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Our File No. 20190018

Ontario Energy Board
2300 Yonge Street
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Attn: Christine Long, Registrar and Board Secretary

Dear Ms. Long;

Re: EB-2019-0018 – Alectra 2020 Rates – SEC Submissions

We are counsel for the School Energy Coalition. Pursuant to Procedural Order #4, these are SEC's submissions with respect to the issues other than the M-Factor.

Capitalization Adjustment Methodology

The Applicant's Flawed Perspective. SEC submits that the Applicant's proposals with respect to adjusting for their capitalization policy change have fundamentally missed the point. The Applicant's various approaches over the 2018, 2019 and current proceedings have been based on the erroneous assumption that they must do a cost of service calculation, in order to recalculate the revenues the utility should have received.

This utility-centric approach is wrong. The Board adjusts for accounting changes, not to make the utility whole, but to make the customers whole.

The Cost of Service Approach. The Applicant proposes that the Board recalculate what it should have received in rates, as if the accounting changes had been included in rates on a cost of service basis. Its theory is that, if rates are re-set based on the accounting change having been implemented, both the customers and the utility will be fairly treated. It is true that, under a cost of service assumption, the change in costs (calculated on a regulatory basis) should be reflected dollar for dollar in rates. The Applicant is not in cost of service.

This is why the Applicant, in G-Staff-6 and G-Staff-7, seeks to ignore the Board's clearly understood process for using accounts 1575/76 to adjust for accounting changes that reflect capital vs. operating expense differentials. Instead of the Board's approach, which the Applicant claims is simply incorrect, the Applicant wishes to invent its own method of calculating the entries in those accounts.

Under the Applicant's method, revenue requirement is recalculated as "if the capitalization policy change would have been in place at the time of each legacy utilities' [sic] rebasing applications". OM&A costs in revenue requirement are replaced with depreciation, return and PILs on an annual basis. The difference is for account of the customers or the shareholders, as the case may be. The paradigm is cost of service.

The Board's 1575/76 Approach. The use of these accounts to adjust for accounting changes has its roots in the changeover to IFRS. After a lengthy consultation, the Board correctly concluded that the key impact of this category of accounting changes (capital vs. operating treatment of expenditures) was that they change the rate base on rebasing, for which the customers would eventually be responsible over time. This approach focused on the customer impact, and the question the Board was dealing with was how to make the customers whole.

What the Board correctly realized is that changes in accounting that happen at the time of a cost of service proceeding can be dealt with by the calculation of the revenue requirement properly at that time. Customers are affected in the sense that their rates will be lower or higher based on the new accounting treatment of certain expenses, but that impact will self-correct over time. There is no double-counting, and no costs missed, because cost of service is by its nature comprehensive.

On the other hand, when accounting changes happen during an IRM period, there is no recalculation of revenue requirement. Rates are decoupled from costs, so a change in costs has no immediate impact on customers.

However, a change in amounts capitalized (or a change in depreciation rates, or similar things) will result in a change in rate base. When the utility comes in to rebase, the rate base may be higher or lower than the customers should have reasonably expected at the time the IRM was implemented. This is not because more assets are in service. Rather, it is because the costs of those assets for accounting purposes have been altered. Customers paid amounts to the utility for OM&A expenses (for example), but those amounts have instead been added to rate base. When it comes time to rebase, those amounts, already recovered in rates as OM&A, will be recovered again through a higher rate base. It was this double-collection that the Board sought to prevent with the use of 1575/76.

It is worth noting that the Board's method does not deal with the revenue requirement in any IRM year, because there is no impact on rates. Rates are set by formula. Instead, the Board requires the utility to do an rate base continuity with and without the accounting change, and calculate the difference in closing rate base at the time of rebasing. If there is an increase in closing rate base, that is the amount of the potential double-collection, and so it is refunded to the customers (and vice versa). This is the only impact on customers.

The Board will recall that, at the time this was first debated, the tough question was actually whether the regulatory rate base should simply be kept at the level without the accounting change. The Board concluded that this would require utilities to keep separate regulatory books, basically indefinitely. To avoid that, the rate base differential is refunded to the customers, so that they are whole at the time of rebasing. From that point on (but not before), revenue requirement is calculated based on the new accounting rules.

Inclusion of Return. In G-Staff-7, the Applicant appears to be outraged that they would have to refund to customers return that they have never received from the customers in rates.

This appears to us to be just a misunderstanding of the 1575/76 mechanism. The inclusion of return is to reflect the fact that the increased rate base is not refunded to the customers in one lump sum. Instead, it is refunded over one or more years. During that time, as a result of rebasing the utility is earning a return on that increased rate base, but hasn't yet refunded it to the customers. Until it does, it therefore has to refund the return it is earning on the unrefunded balance. The Board's calculation simplifies this, but fundamentally adheres to the principle that only return from rebasing onward is part of this calculation.

Quotations from Prior Cases. The Applicant continues to rely heavily on comments in past cases when they appear to assist the Applicant, although as we have seen the Applicant is more than willing to reject those past cases if it doesn't like the outcome.

In this case, the Applicant quotes (G-Staff-6) from EB-2017-0024 that the deferral accounts should reflect a number of components, all of which appear to be based on revenue requirement.

In EB-2017-0024, the Board did reject the use of the 1575/76 approach to correct for this accounting change, and instead went in the direction of an annual revenue requirement calculation. However, in EB-2018-0016, there was a further, more detailed debate about how to adjust for the capitalization policy change. SEC during that debate had asked the Board to reconsider whether "adjusting rate base", essentially the 1575/76 approach, would be a better approach.

In Procedural Order #3 in that proceeding, the Board deferred consideration of this question until the 2020 case, and agreed that all methods of adjustment should be on the table at that time, saying:

> *"Given that the OEB wants to assess different options, there were two approaches it considered. The first was to direct Alectra Utilities to complete the information requested by SEC to file in this 2019 rate proceeding. The second was to defer consideration of this issue and direct Alectra Utilities to file a comparison of different options and its preferred option in its 2020 rate application. The OEB is adopting the latter approach as it will allow Alectra Utilities sufficient time to consider different options and provide supporting evidence. In developing options, <u>Alectra Utilities is expected to take into consideration options proposed in this proceeding, including options involving adjustments to rate base</u>." [emphasis added]*

The Applicant did not use that quote in its interrogatory response, presumably because it negates the prescriptive nature of the quote used by the Applicant.

Failure to Maintain Adequate Records. The Applicant takes the position (Capitalization Policy Submission, and G-Staff-3, p.3) that it is no longer, after 2018, able to identify the amounts that would have been capitalized under the old capitalization policies vs. the new. They therefore propose a proxy calculation for the remainder of the deferred rebasing period.

SEC submits that the Applicant, knowing that the Board was concerned about this issue, should not have taken any steps that would prevent it from complying with any Board order as to the capitalization policy change. That includes their apparent decision to stop recording the actual impact of the accounting change starting in 2019. This is wrong, and should not be tolerated by the Board.

The alternative presented by the Applicant (G-Staff-3, p. 4) does not on the surface appear to be unreasonable, but there is simply no way for the Board to know whether this proxy approach is likely to be close to a true calculation of actuals. Given the substantial amounts involved, a change in the mix of utility assets could have a multi-million dollar impact on the capitalization differential.

SEC therefore submits that the Applicant should be ordered to maintain proper records of the capitalization impact in each year (i.e. the difference in the amounts capitalized under old and new accounting policies) and file the results and calculations with the Board, for information purposes, in their annual rate cases during the deferred rebasing period.

SEC Recommendation. SEC submits that the purpose of adjusting for the capitalization policy change should be to ensure that the customers are kept whole. The Board has spent a lot of time and resources considering this, and has established the 1575/76 approach as the appropriate approach to ensure this goal is achieved when accounting changes occur during an IRM period.

It follows from this recommendation that no payments would be made to customers prior to rebasing. At the time of rebasing, the cumulative rate base differentials for each of the rate zones should be calculated, and those differentials should be refunded to, or collected from, the customers to offset the difference in their rate base on rebasing.

Those clearance amounts could, of course, be substantial. In the case of Horizon, for example, the cumulative differential payable to customers is likely to be over $50 million, for Enersource $19 million, and for Powerstream and Guelph smaller amounts. For Brampton, the amount to be collected from customers could be as much as $20 million. (See G-Staff-3 p. 6.) However, the Board can at that time determine a disposition period that avoids rate shock, keeping in mind that during the disposition period the customers will earn, or pay, WACC on the amount of the differential not yet adjusted through riders.

The one other consideration is the annual entries by the Applicant to the deferral accounts. Since the accounting differential each year will ultimately have to be refunded to or collected from customers, SEC submits that a regulatory liability or asset, as the case may be, should be recorded in those accounts equal to the incremental closing rate base differential in that year. No interest should accrue on those accounts, because the liability or asset does not mature and become payable until rebasing.

Conclusion. SEC therefore submits that, in order to ensure that the customers are kept whole, the Board should order the Applicant to record annually in account 1576 the year's incremental difference between closing rate base with and without the capitalization policy change. The Applicant should then follow the Board's normal rules to calculate and clear those accounts at the time of rebasing.

Impact of IFRS 16 on Leases

G-Staff-1 describes the impact on the Applicant of the capitalization of operating leases under IFRS 16. Regulated assets are increased by $3.4 million, and then those leases are charged to operating costs based on depreciation and cost of capital, as opposed to rent (OM&A). The effect is essentially a timing difference, and in the example there is lower annual cost in the early years, self-adjusting in the later years.

The Applicant argues (p. 4) that the impact of this accounting change is minimal, and therefore they declined to calculate revenue requirement impacts.

SEC is concerned that the Applicant's evidence appears to deal only with existing operating leases, and not with new operating leases that would be added over time. Thus, the apparent minimal impact over several years would not be true if new operating leases are added.

Further, it appears that the impact calculation provided by the Applicant uses interest as a proxy for cost of capital. If it is the Applicant's intention to add these now-capital assets to rate base, then on rebasing they will attract interest, return on equity, and PILs. It is not clear on the evidence that the lifecycle cost of these operating leases is the same treated as OM&A as it will be under IFRS 16.

SEC submits that the Applicant should be required in their next rate case to provide a more detailed description of the impact of IFRS 16, and their proposals, if any, for including these capitalized leases in rate base. The impact analysis should include the actual and forecast revenue requirement impacts of the change. The details provided should be sufficient so that the Board can determine a) if the IFRS 16 change should be implemented for regulatory purposes, and b) if any entries to account 1576 should be required for this accounting change.

Horizon ESM Calculation and Capital Investment Variance Account (CIVA)

The conclusion SEC has reached with respect to correcting for the capitalization policy change has implications for both the Horizon ESM and the CIVA.

Under the Board's account 1576, the customers' rates are being set by formula under IRM, and the revenue requirement impacts of the capitalization policy change are not reflected in rates each year. The only impact on customers is at the end of the IRM, when the utility rebases. At that time, the rate base differential is adjusted to ensure the customers do not pay the same amounts twice.

Following from that, the ESM for Horizon should be calculated as if the accounting policy change had not been made. Rate base will be lower, and OM&A will be higher. This will reduce earnings eligible for sharing.

SEC is conscious that this is inconsistent with the Board's decision in EB-2017-0024, in which the Board said that, until the end of the Horizon Custom IR, the only impact of the accounting change for Horizon would be in earnings sharing. We note, however, that this determination was made in the context of the Board's expectation that the capitalization policy change would be reflected in annual revenue requirement calculations. The Board in EB-2018-0016 and this year has recognized that the appropriate method of reflecting the capitalization policy change may be in adjusting the rate base differential on rebasing.

If the Board adopts the 1575/76 approach, as SEC recommends, then to be consistent there should be no impact on Horizon ESM in 2017 and 2018. In fact, the change should not have any impact during IRM, the same as with the other rate zones. Instead, all of the change should be reflected in the rate base differential on rebasing, in accordance with the Board's standard policy.

SEC would also note that the CIVA should then be calculated using the lower capital additions that reflect the previous capitalization policy, consistent with both the ESM and the entries to 1576.

<u>Conclusion</u>

SEC therefore submits that the Board should order:

a. Adjustment of the capitalization policy change using the standard account 1576 approach, in which the rate base differential on rebasing is refunded to, or collected from, customers at that time.

b. Filing by the Applicant in their next rate case of full information on IFRS 16 impacts, so that the Board can determine what steps to take to deal with that accounting change.

c. Calculation of the 2017 and 2018 Horizon ESM and CIVA without the impacts of the capitalization policy change, thus treating OM&A as higher and capital additions as lower consistent with the previous policy.

All of which is respectfully submitted.

Yours very truly,
SHEPHERD RUBENSTEIN
PROFESSIONAL CORPORATION

Jay Shepherd

cc: Wayne McNally, SEC (email)
Interested Parties