons* EB-2013-0321 - OPG), November 20, 2014, p.135

¹⁸ Ex.5-1-1, p.7

¹⁹ 5-SEC-9

²⁰ 5-VECC-20

addition to meet its forecast in-service amount in 2016.²¹ The Board should require Hydro One SSM to calculate the revenue requirement impact over the two years of bringing into-service \$716,452 in 2015 and \$210,763 in 2016 (a total of \$927,185), less than what was built into its rates.

Further, the Board should reject Hydro One SSM's request to close the account.²² Hydro One SSM's revenue requirement going forward will still reflect an amount that is artificially high as a result of the increase in cost of capital, deprecation and PILS reflecting in-service additions of \$927,185 more than actuals built into the 2016 approved revenue requirement, which is the base for the proposed 2017 adjustment. The account is still required to track the revenue requirement difference in 2017 of the underspending on capital in 2015 and 2016. This would maintain the purpose of the variance account, which was to ensure "that ratepayers pay only for assets in service."²³

Yours very truly, **Shepherd Rubenstein P.C.**

Original signed by

Mark Rubenstein

cc: Wayne McNally, SEC (by email) Applicant & Interested parties (by email)

²¹ Ex.5-1-1, p.7, "GLPT's <u>forecast</u> cumulative in-service additions are equal to the Board-approved amount of inservice additions for 2015 and 2016, which is \$19,228,700."

²² Ex.5-1-1, p.7

²³ Ex.1-2-10, Appendix A, p.11 of 42



ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an Application by Hydro One Networks Inc. for an Order or Orders approving or fixing just and reasonable rates and other service charges for the transmission of electricity as of January 1, 2017 and January 1, 2018.

FINAL ARGUMENT OF THE SCHOOL ENERGY COALITION

February 1, 2017

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so, and instead emphasized that their best practices recommendations to Hydro One "were based on a balanced view of Hydro One costs and other operating performance factors as well as *drawing on the deep experience of the experts*" [emphasis added]. There is no mention of the peer group or the study data.

- 2.3.21 During the course of a discussion with the experts in the oral hearing⁵¹, counsel for SEC then elicited from them the information that a lot of their best practices were the result of discussions with Hydro One staff. The experts heard in those discussions that Hydro One is not doing something; they know from their past dealings that other utilities do that, so they recommend it. There would appear to be little connection between the study data and the recommendations. As Mr. Grunfeld said, "...not everything has a straight line between A and B".
- **2.3.22** What this means, though, is that while one of the reasons for the diverse peer group was to identify best practices, it turns out that particular goal was not achieved. Or, put another way, if the peer group had been a more similar group of utilities, the best practices recommendations would have been virtually the same.
- **2.3.23 Conclusion.** SEC believes that, even if unit cost benchmarking was the best way to compare transmission companies (a subject that was not pursued in this proceeding), the peer group selected did not produce a proper comparison of Hydro One to its real peers. Whether this could have been improved by a better peer group, or by using econometric benchmarking instead, is not apparent from the record. What is apparent is that the comparison to this group of transmitters is not helpful to the Board.⁵²

2.4 <u>The Denominator of the Metric</u>

2.4.1 Despite the problems with the peer group, it is the problems with the metric selected that are really significant. Essentially all of the metrics used by the experts to compare Hydro One to the

⁵¹ Tr.3, p.39-45

 $^{^{52}}$ SEC notes that this only hit the highlights of the problems with the peer group. By way of example, many of these companies are integrated generation and transmission (and distribution, in some cases) utilities, with much different cost drivers than Hydro One. As well, although age of assets is known to be an important factor in transmission costs – see Tr.3, p.34-35 – and the experts had some asset demographics information, no adjustments were made for this. There are a number of other, similar problems.

peer group had as their denominator gross asset value.⁵³ The intent was to use gross asset value to normalize for size of utility⁵⁴, because the companies in the peer group were different sizes. While, as noted earlier, that doesn't pick up economies of scale, it does pick up the raw difference between Utility A, and Utility B that is half its size.

- **2.4.2** The problem with using gross asset value is that all performance is driven by how expensive is your system. Costs at a given \$ amount are better performance if you have a more expensive system, and worse performance if you have a less expensive system. At no time did the experts explain how this supposed relationship can be justified.
- **2.4.3** The Problem of Age. Older systems will have a lower gross asset value, because the original cost of the assets was incurred years ago, when costs were lower. Someone who has an older system should be spending more, both on operating costs, and on capital renewal. However, when you normalize using gross asset value, you conclude that the company with an older system is a poor performer relative to its peers.
- 2.4.4 Conversely, if a transmitter has gone through a recent building boom, so their system is generally fairly new, their gross asset value will be very high. This means, for them to perform as well as their peers, they can spend a lot more each year on operating and capital costs. In the real world, that is not the case. In the real world, the company with the new system should be spending less on a unit basis than its peers, because the equipment needs less maintenance, and because the amount of capital replacements required should be lower.
- 2.4.5 A simple example shows that. Utility A has a \$1 million station that it built 30 years ago. It already has to replace some of its components, and will have to replace the whole thing in a few years. Capex on the station is \$50,000 this year. Meanwhile, the costs to operate that station are fairly high, \$50,000 this year. Not only is it in worse condition, but the technology built into the station is less sophisticated, and more in need of TLC. Utility B just built a similar-sized station, at today's \$2 million cost. That station does the same work, but there is no capital spending

⁵³ Tr.3, p.38 ⁵⁴ Tr.3, p.30

needed on that station this year, and only \$20,000 of operating costs.⁵⁵

- 2.4.6 If Utility A has 10% ratio of Opex+Capex/Gross Asset Value, and Utility B has a 1% ratio of Opex+Capex/Gross Asset Value, they are actually equivalent performers. However, when normalized using the Navigant/First Quartile approach, Utility B is ten times better than Utility A. In fact, Utility B could spend \$200,000 on their station, and still be judged as having equivalent performance to Utility A.
- 2.4.7 Economists (and financial analysts, and engineers, and many others) use the term "sanity check" to describe testing an analytical conclusion against the real world. In this case, the simplest of sanity checks shows that the gross asset value approach produces not just an inexact result, but a result that is the <u>opposite</u> of what it should produce.
- 2.4.8 The Problem of Gold-Plating. Even if assets are all of the same age, one utility may have better cost control on their capital projects than the other. If Utility A and Utility B, each put in the same station five years ago, and have the same annual costs for that station today, common sense says that they should be considered comparable performers.
- 2.4.9 However, if Utility A spent \$2 million on that station, and Utility B spent \$2.5 million, because it doesn't control capital spending as well, Utility B will look like a better performer this year than Utility A. In fact, again the opposite is true. Using gross asset value as the denominator in normalizing comparisons is the reason for this incorrect result.
- 2.4.10 Time Series Comparisons. The biggest problem with this, though, is seen when a transmission utility embarks on a period of increasing capital expenditures, as Hydro One proposes to do now. Each year that the utility replaces old assets with new, its gross asset value goes up.
- *2.4.11* Under the approach proposed by the experts, the annual costs of that utility should also go up by the same percentage, in order to maintain the same level of performance. If the cost of the asset doubles because it is new, the operating costs to run it should double, and so should the capital to

⁵⁵ Interestingly, the cost of the two stations for regulatory purposes is probably similar. Although the Opex plus Capex is higher for the older station, the rate base is much lower too. When you add that cost in, the two stations may have broadly similar total costs to be included in rates.

replace it or its component parts.

- *2.4.12* What actually happens in that case? Well, in fact, with newer assets the utility should be able to drive down some operating costs. Newer costs have better technology, and are less prone to breaking, and need less maintenance. Also, with newer assets, the utility should have fewer old assets to replace, so annual capex should go down (at least, over time).
- 2.4.13 In the case of Hydro One, this means that, if the capital budget requested is approved, Hydro One will show improving performance on all of the Navigant/First Quartile metrics without ever having to reduce their costs. This is not just a question of better performance without being more efficient. It is worse than that. Hydro One, on this scenario, does not even need to get the operating and capital savings that naturally flow from having spent more on the system. They can become less efficient, and as long as they are spending money to build new infrastructure, they will be considered to be improving in their efficiency.
- 2.4.14 Conclusion Don't Forget the Customers. Gross Asset Value is not a reasonable denominator to use, either to normalize companies in a peer group for size, or to keep score as to whether a company's performance is improving over time.
- 2.4.15 The primary reason for this is that the metric being used is not an "outcome" that the customers value. Ratepayers do not want them to increase their gross asset value. That is not a goal of benefit to them.
- 2.4.16 Contrast that with a denominator (to normalize for size) based on system capacity, or throughput, or similar non-dollar metrics. Customers value those things. When you increase the capacity of the system, you are doing so to provide more service to the customers. When you increase the throughput, it is because the customers sought and received more electricity delivered to them. These are outcomes customers should pay for. These are outcomes that justify increasing annual costs. Ratepayers are getting something for it. Gross asset value is not such an outcome. Justifying increasing costs by reference to increasing gross asset value is just asking the customers to pay twice. It measures no cost differential that is of relevance to what the customers are receiving for their money.