ONTARIO ENERGY BOARD

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

AND IN THE MATTER OF an Application by Hydro One Networks Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates for the delivery and distribution of electricity.

WRITTEN ARGUMENT OF THE CONSUMERS COUNCIL OF CANADA

HYDRO ONE NETWORKS INC.
2008 DISTRIBUTION RATES APPLICATION

EB-2007-0681

INTRODUCTION:

1. By application dated August 15, 2007, Hydro One Networks Inc. ("HON") applied to the Ontario Energy Board ("Board") for approval of its proposed 2008 revenue requirement and rates for its distribution business.

2. In May 2008, a Settlement Conference was held between HON and the intervenors. The Settlement Conference resulted in a number of issues being settled, limiting the issues left for the Board's consideration through the oral hearing process. The Consumers Council of Canada ("Council") was an active participant in the Settlement Conference and a party to the Settlement Agreement dated June 3, 2008.

3. This is the written argument of the Council. The Council will make submissions on the issues that were not resolved during the Settlement Conference in the order they appear on the Board-approved issues list.

4. The Council will first address some overview issues that are relevant to the Board's consideration of HON's Application and rate proposals for 2008.

OVERVIEW:

5. HON's Application for 2008 rates is significant for a number of reasons. First and foremost is the fact that this represents a rebasing year for HON. The 2008 rates approved through this proceeding will form the base from which rates will be set for the next three years under the Board's 3rd Generation Incentive Regulation Mechanism ("3GIRM") framework. From a ratepayer perspective, given this represents a base year, it is particularly important that the Board carefully consider the long-term impact of HON's proposals to ensure they will result in just and reasonable rates over the duration of the incentive regulation period. Given rates will be set through the IRM regime this will be the last full opportunity to scrutinize HON's costs and revenues for many years.

6. HON's application is also significant as it includes cost allocation and rate design proposals that significantly diverge from what is currently in place. There will be customer impacts arising from the new approaches within rate classes, among rate classes and across HON's franchise area. The Board must carefully consider all of those impacts particularly when it assesses HON's harmonization plan.

7. HON is seeking approval of the following major elements of its Application:

1. A total revenue requirement of $1.067 billion for the 2008 test year;
2. Operations, Maintenance and Administrative ("OM&A") costs of $478 million;
3. A total capital budget of $566.2 million resulting in a distribution rate base of $4.382 billion;
4. Approval to refund a credit to customers representing the balances in the Regulatory Asset Accounts as of April 30, 2008 totaling $65.5 million;
5. Approval to refund that credit over a four year period;

6. Approval to harmonize its distribution rates over a four year period;

7. Approval of two new deferral accounts to deal with incremental Board costs and to track variations in pension costs.

8. Approval of a deferral account to record the revenue deficiency resulting from the mitigation proposals. **(HON Argument in Chief, pp. 11-14)**

ISSUES:

1.1 Has H*ON responded to all relevant Board directions from previous proceedings?*

8. As a result of the Settlement Proposal only two aspects of this issue are left for consideration by the Board. In its RP-2005-0020 Decision, HON had been given regarding Conservation and Demand Management ("CDM") and levels of compensation. HON's compliance with the CDM directives is dealt with under Issue 1.5.

9. With respect to compensation the Board indicated that it was particularly concerned with the "apparently high labour rates" and expected HON to identify steps to reduce related expenses. The Board directed HON to report upon the results of its "positive steps" at its next rates case. The specific Board's directives regarding compensation were:

- The Board is particularly concerned about the apparently high labour rates. In this respect, the Board expects Hydro One to identify what steps the company has taken or will take to reduce labour rates (para 3.4.3).

- The Board will not make an adjustment to the proposed OM&A costs based on compensation levels at this time but expects the utility to demonstrate that lower compensation costs per employee have been achieved or demonstrate concrete initiatives whereby compensation costs will be brought more in line with other utilities. (para. 3.5.4)

- While the Board is not prepared to order a comprehensive benchmarking, the Board sees value in a high level benchmarking study for initial review at the next rates proceeding. The Board directs Hydro One to engage an independent party to develop a list of comparable North American companies with similar business models (transmission and/or distribution) and to report on a high level comparative performance and cost information for Hydro One and these companies. Hydro One will want to consult with intervenors regarding the scope of the study. The independent study should be submitted as part of Hydro One's next main application for distribution rates. (para 3.4.6)

- In addition, the Board directs Hydro One to engage an independent party to develop a comparison of labour rates and overtime policies amongst Hydro One, other comparative Ontario electricity distributors and other Canadian utilities as identified in the high level benchmarking study. The independent study should also be submitted as part of Hydro One's next main applications for distribution and transmission rates. (para. 3.5.7)

10. The Council is unable to determine whether HON has achieved the Board's Directives regarding labour rates and overall compensation levels based on the information contained in the pre-filed evidence. Specifically, given the way in which compensation data has been presented HON has not demonstrated that it has taken steps to reduce rates or that compensation costs have been brought in line with those of other utilities. HON has a unique work-based budget rather than a traditional resource-based budget organized by cost category. In addition, total labour costs include HON's allocated portion of central corporate costs. From the Council's perspective the structure of the pre-filed evidence impeded a thorough review of HON's annual labour costs by category **(Tr. Vol. 3, pp. 101-104)**.

11. The Council submits that the Board should direct HON to file evidence based on annual data for significant cost categories such as labour. The evidence should be in a standard format that enables the comparison of labour costs among historical, bridge and test years on a total and sub-category basis in compliance with the common filing requirements. In the absence of this information the Board's concerns regarding controls cannot properly be addressed and resolved.

12. With respect to the independent study, the Council notes that HON is currently undertaking an independent market based assessment of HON's overall total compensation costs. There is an expectation that the study will be brought forward in HON's next transmission rates proceeding. With the filing of that study and the comparative data requested above the issue of compensation can be more thoroughly scrutinized in HON's next distribution rates proceeding.

1.5 Is the load forecast and methodology appropriate and has the impact of CDM initiatives been suitably reflected?

13. As a result of the Settlement proposal the scope of this issue has been reduced. The issues for consideration by the Board are whether HON's load forecast has appropriately incorporated the potential impact of CDM for 2008, whether HON's forecast is compatible with the Ontario Power Authority's ("OPA") load forecast for the Province and whether HON should have a lost revenue adjustment mechanism ("LRAM") in place to compensate it for lost revenue resulting from its CDM programs.

14. In its 2006 Distribution Rates Decision the Board directed HON to present future CDM load reduction forecasts on with a bottom-up analysis estimating the expected results of their CDM activities and those of others that affect their load. The Board also indicated that it expected HON's next load reduction forecast to include a proposal for a LRAM.

15. HON has provided what it views as an appropriate "bottom-up" analysis of the impacts expected from its existing programs, programs initiated by other government agencies such as the federal and provincial governments, the OPA and the Independent Electricity System Operator ("IESO") **(Ex. H1.105)**. Mr. But testified that, with respect to future CDM load reduction forecasts, the information is simply not available **(Tr. Vol. 4, p. 8)**.

16. The Council is not making detailed submissions regarding the way in which HON has incorporated the expected impact of CDM in it 2008 load forecast, but supports the submissions made by the Vulnerable Energy Consumers Coalition ("VECC") in this area.

17. The Council believes there is an information gap that needs to be filed for future load forecasting. The Council urges the Board to require HON to come forward in it next rates proceeding with a detailed proposal to incorporate the impacts of CDM into its load forecast. As the scope and number of CDM initiatives increase over the next several years the need for developing a detailed and comprehensive approach will become more important. As the development of CDM Evaluation, Measurement, and Verification ("EMV") techniques, by both the OPA and HON moves forward the ability to accurately

forecast expected outcomes and measure actual results will increase. There is also an expectation that the implementation of the smart meter initiative will facilitate better measurement of CDM results.

18. The Council notes that the Board, in the recent Toronto Hydro Electric System Ltd. Decision for 2008-2010 rates ("THESL Decision"), commented on the inconsistent practices among LDCs as to how to incorporate CDM activities in forecasts. In addition, the Board commented on the apparent lack of alignment between the OPA forecasts and those generated by individual LDCs and the potential implication of this misalignment for LRAM and shared savings mechanisms ("SSM") (**THESL Decision with Reasons, EB-2007-0680**). The Council agrees that, like THESL, HON should be required to work with the OPA, IESO and others to understand the differences in the methodology employed by each. Of special interest is the development of a methodology to account for the specific effects of CDM activities in forecasts. The success of LRAM and SSM applications is dependent on fully developed evidence respecting the effects of CDM activities on throughput. (**THESL Decision with Reasons, EB-2007-0680, p. 33**)

19. With respect to the request for a LRAM HON has indicated that it is not proposing or requesting the use of one at this time for the following reasons:

> Hydro One has concerns with the practical difficulties and related accuracy of determining the actual amount of CDM savings achieved by its customers in a given year through the implementation of CDM from various sources such as the Ontario Power Authority, Provincial Government and federal Government. Hydro One believes it is prudent to wait for the OPA to develop Measurement and Verification programs for determining actual CDM achievements at this time. (**Ex. A/T17/S1/p. 5**)

20. HON contends that, in order for it to propose a LRAM, the EMV results would be required for OPA-initiated programs, non-OPA initiated programs as well as conservation efforts undertaken by distribution customers that are not captured by OPA or non-OPA programs that are incremental to natural conservation. (**Tr. Vol. 4, p. 10**)

21. It is clear that Ontario LDCs and the OPA are in the relatively early stages of developing, implementing and evaluating their CDM initiatives. The Council has supported LRAM proposals in the past, particularly in cases where rigorous evaluation and audit

protocols for CDM programs are in place. Specifically, the Council has supported LRAM proposals for the Ontario natural gas LDCs. The Council agrees with the Green Energy Coalition that a LRAM compensates a utility for lost sales revenues when its CDM results exceed the CDM impact forecast used in rate setting and returns revenues to customers if a utility underperforms below the CDM forecasts used to set rates. In effect, it acts to remove the disincentive to CDM success and remove the positive incentive in prospective rate-making to fail at CDM. (GEC, Argument, p. 3) The Council does, however, believe it is premature to put a LRAM in place for HON at this time.

22. HON has taken the OPA's 2008 CDM forecast and pro-rated it for its service territory. Although in the absence of a LRAM there is a risk that HON may under-perform relative to the assumptions it has embedded in its load forecast, the Council believes it has sufficient incentives to pursue cost-effective CDM efficiently. It is a publicly owned utility, with a shareholder that has been aggressively promoting CDM across Ontario. In addition, HON is doing virtually all of its CDM programs through the OPA, whose contracts contain performance incentives.

23. The Council does accept that the LDCs in the Province, the OPA and the OEB should work together to develop the protocols necessary to put LRAMs in place in the future. If an LDC has sufficient information to accurately forecast its expected CDM results, and the proper EMV mechanisms to evaluate those programs after the fact, then a LRAM is appropriate. It would be fair to both the ratepayers and the shareholders. HON, has indicated, however, that it does not have sufficient information to accurately forecast its expected CDM results or evaluate the impacts that those programs may have at the end of the year. Accordingly, the Council does not support the implementation of a LRAM for HON at this time.

3.1 Are the overall levels of Operation, Maintenance and Administration budgets appropriate?

24. HON is proposing an OM&A budget of $468 million for 2008 excluding the costs of the smart meter initiative. This compares to an actual budget of $399.2 in 2006 or an increase of 17.2% over the two years. **(J2.2)** The Council considers it appropriate for the Board to assess the reasonableness of the 2008 OM&A budget by comparing year over

year increases. This approach has been adopted by the Board in the past. From the Council's perspective HON has not justified why a 17.2% increase is required. We support the arguments advanced by VECC, SEC and CME regarding HON's OM&A budget for 2008 and submit that HON should be permitted an OM&A budget that represents an increase of 6% over the 2006 actual expenditures.

3.2 Is the 2008 Vegetation Management budget appropriate?

25. HON's 2008 vegetation management budget is $119.4 million, 34% greater than 2004. Vegetation Management is the largest program managed by HON and has the greatest impact on system reliability **(Ex. C1, T2, S2, pp. 30-31)**. The Council does not take issue with the increase in costs historically as HON has demonstrated a corresponding improvement in system reliability.

26. The significance of the annual expenditures necessitates that HON continually demonstrate prudence in ensuring external contractors are retained at the lowest possible cost. In addition, HON should continue to demonstrate that system reliability by region directly reflects the level of associated O&M and capital expenditures.

27. Currently, the average feeder on HON's system is cleared every 10 years. In 2008, HON conducted a benchmarking study of the electric utility industry and determined that the majority of utilities operated on clearance cycles between 4 and 6 years. The clearance cycle is an important issue for HON and its customers; the shorter the clearance cycle, the higher HON's expected system reliability and customer rates. "The condition of vegetation on a distribution right-of-way has proven to be – by a considerable margin – the dominant influence on system reliability during storm events" **(Ex. H1/T14/Attachment B, p.2)**.

28. A clearance cycle shorter than 10 years will result in lower costs per cycle but higher annual costs. The benchmarking study indicated that the current cost per cycle could be reduced by $14 million or $21 million if HON moves from a 10-year cycle to an 8 or 6-year cycle respectively. However, the full cost of maintaining an 8 or 6-year cycle would increase costs by $60 million or $125 million respectively, over the next 5 years **(Ex. H1/T14/Attachment B, pp. 11, 19)**.

29. HON proposes to move from a 10-year to an 8-year cycle. HON's witnesses indicated that the company was hesitant to move to a clearance cycle within the industry range of 4 to 6 years given the risks, difficulties in execution, availability of additional skilled staff and customer impact. Given the nature of the clearance cycle management program, costs are incurred before the expected benefits in system reliability are accrued **(Tr. Vol. 2, pp. 166-168).**

30. The Council supports HON's proposal of an 8-year clearance cycle. The Council sees merit in further review of shorter clearance cycles and agrees with HON that it should gain experience with the adoption of an 8-year cycle and the benefits are substantiated prior to considering a shorter clearance cycle **(Ex. J. 2.7).**

31. As indicated by the Presiding Member, the accounting and rate-making options need to be examined further. The Council would want to ensure that the benefits are matched to costs in the appropriate time periods **(Tr. Vol. 2, pp. 166-169).** The Council submits that this issue should be re-examined in HON's next rate case.

3.6 Are the 2008 Human Resources related costs (wages, salaries, benefits, incentive payments, labour productivity and pension costs) including employee levels appropriate?

32. The Council's submission regarding Human Resources related costs are set out under Issue 1.1.

3.10 Is the level of HON initiated and or delivered CDM activity and budget appropriate and should it be funded by the OPA or in rates?

33. HON is asking for approval in rates of $1 million to maintain the programs it initiated in the 2005-2007 period through the market adjusted rate of return ("MARR") CDM funding framework. The funding is to maintain a base level of CDM capability required to participate in industry activities, and to assess resources required to develop future CDM programs and prepare funding applications. From HON's perspective, in the absence of this funding, it would not be able to keep abreast of evolving CDM trends, develop credible CDM programs and prepare satisfactory application to the OPA **(Tr. Vol. 4, p. 32)**

34. HON is not planning any new CDM programs beyond those being funded by the OPA and has not included any CDM funding in the 2008 revenue requirement beyond the amount referred to above. **(Tr. Vol. 1, p. 80)** For 2008, based on the currently approved funding from the OPA, HON expects to undertake about $20.195 million of CDM. **(Tr. Vol. 4, p. 108)** In addition, HON has further proposals being considered by the OPA. If successful with the OPA application the total amount of funding would be increased by a further $12 million. **(Tr. Vol. 4, p. 108)**

35. The Council submits that HON has provided evidence to support the fact it is undertaking a wide range of comprehensive CDM programs which are being funded by the OPA. Potentially, that funding may exceed $30 million if the current application before the OPA is approved. If, going forward HON determines that it has the capacity to undertake further CDM, beyond that supported by the OPA, it has an opportunity to apply to the Board for approval of those programs and funding through rates. HON is not choosing to do that at this time.

36. There was no evidence provided by any intervenors to demonstrate that, for 2008, HON is capable of undertaking CDM programs beyond those approved or currently before the OPA for consideration. From the Council's perspective the fact that HON is undertaking a broad portfolio of programs is clear **(Ex. J4.2)**. It would be premature to require further programs or further spending in the absence of support from HON. There is no evidence that, if the second tranche of programs is rejected by the OPA, it would appropriate for HON to move forward with those programs in the absence of OPA support. Accordingly, the Council supports HON's CDM proposals as set out in the evidence.

4.1 Are the amounts proposed for 2008 Capital Expenditures appropriate?

37. The Council is making submissions regarding the regulatory treatment of HON's Cornerstone Project. The Council is not taking issue, in this proceeding, with the overall level of HON's 2008 capital expenditures budget.

38. HON's Cornerstone Project is a major information technology project being put in place to facilitate the replacement of HON's core business systems, in a phased approach allowing the replaced applications to be upgraded on a continual basis, without the

cost of a significant one-time upgrade **(Ex. D1/T3/S5/p. 18)** A significant portion of this project relates to change management, streamlining business processes and putting in processes and process measures to ensure ongoing adherence to the new business model and to the business rules embedded in the application **(Ex. D1/T3/S5/p. 19)**.

39. The Cornerstone Project is a significant multi-year capital project. The Phase I portion of the Cornerstone Project is expected to be in service in 2008 with the corresponding costs for 2007 and 2008 included in rate base. This would include the $28 million for 2008 and the distribution allocation of the $60.4 million that was incurred in 2007. **(Ex. D1/T3/S5, p. 16, Table 6)** Board Staff interrogatory H.1.37 provides a detailed description of the anticipated benefits arising from the Cornerstone project. HON was also asked to provide a breakdown of the expected benefits attributed to the distribution operations. **(J3.7)** The total expected benefits resulting from Phase I amount to $200 million for both the transmission and distribution operations. 44% of the Phase I Cornerstone costs are allocated to Distribution and there are specifically identified savings to the distribution customers of Cornerstone Phase I of about 30%. **(H1.37)**

40. HON testified that it intended to build in a forecast of savings associated with the Cornerstone project during the 3GIRM period. **(Tr. Vol. 3, pp. 85-89, 147-148)** Later during the hearing Counsel for HON seemed to be changing or correcting that testimony. Mr. Rogers stated that, with respect to Cornerstone and the 3GIRM plan, there will not be a discrete adjustment to the revenue requirement to reflect the Cornerstone savings. **(Tr. Vol. 5, pp 6-7)**

41. The Council submits that the regulatory treatment of the Cornerstone Project as proposed by HON is simply not fair to ratepayers. Ratepayers are being asked to fund the capital costs associated with the Phase I component of the Cornerstone Project, but will not realize any benefits until HON distribution comes before the Board for rebasing. Under the Board's current proposal for its 3GIRM the benefits would not flow to ratepayers until 2012.

42. The Council submits that the Cornerstone is a sufficiently large and unique project to merit special regulatory treatment. The total project costs are $144 million of which HON's distribution and transmission customers are being asked to fund 100%.

(D2/T2/S3/Ref # IT1) If ratepayers are being asked to fully fund the project they should also be entitled to the full benefits. The only way to ensure that the benefits and costs are matched is for the Board to approve a deferral account to allow the annual benefits, as projected by HON, to flow through to customers during each year of the 3GIRM term. In the absence of such a mechanism the ratepayers will fund the entire project with <u>all</u> benefits flowing to HON's shareholders.

43. If the Board does not accept that deferral account treatment is appropriate the Board should make an up front adjustment to revenue requirement to ensure an annual level of benefits flow to ratepayers. The Cornerstone Project is intended to create efficiencies throughout the HON organization. It would be unfair to ratepayers to wait until 2012 before benefiting from those efficiencies. HON's current proposal should be rejected by the Board and an appropriate regulatory mechanism adopted to ensure the recovery of costs and the realization of the benefits are aligned.

6.1 Is the proposal for the amounts, disposition and continuance of HON's existing Deferral and Variance Accounts (regulatory assets) appropriate?

44. The Council supports HON's proposals for disposition and continuation of existing deferral and variance accounts. In particular, the Council supports the clearance of the regulatory asset balances as of April 30, 2008 and the full remittance of refunds to ratepayers. The refunds should reduce the impact of HON's harmonization proposals if those proposals are approved by the Board.

45. As HON's financial statements are audited as of Dec. 31, 2007, the regulatory account balances between January 1, 2008 and April 30, 2008 have not been audited and may be subject to change. The Council considers the potential variance to be acceptable as HON has the opportunity to true up the disposition of customer refunds in future years. The proposal to defer clearance of the accounts until audited results are available only delays the remittance of funds owed to ratepayers.

46. Board Staff has suggested that there may be some merit in refunding the money over a shorter time period. Although the current proposal would align recovery with the IRM term the Council could support an accelerated timeline to either mitigate the

harmonization proposals (if approved by the Board) or reduce any intergenerational inequity that may arise if the balances are cleared over a longer time period.

47. The Council notes that the total balance to be remitted to HON's customers will increase if the Board rejects HON's proposal to clear the amounts related to smart meter costs exceeding minimum functionality.

6.2 Is the proposal to establish new Deferral and Variance Accounts appropriate?

48. HON proposes to establish three new accounts for the 2008 test year:

- Pension Cost Differential Account;
- OEB Cost Differential Account; and
- Bill Mitigation Account

49. Traditionally, the Board has applied a set of standard criteria to evaluate proposals for new deferral and variance accounts that include the following elements:

- Prudence;
- Materiality;
- Causation; and
- Uncontrollability.

50. The Council will refer to the above set of criteria in reviewing HON's proposed new accounts for 2008.

Pension Cost Differential Account

51. The proposed Pension Cost Differential account would record variances between forecast pension expenses included in HON's revenue requirement and the actual 2008 expenses incurred **(Ex. F1/T3/S1/p. 1)**.

52. The Council does not support the proposed new account for the following reasons:

1. The estimated account balance is not material;

2. There is no regulatory precedent. The unique set of circumstances that justified HON's 2004 pension deferral account no longer exist in 2008;

3. Hydro One Transmission does not have a pension-related deferral account;

4. The account would transfer the forecast risk associated with pension expenses from shareholders to ratepayers; and

5. Approval of the proposed account would set a regulatory precedent, creating the opportunity for other OEB-regulated utilities to apply for a similar account.

53. Since HON filed its evidence, Mercer Human Resource Consulting completed their actuarial assessment of HON Corporate's pension plan and revised the pension expense calculation based on 2007 data.

54. Given current information available, HON estimates the proposed pension variance account would have a balance of $1.5 million for 2008 associated with the expected change in base pensionable earnings from 2007 to 2008 **(Tr. Vol. 6, p. 115)**. The $1.5 million would be a reduction to the forecast pension expense included in the proposed 2008 revenue requirement.

55. While the Council considers pension expenses to be prudently incurred, with cause and with cost drivers beyond management's control, an estimated variance of $1.5 million to forecast is not material.

56. HON's witnesses testified that HON's pension cost deferral account approved by the Board in RP-2004-0180 in 2004 established regulatory precedent (**Tr. Vol. 5, p. 58**). The purpose of the deferral account in RP-2004-0180 was to capture the pension costs that commenced on January 1, 2004. Prior to 2004, HON Corporate had a pension surplus and contributions were not required. Two events triggered HON's resumption of pension plan contributions:

1. a $270 million withdrawal from the pension fund; and

2. a reduction in the value of the underlying securities and earned interest rates due to a market downturn.

57. The 2004 pension deferral account was justified given the lack of historical information and the unique set of circumstances in the market that would affect HON's 2004 and 2005 required contributions.

58. The Councils submits that there are no unique circumstances in 2008 to justify HON's proposed Pension Cost Differential Account. An actuarial assessment is performed every three years based on historical experience. The only risk to the calculation made by Mercer Human Resource Consulting is the difference between 2007 and 2008 base pensionable earnings **(Ex. F1/T3/S1/p. 1)**. The Council submits that the only risk to the forecast is the variance around HON's $1.5 million estimate. It is a manageable risk that exists every year. In addition, Hydro One Transmission does not have a pension-related deferral account which would create inequity within Hydro One Corporate.

59. Shareholders of OEB-regulated entities are generally compensated for the forecast risk through the Board's deemed capital structure and return on equity award. Approval of OPG's proposed Pension Differential Account would transfer the forecast risk associated with pension expenses from the shareholder to the ratepayer. The Council submits that this transfer of risk is inappropriate. As a result, if the Pension Cost Differential account is approved, HON's return on equity settled through ADR would have to be reconsidered.

60. The Council is concerned that HON's proposed Pension Cost Differential account would set a regulatory precedent if approved, establishing the basis for all OEB-regulated entities to seek a similar account. In fact, OPG has proposed a similar account in its EB-2007-0905 Application. As proposed by one of the Panel Members, the Council agrees that it may be more efficient for the Board to deal with this issue on a generic basis **(Tr. Vol. 6, p. 138).** Consistency and equity of ratemaking treatment among OEB-regulated utilities are particularly important in the context of Market-Based Returns and mechanisms for setting ROE.

61. In summary, the Council submits that the Board should direct HON to reduce its forecast pension expense by $1.5 million and reject the creation of a Pension Cost Differential Account for the 2008 test year.

OEB Cost Differential Account

62. The proposed account would track the difference between forecast and actual:

1. OEB cost assessments;
2. Intervenor cost awards; and
3. Costs associated with OEB-initiated studies **(Ex. F1/T3/S1/p. 1).**

63. The Council does not support the OEB Cost Differential Account as proposed by HON. The Council does not take issue with the first two components of the proposed new account. The Council supports the continuation of HON's current OEB Cost Assessment Differential Account as approved by the Board in RP-2005-0020 **(Decision with Reasons, p. 46)** and would support expanding the scope of the account to include variances in forecast to actual intervenor costs. The Council submits that intervenor cost awards are subject to a prudence review by the Board and are incurred with cause, with potentially material variances that are generally beyond management's control.

64. The third component of the proposed new account, the costs associated with OEB-initiated studies, does not pass the criteria of prudence or materiality. HON was unable to define the nature or magnitude of the "other costs incurred" as they would relate to future initiatives that have yet to be defined or even anticipated **(Tr. Vol. 5, pp. 8-10).** The Council submits that it would be inappropriate for the Board to approve the establishment of new deferral accounts "just in case". Prior to HON's next rates, should the situation arise during the IRM period, the Board has the authority to approve a new deferral account if necessary.

65. In summary, the Council submits that the Board should expand the scope of HON's existing OEB Costs Assessment Differential Account to include intervenor costs and deny the proposed new OEB Cost Differential Account.

Bill Impact Mitigation Account

66. The Council supports HON's proposal to create the Bill Impact Mitigation Account. The account will record the difference between HON's approved revenue requirement and distribution rates. If HON's current Application is approved, the account balance will be $2.5 million **(Ex. F1/T3/S1/p. 2)**.

67. The Council submits that the Bill Impact Mitigation Account is necessary to record the revenue shortfall that remains after HON's mitigation measures and proposed rates are applied **(Ex. G1/T8/S2/pp. 1-2)**. HON's proposed rates are designed to recover the revenue requirement for all rate classes except R1 **(Tr. Vol. 6, p. 169)**. The Council submits that the Bill Impact Mitigation Account should be approved, yet the balance will depend upon the Board's findings with respect to HON's 2008 rates.

68. The Council not will comment on the appropriate recovery of the Bill Impact Mitigation Account balance as balance recovery is not an issue to be decided in this proceeding.

7.1 Are HON's proposed new Customer Rate Classes appropriate?

69. HON has proposed a rate structure with 12 new rates classes, a reduction from the current number of 280 rate classes. "One of the main objectives of this Application is to simplify the structure of Hydro One Distribution's current rate classes to better reflect utilization of assets and services which impact cost causality...With the implementation of time-of-use rates, and assuming not all customers in a rate class will want to adopt time-of-use, the number of rate classes to be administered can potentially expand to a value of close to 600 if action is not taken to reduce the number of rate classes" **(Ex. G1/T2/S1/pp. 1-2)**.

70. HON originally proposed 10 new rate classes, but agreed to revise its proposal based on feedback from stakeholders.

71. HON will map each customer from one of the 280 existing classes to one of the 12 new classes. Of the 12 new classes, 4 are designed for residential customers. Based

on 2006 billing data, HON will have the following number of customers per new residential class:

2008 New Rate Class	# of Customers
Urban Residential High Density	155,840
R1 Residential Medium Density	365,190
R2 Residential Low Density	358,328
Seasonal Residential	154,437
Total	**1,033,795**

(Ex. G1, T2, S3, pp. 2-4)

72. The Council supports HON's proposed rate class structure with the 12 new rate classes. The Council commends HON for seeking input and accommodating requests from stakeholders in developing the current proposal before the Board.

7.2 Is HON's cost allocation appropriate?

73. Once the rate class structure was developed, the next step in HON's process was to allocate costs to the rate classes.

74. In HON's 2006 rates case, RP-2005-0020, the Board rejected HON's harmonization proposal as premature as it was not supported by a cost allocation study **(Ex. G1/T2/S5/p.1)**. In preparing the current Application, HON utilized the Board's cost allocation methodology detailed in the EB-2007-0667 Report of the Board.

75. HON's witnesses indicated that they maintained the intent of the OEB cost allocation model to reflect cost causality but modified the model to take into consideration HON's rate classes. "For instance, we added subaccounts and related cost allocators to accommodate the sub-transmission system currently referred to as the low voltage system or LV system" **(Tr. Vol. 4, p. 13)**.

76. The Council submits that HON has met the Board's directives in conducting a cost allocation study based on its proposed new rate classes for 2008 by applying the OEB cost allocation model in EB-2007-0667.

7.4 Are the proposed revenue to cost ratios appropriate?

77. HON relied upon the revenue-to-cost ratio ranges contained in the EB-2007-0667 Report of the Board in order to develop its target rates for its new rate classes. For customer classes that were initially below the Board's recommended ratio, rates were adjusted up to achieve the minimum ratio. For customer classes that were initially above the Board's recommended ratio, rates were adjusted down to the maximum of the range. As a result, HON's proposed rates achieve target revenue-to-cost ratio within the Board approved ranges for each customer class, starting in 2008 **(Tr. Vol. 4, p. 14)**.

78. In order to achieve recovery of the proposed 2008 revenue requirement, HON ensured all rate classes achieved revenue-to-cost ratios of 1.0 or greater, with the exception of the R1 rate class. The R1 ratio was maintained at 0.88 given the potential significant impact on R1 customers of moving to 1.0. The 0.88 ratio is still within the range recommended in EB-2007-0667 for residential, yet the rate does not recover the revenue requirement **(Tr. Vol. 4, p. 41).**

79. The Council supports HON's proposed target rates and the implicit revenue-to-cost ratios. The Council notes that this is the first year in which HON has applied the Board's cost allocation methodology and agrees with HON that it would be premature, in the absence of historical results, for HON to adjust all rates to achieve revenue-to-cost ratios of 1.0 or greater **(Tr. Vol. 4, p.43)**.

80. In general, the Council supports the use of the revenue-to cost ratios as a tool for rate-making purposes with reference to a range of acceptable outcomes. A ratio of 1.0 for every rate class should not necessarily be the ultimate rate-making objective as it would imply that the cost allocation and rate design process were precise mathematical exercises. The Council submits that the Board's range of ratios provides the appropriate level of guidance to OEB's regulated utilities, including HON.

7.5 Are the fixed/variable splits for each rate class appropriate?

81. The Council submits that HON's proposed rate structure, with the embedded fixed and variable splits, is appropriate. The Council notes that the Board has initiated a Rate Design Consultative Process to review the purpose and structure of fixed and variable

rates. To the extent that generic recommendations are forthcoming, changes to HON's rate structure may be warranted.

7.6 Is the proposal for harmonization of rates appropriate?

82. HON proposes to harmonize the rates for all its customers among the 12 new customer classes over a 4-year period starting in 2008. HON's customer base includes both legacy and acquired customers whose rates have been segregated to date. HON's proposal will combine similar customers into homogeneous customer classes. In effect, similar customers will be paying the same rate.

83. HON's proposed rates are designed to recover the costs of serving each class as a whole. HON has stated that harmonization is appropriate as their accounting records are not segregated on an asset or expense basis for legacy and acquired customers. "We have one set of books. We record our costs for both serving legacy and acquired customers in one set of books. We don't separate them." **(Tr. Vol. 5, p. 146)**

84. The 4-year period was selected by HON for the following reasons:

1. to limit the total bill impact for customers to 10% per year based on average consumption for each rate class;
2. to coincide with the expected end date for the Board's third-generation IRM;
3. to coincide with the implementation of HON's new billing system; and
4. to coincide with the anticipated date for full implementation of commodity time-of-use rates.. **(Tr. Vol. 6, pp. 189-190)**

85. HON's mitigation proposal limits the total bill impact to a maximum of 10% in 2008, 8% in 2009 and 7% in 2010 for customers with average consumption within each customer class. HON relied upon the Board's 2006 Electricity Distribution Rate Handbook, RP 2004-0188, to develop its mitigation proposal.

86. The mitigation proposal requires cross subsidization within rate classes in 2008 and over the 4-year phase-in period. "Any shortfall in revenues resulting from this

mitigation measure is being absorbed first by the acquired LDC in subsequent years and, if this is not possible, the by legacy customer classes in the same group as the acquired customer class" **(Tr. Vol. 6, p. 172).** Despite this two-step mitigation approach or method, HON's witnesses indicated that the cross subsidization is usually the legacy customers subsidizing the acquired customers **(Tr. Vol. 4, pp. 14-15).**

87. The Council supports class-based, rate making principles that combine similar legacy and acquired customers in one class. The Council agrees that it is impractical for HON to manage 280 rate classes and is supportive of the need for harmonizing legacy and acquired customers.

88. The migration to class-based rates necessitates a transition or harmonization period given the potential billing impacts to HON's customers. HON has selected a 4-year harmonization period for the reasons stated previously. The Council does not take issue with HON's proposed 4 –year harmonization period in principle. HON's reasons for supporting a 4-year period seem reasonable.

89. However, the 4-year period is directly linked to HON's objective of limiting the increase in total bill for customers with average consumption to 10%. HON's witnesses testified that "if we held to a 10 percent impact on low use customers to bring them to the target rates, it would take much longer than 4 years **(Tr. Vol. 4, p. 32)**. However, HON did not analyze the total bill impact of a 5 or 6 year alternative, so the bill impacts of a longer harmonization period are unknown.

90. The Council notes that the longer the harmonization period, the lower the annual bill increase required to achieve harmonization. A longer phase-in period could be accommodated without compromising HON's objective of "no more than" 10%. In addition, HON's witnesses testified that they could apply the same mitigation method to a 6-year phase-in period **(Tr. Vol. 6, p. 190).**

91. The Council is sensitive to the amount of cross subsidization within each rate class. Within the R1 rate class, legacy customers are subsidizing acquired customers by $3.2 million **(Tr. Vol. 6. 173).** The $2.5 million Bill Impact Mitigation Account forecast balance of $2.5 million is predicated on the fact that acquired customers first absorb $3.2

million through cross subsidization within the R1 rate class. As a total figure, $3.2 million is significant, aside from the impacts on an individual legacy customer. The Council notes that the $3.2 million figure could be reduced with a longer phase-in period as acquired customers would have the opportunity to absorb more of the overall increase required within the R1 rate class.

92. The Council takes issue with HON's sole reliance on the Board's Handbook guidelines and a mitigation proposal based on customers with average consumption. With any average calculation, there will be data points above and below the average. By focusing on the average customer, HON failed to analyze individual customer data. The Council submits that may be outliers; that is customers with billing impacts significantly above and below the average that have not been identified or evaluated.

93. The Council submits that the Board should have customer level information, not just the average, in order to provide outlier data for further analysis. HON's witnesses indicated that individual customer impacts had not been analyzed as it would require the analysis of more than 1 million customers. "I don't think we have the capability" **(Tr. Vol. 4, pp. 96-97)**.

94. The Council is concerned with the lack of information. Whether there is one outlier or one-thousand outliers, HON should identify those customers and provide information regarding their billing impacts over the harmonization period.

95. For example, HON's proposal results in low-use residential customers in Woodville having a $16 increase in their monthly fixed charge over the 4-year phase-in period, for an increase of 122.8% on their total bill. HON's witnesses did not consider a $16 increase to be significant **(Tr. Vol. 5, pp. 32, 61-62)**. The Council disagrees; an increase of $16 per month over 4-years is significant. Their annual cost increase will be $48 for the next 4-years equating to a total increase of $192 per year by 2011.

96. The Council submits that the Woodville example raises two issues: the magnitude of percentage increases and the related dollar impact. HON places sole reliance on mitigating the percentage increase in rates. The Council submits that ratepayers are concerned with the dollar increase to their bill, not just the percentage increase. Materiality

is defined on a dollar basis. The Council submits that HON's mitigation plan is not complete as it does consider the dollar impact to customers over the harmonization period. The Woodville example highlights the implications for an acquired LDC migrating to the new R1 rate class. The Council submits that potential outliers exist in every rate class, not just R1.

97. The Council cannot support a mitigation proposal based on averages and percentages as the outliers are not identified, the billing implications are unknown and alternative phase-in periods were not considered. The Council submits that HON's proposed rates may be just, but there is insufficient evidence to evaluate whether the proposed rates are reasonable.

98. The Council is also concerned about the lack of evidence to support the extent to which the acquired customers are currently paying rates that do not reflect the cost to serve them. In the absence of that data customers across Ontario will question the rationale for their proposed rate increases.

99. The Council submits that the Board should defer approval of HON's harmonization proposal. The Board should direct HON to provide additional information on the outliers and develop rate-making options in order to address the potential adverse impacts on those outliers. HON's should be required to come forward with a new approach as soon as possible.

100. In summary, the Council supports HON's proposals with respect to:

1. establishing 12 new rate classes;
2. the harmonization of rates for acquired and legacy customers;
3. revenue to cost ratios;
4. rate structure; and
5. mitigation approach or method.

101. The Council cannot support HON's harmonization and mitigation proposals at this time given the potential adverse impact on the outliers even if average bill impacts are capped at 10%.

8.1 Is the 2008 smart meter budget appropriate?

98. For 2008 HON is forecasting to spend $164.8 million in capital and $9.7 million on OM&A related to its smart meter implementation program. **(Ex. J2.2)** This assumes a planned installation of 370,000 meters in 2008.

99. Activities associated with the government's regulations concerning minimum functionality account for $64.2 million in 2007 and $136.5 million in 2008. This involves:

- Installing additional meters and advanced metering communication devices;
- Building and expanding the advanced metering collector and underlying networks;
- Commissioning and placing into service hardware and software for the advanced metering control computer to enable it to communicate and transmit quality meter data to and from the meter data management and meter data repository and HON's CIS. **(Ex. D1/T3/S2/p. 25-27)**

100. HON is also seeking recovery of costs which relate to functions which exceed those prescribed by regulation. The 2007 budget is $12.5 million and the 2008 budget is $28.3 million. These activities are:

- Upgrades to the CIS system to provide for time of use billing and related required settlement changes.
- Integration of the end to end systems including business process redesign.

- The added cost of super capacitors in meter and batteries in the regional collectors that provide for real time outage reporting after and during loss of power. **(Ex. D1/T3/S2/p. 27-28)**

101. The Council accepts that smart meter costs that have been prudently incurred should be recovered by LDC customers. This is consistent with Government policy and all of the decisions made by the Board with respect to smart meter expenditures to date. The Council has, in previous Board proceedings related to the 2008 cost of service applications, has taken a consistent position with respect to the regulatory treatment of smart meters. That treatment can be summarized as follows:

- LDCs should be able to recover the full costs of all prudently incurred smart meter capital and operating costs incurred consistent with the minimum functionality standards set by the Government and the Board;

- The LDCs that participated in the generic smart metering proceeding should be permitted to include in 2008 rate base the actual capital costs that were approved by the Board in that proceeding;

- Smart meter costs incurred after April 30, 2007, should be subject to a prudence review by the Board before those costs can be expensed or booked to rate base;

- Forecast smart meter costs, both capital and operating, should continue to be tracked through the continuation of the existing variance accounts and not until a future prudence review. The impact on rates would essentially be the same, but this approach would allow of an assessment of the actual costs incurred not a forecast. This will ensure that ratepayers and shareholders are both kept whole with respect to smart meter costs. Only prudent actual costs will ultimately be recovered from ratepayers;

- It is inappropriate for a forecast of smart meter costs to be included in rates on a final basis. If, for example, the LDC actually spends less than forecast the shareholders would obtain a windfall. This would be inconsistent with the Government's policy that actual smart meter costs are to be recovered fro the ratepayers;

- There should be a continuation of the smart meter adder to recover the costs that have not been subject to an after the fact prudence review instead of recovering the costs through final rates.

102. The Council notes that the Board has largely accepted the regulatory treatment set out above. Enersource and Hydro Ottawa Limited both agreed to the continued use of the variance accounts and rate adders. The Settlement Proposals for those two LDCs were subsequently approved by the Board. In the most recent Toronto Hydro Electric System Decision the Board approved similar treatment.

103. Given the regulatory precedent HON has agreed to support the treatment of its smart meter costs in the manner described above if the Board chooses to adopt that approach. **(Tr. Vol 7, p. 25)**

104. The Council is of the view that HON should be able to recover all smart meter costs related to minimum functionality incurred up to December 31, 2007. Costs beyond that period should continue to be captured in the deferral accounts and funded through the smart meter rate adder.

105. With respect to the costs incurred and expected to be incurred in 2008 the Council is not supporting recovery at this time. To date there has been no government policy, regulation or Board directive to mandate what functions and associated costs, incremental to those related to minimum functionality, are acceptable. The Council submits that in the absence of such a policy the Board should not consider these applications on a case by case basis. The Board and/or the government should, in our view, prescribe what functions the LDCs should be implementing as a part of the overall smart meter implementation plan. In addition, until those assets are used and useful full recovery would be inconsistent with accepted regulatory practice.

106. The Council is not saying that the costs incurred by HON are not appropriate or have not been prudently incurred. The position of the Council is that it would be premature to approve recovery at this time. These costs should continue to be recorded in the relevant deferral account until such time the Board initiates a review of the costs related to functions that exceed minimum functionality.

CONFIDENTIALITY:

107. The Council supports the arguments advanced by SEC regarding the confidentiality of the three documents produced in this proceeding.

COSTS:

108. The Council asks that it be awarded 100% of its reasonably-incurred costs for its participation in the HON application. The Council submits that it has acted both prudently and responsibly. The Council coordinated its efforts with several of the other intervenors during the settlement process, the hearing and in the preparation of argument, in an attempt to reduce costs and avoid duplication.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

Robert B. Warren

Counsel to the Consumers Council of Canada

1068812.1