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2300 Yonge Street
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November 18, 2020
Our File: EB20200030

Attn: Christine Long, Registrar

Dear Ms. Long:

Re: EB-2020-0030 – Hydro One Dx 2021 – SEC Submissions

We are counsel to the School Energy Coalition ("SEC"). Pursuant to Procedural Order No.1, these are SEC's submissions on the application of Hydro One Network Inc. ("Hydro One") for approval of its 2021 distribution revenue cap adjustment and disposition of certain deferral and variance accounts ("DVA").

A. 2021 Revenue Cap Adjustment

SEC requests the Board make certain adjustments to the calculation of the Hydro One's 2021 revenue requirement, to correct a significant deficiency in Hydro One's calculation of the Capital Factor which was approved in its 2018-2022 Custom IR proceeding (EB-2017-0049), to ensure rates are just and reasonable. The method used to calculate the Capital Factor is inconsistent with the intent of the Board's *Decision with Reasons* in EB-2017-0049 [the "EB-2017-0049 Decision"][1], and also more generally, the purpose of a stretch factor.

The Board in the EB-2017-0049 Decision ordered Hydro One to increase the stretch factor, applicable to capital only, from 0.45% to 0.60%.[2] The clear intent was to reduce the capital revenue requirement by reducing annual capital spending through productivity improvements.

Instead of applying the 0.6% stretch factor to the percentage formula, as would be normal in a revenue cap, Hydro One applied it to the current year capital revenue requirement, which is calculated on a cost of service basis for each year (without taking into account any productivity requirements in prior years). This was consistent with the original methodology proposed by Hydro One in its EB-2017-0049 application, but not with the Board's intention as expressed in its decision, nor how a stretch factor is meant to operate.

[1] *Decision and Order* (EB-2017-0049 - Hydro One Dx Custom IR), March 7, 2019 ["EB-2017-0049 Decision"]
[2] EB-2017-0049 Decision, p.31-33

Under the methodology used to set the Capital Factor in EB-2017-0049, the stretch factor for capital applies only for one year, and then the revenue requirement for that capital reverts to the higher amount for subsequent years. Hydro One is not incented to control capital spending, since it would have only a transitory and minor reduction in rate recovery, for one year only. This was clearly not the Board's intent in the EB-2017-0049 Decision and, more broadly, it was inconsistent with the well-established use by the Board of stretch factors in rate-setting.

The effect of this problem increases over time. In the rate year at issue in this application, 2021, the impact is that Hydro One will over-collect on capital by about $11.4 million. In 2022, the overcollection would be about $17.3 million.[3]

SEC submits that it is appropriate for the Board to correct this issue, and require Hydro One to calculate the 2021 Capital Factor, including the stretch factor, on a basis that is consistent with the Board's intent in the EB-2017-0049 Decision and how stretch factors are supposed to operate.

The balance of this section of our submissions sets out the details of the problem, its impact, and a proposed solution.

Hydro One's Custom IR Methodology

Hydro One's 2018-2022 Custom IR methodology was approved in EB-2017-0049 and uses a Revenue Cap Index ("RCI") for annual adjustments. The RCI consists of an Inflation Factor, minus a Productivity Factor, plus a Capital Factor, all of which is applied to the previous year's approved revenue requirement in years 2 through 5 of the plan term (2019-2022).[4] The Capital Factor is a mechanism meant to ensure that the annual adjustments to Hydro One's revenue requirement recover all of its approved capital related revenue requirement (cost of capital, depreciation and incomes taxes), net of a stretch factor, over and above what is collected through the other elements of the RCI formula (i.e. Inflation and Productivity).[5] The specific Capital Factor to be applied each year was determined in the EB-2017-0049 proceeding.[6]

In the Board's EB-2017-0049 Decision, the Board approved an additional stretch factor of 0.15% (over and the proposed 0.45% stretch factor to be applied to all revenue requirement) to be applied to the Capital Factor:

> The OEB approves the approach to the capital factor as proposed by Hydro One, but imposes an additional 0.15% stretch factor <u>to be subtracted from the calculated capital factor</u>. [emphasis added] [7]

Stretch Factor Applied to Capital

Notwithstanding that Hydro One did not actually subtract the additional 0.15% stretch factor from the calculated Capital Factor as set out in the EB-2017-0049 Decision, on a more fundamental level its

[3] The 2020 impact, which SEC is not seeking a retroactive adjustment, is $5.5M.
[4] Pre-filed evidence, p.9; EB-2017-0049 Decision, p.19-24;
[5] EB-2017-0049 Decision, p.19-24
[6] *Decision and Rate Order* (EB-2019-0043 - Hydro One Networks Inc. 2020 Rates), December 17, 2019, p.5, See ft note 11.
[7] EB-2017-0049 Decision, p.30-31

application of the total capital stretch factor of 0.6% (0.45% + 0.15%) is fundamentally flawed and requires correction on a prospective basis.

Unlike OM&A, which was set based strictly on a formula applied to an approved test year in each subsequent year of the Custom IR term, Hydro One's capital related revenue requirement was determined using cost of service principles based on an approved rate base for each year of the 5 years of the plan. Hydro One then applied the 0.6% stretch factor to the capital related revenue requirement (excluding working capital which the Board ordered not to be included in the Capital Factor) in each of years 2 through 5 of the plan, rather than applying it to the Capital Factor, as ordered by the Board. More importantly, the capital related revenue requirement used for each of years 3 through 5 of the plan does not take into account the stretch factor in the prior years of the plan. Instead, the capital related revenue requirement resets each year to the higher amount, as if there had been no stretch factor in prior years.

The problem with Hydro One's application of the stretch factor is that it is not applied cumulatively. The effect is that each subsequent year the starting revenue requirement for capital reverts back to the higher amount, because the capital related revenue requirement assumes that the prior year stretch factor did not reduce capital spending. Each year customers lose the benefit of the supposed productivity reductions that they are supposed to get the benefit of through the stretch factor.

The effective stretch factor applied to the capital-related revenue requirement in each of years 3 through 5 (2020-2022) is not the approved 0.6%, but a *de minimis* amount. For 2021, the effective actual stretch factor for capital is not 0.6%, but 0.02%.This is shown on the table below, which with the exception of the two highlighted rows, is from the revenue requirement table included in the EB-2017-0049 DRO, reproduced in response to interrogatory SEC-5, used to calculate the annual Capital Factor.

	Summary of Revenue Requirement Components					
Line		**2018**	**2019**	**2020**	**2021**	**2022**
1	Rate Base	7636.9	7894.1	8175.1	8514.1	8803.5
2	Return on Debt	198.3	205.0	212.3	221.1	228.6
3	Return on Equity	274.9	284.2	294.3	306.5	316.9
4	Depreciation	397.8	415.0	425.5	442.3	455.4
5	Income Taxes	43.1	50.0	51.1	54.6	64.6
6	Total Capital Related Revenue Requirement	914.1	954.2	983.2	1,024.5	1,065.5
7	Working Capital Related Revenue Requirement	21.2	22.4	23.4	24.5	25.7
8	Total Capital Related Revenue Requirement (excluding working capital component)	892.9	931.8	959.8	999.9	1,039.8
9	Less Productivity Factor (0.45%+0.15%)		(5.6)	(5.8)	(6.0)	(6.2)
	Incremental Productivity		*(5.59)*	*(0.17)*	*(0.24)*	*(0.24)*
	Effective Incremental Stretch Factor		*0.60%*	*0.02%*	*0.02%*	*0.02%*
10	Less Removing Working Capital from Capital Factor		(0.9)	(1.7)	(2.6)	(3.5)
11	**Total Capital Related Revenue Requirement**	**914.1**	**947.7**	**975.7**	**1,015.9**	**1,055.8**
12	OM&A	544.4	550.1	555.9	561.7	567.6
13	Integration of Acquired Utilities					
14	**Total Revenue Requriement**	**1,458.5**	**1,497.8**	**1,531.6**	**1,577.6**	**1,623.4**
15	Increase in Capital Related Revenue Requirement		33.6	28.0	40.2	39.9
16	Increase in Capital Related Revenue Requirement as a percentage of Previous Year Total Revenue Requirement		2.30%	1.87%	2.62%	2.53%
17	Less Capital Related Revenue Requirement in I-X		0.66%	0.66%	0.67%	0.68%
18	**Capital Factor**		**1.65%**	**1.21%**	**1.95%**	**1.85%**

Source: IR Response SEC-5, Table 2 (I-4-5, p.2). In that response Hydro One notes it a corrected version of the table provoded in its EB-2017-0049 Draft Rate Order that takes into account changes made in its EB-2017-0049 DRO Reply Submissions

The intent of a stretch factor is to embed productivity into the rates so that customers get an upfront benefit. In the case of a stretch factor on capital, this means that rates exclude a level of capital spending represented by the stretch factor. In effect, the utility is supposed to spend that much less on new capital additions, so that the rates to customers, for that year and for all subsequent years in which that capital would be recovered, are reduced.

In ordering an additional 0.15% stretch factor to be applied to capital related revenue requirement, the Board in the EB-2017-0049 Decision stated that it "expect[ed] Hydro One to stretch itself more to find additional initiatives and to consider new approaches to its business" and the additional amount would "incent further productivity improvements throughout the term, and to provide customers the benefit from these additional improvements upfront".[8] Yet, Hydro One's methodology in implementing the stretch factor to capital is contrary to the Board's intent, as it provides essentially no incentive to the company to find further capital related productivity improvements. Customers do not get the intended upfront benefit after the second year of the Custom IR term.[9] Instead of the Board's intent to exclude from rates the cost of a certain amount of capital spending (which the utility is supposed to achieve through productivity improvements), Hydro One's proposed approach excludes from rates only the first year impact of capital spending, but all subsequent years are fully included.

The Board's Handbook to Utility Rate Applications notes that with respect to a Custom IR application it "is insufficient to simply adopt the stretch factor that the OEB has established for electricity distribution IRM applications, and that it must be "higher, and certainly no lower, than the OEB-approved X factor for Price Cap IR".[10] SEC submits this refers to not just the specific stretch factor amount, but also the impact it has when it is implemented into rate-setting.

In a previously rejected Custom IR plan (EB-2013-0416), the Board found that Hydro One's proposal did not contain "adequate efficiency incentives to drive year-over-year continuous improvement in the company."[emphasis added][11] The Board further commented that in a Custom IR it expects "explicit, objectively determined productivity and efficiency adjustments such as stretch factors include mimicking competitive market conditions, sharing anticipated savings with ratepayers "up front", and facilitating a more outcome-based approach to regulation."[12] The problem with Hydro One's current methodology is that because of the way the stretch factor is included in the Capital Factor calculation, after year 2, it does not incent capital related year-over-year continuous improvement, nor does it provide ratepayers with the "up front" savings if any are achieved.

Correcting the Problem

The correct method of applying the stretch factor would be to emulate the effect it would have under the Board's 4th Generation IRM price cap framework, i.e. including in the annual stretch factor the previous year's reductions, as Hydro One has done for its OM&A costs. This would result in the stretch factor reductions in the capital related revenue requirement carrying forward into subsequent years. This approach is consistent with what the Board approved in EB-2016-0152, with respect to Ontario

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[8] EB-2017-0049 Decision, p.32

[9] There is a small impact of the stretch in subsequent years, which represents the stretch factor being applied to the change in year-over-year capital related revenue requirement only.

[10] Handbook to Utility Rate Applications, October 13, 2016, p.26

[11] *Decision* (EB-2013-0416/2014-0247 - Hydro One Dx), March 12 2015, p.-14-15

[12] *Ibid*

Power Generation's nuclear business where payment amounts were also determined based on an annual approved revenue requirement.[13]

The table below shows the application of this proposed corrected methodology in determining the Capital Factor. In 2020, if the proposed correction method had been applied, instead of a reduction to the capital-related revenue requirement of $5.8M, it would have been $11.4M. For 2021, the impact would be a benefit to customers of $17.3M, instead of the proposed $6M. It would also apply in 2022, where the impact would be $23.6 million instead of the proposed $6.2 million.

Summary of Revenue Requirement Components (SEC Proposal)						
Line		**2018**	**2019**	**2020**	**2021**	**2022**
1	Rate Base	7636.9	7894.1	8175.1	8514.1	8803.5
2	Return on Debt	198.3	205.0	212.3	221.1	228.6
3	Return on Equity	274.9	284.2	294.3	306.5	316.9
4	Depreciation	397.8	415.0	425.5	442.3	455.4
5	Income Taxes	43.1	50.0	51.1	54.6	64.6
6	Total Capital Related Revenue Requirement	914.1	954.2	983.2	1,024.5	1,065.5
7	Working Capital Related Revenue Requirement	21.2	22.4	23.4	24.5	25.7
8	Total Capital Related Revenue Requirement (excluding working capital component)	892.9	931.8	959.8	999.9	1,039.8
9	*Less Productivity Factor (0.45%+0.15%)*		*(5.6)*	*(5.8)*	*(6.0)*	*(6.2)*
	Total Incremental Productivity Factor (Line 9 + Previous Years Total)		*(5.6)*	*(11.3)*	*(17.3)*	*(23.6)*
10	Less Removing Working Capital from Capital Factor		(0.9)	(1.7)	(2.6)	(3.5)
11	**Total Capital Related Revenue Requirement**	**914.1**	**947.7**	**970.2**	**1,004.6**	**1,038.4**
12	OM&A	544.4	550.1	555.9	561.7	567.6
13	Integration of Acquired Utilities					
14	**Total Revenue Requriement**	**1,458.5**	**1,497.8**	**1,526.1**	**1,566.3**	**1,606.0**
15	Increase in Capital Related Revenue Requirement		33.6	22.4	34.4	33.9
16	Increase in Capital Related Revenue Requirement as a percentage of Previous Year Total Revenue Requirement		2.30%	1.50%	2.25%	2.16%
17	Less Capital Related Revenue Requirement in I-X		0.66%	0.66%	0.67%	0.67%
18	**Capital Factor**		**1.65%**	**0.84%**	**1.58%**	**1.49%**

Source: IR Response SEC-5, Table 2 (I-4-5, p.2). In that response Hydro One notes it a corrected version of the table provoded in its EB-2017-0049 Draft Rate Order that takes into account changes made in its EB-2017-0049 DRO Reply Submissions

In requesting this change to the Capital Factor, SEC is not claiming that the Board made an error in the EB-2017-0049 Decision, as that term is usually understood in the context of a motion to review and vary. A review of the record in EB-2017-0049 demonstrates that Hydro One proposed this methodology in applying a productivity factor (which included the stretch factor) to its capital related revenue requirement in its application, and this specific criticism of that approach was not raised by any party, including SEC. Similarly, no party raised concerns at the Draft Rate Order stage.

As the Board is aware, Custom IR applications are incredibly complex, especially ones for a company the size of Hydro One. The asymmetry of information between an Applicant on one hand, and intervenors, Board Staff, and the Board panel, on the other hand, are very significant. Invariably problems with the proposed applications will fall through the cracks, but when significant and material, they should be remedied. In fact, Hydro One itself may not have fully realized the impact of their methodology, as it is clearly inconsistent with the purpose of a stretch factor, just as it is inconsistent with the direction and intent of the Board's EB-2017-0049 Decision.

[13] Payment Amounts Order (EB-2016-0152 - OPG), March 29, 2018, Appendix A, Tables 1-7

The Board has an on-going obligation to ensure rates are just and reasonable, and has the authority in this proceeding to depart from the EB-2017-0049 Rate Order on a prospective basis, if current rates do not meet that standard. This is especially true if the approved Draft Rate Order is not consistent with the decision it is supposed to implement.

The Board has recognized its on-going obligation to ensuring rates are just and reasonable during a rate-setting term, and have previously made corrections in what would otherwise be a mechanistic rate adjustment application, again on a prospective basis. For example, in Halton Hills Hydro's 2018 IRM application, the Board approved a deferral account to capture the annual revenue requirement associated with an error in the calculation of its depreciation expenses included in the application filed in its most recent cost of service proceeding.[14] The Board approved the deferral account, with the expectation that subject to certain conditions, it would be disposed of at Halton Hills Hydro's next cost of service application.[15]

SEC submits the deficiencies identified are the type in which it appropriate to depart from what was approved in the EB-2017-0049 to ensure Hydro One's rates are just and reasonable in 2021. To correct the obvious deficiency in the Hydro One Capital Factor on a prospective basis, SEC submits that the Board should make two specific changes.

First, as discussed above the Board should adjust the 2021 Capital Factor to reflect the cumulative impact of the approved stretch factor applied to the capital related revenue requirement. This would result in a 2021 Capital Factor of 1.58%, as opposed to the 1.95% used in this Application (and approved as part of the DRO process in the EB-2017-0049 proceeding).

Second, even though the change to rates is only being requested on a prospective basis, the 2020 approved revenue requirement that is used as a base on which the revised RCI formula is being adjusted, is artificially high, as it includes a 2020 Capital Factor that does not include the necessary compounding of the approved stretch factor. To remedy this, the Board should revise the 2020 revenue requirement used as the base for the 2021 RCI formula adjustment, as if the amount was calculated based on the corrected 2020 Capital Factor. This adjustment would not change 2020 rates, so it would not be retroactive. It only corrects the base on which 2021 rates are being calculated. The problem arose first in 2020, and was not identified at the time, but those rates were final and cannot be corrected.

The table below shows the proposed calculations for 2021.

[14] *Decision and Order* (EB-2018-0045 – Halton Hills Hydro Inc.), April 26, 2018, p.17-22
[15] *Ibid*

2021 Revenue Requirement			
		Hydro One	**SEC Proposal**
A	2019 Revenue Requirement	1,497.90	1,497.90
B	2020 Inflation Factor	2%	2%
C	2020 Productivity Factor	0.45%	0.45%
D	2020 Capital Factor	1.21%	0.84%
E	2020 Revenue Requirement [A x (1+B-C+D)]	**1,531.75**	**1,526.21**
F	2021 Inflation Factor (1)	2.20%	2.20%
G	2021 Productivity Factor	0.45%	0.45%
H	2021 Capital Factor	1.95%	1.58%
I	2021 Revenue Requirement [E x (1+F-G+H)]	***1588.43***	***1577.03***
(1) SEC has updated the 2021 Inflation-Factor based on the Board's Letter dated November 10, 2020			
Source: Decision and Rate Order (EB-2019-0043), December 17 2019; Pre-filed Evidence, p.9			

Summary

SEC submits that the Board should correct this significant deficiency in the underlying Custom IR methodology for Hydro One for 2021, so that the intended purpose and benefits of the approved stretch factor are appropriately applied to calculate the capital related revenue requirement. Without this adjustment, Hydro One rates do not appropriately reflect any meaningful inclusion of the approved stretch factor applied to capital, and the supposed upfront benefits to ratepayers and productivity incentives for the company are not achieved.

The proposed adjustment would reduce the 2021 revenue requirement from $1,588.43M to $1,577.0M, a reduction of approximately $11.3M.

B. <u>Deferral and Variance Account</u>

SEC has reviewed Hydro One's proposal to dispose of the balance in its Earning Sharing Mechanism ("ESM") Deferral Account that relates to over-earnings in the 2018 and 2019 rate years.[16] Based on Hydro One's responses to interrogatories, SEC raises the following two issues.

First, Hydro One appears to have used the Board approved mid-year rate base instead of actual rate base for the purpose of calculating the achieved ROE.[17] Hydro One should be required to use *actual* rate base as this is the appropriate way to calculate its *actual* ROE. SEC does recognize that based on the table provided in response to Interrogatory Board Staff No. 17, the impact appears to be immaterial with respect to the years at issue in this proceeding, but this should be considered for future applications.

Second, Hydro One has filed the 2018 ESM calculation on a full year basis even though rates were effective only as of May 1, 2018.[18] This would seem to indicate the more appropriate that the ESM should be based on a comparison between the actual vs approved ROE with respect to May to

[16] Pre-filed Evidence, p.10

[17] Interrogatory Response Board Staff No. 17(e) (I-1-17(e))

[18] Interrogatory Response Board Staff No. 17(b) (I-1-17(b))

December 2018 net income and rate base. SEC requests that Hydro One provide a revised ESM calculation for 2018 on this basis.

Yours very truly,
Shepherd Rubenstein P.C.

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cc: Wayne McNally, SEC (by email)
Applicant and intervenors (by email)