

**ONTARIO ENERGY BOARD**

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

**AND IN THE MATTER OF an application by Hydro One Networks Inc., 1937680 Ontario Inc., Peterborough Distribution Inc., and AmalCo (defined below), under sections 86(1)(a), 86(1)(c), 78, 18, 77(5), and 74 of the *Ontario Energy Board Act, 1998*, as the case may be, for the relief necessary to effect Hydro One Networks Inc.'s purchase of the electricity distribution system assets of Peterborough Distribution Inc.**

**VULNERABLE ENERGY CONSUMERS COALITION  
FINAL ARGUMENT**

**December 23, 2019**

## **1. INTRODUCTION**

On October 13, 2018 Hydro One Networks Inc., 1937680 Ontario Inc. (together referred to as "Hydro One"), AmalCo<sup>1</sup> and Peterborough Distribution Inc. (together referred to as "PDI") filed an application<sup>2</sup> with the Ontario Energy Board (the "OEB" or the "Board") seeking for the relief necessary to effect Hydro One's purchase of the electricity distribution system assets of PDI. The specific approvals requested are<sup>3</sup>:

- PDI is applying to the Board, pursuant to section 86(1)(c) of the Act, for leave amalgamate with Peterborough Utility Services Inc. ("PUSI").
- If the Board grants PDI leave to amalgamate with PUSI, then:
  - PDI and the amalgamated corporation (AmalCo) request that the Board, pursuant to section 18 of the Act, grant PDI leave to transfer its distribution licence to AmalCo.
  - PDI and AmalCo request that the Board, pursuant to section 18 of the Act, grant PDI leave to transfer its rate orders to AmalCo.
- AmalCo is applying to the Board, pursuant to section 86(1)(a) of the Act, for leave to sell its distribution system to 1937680.
- If the Board grants PDI leave to amalgamate with PUSI, and grants AmalCo leave to sell the distribution system to 1937680, then:
  - PDI requests that the Board, pursuant to section 78 of the Act, include a rate rider applied to PDI's current OEB-approved rate schedules to give effect to a 1% reduction relative to Base Distribution Delivery Rates applicable at the time of closing.
  - AmalCo and 1937680 request that the Board, pursuant to section 18 of the Act, grant AmalCo leave to transfer its distribution licence to 1937680.
  - AmalCo and 1937680 request that the Board, pursuant to section 18 of the Act, grant AmalCo leave to transfer its rate orders in existence at the time of closing to 1937680.

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<sup>1</sup> AmalCo will be formed via the amalgamation of Peterborough Distribution Inc. and Peterborough Utilities Services Inc. (PUSI) - the first step in the series of steps to ultimately transfer the electricity distribution system in Peterborough to Hydro One

<sup>2</sup> Subsequently amended on November 1, 2018 and updated on February 27, 2019 and April 26, 2019

<sup>3</sup> Exhibit A, Tab 1, Schedule 1, page 6

- 1937680 is applying to the Board, pursuant to section 86(1)(a) of the Act, for leave to dispose of its distribution system to Hydro One.
- If the Board grants leave for 1937680 to dispose of the distribution system to Hydro One, then:
  - 1937680 requests, pursuant to section 77(5) of the Act, that its electricity distribution licence be cancelled.
  - Hydro One requests, pursuant to section 74 of the Act, that Hydro One's distribution licence be amended such that Appendix B, Tab 1 of Schedule 1 include; The City of Peterborough, the Township of Asphodel-Norwood, the former Village of Lakefield and locations outside the Village of Lakefield as at the date of closing, as described in Schedule 1 of PDI's current distribution licence.
  - 1937680 and Hydro One request that the Board, pursuant to section 18 of the Act, grant 1937680 leave to transfer its rate order in existence at the time of the disposition to Hydro One.
  - Hydro One requests that the Board, pursuant to section 78 of the Act, update PDI's current Specific Service Charges to align with the Specific Service Charges Schedule that are, or will be, approved by the OEB for Hydro One Distribution.
- If the Board grants the relief requested above, Hydro One is seeking approval to establish a new deferral account to record the costs of the ESM refund amount for future disposition.

In addition, the Application requests the following approvals and considerations:

- 1937680 and Hydro One are applying for approval to defer the rate rebasing of PDI for ten years from the date of closing of the proposed transaction, consistent with the new Board policy set out in the Amended Report,
- 1937680 and Hydro One are applying for approval to continue to track costs to the regulatory asset accounts currently approved by the OEB for PDI and to seek disposition of their balances at a future date,
- All PDI rate riders will continue as per PDI's existing rate schedules until expiry,

- 1937680 and Hydro One are applying for approval to utilize US GAAP for PDI financial reporting,
- Hydro One is applying for approval to use an ESM to operate during the extended deferred rebasing period (i.e., years six to ten),
- Hydro One is applying to use an Incremental Capital Module (“ICM”), should it be required for the former PDI service territory, and
- During the extended deferred rebasing period, the rates of customers of PDI will be set using the Price Cap Index adjustment mechanism.

## **2. VECC’s INTEREST IN THE APPLICATION**

VECC’s interest in the Application is primarily two-fold. First, does the Application meet the “No Harm” test? In this regard, VECC supports the Board’s approach whereby the focus is on “whether the proposed transaction will have an adverse effect on the attainment of the OEB’s statutory objectives, as set out in section 1 of the OEB Act”<sup>4</sup>:

1. To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.
  - 1.1 To promote the education of consumers.
2. To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.
3. To promote electricity conservation and demand management in a manner consistent with the policies of the Government of Ontario, including having regard to the consumer’s economic circumstances.
4. To facilitate the implementation of a smart grid in Ontario.
5. To promote the use and generation of electricity from renewable energy sources in a manner consistent with the policies of the Government of Ontario, including the timely expansion or reinforcement of transmission systems and distribution systems to accommodate the connection of renewable energy generation facilities.

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<sup>4</sup> Handbook, page 4

Furthermore, VECC agrees that the primary focus of Board's review<sup>5</sup> should be with respect to the impacts of the proposed transaction on price and quality of service to customers, and the cost effectiveness, economic efficiency and financial viability of the electricity distribution sector (i.e., Objectives 1 and 2). In this regard, VECC's focus is on the impact of the transaction on the price and quality of service to customers. It is VECC's view that protecting customers' interests with respect to price and quality of service is consistent with, and will further, the Board's objectives as they pertain to the promotion of economic efficiency and cost effectiveness<sup>6</sup>.

VECC's second area of interest is with respect to the rate-making aspects and implications of the Application.

### **3. NO HARM TEST**

#### **3.1 Price of Service to PDI Customers**

In order to demonstrate that the Application protects PDI customers with respect to price, the Application presented a comparison of Hydro One's 2017 OM&A costs to serve customers in its high density residential rate class of \$179/customer versus PDI's cost per customer of \$241<sup>7</sup>. The Application justifies this comparison by noting that Hydro One's urban (i.e. high density) rate class covers areas containing more than 3,000 customers with a density of at least 60 customers per kilometer of line and that PDI has 37,000 customers with a density of 65 customers per km of line of whom approximately 90% are residential.

The HON value was subsequently updated based on its 2018 Draft Rate Order and the result was \$176/customer for its UR rate class<sup>8</sup>. Based on the OEB's 2018 Yearbook PDI's average OM&A per customer was \$245<sup>9</sup>.

The Application also notes that<sup>10</sup>: i) the base distribution rates will be reduced by 1% and frozen for a period of five years<sup>11</sup> from the closing of the transaction; ii) beginning

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<sup>5</sup> Handbook, page 6

<sup>6</sup> This is because it is "customers" who, in the end, pay the costs incurred the utility and benefit/suffer from the reliability and service quality implications that result from those expenditures.

<sup>7</sup> Exhibit A, Tab 2, Schedule 1, page 3. The PDI value is the average for all PDI customers as shown in the 2017 OEB Yearbook. The HON value is the UR value from HON's 2017 DRO.

<sup>8</sup> JT2.8-2

<sup>9</sup> Based on a total OM&A of \$9,093,631 and a total of 37,139 customers (Residential, GS and Large User)

year six through year ten base distribution rates for former PDI customers will be set using the Price Cap Adjustment Mechanism and iii) an Earnings Sharing Mechanism will be implemented based on expected earnings in years six through ten.

In previous decisions<sup>12</sup> and its 2016 Handbook<sup>13</sup> the Board has indicated that it is the cost structures resulting from the proposed transaction and not near term rate expectations that will be determinative of whether there will be harm. As a result, VECC's consideration of the no harm test as it applies to price and PDI's customers looked at the cost comparison provided in the Application and the Technical Conference undertakings.

While the difference in 2018 cost structures appears significant (\$176 vs. \$245) VECC notes that there are several issues with the comparison:

- First, the Application compares Hydro One's residential cost per customer with average cost per customer for all PDI residential, GS and Large Use customers. While a significant portion<sup>14</sup> of PDI's customer base is Residential, Hydro One's average costs to serve its urban GS classes and ST class are considerably higher than \$176/customer<sup>15</sup>. Indeed, if one were to weight the Hydro One per customer costs for its UR (\$176); UG<sub>e</sub> (\$447), UG<sub>d</sub> (\$5,028) and ST (\$23,904) classes by PDI's 2018 customer counts for the four classes the resulting weighted average cost per customer would be \$249/customer<sup>16</sup>.
- Second, the comparison is based on forecast 2018 costs/customer counts for Hydro One versus actual costs/customer counts for PDI. Hydro One's actual 2018 OM&A costs were 2.9% higher than forecast while its 2018 actual customer count was only

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<sup>10</sup> Exhibit A, Tab 2, Schedule 1, pages 4, 7 and 8

<sup>11</sup> The rate reduction will only apply to the Residential, General Service and Large Use rate classes. All other PDI tariffs will remain as approved in PDI's last rate order with the exception of the specific service charges which will be set equivalent to those approved for Hydro One Networks (Exhibit A, Tab 2, Schedule 1, pages 4-5)

<sup>12</sup> EB-2014-0213 (Woodstock), page 9; EB-2014-0244 (Haldimand), page 3; and EB-2013-0196/Eb-2013-0187/EB-2013-0198 (Norfolk), page 12

<sup>13</sup> Handbook, pages 6-7

<sup>14</sup> See Application, Attachment 2. For 2018, the total for Residential, GS and Large Use customers is 37,139 of which 33,351 are Residential – per OEB 2018 Yearbook

<sup>15</sup> JT2.8-3

<sup>16</sup>  $(\$176*33,351+\$447*3,426+\$5,028*360+\$23,904*2)/37,139$

slightly (0.01%) less than forecast<sup>17</sup>. Combining these two factors would suggest that for fair comparison the Hydro One costs should be increased by 3.0%. This would result in an average cost of \$256/customer<sup>18</sup>.

- Third, in the case of PDI the cost per customer calculation only includes the Residential, GS and Large Use customer count in the denominator (i.e., excludes customers in the USL, Street Lighting and Sentinel Lighting classes) whereas Hydro One's calculation is taken from its cost allocation model filed with its 2018 DRO which includes an allocation of costs to these excluded classes<sup>19</sup>. It is noted that in the most recent Cost Allocation provided to the Board by PDI, only 97.7% of its OM&A costs were allocated to its Residential, GS and Large Use classes<sup>20</sup>. As a result, in order to fairly compare PDI's and Hydro One's costs it would be appropriate to reduce PDI's costs by 2.3%.

Making the above adjustments results in a comparison of \$239/customer for PDI<sup>21</sup> versus \$256 for Hydro One which suggests that Hydro One's underlying cost drivers for its urban customers are higher than those for PDI.

As a result, VECC submits that, when the OM&A/customer costs are considered on an "apples to apples" basis, HON's current cost to serve similar customers is higher than PDI's. In this context, the "no-harm" test is not met for PDI's legacy customers.

It is also noted that despite the fact PDI's rates have not been rebased since 2013<sup>22</sup>, its actual regulated rate of return in 2018 was 7.31% while for the same year HON's was just slightly more at 8.07%<sup>23</sup>. Despite this PDI's 2018 rates were substantially lower than HONs' urban rates as can be seen from the following table. VECC acknowledges that the Board's Handbook states<sup>24</sup>: "A simple comparison of current rates between consolidating distributors does not reveal the potential for lower cost service delivery. These entities may have dissimilar service territories, each with a different customer mix

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<sup>17</sup> J2.3

<sup>18</sup> \$249 x 1.03

<sup>19</sup> Exhibit I, Tab 4, Schedule 10 e)

<sup>20</sup> Exhibit I, Tab 4, Schedule 10 g)

<sup>21</sup> 97.7% x \$245

<sup>22</sup> Oral Hearing, Volume 2, page 54

<sup>23</sup> JT2.3

<sup>24</sup> Page 6

resulting in differing rate class structure characteristics”. However, given Hydro One’s contention that PDI’s service area is comparable to its urban density service territory, VECC submits that PDI’s lower rates/bills based on roughly the same ROE further demonstrates that PDI’s current cost structure is less than HON’s.

<b>COMPARISON OF 2018 MONTHLY BILLS</b>								
			<b><u>PDI</u></b>			<b><u>HON</u></b>		
			<u>Rate</u>		<u>Monthly</u>	<u>Rate</u>		<u>Monthly</u>
			<u>Fixed</u>	<u>Vol.</u>	<u>Bill</u>	<u>Fixed</u>	<u>Vol</u>	<u>Bill</u>
Residential/UR (@750 kWh)			\$18.98 /Month	\$0.0047 /kWh	\$20.16	\$30.09 /Month	\$0.0075 /kWh	\$31.97
GS<50/UGSe <50 (@2,000 kWh)			\$31.36 /Month	\$0.0089 /kWh	\$49.16	\$25.05 /Month	\$0.0301 /kWh	\$85.25
GS>50/UGSd >50 (@250kW)			\$160.31 /Month	\$2.7323 /kW	\$843.39	\$98.94 /Month	\$10.3954 /kW	\$2,697.79
Sources: 1) PDI: EB-2017-0266, Decision and Rate Order								
2) HON: EB-2017-0049, Interim Rate Order								

In its EB-2016-0276 Decision<sup>25</sup> the OEB expressed the view that the “no-harm” test also required that, following the deferral period, the underlying cost structures for the acquired utility’s customers would be no greater than they would have been absent the acquisition. This issue is discussed in Section 4.5.

### 3.2 Price of Service to Legacy Hydro One Customers

The Application notes<sup>26</sup> that the costs to serve PDI’s customers will not be included in any Hydro One revenue requirement applications until the deferred rebasing period has expired. The implication is that for this period the Application will have no impact on Hydro One’s legacy customers. Once the deferred rebasing period has expired, the Application states that the rates set for PDI’s legacy customers will reflect a sharing of the acquisition benefits with Hydro One legacy customers<sup>27</sup>.

Hydro One’s claim that the acquisition has no impact on its legacy customers during the deferral period is based on the premise that there are no incremental costs to any of its

<sup>25</sup> Pages 11-13

<sup>26</sup> Exhibit A, Tab 2, Schedule 1, page 8

<sup>27</sup> Exhibit A, Tab 5, Schedule 1, page 1 and Exhibit I, Tab 1. Schedule 48 e)



corporate service functions (e.g., human resources, finance, regulatory, IT, etc.). Hydro One explained how this was determined as follows<sup>28</sup>:

*CHAIR SPOEL: Is there a point at which, when you are doing acquisitions, that that will no longer be the case, that you will kind of -- you will be full? And you won't be able to bite off another piece without having to hire some more people to do the extra work?*

*MS. RICHARDSON: I imagine there will be. I mean, at this point in time certain functions, like, for a regulatory rate filing it should not really add any significant new costs, if you add other utilities you just have bigger numbers that you are dealing with.*

*But there would be some areas, like right now our HR department we were seeing, like, they don't need to increase their staff, but let's say we acquired a substantive Toronto Hydro, somebody big, obviously, like then obviously then there would be additional -- why not go big, right?*

*[Laughter]*

*MS. RICHARDSON: But, you know, like, I think as you get bigger and bigger of course there will be -- at one point in time there will be some costs that will need to be added.*

*That would be looked at, you know, if we do continue to try to acquire new companies, and I said that we still have a corporate strategy that is being worked on right now, but that would be something that the acquisition team would have to go out, and basically they go -- you know, we go around to all of the lines of businesses that we have and ask them, will you have incremental costs as a result of serving another 20,000 customers, 10,000 customers, and at some point in time, yes, that would impact it.*

*CHAIR SPOEL: But you haven't got there yet?*

*MS. RICHARDSON: No..*

In VECC's view this is very narrow approach to determining whether or not there are incremental costs associated with a transaction. While the acquisition of PDI may not

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<sup>28</sup> Oral Hearing, Volume 2, pages 183-184

require corporate departments such as human resources to “hire” additional staff, the acquisition will require extra time from the existing staff to deal with the new employees. This will utilize some of the existing staff’s capacity to do work and, therefore, in VECC’s submission has a “cost”. There may be no need to immediately add staff but the acquisition may reduce the capability/capacity of existing staff to serve Hydro One’s legacy customers – whose needs and expectations are growing over time.

It is VECC’s submission that the Board should be sceptical of Hydro One’s claim that the acquisition will have no impact on its legacy customers during the deferral period.

### 3.3 Adequacy, Reliability and Quality of Service

The Application states that, based on reliability statistics for 2014-2017, Hydro One customers in the vicinity of the City of Peterborough experience a level of service in terms of frequency and duration similar to the level experienced by PDI customers. It also states that reliability may in fact improve with the combination of the pre-existing Hydro One and former PDI resources optimized for the broader Peterborough area<sup>29</sup>.

Comparative results for 2018 were provided during the proceeding and results for the five year average (2014-2018) indicate that<sup>30</sup>:

- For SAIDI (i.e. outage duration), PDI’s average (2.18) is lower than that for Hydro One (2.47), whereas
- For SAIFI (i.e., frequency), PDI’s average (2.09) is materially higher than that for Hydro One (0.87).

As a result, the evidence presented is inconclusive as to whether Hydro One’s reliability performance is better or worse than that of PDI.

With the respect to the claim that reliability “may” in fact improve for both Hydro One and former PDI customers, it is noted that the Application calls for a reduction in the number of local direct staff positions<sup>31</sup>. Hydro One indicates that the associated work will be picked up by other (more centralized) units in Hydro One<sup>32</sup>. While this may

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<sup>29</sup> Exhibit A, Tab 2, Schedule 1, pages 9-10

<sup>30</sup> Exhibit I, Tab 4, Schedule 14

<sup>31</sup> Exhibit A, Tab 2, Schedule 1, page 12

<sup>32</sup> Exhibit A, Tab 4, Schedule 1, page 6

reduce costs, there is no indication/evidence that it will improve reliability. As a result, it is VECC's submission there is no evidence that based on Hydro One's plans reliability for former PDI customers will improve in the future. Overall, VECC submits that the evidence regarding the no-harm test vis-à-vis reliability of service is mixed.

As well as the reliability of electricity service delivery, there are other aspects of service adequacy and quality that the Board has deemed to be important and required distribution utilities to report on. Exhibit I, Tab 4, Schedule 14 c) compares Hydro One's and PDI's performance on these various dimensions of service quality. For the majority of measures where data is available over the four-year period<sup>33</sup>, PDI's current performance levels equal or exceed those of Hydro One. In its response Hydro One implies that it is inappropriate to compare Hydro One (largely a rural utility) with PDI (largely an urban utility) on these metrics. However, during the Technical Conference, Hydro One confirmed that the service quality indicators were not influenced by whether a utility was urban or rural<sup>34</sup>. As a result, it is VECC's submission that the available evidence suggests that service quality for PDI customers could just as easily decline as it could increase as a result of the Application.

### 3.4 Economic Efficiency and Cost Effectiveness

The Application claims that the transaction will promote economic efficiency and cost effectiveness which will result in lowering ongoing cost structures<sup>35</sup>. Specifically, the Application claims the transaction will, in the later part of the deferral period, lead to OM&A savings of over \$7 M annually and capital expenditure savings of \$1.3 M per year<sup>36</sup>.

The OM&A savings are to be achieved through:

- The elimination of 45 PDI/PUSI back office and management positions<sup>37</sup> whose related responsibilities will be picked up by existing Hydro One administrative and

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<sup>33</sup> The exceptions are written responses, appointment scheduling and new micro-embedded generation facilities connected.

<sup>34</sup> Day 2, pages 67-68

<sup>35</sup> Exhibit A, Tab 2, Schedule 1, page 11

<sup>36</sup> Exhibit A, Tab 2, Schedule 1, page 2

<sup>37</sup> Exhibit A, Tab 2, Schedule 1, page 12

support functions at materially lower incremental cost. It should be noted that this accounts for the majority of the reduction<sup>38</sup>.

- The elimination of 4 direct positions<sup>39</sup> (i.e., staff that works directly on distribution assets).
- The elimination of the service area boundaries (PDI versus Hydro One) which will allow for a more optimal use of resources<sup>40</sup>.

The Application claims that the elimination of service area boundaries will also reduce capital sending costs as will the application of Hydro One's Asset Risk Assessment process<sup>41</sup>.

VECC accepts that there are efficiencies to be gained through the integration of administrative and support activities formerly required for PDI with those of Hydro One. VECC also accepts that there are likely to be capital and OM&A savings as a result of the elimination of the "artificial" boundaries between Hydro One and PDI and the associated elimination of duplicated services.

However, VECC notes that in terms of capital savings the difference between Hydro One's projection and PDI's status quo projection are not that large and may even become small when one accounts for the fact that PDI's forecast includes capitalized overheads whereas Hydro One's does not<sup>42</sup>.

In the case of OM&A costs, VECC has already expressed concerns regarding the strict and limiting definition Hydro One has used in determining its incremental costs to serve. Compounding this concern is the fact that:

- The two parties used different assumptions regarding future OM&A escalation: Hydro One used 2% whereas PDI used 2.5%<sup>43</sup>.
- Hydro One has assumed that customer care costs will increase at a materially lower rate (1.4%/annum) primarily due to a customer shift to greater reliance and use of

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<sup>38</sup> JT2.11-Attachment 1

<sup>39</sup> Exhibit A, Tab 2, Schedule 1, page 12

<sup>40</sup> Exhibit A, Tab 2, Schedule 1, page 12

<sup>41</sup> Exhibit A, Tab 2, Schedule 1, page 14.

<sup>42</sup> Exhibit I, Tab 2, Schedule 47

<sup>43</sup> Application, Attachment 20

digital service channels which typically can be delivered at a lower cost<sup>44</sup>. However, PDI has indicated that it too relies on digital service channels and would expect that reliance to increase if customers were to continue to be served on a “status quo” basis<sup>45</sup>.

- Hydro One has been unable to fully explain<sup>46</sup> the significant decrease in Distribution Operations costs given that only four out of the 17 direct positions<sup>47</sup> currently required to service the existing PDI service territory are being eliminated.

Overall, VECC accepts that there are efficiencies and cost reductions to be gained from the acquisition. However, it submits the savings as set out in the Application<sup>48</sup> are overstated.

#### **4. RATE MAKING CONSIDERATIONS**

##### **4.1 Deferred Rebasing Period**

In order to encourage consolidations the Board provides consolidating entities with the opportunity to defer rebasing for a period of up to 10-years in order to provide an opportunity to offset transaction costs with any achieved savings. However, the Handbook requires that distributors select a definitive timeframe for the deferred rebasing period but does not require evidence justifying the period select provided it meets certain minimum standards and is no greater than 10 years<sup>49</sup>. In the Application, Hydro One is seeking approval for a 10 year deferred rebasing period, which falls within the norms set by the Board<sup>50</sup>.

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<sup>44</sup> TC Day 2, page 122 and J2.10

<sup>45</sup> Oral Hearing, Volume 2, page 125

<sup>46</sup> Oral Hearing, Volume 2, pages 119-122

<sup>47</sup> Exhibit A, Tab 2, Schedule 1, page 12

<sup>48</sup> Exhibit A, Tab 2, Schedule 1, page 2

<sup>49</sup> Handbook, pages 11-12

<sup>50</sup> Exhibit A, Tab 1, Schedule 1, page 8

#### 4.2 Rate Setting During the Deferred Rebasing Period

The Handbook also sets out various options available for setting rates during the rebasing period, depending upon the rate setting options employed at the time of the closing of the transaction<sup>51</sup>. Hydro One Networks is proposing that:

- For customers in the former PDI territory, base distribution rates will be frozen for the first five years (following a 1% rate reduction) and then set using a Price Cap adjustment mechanism for years six through 10<sup>52</sup>.
- For legacy Hydro One Networks customers, distribution rates for 2018-2022 will be set in accordance with the Board's Decision in EB-2017-0049. After 2022, Hydro One will again apply to Board to set future rates for its legacy customers. While Hydro One has made no commitment as to what form this latter Application will take it has indicated that costs to serve former PDI customers will not be included until after the deferred rebasing period has expired<sup>53</sup>.

In VECC's view the rate setting proposal put forward by Hydro One for the deferred rebasing period is reasonable provided Hydro One is required to provide clear and conclusive evidence in any rate applications applicable to its legacy customers during the rebasing period that no costs associated with serving PDI's legacy customers (including incremental costs incurred by its administrative and support functions or by centralized service such as its Utility Arborist division<sup>54</sup>) are included in the rates to its legacy customers.

#### 4.3 Earnings Sharing Mechanism (ESM)

The Handbook states<sup>55</sup> that "Consolidating entities that propose to defer rebasing beyond five years, must implement an ESM for the period beyond five years". The Handbook then goes on to state that "excess earnings are shared with consumers on a 50:50 basis for all earnings that are more than 300 basis points above the consolidated entity's annual ROE" and that "earnings will be assessed each year once audited

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<sup>51</sup> Page 15

<sup>52</sup> Exhibit A. Tab 2, Schedule 1, pages 4 & 7

<sup>53</sup> Exhibit A, Tab 2, Schedule 1, page 8

<sup>54</sup> EB-2018-0270, Exhibit I, Tab 1, Schedule 2 b)

<sup>55</sup> Page 16

financial results are available and excess earnings beyond 300 basis points will be shared with customers annually". However, the Handbook<sup>56</sup> also made the comment that "ESM as set out in the 2015 Report may not achieve the intended objective of customer protection for all types of consolidation proposals" and invited applicants "to propose an ESM that better achieves the objective of protecting customer interests during the deferred rebasing period. For example, a large distributor that acquires a small distributor may demonstrate the objective of consumer protection by proposing an ESM where excess earnings will accrue only to the benefit of the customers of the acquired distributor".

In its Application<sup>57</sup> Hydro One has proposed an earnings sharing mechanism that covers the years six through ten and includes a 50:50 sharing of forecast earnings above 300 basis points from the operations of the acquired utility. In calculating the forecast earnings Hydro One has compared the forecast revenues from former PDI customers for years 6 to 10 of the deferral period with the costs for period based on: i) the acquired assets, ii) Hydro One's forecast capital expenditures for the acquired service area and iii) Hydro One's forecast incremental OM&A costs as a result of the acquisition. In the case of Hydro One's forecast OM&A costs a 20% premium was added as a result of the risks assumed by Hydro One in committing to a guaranteed ESM. The long term and short term debt rates as well as the ROE used in the calculation are based on the values embedded in PDI's current rates. The calculated amount for the ESM is \$1.773 M.

Hydro One's proposal varies from the Handbook in one unique but significant aspect and that is that the determination of the earnings to be shared is pre-calculated using forecast OM&A and capital costs<sup>58</sup>. In contrast, it is clear from the wording in the Handbook regarding the use of audited results<sup>59</sup> that the Board's expectation is that the ESM calculation will be done based on actual results and reflect the actual savings achieved. Hydro One's primary rationale for using "forecast" savings as the basis for the ESM is that it does not intend to provide separate financial statements for acquired

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<sup>56</sup> Pages 16-17

<sup>57</sup> Exhibit A, Tab 3, Schedule 1, pages 4-7

<sup>58</sup> Exhibit A, Tab 3, Schedule 1, page 2, lines 16-17

<sup>59</sup> Handbook, page 16

utilities (including PDI) and therefore will not be a position to report on the actual audited earnings of the former PDI<sup>60</sup>. VECC notes that Hydro One has committed to tracking both the incremental OM&A and incremental capital costs associated with acquisition of PDI during the 10-year deferral period<sup>61</sup>. As result while “audited financial statements” will not be available<sup>62</sup> Hydro One will be in the position to calculate the actual earnings attributable to the former PDI service territory using the methodology set out in the Application.

VECC also has issues with the methodology used by Hydro One to forecast the value of the ESM. The Board’s Consolidation Handbook states<sup>63</sup> “The ESM is designed to protect customers and ensure that they share in any increased benefits from consolidation during the deferred rebasing period”. In Hydro One’s case these benefits arise not only from purported savings in OM&A and capital spending but also potentially lower borrowing costs<sup>64</sup>. In order for rate payers to “share” in these benefits it is necessary that Hydro One use its cost of capital parameters (i.e., debt costs and ROE) in the calculation of the ESM as opposed to those currently approved for PDI<sup>65</sup>. This also extends to the assumptions Hydro One uses in the calculation regarding working capital which, again, Hydro One has based on PDI’s current approved allowance<sup>66</sup> as opposed to Hydro One’s working capital allowance percentage. VECC notes that for depreciation the ESM calculation does use Hydro One’s approved depreciation rates<sup>67</sup>. It is VECC’s view that, to be consistent with the spirit of the Handbook, the ESM calculation should, to extent possible, forecast what would actually be reported as the earnings and over earnings. In this regard, if prepared, the actual financial statements for PDI would presumably reflect Hydro One’s cost of debt and approved working capital. Furthermore, the calculation of over earnings would be done using Hydro One’s approved ROE.

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<sup>60</sup> Exhibit A, Tab 3, Schedule 1, page 4 and Exhibit I, Tab 1, Schedule 18 d)

<sup>61</sup> Exhibit A, Tab 4, Schedule 1, page 9 and Exhibit A, Tab 5, Schedule 1, page 2

<sup>62</sup> Exhibit I, Tab 6, Schedule 2

<sup>63</sup> Page 15

<sup>64</sup> EB-2018-0270, Exhibit I, Tab 2, Schedule 8 a)

<sup>65</sup> Exhibit A, Tab 3, Schedule 1, page 6

<sup>66</sup> Exhibit I, Tab 1, Schedule 27

<sup>67</sup> Exhibit A, Tab 3, Schedule 1, page 6



VECC also has an issue with the 20% risk premium Hydro One has added to the forecast OM&A cost for purposes of calculating the ESM. The addition of this premium reduces the value of the ESM by more than 50% (i.e., from \$3.8 M to \$1.8 M)<sup>68</sup>. However, Hydro One has provided no evidence to demonstrate that this level of risk premium is justified and, in light of this, VECC submits the proposed “premium” is excessive.

Overall it is VECC’s submission that if the Board approves the transaction and the 10-year deferral period then the ESM calculation should be:

- Based on Hydro One’s approved cost of capital, depreciation rates and working capital allowance for the relevant years, and
- The risk premium added to OM&A should be no more than 10%.

#### 4.4 Incremental Capital Module

The Handbook indicates that the Incremental Capital Module is available to utilities during the deferred rebasing period to address discrete capital needs<sup>69</sup>. In the Application, Hydro One states<sup>70</sup> that it “is applying to use an Incremental Capital Module (“ICM”) should it be required for the former PDI service territory consistent with the OEB’s policies for an ICM as described on page 17 of the Handbook”.

VECC acknowledges that the Incremental Capital Module is available to Hydro One to address capital needs in the former PDI service area should the need arise and the proposal meet the prescribed eligibility criteria. However, no such need has been identified in the current Application nor has a specific application for a discrete capital project (or projects) been presented. As a result, VECC submits that this particular request is premature and should not be granted by the Board at this time.

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<sup>68</sup> Exhibit I, Tab 1, Schedule 18 d)

<sup>69</sup> Page 17

<sup>70</sup> Exhibit A, Tab 1, Schedule 1, page 9, lines 8-10

#### 4.5 Future Cost Structures/Rates

The Board's no-harm test focuses not only on current cost structures but is also concerned with future cost structures and the resulting rates. This is evident from the EB-2016-0276 proceeding wherein:

- The Board ordered<sup>71</sup> Hydro One to file further material, in the form of evidence or submissions on its expectations of the overall cost structures following the deferred rebasing period and the impact on Orillia Power customers, and
- Its final Decision stated<sup>72</sup>: "The OEB has determined that it is reasonable to expect that the underlying cost structures to serve acquired customers following a proposed consolidation will be no higher than they otherwise would have been."

This view was confirmed in the Board's more recent EB-2017-0049 Decision which also stated: "It is clear that the OEB's framework for consolidations is intended to ensure costs to serve a given service area following an acquisition will be no higher than they otherwise would have been"<sup>73</sup>.

In support of the current Application Hydro One has indicated that following the deferral period:

- Separate rate classes will be established for PDI's former Residential, GS<50 and GS>50 customers. The remaining PDI customers will be folded into the comparable existing Hydro One customer class<sup>74</sup>.
- The cost allocation methodology will be revised so as to ensure an appropriate allocation of fixed assets and their associated costs to the acquired classes as well as an allocation of Shared Costs. This will be achieved by adjusting the allocation of fixed assets to the acquired customer classes so as to reflect the fixed assets specifically used in PDI's service area<sup>75</sup>.
- The resulting revenue to cost ratios for the acquired customer classes will be adjusted so as to ensure that the costs recovered from these classes is between the

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<sup>71</sup> Procedural Order #7

<sup>72</sup> Page 10

<sup>73</sup> Page 163

<sup>74</sup> Exhibit I, Tab 4, Schedule 27

<sup>75</sup> Exhibit A, Tab 5, Schedule 1, page 5

following “goal posts”: i) no less than the forecast residual (i.e., Hydro One’s incremental cost the acquired PDI service territory) to serve these acquired classes at the time of rebasing (\$17 M) and ii) no more than PDI’s status quo revenue requirement (i.e., PDI’s forecast of what its revenue requirement would be at the time of rebasing assuming the acquisition did not occur - \$26.3 M)<sup>76</sup>.

Based on Hydro One’s forecast of its incremental cost to serve the PDI service territory, the revenue requirement to serve its legacy customers at the time of rebasing and PDI’s forecast of what its status quo revenue requirement would be at the time of rebasing, Hydro One indicates that the revenues recovered from the former PDI customers (\$20.6 M) will fall between these goal posts with revenue to cost ratios that fall within the Board’s policy ranges<sup>77</sup>. It is Hydro One’s position that, provided the costs recovered from the former PDI customers fall between these “goal posts”, neither legacy customers nor former PDI customers are harmed<sup>78</sup>.

VECC has no concerns regarding Hydro One’s proposal to create separate customer classes for the PDI’s main classes of acquired customers. However, VECC has a number of concerns with Hydro One’s overall cost allocation approach for the acquired customers and its subsequent forecast of the revenues to be recovered from the acquired classes.

In terms of the cost allocation, Hydro One has characterized its use of adjustment factors as an application of direct allocation per the Board’s cost allocation methodology<sup>79</sup>. However, the adjustment factors do not directly assign cost to a specific customer class but rather identify costs that are to be allocated to a subset of Hydro One’s customer classes, i.e., the acquired customer classes<sup>80</sup>. In this regard, the treatment does not meet the requirements for direct allocation as set out in the Board’s 2005 cost allocation methodology report<sup>81</sup> which states: “Direct allocation must be applied if and only if one hundred percent of the use of a clearly identifiable and

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<sup>76</sup> Exhibit A, Tab 4, page 7 and Exhibit I, Tab 1, Schedule 49

<sup>77</sup> Exhibit I, Tab 1, Schedule 49

<sup>78</sup> Oral Hearing, Volume 1, page 58

<sup>79</sup> Oral Hearing, Volume 1, page 23

<sup>80</sup> Oral Hearing, Volume 2, page 143

<sup>81</sup> Page 31. See also Oral Hearing, Volume 2, pages 142-143

significant distribution facility can be tracked directly to a single rate classification”. VECC submits that for the Board to accept Hydro One’s proposal as “direct allocation” would be inappropriate.

Hydro One’s proposal to specifically track and “assign” the costs incurred to serve customers (in a number of customer classes) in a specific area is not without merit. However, VECC’s concern is that the application of the proposal is being limited only to customers in future acquired utilities – even if the data to implement elsewhere is available<sup>82</sup>. In VECC’s view this is inappropriate and counter to the rate making principle of fairness – which requires that equals be treated equally<sup>83</sup>.

Another concern is the fact that the determination allocation of the directly assigned assets across the acquired customer classes is based on the results of PDI’s cost allocation as submitted for its 2013 rebasing application. By the time the deferral period ends, more than 15 years will have transpired. Hydro One acknowledges that the cost allocation results they will be relying on will be “dated” but notes it is the best information available<sup>84</sup>. While it may be the best information available, the fact that it is based on a cost allocation done more than 15 years ago raises questions as to whether the results can truly satisfy the “no harm” test.

Finally, as VECC noted in its EB-2017-0049 submissions<sup>85</sup>, calculating and applying single adjustment factor to all USOA accounts will produce a different cost allocation than if account specific adjustment factors (which can be determined) were used.

However, more fundamental are VECC’s concerns about Hydro One’s proposed approach to setting rates for the acquired and legacy classes after the cost allocation results have been calculated. VECC has already questioned whether the savings Hydro One is forecasting to achieve are overstated. To the degree they are the residual cost to serve will increase, thereby decreasing the acceptable range of results between the “goal posts”. However, more problematic in VECC’s view is Hydro One’s forecast of its future revenue requirements in the absence of the acquisition.

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<sup>82</sup> Oral Hearing, Volume 2, pages 138-141

<sup>83</sup> Oral Hearing, Volume 2, page 138

<sup>84</sup> Oral Hearing, Volume 2, pages 132-133

<sup>85</sup> Pages 72-73

During the oral proceeding questions were posed regarding the differences between the forecast annual increase in PDI's status quo revenue requirement between 2019 and 2030 versus Hydro One's (4.0% and 2.2% respectively)<sup>86</sup>. During cross examination Hydro One attributed the difference to the fact that PDI had not rebased since 2013<sup>87</sup>. If one recalculates the average annual increase in PDI's revenue requirement from its last rebasing (2013) to 2030 the result is 3.2% per annum<sup>88</sup>. This is not that much higher than the 2.9% average increase since their last rebasing experienced by those distributors that rebased on 2017 and 2018<sup>89</sup>. In comparison to PDI's forecast for 2030, which is based on work up of its anticipated 2030 revenue requirement<sup>90</sup>, the annual increase for Hydro One is simply based on the compound annual growth in its total revenue requirement between 2017 and 2022<sup>91</sup>. In VECC's view the resulting 2.2% is low by comparison to the industry average of 2.9%. Use of a higher percentage would increase Hydro One's 2030 revenue requirement for both the with and without consolidation cases and increase the costs allocated to the acquired customer classes. Such results would increase the likelihood of the costs allocated to the acquired classes exceeding the upper "goal post".

Hydro One has indicated that if required the costs allocated to the acquired classes for purposes of setting rates would be reduced so as to remain within the "goal posts" and the costs to the legacy customers increased accordingly. However, the goal posts only apply to the total costs allocated to all of the acquired classes. They provide no information as to which of the individual acquired customer classes' revenue to cost ratios should be adjusted or by how much<sup>92</sup>. Similarly, even if, as Hydro One asserts, the overall cost to legacy customers will be lower<sup>93</sup> than if the acquisition had not occurred, the shift in costs must be allocated to specific legacy customer classes and it is not evident that these classes will be held harmless.

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<sup>86</sup> Oral Hearing, Volume 2, page 56

<sup>87</sup> Oral Hearing, Volume 2, page 59

<sup>88</sup> Per Board Staff's Submissions, page 15

<sup>89</sup> Exhibit K2.1, page 7

<sup>90</sup> Attachment 20

<sup>91</sup> Exhibit I, Tab 2, Schedule 44

<sup>92</sup> Oral Hearing, Tab 2, pages 131-132

<sup>93</sup> Oral Hearing, Volume 2, page 76

A further problem with such an event is that the 2030 status quo revenue to cost ratios are likely to be at the low end of Board's policy range<sup>94</sup>. Indeed the results set out in Exhibit I, Tab 1, Schedule 49 (copied below) show this to be the case.

Rate Class	R/C Ratio from CAM	Proposed R/C Ratio from Rate Design	Board Approved R/C Ratio Range
Residential	0.74	0.85	0.85 to 1.15
GS < 50kW	0.67	0.80	0.80 to 1.20
GS 50-4,999 kW	0.69	0.80	0.80 to 1.20
Large Use*	1.00	1.00	0.80 to 1.20

*\* Large Use Customers are proposed to be moved to Hydro One's Sub-Transmission Rate Class*

Hydro One has indicated that<sup>95</sup>:

*Beyond year 11, once they're integrated into Hydro One's cost allocation model with those direct allocation adjustment factors, then the normal Board's cost allocation and rate design process would continue.*

This means that after year 11 the revenue to cost ratios for the acquired classes would be set in accordance with the Board's policy range. The implication is that any reduction made to their revenue to cost ratios in the initial rebasing year to levels below the Board's policy range in order to meet the no harm test would be eliminated in subsequent years.

Between the shortcomings in Hydro One's proposed cost allocation methodology and the above concerns regarding its approach to setting the rates for acquired and legacy customers, VECC submits that Hydro One's proposals do not demonstrably meet the "no harm test" as it applies to future cost structures.

## **5. CONCLUSIONS**

Hydro One's current cost structure is higher than PDI's and its proposals for setting rates following the deferral period do not ensure that the no harm test will be met vis-à-vis its legacy and acquired customers at the time of rebasing. As a result, VECC submits that Hydro One's acquisition of PDI does not meet the no-harm test with respect to price. With respect to reliability and quality of service, it is VECC's

<sup>94</sup> Oral Hearing, Volume 2, page 135

<sup>95</sup> Oral Hearing, Volume 2, page 106

submission that Hydro One's evidence does not clearly demonstrate that the no-harm test will be satisfied. Overall, it is VECC's submission that the Board should not approve the application.

If the OEB decides to approve the Application, then it is VECC's submission that:

- Any rate application made for Hydro One's legacy customers during the deferral period should provide evidence clearly demonstrating that no costs to service customers in the service area are included.
- The Board should direct changes to Hydro One's proposed ESM as set out in Section 4.3 above.
- The Board should direct that Hydro One correct the shortcomings in its proposed cost allocation methodology to address the issues raised in Section 4.5 above.
- At the time of rebasing, to the extent revenue to cost ratios for the acquired customers classes must be set outside (i.e. below) the Board's policy range in order to satisfy the no-harm test, Hydro One's shareholders and not legacy customers should be responsible for any revenue shortfalls.

## **6. COSTS**

VECC respectfully submits that it has acted responsibly and efficiently during the course of this proceeding and requests that it be allowed to recover 100% of its reasonably incurred costs.