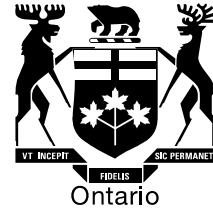


Ontario Energy
Board

Commission de l'énergie
de l'Ontario



EB-2008-0187

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. for an order or orders approving or fixing just and reasonable distribution rates and other charges, to be effective May 1, 2009.

BEFORE: Paul Vlahos
Presiding Member

Paul Sommerville
Member

Ken Quesnelle
Member

DECISION
May 13, 2009

Introduction

Hydro One Networks Inc. (“Hydro One”) is a licensed distributor of electricity providing service to consumers within its licensed service area. Hydro One filed an application with the Ontario Energy Board (the “Board”) for an order or orders approving or fixing just and reasonable rates for the distribution of electricity and other charges, to be effective May 1, 2009.

Hydro One is one of about 80 electricity distributors in Ontario that are regulated by the Board. In 2008, the Board announced the establishment of a new multi-year electricity distribution rate-setting plan, the 3rd Generation Incentive Rate Mechanism (“3GIRM”) process, that would be used to adjust electricity distribution rates starting in 2009 for those distributors whose 2008 rates were rebased through a cost of service review. Building incrementally on the previous plan, the 3GIRM is more specifically grounded in empirical analysis and takes the differences in the operations of distributors into account. The Board’s policy approach is set out in the Report of the Board on 3rd Generation Incentive Regulation for Ontario’s Electricity Distributors dated July 14, 2008. A Supplemental Report of the Board setting out the Board’s determination of the values for the productivity factor, the stretch factors, and the capital module materiality threshold for use in the plan was issued on September 17, 2008. On January 29, 2009, the Board issued its Addendum to the Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario’s Electricity Distributors. The Addendum sets out the Board’s determination on the model it will use to assign stretch factors to distributors and on the membership of the three distributor groupings for stretch factor assignment for the 2009 rate year.

As part of the plan, Hydro One is one of the electricity distributors to have its rates adjusted for 2009 on the basis of the 3GIRM process. Hydro One applied for both the standard formulaic adjustment to distribution rates under the plan as well as for an adjustment under the incremental capital module (“ICM”) provision of the plan.

Notice of Hydro One’s rate application was given through newspaper publication in Hydro One’s service area advising of the availability of the rate application and advising how interested parties may intervene in the proceeding or comment on

the application. Ontario Power Generation (“OPG”), Power Workers Union (“PWU”), Society of Energy Professionals (“SEP”), Association of Major Power Consumers in Ontario (“AMPCO”), Canadian Manufacturers and Exporters (“CME”), Consumer Council of Canada (“CCC”), Corporation of the Municipality of West Grey, Energy Probe, Pollution Probe, School Energy Coalition (“SEC”) and the Vulnerable Energy Consumers’ Coalition (“VECC”) applied and were granted intervenor status in this proceeding. In addition, the Board received and reviewed 16 letters of comment.

On March 17, 2009, Pollution Probe filed a Motion for Full and Adequate Interrogatory Responses Regarding Conservation and Demand Management (the “Motion”). The Board in Procedural Order No. 3 determined that Pollution Probe’s Motion would be heard orally on March 26, 2009. On March 26, 2009 the Board heard and dismissed the Motion.

On March 26, 2009, the Board declared Hydro Ones rates interim for May 1, 2009.

While the Board has considered the entire record in this rate application, it has made reference only to such evidence as is necessary to provide context to its findings.

The Price Cap Adjustment

This part of Hydro One’s application is a fairly straightforward price cap adjustment pursuant to the provisions of the 3GIRM. This part also includes a Z-factor adjustment intended to return to ratepayers their share (50%) of recent reductions in income tax and capital tax rates, totalling \$0.3 million. This adjustment is to be effected through the use of a rate rider. This part also includes a revised funding adder for smart meters to \$1.65 per customer per month from the current level of \$0.93.

No party was opposed to this part of Hydro One’s application. Intervenors noted, and Hydro One agreed, that an adjustment needed to be made to reflect the Board’s March 2009 re-calculation of the inflation escalator to 2.3% from 2.1% used by the Applicant, raising the escalator factor from 0.98% to 1.18%.

Board Findings

With the above agreed to adjustment, the Board accepts this part of Hydro One's application as it conforms to the price cap adjustment mechanism of the 3GIRM.

The Incremental Capital Module Application

This part of Hydro One's application relates to the Incremental Capital Module of the 3GIRM. This part of Hydro One's application was highly contested by all active intervenors except PWU and SEP.

Under the Board's incremental capital module framework under 3GIRM, electricity distributors may apply for unusual capital expenditure requirements. In its Addendum to the Supplemental Report the Board established a threshold, below which recourse to the Incremental Capital Module would not be available. That threshold consists of the amount of the depreciation allowance reflected in rates, the additional revenues from the price cap mechanism adjustment and an assumed growth factor. To eliminate marginal applications the Board added 20% to the sum of the above parameters. The total amount serves as the threshold over which revenue requirement relief may be provided by the Board. However, the Board also set out certain expectations and criteria to be used in assessing an applicant's request for capital expenditure relief over the threshold. These are set out in the Board's Supplemental Report.

Hydro One's 2008 depreciation of \$188 million, the contribution of the price cap mechanism of \$42 million (before adjustment), the contribution from growth of \$20 million, and the 20% deadband of \$38 million add to a threshold of \$288 million. Hydro One's application is for a total capital expenditure in 2009 of \$461 million. Subtracting the \$288 million threshold amount from the \$461 million total proposed capital expenditures in 2009, results in a requested ICM capital relief of \$173 million. The associated revenue requirement relief was calculated at \$21.3 million. The rate relief amount is 12.3% of the requested capital relief. During the hearing, there was general acceptance that the 12.3% factor would apply for making adjustments to the revenue requirement if there were any adjustments to the requested capital amounts.

No party took issue with Hydro One's calculation of the materiality threshold. However, as parties pointed out, and the Applicant agreed, the inflation escalator (X factor) determined by the Board is 1.18%, not 0.98% used by the Applicant. This raises the threshold to \$296 million and, correspondingly, lowers the proposed incremental capital requirement to \$165 million. Using the 12.3% factor, the starting revenue requirement relief is reduced to \$20.3 million.

As described in detail below, the Supplemental Report of the Board indicated that the Incremental Capital Module was meant to be reserved for unusual circumstances. In the Applicant's view, the fact that the threshold has been exceeded meets the unusual circumstances test adopted by the Board for triggering the use of the ICM mechanism. Hydro One argued that the ICM mechanism was meant to address any funding gap that may exist after applying the price cap formula. The Applicant noted specifically that its increasing capital expenditure requirements since 2002 are the unusual circumstances that the Board contemplated by instituting the ICM mechanism.

Hydro One's rates were rebased for the 2008 rate year. The 3GIRM plan term is for three years. Hydro One's rates were therefore not expected to be rebased until the rate year 2012. Prior to the hearing, Hydro One announced that it will in fact be filing for a cost of service review for the 2010 and 2011 rate years, which would effectively end the IRM term after the 2009 rate year. The Board has since scheduled Hydro One as one of the distributors to apply under cost of service.

All intervenors except PWU and SEP argued that the ICM application should be dismissed as it does not meet the criteria for ICM approval established by the Board. Should the Board not reject the application on that basis, these intervenors argued for various reductions on the requested relief. They suggested that the revenue deficiency claimed by Hydro One is substantially lower than proposed, non-existent or that there may even be a revenue sufficiency. They also pointed out that Hydro One's own management had advised its board of directors in November 2008 that ICM relief was not needed and that Hydro One stated that it will proceed with its capital plan irrespective of the Board's decision in this proceeding. Certain intervenors also grounded their objection on the current economic climate facing energy consumers.

Board Findings

Before we deal with the specifics of the ICM application, we address the last two issues raised by certain intervenors. Those are:

- Whether the Board should reject the application because Hydro One management had advised their board of directors in November 2008 that ICM relief is not needed and that Hydro One stated that it will proceed with its capital plan irrespective of the Board's decision in this proceeding.
- Whether the Board should reject the application on the basis of the current economic climate facing energy consumers.

While the genesis of an application is of general interest to the Board, it is not determinative of the substantive aspects of the application. Once filed in accordance with the provisions of the legislation, applications are reviewed on their merit. The particulars surrounding the levels of approvals before a distributor makes an application, is a matter that is internal to the company itself.

We agree with intervenors' assertions that in periods of economic downturn increased electricity rates may compound the financial stress being felt by customers. However, the Board does not consider it appropriate to unduly constrain the relief sought by applicants of regulated entities due to current economic conditions. Capital projects are long-term in nature and planning for their execution should not be dependent on economic cycles. In reviewing applications for rate adjustments, the Board considers the impacts of those rates on customers. For example, the Board is mindful in avoiding rate shock through the smoothing out of an applicant's spending program. This is not the case here. The increase resulting from Hydro One's application is 2.1% to its revenue requirement resulting in a 4.28% increase when combined with the price adjustment mechanism. The percentage increase is even smaller on a customer's total bill as distribution is only a component of the total bill, and not the largest component.

An adverse consequence of unduly constraining capital spending to match the speed of the economy would be to reduce the economic efficiency of asset

optimization plans. The state of the economy has very little impact on the life expectancy or operability of system assets. The introduction of an input consideration such as the health of the economy into the planning process would substantially impact the ability of asset managers to optimize the economic usefulness of the assets.

The ICM Framework

On pages 30 and 31 of its September 17, 2008 Supplementary Report, the Board stated:

The Board notes that there are clearly differences in perception as to the purpose of the incremental capital module. Ratepayer groups perceive the capital module as a mechanism aimed solely at addressing extraordinary or special CAPEX needs by distributors. The distributors, on the other hand, perceive the module as a special feature of the 3rd Generation IR architecture which would enable them to adjust rates on an on-going, as-needed basis to accommodate increases in rate base.

In the Board's view, the distributors' view is not aligned with the comprehensive price cap form of IR which has been espoused by the Board in its July 14, 2008 Report. The distributors' concept better fits a "targeted OM&A" or "hybrid" form of IR. This alternative IR form was discussed extensively in earlier consultations but was not adopted by the Board. The intent is not to have an IR regime under which distributors would habitually have their CAPEX reviewed to determine whether their rates are adequate to support the required funding. Rather, the capital module is intended to be reserved for unusual circumstances that are not captured as a Z-factor and where the distributor has no other options for meeting its capital requirements within the context of its financial capacities underpinned by existing rates.

The Board's objective in establishing the incremental capital module was to enhance the regulatory efficiency of the incentive rate mechanism, which is intended to be formulaic and simplistic in its application, by adding a method to accommodate extraordinary capital spending requirements should they arise during the term of the incentive rate mechanism. The ability to address

extraordinary capital spending requirements within the IRM framework increases the efficiency opportunities without requiring a full cost of service rebasing review.

As reference to the Board reports above indicate, there was considerable debate during the consultation respecting the appropriate nature of the proposed incremental capital module. In the course of that debate there was a general recognition that the incentive rate mechanism itself accommodated a normal level of capital spending year over year during the term of the incentive rate mechanism. The incremental capital module was intended to address, in a prospective manner, extraordinary spending requirements that were identified during the course of the incentive rate mechanism term.

In its adoption of the incremental capital module as part of the third generation incentive rate mechanism the Board was providing the regulatory flexibility that is required to accommodate unanticipated events that may occur over an extended IRM term. The rapid policy evolution that is currently being experienced in the electricity distribution sector, such as the requirements under the Green Energy Act (Bill 150) may drive capital spending on an array of initiatives that would not typically be considered in a distributor's traditional planning exercise. This evolving policy environment is an example of the envisioned drivers that justified the provision of the regulatory flexibility that the incremental capital module is intended to create.

It should be noted however, that in this application the proposed capital spending was not linked to any anticipated new legislative directives or requirements, in particular those associated with the tabled Green Energy Act; as Hydro One noted, that would be the subject of another application.

In considering Hydro One's application in this case it is apparent that Hydro One has conflated the calculation of the threshold and the eligibility criteria. While the relationship between depreciation expense and capital spending establishes the base materiality threshold, the relationship itself is not the determinative factor in assessing the appropriateness of the use of the incremental capital module. Hydro One has substantially predicated its application on the gap between its depreciation expense and its capital spending plan. In fact what the Board

requires in considering an application under the incremental capital module is a demonstration that the distributor is facing extraordinary and unanticipated capital spending requirements; i.e. something other than the normal course of business.

The Board's September 2008 Supplementary Report specifically refers to unusual circumstances in giving rise to eligibility under the module. Hydro One's application points to the gap between its depreciation expense and its capital spending as its qualifying characteristic. In fact, as is clear from the evidence in this case, Hydro one has been operating since 2002 with a similar gap between its depreciation expense and its capital spending. The Board does not accept that the terminology "unusual circumstances" can reasonably be applied to this scenario. The Board notes Hydro One's use of the language "capital adjustment mechanism". This terminology, which was uniquely used by Hydro One and which does not appear in either of the Board's reports seems to be a good characterization of the manner in which the module was applied by Hydro One. But in the Board's view it is also indicative of the departure from the intended use of the module that is referred to by the Board as an **incremental** capital spending module.

Accordingly, the Board cannot consider Hydro One's application under the Incremental Capital Module.

However, what is before the Board is a request for rate relief that goes to a large degree to the distributor's plan to continue to serve its existing customers in a safe and reliable manner. Also, Hydro One's application is the first case in which the Board has considered a proposed incremental capital module and Hydro One did not have the benefit of any case-specific Board decision for either Hydro One or any other distributor. Hydro One's misinterpretation of the Board's ICM plan does not invalidate the substance of its application which it filed in good faith. Further, there is a relatively significant gap between Hydro One's apparent capital needs in 2009 and the available funding through rates for these needs. The Board is therefore prepared to consider providing some relief so as to not impair the company's ability to maintain a reliable and safe distribution system..

Intervenors made a number of arguments respecting the nature of and adequacy of the evidence provided by Hydro One in support of its application. Intervenors also suggested that the fact Hydro One was going to seek rebasing for the 2010 rate year had important implications for the application of the incremental capital module. In light of the decision we have made with respect to basic eligibility under the incremental capital module, it is redundant for us to consider those arguments as additional reasoning for not considering the application as framed. However, those arguments have led the Board to institute in its findings below a mechanism where there will be an opportunity for intervenors to review the matters that were of concern to them.

The Board's Assessment

The Board considered that the proposed relief is related to capital expenditures, not to other components of revenue requirement. If the proposed relief was grounded on revenue and OM&A issues, there would be an unacceptable risk that the resultant rates would not be reasonable and there would be no recourse to capturing and returning potential excess revenues. In this case, the proposed relief is for higher capital expenditures. The Board is willing to approve rate adjustments for higher capital expenditures, subject to the Board employing certain standard regulatory tools and practices in determining appropriate adjustments to rate base and revenue requirement and to safeguard ratepayers.

As noted earlier, using the appropriate inflation escalator (X factor), the Applicant's request is for an incremental capital requirement of \$165 million. Using the 12.3% factor cited above, the starting revenue requirement relief is \$20.3 million. These amounts reflect the contributions from Hydro One's 2008 depreciation of \$188 million, the contribution of the price cap mechanism of \$50 million (adjusted from \$42 million to reflect the updated inflation escalator noted above), the contribution from growth of \$20 million, and the 20% deadband of \$38 million. The Board will accept the above contributions, except the \$38 million contribution from applying the deadband. While the contributions from allowable depreciation expense, the price cap mechanism, and from growth are legitimate sources of funding in setting rates in a traditional rates review, the deadband is unique to the Board's incremental capital module. As the Board will not accept the application under the incremental capital module, the starting point is revised by adding back the \$38 million to the unfunded capital expenditures

amount. This results in \$203 million of unfunded capital expenditures. Using the 12.3% factor, the associated rate relief is \$24.9 million, before any adjustments.

The 12.3% factor reflects 2008 cost of capital and PILs parameters. As this is not a rebasing application, the Board accepts the use of these parameters as this method is consistent with that used by Board in the case of distributors whose 2009 rates have been adjusted pursuant to the 3GIRM process.

The Board will reduce the funding relief for two primary reasons. First, expenditures associated with projects that would not be in service in 2009 should not be impacting 2009 rates. The Board notes the Applicant's testimony that typically some 97% of its capital expenditures in a given year form part of rate base for that year. The Board accepts this testimony for the purposes of this case. This reduces the capital expenditures for which rate relief should be provided to \$197 million and the rate relief to \$24.2 million.

Second, as the Board has not accepted Hydro One's application under the incremental capital module, it is appropriate to re-instate the half-year rule for determining the rate impact of capital expenditures in a given year. The half-year rule, used in standard cost of service reviews, assumes that the capital expenditures are spread evenly throughout a given year. The revenue requirement, including allowed depreciation expense, is calculated on that basis. For purposes of setting rates under the incremental capital module, the Board abolished the half-year rule so as not to build a revenue deficiency for subsequent years in the term of the plan. The term of the plan was intended to be three years of IRM before rebasing. The revenue deficiency for subsequent years does not apply here since the Applicant will be rebasing next year. Therefore, it would be appropriate to re-instate the half-year rule in the specifics of this case. The re-instatement of the half-year rule statement further reduces the capital expenditures for which rate relief should be provided to \$99 million and, by employing the 12.3% factor, the rate relief to \$12.3 million.

Objecting intervenors also argued for reductions in the following main areas:

- a reduction to the proposed capital expenditures for leasehold improvements for the new head office on the basis that there will be offsetting payments from the landlord;
- elimination of the proposed three pilots for Hydro One's smart grid project on the basis that this project should be deferred until the Green Energy Act is proclaimed and regulations are made and the Board develops standards and processes for implementation;
- reductions in Hydro One's 2009 capital budget for new connections and upgrades in light of economic conditions in 2009;
- reductions in the capital budget for the Cornerstone multi-year computer project on the basis that this project is not incremental or, in the alternative, recognition of the project's savings in 2009; and
- reductions in the capitalization of overheads for 2009 as the capitalization rate appears to be higher in 2009 compared to 2008.

It is the Board's assessment that these matters are primarily a product of the manner in which the Applicant has chosen to frame its application. The intervenors' criticisms and concerns are valid in that the Applicant's filings did not satisfy many of the Board's requirements as set out in its Supplementary Report. However, given the Board's case-specific approach of assessing the relief sought, the Board does not make specific findings on these matters. The specific additions to rate base will be an open question when Hydro One seeks to reflect these expenditures upon rebasing.

In that regard, the Board directs Hydro One to establish a tracking account to track the differences between the capital expenditures it has proposed in the first four bulleted areas noted above and actual spending. The differences will be reviewed at a time when they will be known. The revenue relief provided in the current proceeding will be subject to reimbursement should Hydro One's capital expenditures not materialize as planned or are found to be imprudently incurred.

Should the information not be available to be reviewed early in the planned rebasing proceeding, that proceeding may need to be phased for that purpose.

With respect to the last bulleted point, the appropriate capitalization amounts can be tested at that future review.

The Board wishes to emphasize that this application is in many ways a special case in that it is the first ICM application to come before the Board. Our decision in this case is not meant to alter the guidelines surrounding the incremental capital module as enunciated by the Board in its reports and should therefore not be considered a precedent.

Implementation

The Board directs Hydro One to calculate revised rate riders to reflect revenue requirement relief of \$12.1 million and to submit revised rate schedules that reflect this finding as well as the Board's findings with respect to the adjustments arising from the application of the standard IRM process. The Applicant shall also establish a tracking account as noted by the Board in this decision.

Hydro One shall file a draft rate order attaching the appropriate rate schedules as soon as possible to give effect to the new rates on May 1, 2009. As the changes to the rate schedules will be mechanical in nature, as noted in this Decision, the Board will review the new rate schedules without the need for submissions by the parties. Hydro One should however forward its filing to the parties of record.

Cost Awards

A number of intervenors were deemed eligible for cost awards in this proceeding. These intervenors shall submit their cost claims within fourteen (14) calendar days from the date of this Decision. The cost claims must be filed with the Board and one copy is to be served on Hydro One. The cost claims must conform to the Board's Practice Direction on Cost Awards.

Any objections from Hydro One to the cost claims must be filed with the Board and one copy must be served on the party against whose claim the objection is made within twenty eight (28) calendar days from the date of this Decision.

Intervenors must file with the Board and forward to Hydro One any responses to any objections for cost claims within thirty five (35) calendar days from the date of this Decision.

Hydro One shall pay the Board's costs upon receipt of the Board's invoice.

ONTARIO ENERGY BOARD
DATED at Toronto, May 13, 2009

Original signed by

Paul Vlahos
Presiding Member

Original signed by

Paul Sommerville
Member

Original signed by

Ken Quesnelle
Member