Ontario Energy Board

Commission de l'Énergie de l'Ontario

Ontario

EB-2005-0501

IN THE MATTER OF a proceeding initiated by the Ontario Energy Board to determine whether the transmission rates of Hydro One Networks Inc. are just and reasonable, and to approve or fix just and reasonable rates for 2006.

BEFORE: Gordon Kaiser
Presiding Member and Vice Chair

Paul Vlahos
Member

Bob Betts
Member

DECISION

Background

On October 26, 2005, the Ontario Energy Board commenced a proceeding on its own motion to determine whether the transmission rates of Hydro One Networks Inc. (Hydro One) are just and reasonable, and to approve or fix just and reasonable rates for the transmission of electricity, pursuant to sections 78 and 19 of the *Ontario Energy Board Act*.

In the Notice of Proceeding, the Board required Hydro One to prepare evidence to establish a revenue requirement and set just and reasonable transmission rates, pursuant to subsections 21(1) and 78(9) of the *Ontario Energy Board Act*. The evidence would support Hydro One's transmission revenue requirements for 2006 and 2007. The Board indicated that it would also consider an adjustment formula to be applied to 2007 revenues for 2008. A Notice of Hearing was issued on October 26, 2005.

The Notice of Hearing included the following:

> *The Board is reluctant to have existing transmission rates declared interim for the prolonged period that might occur should Hydro One not be able to file for revised rates in the near future. The Board is therefore considering methods which may limit uncertainty during the rate setting process.*
>
> *Accordingly, the Board will begin this proceeding by holding a hearing on the alternatives for treatment of utility earnings for the period of January 1, 2006 until revised transmission rates are implemented. The apparent alternatives to declaring rates interim are:*
>
> - *Establish an overearnings deferral account; or*
> - *Establish an earnings sharing mechanism.*

The Board began the proceeding by holding a hearing on the alternatives for the treatment of transmission earnings for the period from January 1, 2006 until revised transmission rates are set. A settlement conference was held on November 21, 2005, where Hydro One presented its initial proposal on this issue. No settlement was achieved.

Hydro One's proposal was brought forward to a hearing before the Board on November 25, 2005. Hydro One's proposal outlined four key options that the Board could use to address the treatment of transmission earnings beginning January 1, 2006:

1. Establish Interim Uniform Transmission Rates
2. Reset Revenue Requirement for 2006, and a portion of 2007, retrospectively during the 2007 Transmission Rate Hearing
3. Establish a Tracking Mechanism based on an over/under earnings deferral account
4. Establish a Tracking Mechanism based on an Earnings Sharing Mechanism

Establish Interim Uniform Transmission Rates

Hydro One rejected this option on the basis that it would require some form of detailed review of the utility's revenue requirement which could not be carried out in the near term, would negatively affect other transmission providers due to the make-up of the Uniform Transmission Rates in the province, and would affect the reconciliation process of the IESO for all transmission utilities. Hydro One also noted that this option is not an earnings tracking mechanism and that the financial uncertainty would be harmful to Hydro One.

Reset Revenue Requirement for 2006, and a portion of 2007, retrospectively during the 2007 Transmission Rate Hearing

Hydro One rejected this option on the basis that retroactive rate increases are problematic for customers. Hydro One also noted that this option is not an earnings tracking mechanism.

Establish a Tracking Mechanism based on an over/under earnings deferral account

While noting that this option is focused on earnings, Hydro One rejected it on the basis that there is no incentive for the utility to look for efficiencies. Hydro One also noted that this option could negatively affect the utility's credit ratings due to the length of period of uncertainty. Hydro One further noted that this option has not been typically used for longer periods of earnings tracking mechanisms.

Establish a Tracking Mechanism based on an Earnings Sharing Mechanism

Hydro One submitted that this option is superior in that it provides the utility with incentives for pursuing efficiency gains, benefiting both customers and the utility in the near and longer term. Hydro One noted that the establishment of earning sharing mechanisms is a common method.

Hydro One recommended the implementation of an earnings sharing mechanism with the following design principles:

- The calculation of any over/under earnings based on Hydro One audited transmission financial statements, adjusted for weather normalization.

- Earnings above the established threshold level would be used on a priority basis to invest in designated transmission system expansion projects, which are not currently funded in existing rates. These capital expenditures would be treated for accounting purposes as capital contributions and therefore would not be included in rate base.

- Earnings which exceeded the capital requirements of the transmission system, as established by Hydro One, would be subjected to a sharing mechanism with a dead-band approach, to provide the incentives necessary for the pursuit of utility efficiencies. A plus or minus 2% tolerance band was recommended for the dead-band to moderate the utility risk profile. Earnings in excess of the tolerance band would be returned to customers. Earnings falling below the minus 2% tolerance band would be recoverable from customers.

Hydro One submitted that an earnings sharing mechanism with these design principles would achieve a good balance of benefits to both customers and the utility. The benefits include:

1. Providing the potential for near-term cash required for the expansion of the transmission system, thereby lowering near-term borrowing requirements and stabilizing rates over the medium and long term.

2. Availability of appropriate commercial signals for pursuing utility efficiency gains.

3. Sharing of earnings, which exceed the requirements of the transmission system.

4. The ability to maintain sufficient financial certainty by developing a method for forecasting earnings and reporting ongoing financial results

In its written submission, Hydro One provided details of the mechanism of its proposal.

Intervenor Positions

Hydro One's proposal was supported by Power Workers' Union. This intervenor also submitted that the Board should be mindful that its decision does not create a perverse incentive for the utility in regards to its reliability performance.

The Independent Electricity System Operator stated that it supports the Board's initiative to avoid the adoption of interim rates with their attendant uncertainty and administrative burden of settlement-free calculations.

All other intervenors (School Energy Coalition, Association of Major Power Consumers in Ontario, Energy Probe, Vulnerable Energy Consumers Coalition, Canadian

Manufacturers and Exporters, and ECMI - coalition of seven electricity distributors) were opposed to the establishment of Hydro One' revenue requirement for 2006 in the absence of an evidentiary base and argued that all decisions on the establishment of, and disposition of the 2006 overearnings should be based on the evidence presented to the Board at the time that a full filing was made. These intervenors argued that since the Board has already stated that it will require the preparation of evidence by Hydro One to establish a revenue requirement for 2006, there is no other direction that is required.

Board Findings

In its Notice of Hearing, the Board stated it will require the preparation of evidence by Hydro One to establish a revenue requirement in order to set just and reasonable transmission rates, and that the evidence must support transmission revenue requirements for 2006 and 2007. The Board also stated that it would begin the proceeding by holding a hearing on the alternatives for treatment of utility earnings for the period of January 1, 2006 until revised transmission rates are implemented. Further, the Board noted that it is reluctant to have existing rates declared interim for the prolonged period that might occur should Hydro One not be able to file for revised rates in the near future Finally, the Board stated that Hydro One and interested parties may suggest other methods of ensuring that the interests of ratepayers are sufficiently protected during the period of the rate review, including the alternatives of establishing an overearnings deferral account or an earnings sharing mechanism.

This led to different interpretations of parties. Hydro One's proposals have been noted earlier. Ratepayer groups, and others, interpreted the Board's Notice of Hearing as indicating that the Board has already decided that there will be a standard revenue requirement review for 2006 and argued that the Board did not need to decide anything further until the time of the review. The Board understands the interpretation of the Notice of Hearing by certain intervenors. However, it cannot be concluded from the wording in the Notice of Hearing that Hydro One's proposal should not be considered on its merits, and the Board will do so.

Based on a number of reasons advanced by Hydro One as set out above, the Board accepts on balance that the application of an earnings sharing mechanism is the best option in the circumstances. The issues for the Board then for purposes of this decision are as follows:

- Should the earnings sharing mechanism be based on the reported results in Hydro One's 2006 audited financial statements?

- Should underearnings matter?

- Is Hydro One's contributed capital proposal, namely to use a portion of overearnings to fund capital expenditures, reasonable?

- By what mechanics should excess earnings be established?

Before the Board answers the above questions, it will first address a matter arising from the 2006 Hydro One Distribution Rate Hearing (RP-2005-0020 / EB-2005- 0378) underway concurrently with this application. That proceeding has provided evidence regarding the reallocation of costs between Hydro One's transmission and distribution operations. While costs allocations went in both directions, there seems to have been a net reduction in cost allocation to transmission at the expense of distribution.

While the final disposition of the cost allocation issue in the distribution hearing, has not been made at this time the Board wishes to consider the potential for double recovery of certain costs by Hydro One in the 2006 rate year, by having the costs of certain activities and assets included in both the existing rates of transmission, and the new rates of distribution.

To avoid that unreasonable result, the Board orders Hydro One Transmission to report revenue changes for the 2006 rate year resulting from the Board's decision on cost allocation in RP-2005-0020 / EB-2005- 0378. The report will be reviewed with the objective of crediting the resultant cost allocation adjustment to transmission customers in the 2007 rate application.

The Board findings that follow, regarding excess earnings, are based upon earnings after this cost allocation adjustment is made.

Should earnings sharing be based on Hydro One's financial statements?

The question of whether the review is on the basis of Hydro One's financial statements as requested by Hydro One or a more standard revenue requirement filing, as proposed by ratepayer groups and others, is best addressed after the Board has considered its expectation for the standard of the review. In other words, does the Board expect the review to include an examination of the prudence and reasonableness of the actual costs incurred in 2006? The use of the financial statements is, in the Board's view, simply another depiction of these costs. Hydro One does not object to a revenue requirement review to determine 2006 earnings. What Hydro One objects to is undergoing a full review given a host of considerations, including the need to focus on other regulatory proceedings (such as its 2006 filing for distribution rates and the filing for 2007 rates). Hydro One is also concerned with issues around investor confidence that would be associated with a full review during a time of high investment demands.

The Board accepts Hydro One's proposal to use actual results from its audited financial statements (Transmission) as the basis for determining earnings for 2006. The Board agrees that the near term represents a period that will require significant engagement by Hydro One in preparation for the review of, among other, its 2006 distribution rates and for the filing and review of its 2007 transmission rates. The use of the utility's financial statements and a pre-determined mechanical approach to determining earnings for 2006, while not ideal, is a practical approach. In reaching this conclusion, the Board was mindful not to diminish investor confidence in the utility by heavy handed regulatory actions. Investor confidence is always a key consideration in the Board's deliberations and actions. In the instant case, Hydro One's increased capital investment requirements to enhance or even maintain adequate and reliable electricity service in the Province are not in dispute. Access to needed capital at a reasonable cost is important to Hydro One and the customers it serves. Neither Hydro One nor ratepayers should be burdened with higher financing costs because of diminished investor confidence, when it is unnecessary. Investor uncertainty would arise from the fact that a review for 2006 will be taking place likely in 2007, when 2006 will be a historical rate year. The prospect of a prudence review of the utility's historical costs will not bode well for the need to have as certain an investment environment as possible.

With respect to the rate of return on common equity, Hydro One's proposal was not clear. In its written submission, a reasonable interpretation would be that the utility was willing to accept an adjustment that would flow from the application of the Board's guideline for establishing a rate. During submissions, Hydro One appeared to argue that the rate should be maintained at the previously authorized 9.88%. It pointed to the timing of the Board's Motion for a revenue requirement review for 2006 rates being too late to provide a rate making decision until late in 2006, at best, and the need to minimize uncertainty, as reasonable grounds to continue the currently approved 9.88% ROE into 2006.

The Board recognizes that this rate may be different from the rate that may apply to Hydro One's distribution business and the other electricity distributors for 2006. That rate would be the result of applying the Board's Rate Handbook or in the case of forward test year filers, a rate to be determined by the Board. However, distribution utilities and capital markets have been aware for some time that the current review for 2006 rates might produce a different rate of return on capital. This was not the case for the transmission side of Hydro One. Further, any differences will be short-lived as a new rate for Hydro One Transmission will be set for 2007, and a change at this time would set Hydro One's ROE at a different level than any of the other provincial transmitters.

For the reasons cited above, the Board finds it expedient, fair and reasonable to allow the continued use of the 9.88% ROE.

Hydro One proposes to adjust its actual net income to reflect normal rather than actual weather for 2006. The Board's normal practice is to allow determination of excess earnings on a weather normalized basis. This is the case for the two gas utilities when an earnings sharing mechanism has been instituted. However, unlike the case of the gas utilities, in the case of Hydro One the information is unclear as to whether and, if so, to what extent Hydro One's current rates reflect a Board-approved weather normalization methodology. Hydro One's proposal would add a level of complexity in determining excess earnings and that would be contrary to the Board's efforts to keep the 2006 process as simple as possible. For these reasons, the Board concludes that actual net income should not be normalized for weather.

Should underearnings matter?

In conjunction with its proposal for a dead-band, Hydro One proposed that it should be protected in the event that its earnings fall below 2% of the authorized rate of return on its common equity.

The Board does not accept Hydro One's proposal. Hydro One was willing to forego a review for 2006, meaning that it would have been at risk of not recovering the shortfall in the event that the utility did not achieve the previously Board-authorized rate of return.

Further, it is evident from the Board's Notice of Hearing that the Board's concern was a situation of excess earnings. Moreover, symmetry has not been applied by the Board recently in its regulation of utilities. Utilities have all the information and they in large part are in control of their expenditures and the timing of asking for rate review if they feel that relief is necessary. This information and control imbalance is offset by an asymmetrical approach. Both gas utilities, Union and Enbridge, have recently been under an earnings sharing mechanism and both were established as asymmetrical arrangements.

For the balance of this decision, therefore, discussion on the determination of earnings and sharing for 2006 refers only to excess earnings.

Is Hydro One's contributed capital proposal reasonable?

Hydro One proposed that excess earnings be used by the utility for capital infrastructure spending and treated as ratepayers' contributed capital. Earnings which exceeded these capital requirements would be subjected to a sharing mechanism with a 2% dead-band approach over the rate of return on common equity. Earnings in excess of the tolerance band would be returned to customers.

There are two rationales for Hydro One's proposal. The first is that excess earnings would provide additional capital for projects that are not funded in existing rates. Hydro One acknowledged that its financing plans for 2006 and beyond were already in place and, further, the funding from contributed capital monies would represent "a very small percentage" of the utility's capital financing program. The utility's attempts to explain aspects of the designation of these monies to specific "incremental capital projects" left many questions unanswered. The concern by intervenors that these monies, in whole or in part, might not necessarily be designated to such projects, in which case they would remain with the utility as excess profits, is understandable. The proposal lacked clarity.

The second rationale by Hydro One is that its proposal would smooth future rate increases. This is a laudable consideration but its significance very much depends on the materiality and impact of contributed capital on future rates. There was no information provided in this case to conclude that such a provision is absolutely necessary at this time to offset future rate pressures. Hydro One's revenue requirement review for 2007 and beyond is not yet underway to gain an understanding of any such pressures.

In view of the above, and in view of the Board's finding below that there shall be a 50:50 split of excess earnings between the shareholder and the ratepayers, the Board does not accept Hydro One's contributed capital proposal, but agrees that Hydro One may, if it wishes, bring this matter forward at the time of the disposition of excess earnings for 2006, as an alternate method of disposition. At that time the issue of materiality and need to consider this funding approach would become clearer and assessed for constituting acceptable regulatory practice.

By what mechanics should excess earnings be established?

This section outlines the mechanism for calculating excess earnings for 2006. The outline reflects Hydro One's section 7.1 in its submission with the necessary changes to reflect the Board's findings in this decision.

The following information items will be sourced from the audited financial statements (Transmission):

- Net Income (actual, not normalized for weather) - from Statement of Operations
- Net Interest (financing charges) – from Statement of Operations
- Fixed Assets (net of accumulated depreciation) – from Balance Sheet (average of beginning and ending year)
- OM&A – from Statement of Operations
- Long-term debt (including debt payable within one year) – from Balance Sheet (average of beginning and ending year)
- Gross interest – from note in the Statement of Operations showing breakdown of financing charges

The above information will be used to calculate the following:

- Rate base – average fixed assets, plus a working capital allowance calculated as 15% of OM&A
- Actual return on assets – net income plus net interest, divided by rate base
- Average cost of debt – gross interest divided by average total debt outstanding
- Allowed return on assets – weighted average of a) cost of debt, b) cost of preferred shares, and c) 9.88% rate of return on common equity, based on the previously approved notional capital structure

- Excess earnings – the difference between the actual and the allowed rate of return on assets, multiplied by rate base

Who should be the recipient of any excess earnings?

The remaining issue is whether any excess earnings should be to the benefit of the shareholder, the ratepayers, or shared in some fashion.

The Board acknowledges that intervenors may have more vigorously addressed the excess earnings sharing option and its specifics had they more clearly understood the Board's intent with respect to the options for the 2006 review. Hydro One certainly presented its view of the formula contained in its proposal, but did not have an adequate opportunity to respond to any other alternatives that the Board might contemplate. Hydro One did acknowledge that the Board may choose something different from its proposal. The Board considered the option of leaving this matter to the time that the actual 2006 review took place, but concluded that it would be in the interest of all parties and in the public interest to provide as much certainty as possible and as soon as possible on this issue by deciding now.

In earnings sharing mechanisms in recent decisions for gas utilities, (Union and Enbridge), the Board has found that a 50/50 sharing of excess earnings between shareholders and ratepayers provided a reasonable benefit for ratepayers, balanced by a reasonable earnings expectation by shareholders and a significant utility incentive to control costs. The Board sees no reason to depart from this practice in this case. The Board therefore finds that any excess earning in 2006 shall be split 50:50 between the shareholder and ratepayers.

The Board acknowledges that this decision can reasonably be described as "rough justice". The Board identified the issue of potential overearnings at a point in time that did not allow Hydro One to make a full revenue requirement application for rates to be reasonably implemented in 2006. The decision, with respect to 2006 rates uses the 50/50 sharing mechanism as a simple method of returning some benefit to ratepayers while not undermining the financial and corporate planning foundation of the utility. The Board's motion does allow reasonable time for a full revenue requirement review for the 2007 rate year, which will establish a firm ratemaking foundation going forward.

The Power Workers' Union submitted that the Board ought to require Hydro One to file a continuity statement on its reliability performance indicators back to 2002, and require Hydro One to, at a minimum, maintain its highest historic levels. While reliability remains very important, the Board does not find that this decision creates a perverse incentive for Hydro One that would not otherwise exist with respect to its performance on matters of reliability.

The Board awards intervenors who are eligible for cost awards, 100% of their reasonably incurred costs. Intervenors shall file their cost statements with the Board and Hydro One by March 3, 2006, Hydro One may respond by March 10, 2006, and intervenors may reply by March 17, 2006.

The Board's costs of and incidental to this proceeding, if applicable, shall be paid immediately by Hydro One upon receipt of the Board's invoice.

DATED At Toronto, February 21, 2006

Original signed by

On Behalf of the Panel
Gordon Kaiser
Presiding Member and Vice Chair