

Ontario Energy Board **Commission de l'Énergie
de l'Ontario**



RP-2005-0020
EB-2005-0378

IN THE MATTER OF AN APPLICATION BY
HYDRO ONE NETWORKS INC.

FOR ELECTRICITY DISTRIBUTION RATES 2006

DECISION WITH REASONS

April 12, 2006

**Summary of Decision with Reasons¹
Hydro One Distribution 2006 Rates
(RP-2005-0020/EB-2005-0378)**

| Issue | Board Decision |
|---|--|
| <ul style="list-style-type: none"> • \$423 million OM&A budget • Inergi Outsourcing Agreement • Compensation Costs • Pension Costs | <ul style="list-style-type: none"> • Accepted • Satisfied with cost consequences • Approved for test year, future documentation required. • Accepted |
| <ul style="list-style-type: none"> • Load Forecast • Associated CDM Forecast • LRAM | <ul style="list-style-type: none"> • Approved • Approved • Not required at this time |
| <ul style="list-style-type: none"> • Revenue from other Services • Associated Variance Account | <ul style="list-style-type: none"> • Accepted • Not Required |
| <ul style="list-style-type: none"> • Benchmarking Study | <ul style="list-style-type: none"> • Independent study required |
| <ul style="list-style-type: none"> • Corporate Cost Allocation | <ul style="list-style-type: none"> • Accepted. Consequences must be reflected in future Transmission rates application. |
| <ul style="list-style-type: none"> • Depreciation Costs | <ul style="list-style-type: none"> • Accepted submitted study with recommended lower expense. |
| <ul style="list-style-type: none"> • \$265.6 million Working Capital Allowance • \$333 million capital budget • Additional Line Loss Expenditures • AFUDC | <ul style="list-style-type: none"> • Accepted submitted study with recommended lower expense. • Accepted • Not required • Interest Rate Amended to 6.2% |
| <ul style="list-style-type: none"> • Service Quality Performance | <ul style="list-style-type: none"> • Accepted |
| <ul style="list-style-type: none"> • Capitalization & Cost of Capital • Capital Structure • Rate of Return on Equity | <ul style="list-style-type: none"> • Approved • Approved • Maintained at 9% as per Rate Handbook |
| <ul style="list-style-type: none"> • Regulatory Asset Recovery | <ul style="list-style-type: none"> • Approved with interest rate adjustments |
| <ul style="list-style-type: none"> • Harmonization Plan for Acquired LDCs | <ul style="list-style-type: none"> • Not Approved, should wait for results of cost allocation work. |
| <ul style="list-style-type: none"> • All other proposed rates and charges | <ul style="list-style-type: none"> • Approved |

¹ This summary does not form part of the Decision nor does it itemize all findings and is not to be relied on for the purpose of applying or interpreting the Decision.

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**RP-2005-0020
EB-2005-0378**

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 rates and other charges for the distribution of electricity commencing May 1, 2006.

BEFORE: Pamela Nowina
Vice Chair, Presiding Member

Paul Vlahos
Member

Bob Betts
Member

DECISION WITH REASONS

April 12, 2006

1. INTRODUCTION

1.1 THE APPLICATION

1.1.1 Hydro One Networks Inc. (“Hydro One”, the “Company”, or the “Applicant”) filed an application dated August 17, 2005 with the Ontario Energy Board (the “Board”) under section 78 of the *Ontario Energy Board Act, 1998*; S.O. c.15, Schedule B, for an order or orders approving or fixing just and reasonable rates for the distribution of electricity effective May 1, 2006 (“2006 test year” or “test year”). The Board assigned file number RP-2005-0020/EB-2005-0378 to the Application.

1.1.2 Appendix 1 contains details regarding some of the procedural aspects of the Application, including a list of witnesses and a list of parties.

1.2 THE SETTLEMENT CONFERENCE

1.2.1 An initial Issues List was provided to parties with Procedural Order No. 2 on October 18, 2005. On November 28, 2005 a Settlement Conference was held with the objective of reaching settlement on as many of the topics on the Issues List as possible, and also to refine the Issues List into a list of actual issues that the Board was to determine. While no settlement was achieved, a revised Issues List was proposed which included a more refined list of issues. The revised list also identified a number of topics which would not be the subject of questioning by the intervenors at the oral hearing. The revised Issues List was approved by the Board in Procedural Order No. 5.

1.3 THE HEARING, SUBMISSIONS AND EXHIBITS

1.3.1 The hearing took place at the Board offices in Toronto on January 9, 10, 12, 13, 17, 18, 23, 26, 27, 31 and February 6, 7 and 9, 2006. Copies of the evidence, exhibits,

arguments, and transcripts of the proceeding are available for review at the Board's offices.

- 1.3.2 The Company's filing and the record produced was voluminous. The Board deals in this decision mainly with matters that were raised as issues by parties. Even then, the Board has summarized the record only to the extent necessary to provide context to its findings. The absence of Board commentary on other matters of the Company's evidence should not be construed by the Company as acceptance of those matters beyond the cost consequences for the test year.

2. REVENUE FROM OTHER SOURCES AND LOAD FORECAST

The Company's proposed \$965 million distribution revenue requirement is net of revenue from other sources. The concern about revenue from other sources focused on emergency services provided to other utilities following unexpected events, such as the hurricanes in the State of Florida. The distribution revenue requirement is recovered through the Company's rate classification based on the load forecast. The concerns about load forecasting focused on the Company's forecast for customer additions, its load forecast methodology, and the reduction to the load from Conservation and Demand Management ("CDM") programs. These matters are dealt with in turn below.

2.1 IS THE REVENUE FORECAST FROM OTHER SOURCES REASONABLE AND DOES IT RECOVER COSTS?

2.1.1 The review of this issue focused on the revenues and associated costs of providing emergency support to other electricity utilities in North America. The specific area of focus was support provided to the State of Florida during hurricane seasons in 2004 and 2005. The Company testified that revenues received from Florida for the services provided were based upon the actual cost to Hydro One.

2.1.2 CCC argued there was no evidence that costs for services provided to other states and provinces were tracked correctly or that ratepayers were reasonably compensated for those costs, but also acknowledged that the likelihood of a windfall was remote. CCC recommended that a variance account be created to track both costs and revenues associated with the provision of services to other utilities, so that they can be settled on an annual basis.

2.1.3 The Board accepts the Company's testimony that the revenues generated from services provided to other North American utilities represent a flow through of

costs incurred and this activity has minimal impact on Hydro One's ratepayers. The Board therefore will not require the establishment of a deferral account to track the costs and revenues for those services.

2.2 IS THE LOAD FORECAST REASONABLE?

- 2.2.1 SEC raised concerns regarding the forecasting factors used to predict housing starts and customer additions. The Company predicted a reduction in housing starts in 2006 despite the fact that housing starts had grown in 2002, 2003 and 2004. The Company also forecast the share of housing starts in its service territory to be less than in previous years. SEC challenged both aspects of the forecast. It argued that the Company provided no evidence in support of the predicted decline in housing starts and the Company erred when it failed to base its calculation of future customer additions on an examination of the historic relationship between customer additions and housing starts. SEC asked the Board to find that 13,000 customer additions per year, the average of the last four years, was a more reliable estimate.
- 2.2.2 Hydro One responded to SEC's concerns in an undertaking. Hydro One has estimated that its share of provincial housing starts will decline from about 12% in 2004 to 10% in 2006. Hydro One attributes this decline in its share to the recent growth in the multi-residential segment which occurs primarily in the GTA and other urban centers (not in Hydro One's service territory).
- 2.2.3 For the province as a whole, the current forecast of housing starts by the Canada Mortgage and Housing Corporation (CMHC Housing Market Outlook, Canada Edition, Third Quarter 2005) is about 1,000 higher than the Hydro One forecast included in application. This difference was raised by Board staff. In response to a Board staff interrogatory, Hydro One calculated the impact assuming the CMHC forecast for 2006 was correct. The result would be about 1.2 GWh of additional load for Hydro One Distribution, or only about 0.005% of the total load in the test year.

- 2.2.4 The Board finds that SEC's challenge of the Company's prediction of customer additions and housing starts was largely anecdotal in nature and provided insufficient grounds to displace the forecasting factors used by the Company and the forecasts based upon them. The Company's estimates were based upon its experience and specific knowledge with respect to customer additions and its probable share of provincial housing starts. The Board finds that Hydro One's assumption underlying the decline in its provincial share of housing starts is reasonable. The Board also takes comfort in the fact that Hydro One's forecast, for the province as a whole, is relatively close to the more recent CMHC forecast.
- 2.2.5 The Company's load forecasting methodology combines elements of consensus input; mechanical adjustments to models to include changes in economic forecasts; energy prices; population and household trends; industrial development and production; residential and commercial building activities; and efficiency improvement standards. It employs both a monthly and annual econometric (top-down) and end-use (bottom-up) modeling approach, as well as specific methodology for low voltage, system-connected customers. The prefiled evidence described the logarithmic factors used in the regression equation, as well as the dummy variables applied to adjust for abnormal historical events, such as the 1998 ice storm and the August 2003 Blackout.
- 2.2.6 Several parties questioned the use of "dummy variables" in the forecasting formula as a method of adjusting for unusual events. Certain intervenors expressed concerns with a methodology that used 30-year rather than 5-year historic weather data and the use of dummy variables to adjust the 30-year weather history for unusual weather events.
- 2.2.7 Hydro One responded that the use of dummy variables is a well-established and accepted technique in econometric forecasting, and clarified that dummy variables were not included to normalize for weather. With respect to the use of 30 year versus five-year historic weather data, it was Hydro One's position that its weather normalization methodology was consistently shown to be very accurate,

and no compelling evidence or reason had been presented by the intervenors which warranted changing it.

- 2.2.8 To order Hydro One to alter or change its proven forecasting methodology, the Board would require convincing expert evidence supporting the need for change. No such evidence was led by any of the intervenors. The use of dummy variables in econometric analysis is a standard tool and its very purpose is indeed to increase the fit of the observed data. The evidence indicated a very minimal variation between forecast loads resulting from the use of the Company's methodology and actual loads in the planning years between 1997 and 2004. Within that reporting period, the weather corrected actual energy consumed was within one standard deviation of the forecast. The Board therefore accepts Hydro One's load forecast of 41,509 GWh for the 2006 test year.

2.3 WHAT IMPACT SHOULD CDM ACTIVITIES HAVE ON LOAD FORECAST?

- 2.3.1 Another issue associated with the Company's load forecast was the appropriateness of the assumed reduction in load that would result from CDM activities. The Company forecast the reduction in the load to be 194 GWh in the 2006 test year. In reaching this estimate, Hydro One used the provincial CDM target for 2007 of 5% of peak load or 1350 MW, it assumed that half, or 675 MW, would be achieved during 2006, with 375 MW attributable to load management programs and 300 MW attributable to energy efficiency programs. Of the 300 MW, Hydro One estimated its share to be 43.6 MW using Hydro One Distribution's share of the Provincial peak in 2004.
- 2.3.2 The position of intervenors with respect to the forecast reduction varied greatly. Some parties argued that the load reduction estimate due to CDM was overstated and it should be reduced or even eliminated. Others argued that it should remain as proposed in order to support the provincial CDM objectives, and to promote a conservation culture within Hydro One.

- 2.3.3 All parties, including Hydro One, agreed that the reduction estimate was the result of a statistical dissection of provincial targets, rather than an estimate of reasonable results from Hydro One CDM programs.
- 2.3.4 A Board imposed LRAM was suggested by certain intervenors as a means of protecting the ratepayers and Hydro One from a material difference between the CDM reduction forecast and the actual reduction.
- 2.3.5 Hydro One submitted that its commitment to conservation is reflected in the 194 GWh target and that meeting the target, which requires half of the CDM savings to be achieved in the first two years of the three year program, was a reasonable and conservative assumption.
- 2.3.6 Hydro One resisted the inclusion of an LRAM on the grounds that it is premature to implement an LRAM for the 2006 test year because there is too much uncertainty respecting the nature of an LRAM mechanism. Furthermore, the Company is currently unable to predict the market participation rates or to reliably and cost-effectively measure the impact that CDM programs will have on utility revenues. It was the Company's position that LRAM concepts for the electricity industry should be reviewed in a generic proceeding.
- 2.3.7 The Board has not been convinced that the reduction in load forecast related to CDM programs should be changed or eliminated. On balance, the Board favours the Company's position on this question. It has the best vantage point from which to assess the reasonableness of the projects.
- 2.3.8 The Board acknowledges that electricity utilities are still gaining experience in forecasting the achievable results of CDM programs. The Board further acknowledges that the Hydro One's system loads may be impacted by the effects of CDM programs run by the province and other LDCs.

- 2.3.9 While intervenor arguments opposing the CDM factor in the load forecast were not based upon sound technical evidence, the problem may well have stemmed from the fact that Hydro One's CDM forecast was established on provincial targets and some estimate of how those targets will influence Hydro One loads. The Board was dissatisfied with the clarity and precision of the determination of the forecast CDM, and expects Hydro One to provide a more sound analysis of CDM program details and reduction objectives in future applications.
- 2.3.10 The Board agrees that the forecast load reduction due to CDM efforts should be based upon thoughtful expectations of results from a defined CDM program; however, that is not how the reduction was conceived in this case.
- 2.3.11 The Board also acknowledges that there appears to be an insufficient understanding at this time, of the CDM programs and expected participation to define an LRAM capable of protecting either the ratepayer or the utility.
- 2.3.12 The Board accepts Hydro One's arguments regarding the complexity of establishing an LRAM at this time. However, the Board is dissatisfied with Hydro One's efforts to evaluate and analyze the quantum of the forecast load reduction due to CDM programs. The Board understands that Hydro One is not in direct control of the load reductions that may result from CDM activities of others, but no other party, except perhaps the OPA, is in a better position to estimate those effects, and certainly no other party, has a greater interest in doing so.
- 2.3.13 Several parties observed that Hydro One needs to internalize a Conservation Culture and the Board agrees. The Board expects Hydro One to present future CDM load reduction forecasts with a bottom-up analysis estimating the expected results of their CDM activities and those of others that affect their loads. The Board expects Hydro One's next CDM load reduction forecast, of this order of magnitude, to include a proposal for an LRAM.

3. OM&A AND OTHER COSTS

This chapter deals with Hydro One's costs of operating its distribution business and includes operating, maintenance and administration (OM&A) costs, depreciation expenses, income taxes and other taxes. The issues for intervenors centered around OM&A costs but the Board also makes findings on the other cost issues.

3.1 OM&A COSTS

3.1.1 Total proposed OM&A costs for the 2006 test year are \$423.1 million. Grouped by category, they are as follows:

| OM&A Cost Categories | 2006 Total Costs (\$ million) |
|---------------------------------|--|
| Sustaining | \$230.3 |
| Development | \$4.9 |
| Operations | \$14.3 |
| Customer Care | \$101.1 |
| Shared Services and Other Costs | \$67.9 |
| Taxes other than Income Taxes | \$4.6 |
| Total OM&A | \$423.1 |

3.1.2 The Sustaining OM&A budget represents expenses required to maintain existing distribution lines and stations facilities.

- 3.1.3 The Development OM&A budget funds the analysis needed to expand the system for meeting load growth.
- 3.1.4 The Operations OM&A budget represents the annual expenditures required for the Central Distribution Operations function, operated out of Hydro One's Ontario Grid Control Centre.
- 3.1.5 The Customer Care OM&A work program represents the set of work activities that are required to provide services to distribution customers, served either under standard supply or retailer contracts.
- 3.1.6 The Shared Services and other OM&A programs include the provision of Common Corporate Functions and Services and Asset Management programs to support the Distribution business, as well as the maintenance of existing infrastructure, including business systems, facilities, and information technology.
- 3.1.7 Taxes Other than Income Taxes consist of property and proxy taxes, and indemnity payments to the Province.
- 3.1.8 It was agreed by the parties that all of the above expense groupings would be subjects to be addressed by witness panels at the hearing. Associated with these expense groupings were Hydro One's compensation provisions (including benefits and pension provisions), Hydro One's contract with Inergi LP for the provision of services in several areas and the allocation of common corporate expenses to Hydro One Distribution.
- 3.1.9 Based on parties' submissions, the Board needs to address the following issues:
- Should there be a reduction in Hydro One's OM&A costs through either a general reduction or on line-by-line basis?
 - Are the costs flowing from Hydro One's contract with Inergi reasonable?
 - Are Hydro One's compensation, benefits and pension costs reasonable?

- Should the Board order a benchmarking study?
- Is the proposed methodology of allocating common costs reasonable?

3.2 SHOULD THERE BE A REDUCTION IN HYDRO ONE'S OM&A COSTS?

- 3.2.1 A contextual theme of intervenors' submissions was that, given the history of regulation of Hydro One, it is difficult for intervenors and the Board to assess the reasonableness of the proposed OM&A expenses. Intervenors expressed general concern with the 10.6% increase in OM&A costs for 2006 on the heels of a similar increase in 2005 and a 25% increase since 2002. Only two intervenors made specific recommendations for a reduction in the OM&A budget.
- 3.2.2 In the view of the CCC, there is no objective evidence that the proposed costs are either necessary or reasonable without a true baseline and in the absence of comparison with other utilities. CCC also noted that Hydro One itself has acknowledged that its compensation costs are too high. CCC suggested that the Board reduce the proposed budget by 10% and allow Hydro One to make a decision where it will make the cuts.
- 3.2.3 In the Board's view, while global or envelope reductions to costs proposed by a utility can be and have served as a practical tool in other circumstances, this approach is not appropriate in this case. It is true, given the history of regulation of Hydro One, and its anomalous nature, that there is no solid historical baseline to compare the proposed costs. However, Hydro One's filing, interrogatory responses and testimony were thorough and this was recognized widely by intervenors, Board staff and the Board itself. In the circumstances, it would neither be fair for the utility nor would it be appropriate to forego the opportunity to establish a baseline for future rate reviews. An arbitrary reduction would in fact perpetuate the problems perceived by the absence of a baseline. Therefore, the Board does not accept CCC's suggestion. The Board has instead assessed the specific OM&A cost issues that have arisen on their own merits.

- 3.2.4 In addition to a \$38 million reduction associated with pensions, which is dealt with elsewhere in this decision, SEC argued that a line-by-line review of the OM&A costs would support a reduction of \$40.2 million. In calculating this amount SEC used 2002 as the base year, allowed \$28.7 million for inflation and by comparing the proxy amounts with the proposed 2006 amounts, the excess over the proxy amounts totalled \$89 million. The \$40.2 million figure was the result of SEC accepting increases over the proxy amounts for certain categories on the basis that these were justified by Hydro One's evidence.
- 3.2.5 The Board notes that the inflation escalator assumed by SEC is a surrogate, not the actual inflation escalator experienced by the utility. The Global Insight report filed in evidence shows that the total cost escalator for OM&A during the period was about 400 basis points higher than the 8.5% assumed by SEC. Further, SEC's analysis ignores the overall increased level of work over time and the prioritization of work in the test year compared to other years. The analysis also does not consider improvements in service quality. For the above reasons, the Board does not accept SEC's suggested cost reductions.
- 3.2.6 The issue of benchmarking OM&A costs with other utilities was raised by several intervenors. The Board deals with this item later in this chapter in conjunction with benchmarking beyond OM&A costs.
- 3.2.7 By way of general comment, while this first review of Hydro One's OM&A budget proved daunting for the intervenors and the Board, it is the Board's view that this proceeding has provided a good base for future examination of OM&A costs, which will permit a more rigorous assessment of OM&A costs in the future. It is expected that Hydro One will be mindful of, and guided by, concerns raised by intervenors as it is preparing future rate filings.

3.3 ARE THE COSTS FLOWING FROM HYDRO ONE'S CONTRACT WITH INERGI REASONABLE?

- 3.3.1 Hydro One has entered into an outsourcing agreement with Inergi LP, a non-affiliate, to receive a range of services starting March 1, 2002 in the areas of Information Technology, Customer Care, Settlements, Supply Management, Payroll, and Finance ("Base Services"). Under the agreement, Inergi is committed to provide Base Services for a fee of \$122.5 million in the first contract year, assuming performance remained at historical service levels and volumes remained unchanged, and declining in real terms over the 10 year term of the agreement by 30%. Inergi fees for Base Services payable in any given year vary according to agreed changes in volume and scope. In addition to Base Services and ongoing services added to the arrangement from time to time, Inergi also provides short term Project services at predetermined rates. Hydro One owns substantially all assets involved in Inergi's delivery of Base services. In 2006, Hydro One expects to pay a fee of \$115.6 million for Base services.
- 3.3.2 The arrangement involved the transfer of 913 Hydro One employees to Inergi. Of these employees, 569 were represented by the Power Workers Union and 277 by the Society of Energy Professionals. The remaining 67 were not represented by a bargaining union. It was agreed that Hydro One would be responsible for supplementary pension costs and post retirement benefit costs for the transferred employees.
- 3.3.3 The agreement provides for benchmarking of fees in contract years 3, 6, and 9 and downward adjustment of pricing in the event the benchmarking exercise determines the bundled pricing of Base Services is not competitive. The Company issued an RFP for benchmarking but no compliant bids were received as none of the bidders were capable of completing the benchmarking work on all lines of business. P.A. Consulting eventually was awarded the work of completing an IT Services price benchmarking study. The report by P.A. Consulting was filed in evidence in the proceeding. The results of the P.A.

Consulting analysis show that Inergi fees for IT service are \$0.51 million or within 1% above the 50th percentile of the Fair Market Value Range.

3.3.4 The Board notes that despite considerable scrutiny regarding the Inergi arrangement, intervenors did not identify any concerns regarding the selection process, the terms of the contract and the performance to date. Only CME suggested that benchmarking processes could be improved. It is the Board's assessment that the Inergi contract represents a reasonable strategy by Hydro One to reduce costs, improve efficiencies and improve focus on the utility's primary operations. The Board is satisfied that the cost consequences flowing from the Inergi agreement for the test year are reasonable and therefore approved for ratemaking purposes.

3.4 ARE HYDRO ONE'S COMPENSATION, BENEFITS AND PENSION COSTS REASONABLE?

Compensation Costs

3.4.1 A common theme that emerged among intervenors was the utility's high labour rates and generally rich compensation levels. Intervenors urged the Board to reduce compensation costs for ratemaking purposes in the test year or to make it abundantly clear to the utility that in future, excessive compensation levels will not be tolerated. Noting Hydro One's claim that it is a unique utility and cannot be compared against other utilities, some intervenors suggested that an independent benchmarking study be undertaken to compare Hydro One's compensation with other utilities in the Province.

3.4.2 Hydro One countered that while its compensation costs are high, management is aware of its obligations and will continue to address the problem. Hydro One submitted that the Board should find the proposed compensation costs are reasonable in the circumstances.

3.4.3 The Board notes that the high compensation issue for Hydro One has a considerable history before this Board, dating back to the Ontario Hydro days.

The Board has noted in this proceeding that since the de-merger of Ontario Hydro, Hydro One has taken a number of steps to control its overall compensation costs by, for example, instituting a voluntary retirement program, outsourcing, use of the PWU hiring hall, initiating various cost efficiency programs, holding the line on compensation increases for management employees and imposing a two-tiered pension structure or a pension plan that is less generous for new employees represented by the Society of Energy Professionals. These are positive steps and the Board expects the company to continue and enhance such efforts in the future and report to the Board at the next main rates case. 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.

- 3.4.4 Even so, the comparisons between Hydro One's cash compensation with certain other utilities presented by intervenors are of concern. For example, SEC calculated that by applying Ottawa Hydro's compensation costs to Hydro One employees there would a reduction of about \$85 million in Hydro One's cash compensation. The Board recognizes that there may be some roughness in the derivation of that figure and some differences in the profile of the two utilities. However the contrast between the compensation structures is of concern to the Board.
- 3.4.5 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 in the future 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.
- 3.4.6 VECC noted that none of the \$3.4 million in incentive payments paid to employees have been charged to the shareholder when achievement of target net income is one of the factors in the criteria for incentive pay. While the Board does not consider the achievement of net income to be a factor that works only for

the benefit of the shareholder, as customers also benefit by a financially healthy utility through higher credit ratings and good service, the Board would be concerned if this factor predominated compared to the other factors determining incentive pay. The Board expects Hydro One to file appropriate evidence in the next main rates case to establish that none of the incentive compensation should be charged to the shareholder.

- 3.4.7 VECC also noted that Hydro One includes 50% of bonus payments in the calculation of pensionable earnings and suggested that the shareholder should be responsible for part of this liability. The Board notes from the evidence that approximately one in five government sector companies and half of the non-government sector companies listed in the Mercer database consulted by Hydro One provide this benefit. There is a sufficient number of companies that provide such benefit for the Board to conclude that it is a reasonable practice and the Board will not reduce Hydro One's proposed costs in this regard.

Pension Costs

- 3.4.8 Hydro One's pension plan is a contributory, defined-benefit plan. Pursuant to the Board Decision RP-1998-0001, the utility is allowed to record pension costs on a cash basis for ratemaking purposes.
- 3.4.9 Commencing on January 1, 2004, Hydro One Networks (including Transmission) is required to make annual cash pension contributions of approximately \$81 million for the employer-paid portion. In addition, Networks has been paying to Inergi an annual amount of \$7 million related to pension costs for the transferred employees. A further "top-up" payment of about \$24 million became payable to Inergi beginning January 1, 2005. The "top-up" payment is being paid in 36 equal monthly payments, or \$8 million per year.
- 3.4.10 For Hydro One Distribution, the annual amount to recover pension costs through rates is estimated to be \$38 million. Approximately \$19 million in pension costs were allocated to OM&A and \$19 million to Capital projects. In addition, the

utility had received Board approval to record pension contributions starting in 2004. The disposition of this deferral account is dealt with elsewhere in this decision.

- 3.4.11 From its commencement of operations on April 1, 1999 to December 31, 2003, Hydro One did not incur pension costs due to the Plan surplus. The Company also used the accumulated Plan surplus to fund negotiated enhancements to employees in the Plan. The value of enhancements was estimated to be \$109 million.
- 3.4.12 In 2000, Networks introduced a voluntary retirement program. The program was accepted by 1,401 employees. The cost of the program, \$270 million, was funded out of the Plan surplus at the time.
- 3.4.13 SEC suggested that ratepayers should not be burdened with any of the costs associated with the utility's decision to fund the downsizing from the Plan surplus. SEC argued that the funding of the \$270 million cost of downsizing has shifted the costs from a PBR period into the post-PBR period. If the funding did not draw down the Plan surplus, the contribution holiday would have continued until at least 2007. CME made similar submissions.
- 3.4.14 The Board notes that neither SEC nor any other intervenor questioned the prudence of the utility's initiative to downsize or "right-size" when it emerged from the former Ontario Hydro. On the contrary, it was accepted as being a prudent initiative and the Board agrees with that assessment.
- 3.4.15 The Board agrees with the utility that it is not the withdrawal of the \$270 million that triggered the resumption of company pension contributions. The trigger was the down turn in the markets combined with lower interest rates which combined to reduce and eventually place the Plan in a deficit position. However, it is also true that the \$270 million withdrawal advanced the resumption of contributions. The May 2000 coincident timing of the effective date of the PBR regime and the effective date of the voluntary retirement initiative may legitimately raise

questions, but we find no substantiation in SEC's argument that the utility knowingly and intentionally used the Plan surplus to shift costs from a PBR period to a post-PBR period.

3.4.16 Energy Probe argued that the costs associated with the \$109 million drawdown for benefit improvements should not be allowed in rates because it represented an enrichment of an "already overly-rich" pension and an attempt to enhance the value of the company by enhancing its intellectual capital prior to the failed Initial Public Offering (IPO). In Energy Probe's view, this is a risk that the company took and that decision should not now burden ratepayers.

3.4.17 The Board notes the statement of Counsel to Hydro One that the cost associated with the \$109 million drawdown for the test year is only about \$1 million. In any event, the Board finds that there is no evidence to substantiate Energy Probe's contention that this action was driven by the IPO initiative. The Board is convinced by the utility's argument that the evidence substantiates that the enhanced pension entitlement were in lieu of pressures by the utility's unions for enhanced wages and other benefits.

3.4.18 CME suggested that Hydro One should look into changing its pension plan from defined benefit to a defined contribution type to avoid funding fluctuations. In the Board's view, changes to the type of pension plan selected is a management decision and likely a result of labour negotiations; as such, and given the cursory canvas of the matter in this proceeding, the Board leaves decisions concerning the pension plan to the discretion of Hydro One management. The Board will not provide any direction to the utility at this time. This does not prevent the utility from coming forward on its own accord with any plans that it may have in this regard.

3.4.19 The Board will not reduce Hydro one's proposed pension costs.

3.5 SHOULD THE BOARD ORDER A BENCHMARKING STUDY?

- 3.5.1 Although benchmarking was not identified as a formal issue in the proceeding, the issue was raised by a number of intervenors in the context of OM&A costs, in particular compensation and benefits costs, and overall rate levels.
- 3.5.2 Specifically, SEC submitted that the Board should direct Hydro One to study the reasons why its rates are higher than other LDCs, covering both the key external and internal factors. For each factor, the impact should be quantified and a plan developed to manage that factor. CCC alleged that Hydro One is selectively using benchmarking when results favour it and the Board should obtain an objective assessment of whether or to what extent Hydro One's costs, or discrete areas of its operations, can be compared with other utilities. VECC alleged that Hydro One has used comparisons with external parties and uses these results only when favourable to it. Both VECC and CCC took the position that Hydro One should be directed by the Board to undertake formal benchmarking comparisons with like LDCs and report the results at the next rate proceeding. Support for benchmarking was expressed by FONOM, Energy Probe, and CME. PWU expressed skepticism whether the benefits of such study would outweigh the effort and cost involved.
- 3.5.3 Hydro One acknowledged the appeal of benchmarking but cautioned that such efforts could be expensive and may not be productive in the end. Hydro One submitted that if the Board wished that a benchmarking study be conducted, it should be led by the OEB itself as it has the power to compel production of relevant information from all Ontario utilities.
- 3.5.4 The Board is of the view that a study comparing Hydro One's distribution rates with other LDCs should be ordered only if it is likely that the study would yield information of value, and with direct application, to the ratemaking process. Benchmarking Hydro One's rate levels to those of other utilities would not produce information which would assist the Board in setting Hydro One's rates.

Rate levels are underpinned by costs. It is the causation of relative costs that is at issue.

- 3.5.5 The Board recognizes that as part of its ongoing efforts to enhance productivity gains, Hydro One does engage in benchmarking studies of sorts. However, the Board also recognizes that a Board direction for the production of a comprehensive benchmarking study for direct ratemaking, whether it is undertaken by Hydro One or the Board itself, would involve substantial effort and expense.
- 3.5.6 While the Board is not prepared to order a comprehensive benchmarking study, the Board sees value in a high level benchmarking study for initial review at the next rate 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 high level comparative performance and cost information for Hydro One and these companies. In future rate cases, this information may assist with determination of areas for a more comprehensive benchmarking review. The Board does not anticipate that the high level benchmarking study will be overly costly. The Board anticipates that 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. On best efforts basis, Hydro would also submit the report as part of its transmission rates application for 2007.
- 3.5.7 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. This independent study should also be submitted as part of Hydro One's next main applications for distribution and transmission rates.

3.6 IS THE PROPOSED METHODOLOGY OF ALLOCATING COMMON COSTS REASONABLE?

3.6.1 Hydro One Networks provides common services to Distribution and Transmission and Hydro One on a centralized basis. The costs of the services and assets are assigned to business units on the basis of cost causation. Where possible, these costs are directly assigned. Otherwise, they are allocated based on cost drivers and other methods. Hydro One’s evidence described the assignment or allocation of these common costs as well as the derivation of the overhead capitalization rate, which determines the assignment of overhead costs to capital expenditures. In support of its proposals, Hydro One filed a study by R.J. Rudden Associates.

3.6.2 The results of the Rudden cost allocation approach for all common costs are shown in the table below.

**Total Common Costs, 2006
Allocation to Transmission, Distribution and Other
(\$ million)**

| Function/Service | Total | Transmission | Distribution | Other |
|---------------------------------------|--------------|---------------------|---------------------|--------------|
| Common Corporate Functions & Services | 210.7 | 81.2 | 112.7 | 16.8 |
| Asset Management | 91.1 | 51.8 | 39.3 | 0 |
| Operating | 37.0 | 26.5 | 10.5 | 0 |
| Customer Care Management | 7.0 | 2.0 | 5.0 | 0 |
| Total | 345.8 | 161.5 | 167.5 | 16.8 |

3.6.3 Hydro One requested that the proposed methodology in the Rudden study be accepted for purposes of setting distribution rates. Hydro One also indicated that if accepted, the methodology would be used in the pending transmission rates proceeding.

- 3.6.4 VECC noted that the costs allocated to Hydro One Inc., the holding company, appear to be understated as they only represent 0.6% of the total common costs and only 2% of the total corporate costs. The proposed methodology does not assign any Board costs to the holding company or any of the costs associated with the President and CEO's office, even though the Board oversees Hydro One Inc., as well as the subsidiaries, and the President and CEO holds that position for both Hydro One Inc. and Hydro One Networks.
- 3.6.5 VECC acknowledges that its concerns regarding costs allocated to the parent company are influenced by VECC's experience with Ontario's gas utilities. Hydro One notes that, Hydro One Inc. only has regulated subsidiaries and there is no reason to assign more costs to it. The Board accepts Hydro One's explanation as reasonable at this time and will not make any adjustments to the Rudden methodology in this regard.
- 3.6.6 VECC also questioned the use of cost drivers based on the size of the entity rather than on effort expended, and the possible lack of transparency in demonstrating compliance with the Affiliate Relationships Code.
- 3.6.7 The Board notes that all intervenors accepted the Rudden study as a fair and balanced approach to allocate joint costs and the Board agrees with that assessment.
- 3.6.8 The Board therefore accepts the recommendations contained in the Rudden study and accepts the costs flowing to Hydro One Distribution for purposes of setting 2006 rates. The Board also considers it reasonable for the Company to employ the Rudden methodology in the pending transmission case. As noted by SEC, this should not prevent parties from raising issues that were not raised in this proceeding.

3.6.9 VECC also noted that there may be double recovery of costs from both the Transmission and Distribution customers until such time as the rates for both are based on the same cost methodology. Hydro One acknowledged that this is an issue. The Board agrees. In the Board's RP-2005-0501 decision of February 22, 2006 finding that an earnings/sharing mechanism shall apply to 2006 excess revenues for Hydro One Transmission, the Board addressed this issue by stating the following:

“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.”

3.7 DEPRECIATION EXPENSES

3.7.1 In its previous revenue requirement rates case (RP-1998-0001), Hydro One was directed to file an independent Depreciation Study with its next revenue requirement application, which it did. The study, performed by Dr. Ron White of Foster Associates Inc., yields depreciation expenses of \$152.3 million in the test year, compared to \$161.2 million using the existing methodology. If Hydro One had used the depreciation rates in the Handbook, the expense for 2006 would be \$247.4 million. The proposed depreciation rates yield a lower expense of \$8.9 million over the existing rates and \$95.1 million over the Handbook rates. Intervenors had indicated that they would not cross examine on the issue. Therefore, Hydro One was not required and did not produce witnesses to testify to the Depreciation Study.

3.7.2 The Board accepts the costs flowing from the Depreciation Study for purposes of setting rates in the test year. Such approval should not be construed as Board acceptance of each specific recommendation contained in the study or that the study should form the definitive basis for depreciation studies for other electricity distributors.

3.8 TAXES

3.8.1 Hydro One's cost of service includes provisions for Payments in Lieu of Income Taxes (PILS), Capital Tax and Large Corporation Tax, all paid to the Province of Ontario. The Company provided its estimates for these tax payments for 2006. No intervenor objected to the Company's estimates.

3.8.2 The Board accepts the Company's method of calculating these tax provisions, subject to any adjustments that may be required arising from the Board's findings on revenue and cost items in this decision. In a communiqué of December 2005, the Board set out the sources of possible changes to the tax provision for 2006, such as changes in income tax rates, and authorized the establishment of a variance account to capture these differences.

4. RATE BASE

Hydro One’s distribution rate base for the 2006 test year is made up of a forecast of net plant (calculated as a mid-year average) and a working capital consisting of an allowance for cash working capital and materials and supplies inventory. Hydro One’s proposed rate base for the 2006 test year is \$3.7 billion as shown in the table below.

2006 Rate Base

| Rate Base Component | 2006 Test Year (\$ Millions) |
|----------------------------------|-------------------------------------|
| Gross Plant | \$ 5,550.0 |
| Accumulated Depreciation | \$ (2,126.7) |
| Net Plant | \$ 3,423.3 |
| Cash Working Capital | \$ 265.6 |
| Materials and Supplies Inventory | \$ 22.9 |
| Total Rate Base | \$ 3,711.7 |

The specific issues that arose and need to be addressed by the Board are as follows:

- Cash Working Capital
- Capital budget
- Adequacy of expenditures to reduce line losses
- Allowance for funds used during construction

- Overhead Capitalization
- Adequacy of funding for Service Quality Performance

4.1 CASH WORKING CAPITAL

- 4.1.1 The issue before the Board concerning cash working capital is whether the methodology used to produce the result is appropriate and whether the result itself is reasonable.
- 4.1.2 In 1999, the Board issued a directive to Hydro One in its RP-1998-0001 order, requiring that it perform a lead/lag study in preparation for its next distribution rate hearing. Navigant Consulting (“Navigant”) was selected by Hydro One to conduct the study. The Navigant report, (“Navigant study” or “lead/lag study” or “study”) was filed by Hydro One as part of the Application. Hydro One accepted all of the recommendations in the study without changes.
- 4.1.3 The lead/lag study calculated cash working capital using a methodology different than that contained in the Handbook. The net cash working capital allowance of \$265.6 million for the 2006 test year requested by Hydro One represents 11.6% of Hydro One’s OM&A and Cost of Power expenses, and is approximately \$54.5 million lower than it would have been if the Handbook methodology had been used, resulting in a \$5 million reduction to the 2006 revenue requirement.
- 4.1.4 While the amount requested is lower than the amount resulting from the application of the Handbook, it does represent an increase of \$76.7 million over the \$188.9 million approved by the Board in its RP-2000-0023 decision. According to the study, the increase relative to 2000 is primarily accounted for by: an increase in total cost of power, an increase in controllable expenses of \$1,027 million, and the inclusion of four additional items that are not included in working capital as set out in the Handbook methodology. These additional items are removal costs, environmental costs, taxes, and interest on long-term debt.

- 4.1.5 The issue of security deposits and their inclusion in the calculation of cash working capital was the subject of some discussion. The Handbook (section 5.4) does not require an adjustment for customer security deposits in the calculation of the cash working capital. The Navigant study made no express recommendation regarding the treatment of security deposits collected from customers by Hydro One and did not use these deposits as an offset in the determination of working cash allowance.
- 4.1.6 Hydro One testified that it did not include these deposits in the cash working capital calculation because the Handbook did not require it and the Navigant study did not recommend it. Hydro One advised that the funds are kept in reserve, not used for cash flow purposes, and are placed in its general, not a segregated, account. Hydro One pointed out that the deposits are not assured; the Company must be prepared to refund them on short notice, and must pay interest on the deposits.
- 4.1.7 The amount of interest payable as set out in the Board's Distribution System Code is the prime bank rate less two hundred basis points, which is less than Hydro One's cost of debt. Depending on the type of customer, some deposits can be held for up to seven years. After deducting the interest payable to consumers, which would be approximately \$600,000, the net amount of the cash represented by the security deposits is \$21.2 million. As the interest rate is lower than the Company's cost of debt, Hydro One realizes a benefit of \$300,000.
- 4.1.8 With the exception of the broader approach taken by Energy Probe, intervenors generally focused their attention on the appropriateness of excluding customer security deposits from the calculation of working capital requirement.
- 4.1.9 CCC noted that the Ontario natural gas utilities are required by the Board to deduct security deposits from cash working capital and stated that, as a forward test year applicant, Hydro One is not bound by the Handbook, and therefore could include customer security deposits in the calculation. CCC further submitted that Hydro One had not justified the exclusion of customer security deposits from the

working cash allowance calculation, and in the absence of evidence as to why a contrary position should be taken, Hydro One should follow the practice of the natural gas utilities.

4.1.10 VECC submitted that, at a minimum, the revenue requirement should be adjusted for the benefits accruing to Hydro One through the difference in interest rates. CME agreed with the position put forward by VECC, particularly if there is no specific obligation placed on Hydro One to segregate the deposits from its other accounts.

4.1.11 VECC also raised concerns regarding the lead/lag study, noting that there are a number of material differences between the methodology used by Navigant and that approved by the Board for Enbridge. VECC submitted that the cost elements included in Hydro One's working capital should generally align with those approved for natural gas utilities. This would lead to the exclusion of interest costs, capital and income tax, as well as a reduction for customer deposits.

4.1.12 Energy Probe objected to Hydro One using the Handbook to justify the exclusion of customer deposits and, at the same time, including in the calculation a number of cost elements that the Handbook specifically excludes. Energy Probe took the position that any lead/lag methodology employed should be broadly consistent with that approved for the gas utilities under the Board's jurisdiction and, therefore, both inventory and customer deposits should be used in the calculation of the working capital allowance component of rate base. Energy Probe pointed out that even though they pay interest on and refund customer deposits, the gas utilities must reduce the working capital requirements by the amount of customer security deposits they hold.

4.1.13 Energy Probe was the only intervenor with specific concerns related to the lead/lag study. In addition to its position that the lead/lag methodology used by Hydro One should be consistent with that used by all other utilities in Ontario, Energy Probe raised issues with the apparent internal inconsistencies in the

lead/lag study and the impact of Retail Settlement Code requirements on working cash allowance.

- 4.1.14 Although raised in argument by Energy Probe, the impact of the Retail Settlement Code was not an issue in this hearing. The Board has insufficient evidence available from this proceeding to determine what action, if any, is reasonable. The Board suggests that Energy Probe raise the matter when the Board next reviews the Retail Settlement Code.
- 4.1.15 The Board acknowledges the inconsistent calculation of working cash allowance between electricity and natural gas distributors. Inconsistencies between the natural gas and electricity utilities are not uncommon and are often reasonable based upon the operational differences that exist within the two sectors. In this case, relief has been requested by intervenors based upon that inconsistency rather than the merits of excluding or including any of the specific components in the calculation.
- 4.1.16 Another argument relied upon by the intervenors to challenge Hydro One's working cash allowance calculation was the inconsistencies between the Navigant and the Handbook methodologies. The Board recognizes the inconsistencies, however, as a forward test year filer, Hydro One is not required to follow the Handbook.
- 4.1.17 Hydro One was directed by the Board to undertake a lead/lag study, and the Board finds that it acted reasonably when it accepted the Navigant study and its methodology, even though that methodology is inconsistent in certain respects with that of the Handbook.
- 4.1.18 While the Board has concerns about the inconsistencies, the Board finds the Navigant study to be a well-balanced approach that benefits both the ratepayer and Hydro One. The most significant benefit to the ratepayer is a revenue requirement significantly less than that which would be derived by applying the Handbook methodology.

4.1.19 The Board agrees with the intervenors and Board staff that a review of the merits of either methodology, particularly on the issue of the cost elements excluded by one but included by the other is warranted. Such a review will take into account the methodology that has been previously approved by the Board for the natural gas utilities. Following this review, the Board will consider whether the formulaic approach used in the Handbook should be replaced with a revised version of the Navigant methodology for future rate-making purposes.

4.1.20 Similarly, while the Board accepts the exclusion of customer security deposits from the working cash allowance methodology in this case, the appropriateness of the exclusion remains unresolved by this proceeding. The Board may review this question before issuing the next EDR Handbook.

4.1.21 The Board approves Hydro One's request for a working cash allowance of \$265.6 million for the 2006 test year.

4.2 CAPITAL BUDGET

4.2.1 Hydro One proposed a capital budget of \$333.0 million for the test year with expenditures in the bridge year of \$315.5 million. The capital budget was presented under the Sustaining, Development, Operations and Shared Services categories as shown in the table below.

Capital Expenditures and Budget, 2002 – 2006
(\$ million)

| Category/Year | 2002 | 2003 | 2004 | Bridge 2005 | Test 2006 |
|----------------------|-------------|-------------|-------------|------------------------|----------------------|
| Sustaining | 99.4 | 116.3 | 104.9 | 117.9 | 119.6 |
| Development | 100.0 | 107.1 | 138.6 | 141.6 | 137.2 |
| Operations | 3.7 | 11.1 | 6.3 | 3.1 | 3.5 |
| Shared Services | 59.1 | 45.8 | 22.2 | 53.0 | 72.7 |
| Total | 262.2 | 280.4 | 272.0 | 315.5 | 333.0 |

- 4.2.2 SEC argued that capital expenditures should be reduced using the same approach SEC used in its OM&A reduction submissions. Using a 2002 base with a Pension adjustment of \$19 million, an adjustment for more customer additions, and adjusting for inflation on the other line items (\$45 million), SEC proposed a reduction in capital expenditures of \$64 million, for a 2006 test year total of \$269 million.
- 4.2.3 CCC proposed a 10% reduction in capital expenditures, matching its recommendation for OM&A costs.
- 4.2.4 VECC noted that capital spending levels for 2005 and 2006 were significantly higher than in previous years and expressed a concern that capital expenditures do not appear to reflect a concern for the price increases that customers will experience as a result of the increased capital spending. No submissions on the recommended level of capital expenditures were made.
- 4.2.5 In reply, Hydro One argued that consideration should be given to the reasons that capital expenditures are made by Hydro One such as a large increase in customer connections, and an increase in costs due to a change in the Distribution System

Code concerning capital contributions as cited in the Capital Budget evidence. Hydro One cautioned against accepting the argument of SEC to reduce capital expenditures as planned.

4.2.6 The Board has not been persuaded by intervenor argument that Hydro One's capital budget should be reduced from the amount sought. Neither the quantity nor the nature of the specific capital spending was discredited. Intervenor reasons for the requested relief were largely anecdotal and did not convince the Board that adjustments were necessary. The Board finds Hydro One's proposed capital budget for the test year to be reasonable.

4.2.7 The balance of this chapter discusses specific capital budget issues that were raised by intervenors.

4.3 ADEQUACY OF EXPENDITURES TO REDUCE LINE LOSSES

4.3.1 In 2005, Hydro One commissioned Kinetrics Inc. to carry out an independent assessment of the technical losses on Hydro One's distribution system (the 'Kinetrics study'). The Kinetrics study recommended the implementation of a Distribution Loss Reduction Program with spending of \$12.75 million over a two year period (2006 and 2007). Hydro One proposed to spend only \$8 million on this program. The issue was whether or not Hydro One's capital expenditures should be increased by \$4.75, which was comprised of an increase of \$1.45 million for 2006 and for 2007 increased by \$3.3 million.

4.3.2 Hydro One's rationale was that the proposed lower level of spending of \$8 million would result in higher savings per dollar spent and that Hydro One intends to pursue the remaining opportunities in the future. With regard to the expenditures related to shunt capacitor and phase balancing, Hydro One provided three reasons for its resistance to moving ahead with the full budget immediately: 1) incremental power outages resulting from line work; 2) impact on customers; and 3) equipment availability and staff availability issues, training of staff and managing the larger project in a compressed timeframe.

- 4.3.3 Intervenor submissions in support of the full implementation of the Kinetrics study recommendations focused on the net savings associated with reduction of line losses, the relatively small size of the incremental program viewed in light of Hydro One's ability to manage such programs, the need to support energy reduction objectives, and the usefulness of the program as a tool to internalize a conservation culture.
- 4.3.4 Hydro One argued that the implementation of some or all of a consultant's recommendations was purely a management decision, and interference would represent micro-management of the Company's affairs. The Company further argued that it could not prudently spend the balance of the \$4.75 million in the time frame requested, and that the timing of the expenditure, not the expenditure itself, was the issue.
- 4.3.5 Hydro One denied that its decision to implement only part of the Kinetrics line loss recommendation reflected a lack of commitment to CDM and a conservation culture. Hydro One maintained that the decision to undertake part rather than all of the recommendations reflected an attempt to use ratepayers' money wisely, and reflected prudent management decisions made by those with practical experience and knowledge of the problems involved in fully implementing the recommendations.
- 4.3.6 In considering this issue, the Board has reviewed its conclusions contained in its recent decision on Generic CDM Programs by Electricity Distributors (LDCs), RP-2005-0020/EB-2005-0523, dated March 3, 2006.
- 4.3.7 Relevant conclusions taken from pages 8, 9 and 10 of the decisions are presented below:
- The Board, in a rate case, has the authority to direct that CDM expenditures be increased or decreased.

- A utility's expenditures are presumed to be prudent and there is an onus on those challenging them to demonstrate the lack of prudence
- LDC expenditures should be presumed to be prudent unless they are demonstrated to be unreasonable.
- The examination of the investments on the basis of the TRC Test may not be the end of the matter. The utility may have good reasons why it cannot carry forward an investment.
- The Board would not order any spending above the level proposed by the LDC's in the 2006 rate cases.

4.3.8 While this Board Panel recognizes that it is not obligated to find similarly in this case, it has not found sufficient reasons to adopt any conclusions different from those expressed above.

4.3.9 The Board finds that Hydro One acted thoughtfully and prudently with respect to delaying the implementation of the total recommendation of the Kinetrics study, to a timeframe beyond this 2006 rate application. The utility provided good reasons why it could not carry forward the incremental line loss reduction investment in the time frame recommended, primarily related to resources and resource management. The Company in reply argument indicated that they would undertake all of the Kinetrics study recommendations as soon as it was feasible to do so.

4.3.10 The Board does accept the submissions of intervenors regarding the expected benefits of the \$4.75 million expenditure and directs Hydro One to include in its next main rates case filing a budget and a work plan to implement all the cost-effective line-loss reduction suggestions contained within the Kinetrics study. If Hydro One concludes that any of the recommendations in the Kinetrics study should not be implemented, it must clearly demonstrate the reasons for that

position, and an accompanying budget and work plan for its preferred implementation plan.

4.4 ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION

- 4.4.1 Allowance for Funds Used During Construction (AFUDC) refers to the costs associated with financing the capital projects that have yet to be recognized in rate base. Hydro One Distribution applied to use its calculation of a pre-tax Weighted Average Cost of Capital (WACC) as the rate for AFUDC. This pre-tax rate of 8.9% resulted in \$6.5 million being added to capital expenditures in the test year and therefore rate base. Hydro One calculated the post-tax AFUDC rate at 7.02% but interpreted the Board's 2006 Rate Handbook Report as allowing the use of a pre-tax WACC.
- 4.4.2 VECC submitted that the use of the term WACC generally refers to an after-tax number. It also referred to the Board's Distribution System Code which states in APPENDIX B Methodology and Assumptions for an Economic Evaluation, page 2: "A discount rate equal to the incremental after-tax cost of capital based on a prospective capital mix, debt, and preference to the cost rates and the latest approved rate of return on common equity." VECC did not provide a methodology for this after-tax calculation; it just referred to the Distribution System Code. The discounted cash flow approach is applicable to determining contributions from customers, and perhaps in ranking capital proposals.
- 4.4.3 The Board's 2006 Rate Handbook Report suggests that WACC be used as the AFUDC rate but the report does not indicate whether the rate would be calculated on a pre-tax or on a post-tax basis, or how the calculation would be made. In the absence of a prescribed method in the Rate Handbook, the Board finds it appropriate to adopt the same method used for gas utilities which relates to interest during construction based on forecast actual borrowing costs. These costs, or rates, may have been decided by the Board in the case, or approved as part of a settlement agreement.

4.4.4 The Board therefore directs Hydro One to recalculate the AFUDC using a rate of 6.2%, which is the Company's blended long-term debt rate. In the generic cost of capital review to be held in 2006, the Board may consider an appropriate methodology for the determination of AFUDC.

4.5 OVERHEAD CAPITALIZATION

4.5.1 In its original evidence, Hydro One applied for capitalized overhead of \$48.4 million to be added to distribution rate base in the 2006 test year, reflecting a capitalization rate of 17% contained in the Rudden study. Through an update, the capitalization rate was changed to 15.9% resulting in an adjusted \$46.5 million capitalized overhead to be added to rate base. The Applicant noted that, as recommended in the Rudden study, the calculation for overhead capitalization will be done afresh every year, and an appropriate amount will be trued-up in the following year.

4.5.2 No intervenor took issue with the methodology, results or recommendations in the Rudden study or Hydro One's proposals. The Board accepts the cost consequences for the test year flowing from the Rudden study and the study's recommendations and also accepts Hydro One's truing-up proposal as reasonable.

4.6 ADEQUACY OF EXPENDITURES FOR SERVICE QUALITY PERFORMANCE

4.6.1 There were two issues raised concerning the service quality and performance: Will the service quality targets of Hydro One be maintained with the proposed levels of spending; and, should Hydro One increase investment in the Greater Sudbury Area to improve service quality?

4.6.2 With regard to the first issue, the evidence shows that Hydro One met most of its reliability performance targets and that it intends to increase its spending in areas that would improve its reliability and performance, such as the vegetation management program.

- 4.6.3 With regard to the second issue, anecdotal evidence provided by the witness for Greater Sudbury suggested that there is a higher service quality level provided to area residents served by the local municipally owned utility than that provided to residents served by Hydro One.
- 4.6.4 Evidence provided by Hydro One indicated that there is little material difference in the reliability indicators between customers served by Hydro One and those served by Greater Sudbury Hydro. This evidence also indicated that even if there are differences in the service reliability indicators, Hydro One advised that allocating resources to elevate performance standards above the norm in one part of the system would need to be subsidized by other customers, which would be inequitable and unfair to those customers.
- 4.6.5 The Board has not been convinced that service quality indicators for Hydro One's customers in the Greater Sudbury Area are any different than those of Hydro One's other customers, and thus the Board has not been convinced that any additional investment is required by Hydro One to improve service quality in the Great Sudbury Area. In making this finding, the Board found no evidence to suggest that service quality targets of Hydro One will not be maintained based upon the proposed level of spending.

5. CAPITALIZATION AND COST OF CAPITAL

This chapter deals with the capitalization of Hydro One distribution's rate base and cost of capital for the 2006 test year. Hydro One's proposed capitalization and cost of capital for the purpose of setting 2006 rates are shown in the table below.

Capital Structure and Cost of Capital, 2006

| Instrument | \$ Millions | % | Cost Rate (%) | Return (%) |
|--------------------------|--------------------|--------------|----------------------|-------------------|
| Long-Term Debt | 1,994 | 53.7 | 6.24 | 3.35 |
| Unfunded Short Term Debt | 233 | 6.3 | 3.33 | 0.21 |
| Preference Shares | 149 | 4.0 | 5.50 | 0.22 |
| Common Equity | 1,336 | 36.0 | 9.00 | 3.24 |
| Total | 3,712 | 100.0 | | 7.02 |

Third party public investors hold all of the debt issued by Hydro One Inc. When it filed its application, Hydro One had \$99 million in preference shares allocated to support the Distribution operation. In its application Hydro One stated that an additional \$38 million in preferred shares would be issued by Hydro One Distribution during 2005 to maintain the preference shares at 4% of the capital structure.

The Capitalization and Cost of Capital issues that arose in the proceeding and which need to be determined by the Board are as follows:

- Should the deemed common equity component be reduced to 35% from 36%?
- What is the appropriate rate of return on common equity?

5.1 SHOULD THE DEEMED COMMON EQUITY COMPONENT BE REDUCED TO 35% FROM 36%?

- 5.1.1 Hydro One proposed to continue its present capital structure of 60% debt, 4% preference equity and 36% common equity as approved in the RP-2000-0023 decision. The Board's 2006 Rate Handbook establishes a deemed capital structure of 65% debt and 35% equity for a company of Hydro One's size. Hydro One claimed that its proposal was consistent with the Board's Handbook as the debt/equity structure for Ontario electricity distributors remained the same in 2006 as in the 2000 Handbook and Hydro One's proposed capital structure remained the same in 2006 as in 2000.
- 5.1.2 Only two intervenors commented on this issue. CCC accepted the capital structure as proposed but noted an apparent inconsistency in Hydro One's position in that it argued the Handbook should not be followed when the Board considered capital structure but should be followed when the Board considered the rate of Return on Common Equity ("ROE").
- 5.1.3 Energy Probe agreed that Hydro One's position was inconsistent. Energy Probe noted that the capital structure prescribed in the Rate Handbook for a utility the size of Hydro One was 65% debt and 35% equity, and argued that Hydro One should also have a deemed structure that includes a 35% equity component. Energy Probe argued that by proposing an equity portion higher than that in the Handbook, Hydro One was implying that the Company's risk profile is higher than other utilities of its size.
- 5.1.4 Hydro One noted that it has an actual debt/equity structure consisting of 36% common equity and this structure was approved by the Board in two previous rate applications.
- 5.1.5 The Board finds that the capital structure of Hydro One, for the purposes of 2006 rates, will remain unchanged. As Hydro One asserted, the Board has approved the proposed capital structure in two previous rate applications and there is no evidence that a change is required. Also, a change in the capital structure must

generally require a review of the equity risk premium embodied in the authorized rate of return. In any event, the Board plans to hold a generic proceeding on cost of capital this year and it is appropriate that changes to Hydro One's capital structure await the results of that proceeding.

5.2 WHAT IS THE APPROPRIATE RATE OF RETURN ON COMMON EQUITY?

5.2.1 Hydro One requested a ROE for the 2006 test year of 9%, which is the stipulated rate in the Rate Handbook.

5.2.2 Certain intervenors argued that the 9% ROE set out in the Handbook applied only to historical test year filers, not to those distributors that made applications based on a forward test year. They argued that the ROE should be changed by updating the bond yield data that were used to determine the rate of return in the Handbook. The resultant rate would be 8.3%. Hydro One maintained that the Handbook does not distinguish between past and future test years, and that it would inequitable to charge some ratepayers a different return on equity depending on whether the utility chooses to file on an historic or future test year.

5.2.3 Hydro One maintained that the ROE should be 9%. However, Hydro One and most intervenors agreed that if the economic indicators were to be updated, the equity risk premium should also be updated. That is, any change in the bond yield from the previous level underpinning the previous rate of return authorized by the Board should be multiplied by the .75 factor stipulated in the formulaic approach that had been previously been adopted by the Board. This approach was outlined by Kathleen McShane of Foster Associates in a January 19, 2006 document that was filed in the proceeding. Using this approach and based on December 2005 data, the calculated rate of return on common equity would be 8.65%.

5.2.4 Hydro One did not agree with this return. Hydro One argued that the bond yield data that determined the 9% rate were current for April 2005, the same time frame used in the determination of the other data in the application. Therefore, if the

bond yield data were to be updated, Hydro One maintained that other debt parameters and other costs should be updated as well.

5.2.5 Hydro One made reference to the financial markets' expectations that the ROE would be 9%, but did not provide any details of the effects of not meeting market expectations.

5.2.6 The Board agrees with Hydro One and most intervenors that if the ROE were to be updated from that in the Handbook, then the equity risk premium should be adjusted in accordance with the formulaic approach that has been used historically by the Board. However, it is not clear that the updates should end there. Hydro One argued that if the Company had been aware that the ROE would be disputed, it might have filed evidence questioning the method of calculating ROE. In fact, in this case, very little evidence was provided to justify an ROE different than that in the Handbook. The evidence that was provided arose in the Toronto Hydro Distribution Rates case, RP-2005-0020/EB-2005-0421. No witness was examined on the evidence that was provided in the instant case or in the Toronto Hydro case. The Board believes that it has insufficient evidence before it to confidently calculate the appropriate ROE.

5.2.7 We also note that the Report of the Board on the Handbook states:

“Several parties commented on the certainty that the updated but pre-set return on equity and debt rates would provide to distributors, their shareholders, the financial community, and customers. The Board concludes that the simplicity and certainty provided by alternative 1, which is the predetermined and fixed rate on equity, are attractive attributes.”

5.2.8 It is reasonable for Hydro One and other parties to expect, in this matter, that they could rely on the certainty mentioned in the Report, regardless of whether they used a forward test year application.

5.2.9 The Board finds that the ROE for 2006 will be 9.0%. It is in the Board's plans to examine the question of ROE in a generic proceeding in the near future.

**5.3 SHOULD MORE RECENT INTEREST RATE FORECASTS BE USED
DETERMINE THE COST OF NEW PROPOSED DEBT?**

5.3.1 This issue primarily arose as a result of the ROE question.

5.3.2 Consistent with the decision not to update the interest rate data for the ROE, the Board finds that the debt rates should not be updated for 2006 rates.

6. REGULATORY ASSETS AND DEFERRAL /VARIANCE ACCOUNTS

Hydro One applied for the recovery of Regulatory Asset Deferral Accounts in the amount of \$103.7 million. The Regulatory Assets claimed are dealt with in two groups: Pre-authorized accounts with previous prudence review (\$6.6 million) and Pre-authorized accounts without previous prudence review (\$97.1 million).

Hydro One forecast the values in both types of accounts up to April 30, 2006, consistent with the practice of the other distributors in filing their 2006 distribution rate applications for final Regulatory Asset recovery.

6.1 PRE-AUTHORIZED ACCOUNTS WITH PREVIOUS PRUDENCE REVIEW

6.1.1 As is the case with other electricity distributors, Hydro One incurred costs preparing for and making, the transition to the competitive market which opened in May 2002. Hydro One was authorized to record such costs in several Regulatory Assets accounts which also included the Retail Settlement and Retail Costs Variance Accounts. There was also a Low Voltage Costs Account dealt with previously by the Board in Hydro One's Low Voltage facilities application. The Board dealt with the disposition of the December 31, 2003 balances in the above accounts in its RP-2004-0117/0118 decision and order.

6.1.2 The net total balance which has accumulated since January 1, 2004 in these pre-authorized accounts is forecast to be \$6.6 million at April 30, 2006, which consists of a \$58.9 million credit in the Retail Settlement and Retail Costs Variance Accounts, a \$63.3 million debit in the Low Voltage Costs account and a \$2.3 million debit in the Rural and Remote Protection Account. The forecast balance reflects interest at the rate of 7.71% as per the RP-2004-0117/0118 Decision. Hydro One is proposing recovery over a four year period from May 1,

2006 to April 30, 2010. Hydro One proposed to allocate and recover the balance in the same way as the Board had previously approved.

- 6.1.3 With one exception, no intervenor took issue with Hydro One's proposals. VECC argued that the 7.71% interest rate applied to these and other accounts is too high and suggested that the interest rate be reduced to no more than 5%.
- 6.1.4 Subject to the finding below, the Board accepts Hydro One's proposed amounts and method of recovery.
- 6.1.5 The Board accepts the proposed 7.71% interest rate for balances to April 30, 2006 as that rate was previously approved by the Board for these Regulatory Asset accounts. However, as the balances in these accounts will be crystallized and transferred to Account 1590 as of May 1, 2006, the Board needs to determine the appropriate interest rate for electricity distributors to apply from that date forward. That rate will be prescribed by the Board following a consultation process in the near future. This process will also deal with the interest rate to be applied to all deferral and variance accounts post May 1, 2006.

6.2 PRE-AUTHORIZED ACCOUNTS WITHOUT PREVIOUS PRUDENCE REVIEW

- 6.2.1 The accounts noted below have been pre-authorized by the Board but no prudence review was undertaken until this proceeding.

Pension Costs

- 6.2.2 By decision dated July 14, 2004 (RP-2004-0180), the Board approved the authorization of a deferral account capturing pension costs but noted that it would address the prudence of such costs as part of this proceeding. The forecast balance for April 30, 2006 is \$90.6 million, including interest at the rate of 7.71%. Hydro One proposed that distribution revenue be used as the basis for allocating and recovering the recorded amount from customer groups.

6.2.3 The Board has dealt with the prudence of the recorded pension costs in Chapter 3 of the decision. However, the Board notes that by letter dated February 20, 2006 to electricity distributors, the Board indicated that the interest rate to be applied to the pension deferral account would be 3.88%. The Board therefore directs Hydro One to recalculate the interest using 3.88% instead of 7.71%.

OEB Costs Deferral Account

6.2.4 In a letter dated December 20, 2004 to electricity distributors, the Board authorized the establishment of a deferral account to record OEB costs assessments that may not be included in rates. Hydro One calculated the difference to be \$1.2 million based on the Board's invoice for its 2004 fiscal year and \$3.9 million for its 2005 fiscal year. The April 30, 2006 balance is forecast to be \$5.2 million and includes interest at the rate of 5.75% specified in the Board's December 20, 2004 letter to all electricity distributors. Hydro One proposed that distribution revenue be used as the basis for allocating and recovering the recorded amount from customer groups.

6.2.5 VECC argued that the costs claimed in the OEB Cost Assessment account should be reduced to reflect amounts already included in the rates of Hydro One's acquired electricity distributors. While the Board accepts the principle advanced by VECC, the Board finds that there is not convincing evidence that there is indeed double counting. In any event, even if some of the OEB assessment costs were reflected in some of Hydro One's acquired electricity distributors, the total amount would be inconsequential to Hydro One's total revenue requirement. The Board accepts the Company's proposed amounts and method of recovery.

MEU Rate Mitigation

6.2.6 In its March 15, 2005 decision (RP-2005-0014 *et al*) the Board directed Hydro One to adjust its proposals to reflect certain rate mitigation to its acquired electricity distributors and to capture the revenue shortfall in a deferral account. The forecast balance to April 30, 2006 is estimated to be \$1.2 million, including interest at the rate of 7.71%. Hydro One proposed that the recorded amount be

allocated and recovered from its acquired electricity distributors on the basis of distribution revenue.

6.2.7 The Board accepts the Company's proposed amounts and method of recovery with the following exception. The Board did not specify a rate of interest when it authorized the establishment of this account. The Board-approved rate of interest for deferral accounts at or around that time was the 5.75% rate applied to the OEB Costs Deferral Account. The Board therefore directs Hydro One to recalculate the interest using 5.75% instead of 7.71%.

6.3 VARIANCE ACCOUNTS

6.3.1 Hydro One requested approval to establish new variance accounts for:

- Smart Metering – This account would track the costs related to expenditures for implementing smart meters to comply with government directions.
- Standby Rates - This account would capture the revenue from applying a new standby charge to customers who will use the services of Hydro One when their own generation facilities are out of service.
- OEB Cost Assessment Differential - This account would track the incremental OEB assessment costs for 2006.
- Loss of Revenue for Distributed Generation - This account would track the distribution revenue loss resulting from Distributed Generators locating in Hydro One's service territory.

6.3.2 No intervenor objected to the Company's proposals.

6.3.3 Except for Smart Metering and Loss of Revenue for Distributed Generation, the Board authorizes Hydro One to establish the variance accounts as proposed.

6.3.4 With respect to the proposed Smart Metering variance account, the Board's Generic Decision of March 21, 2006 dealing with certain generic matters

pertaining to the establishment of 2006 rates for electricity distributors contains a finding relevant to the Company's request. Hydro One did not file a specific smart meter investment plan or request approval of any associated amount in revenue requirement. In this situation, the Generic Decision provides that an amount determined as \$0.30 per residential customer per month should be reflected in Hydro One's rates. The Board finds in this Decision that the recovery of this increase in the revenue requirement amount, as determined above, will be allocated to all metered customers and recovered through the applicable monthly service charge. This increment shall be reflected in the monthly service charges contained in the Tariff of Rates and Charges to be filed by Hydro One. The Board therefore rejects the Company's specific proposal for a variance account but notes that the Generic Decision on 2006 EDR specifies that capital and operating variance accounts will be established for smart meter expenses. The Decision states that the Board will provide specific details regarding the establishment of the accounts.

- 6.3.5 While the Board approves the proposed Standby Rates variance account, the Generic Decision provided that existing and proposed standby rates should be declared interim upon the effective date of the rates approved in this decision. Given that Hydro One proposes to introduce a standby rate, this rate shall be interim.
- 6.3.6 With respect to the proposed Loss of Revenue for Distributed Generation variance account, the Board's Generic Decision stated that it is premature at this time to establish such accounts and that this matter can be addressed at the time the Board considers a standard methodology for standby rates.
- 6.3.7 There were suggestions by intervenors for the Company to establish certain other deferral or variance accounts. The Board has dealt with these requests elsewhere in this decision. None of the suggestions were accepted by the Board.

7. RATE IMPACTS AND HARMONIZATION

Hydro One’s evidence dealt extensively with the allocation of the revenue requirement to its customer groups and with the various other rates and charges. Intervenors either accepted or did not object to the Company’s proposals, except on the matters of the Company’s harmonization plans for the Acquired utilities and the proposed rates for line losses. The Board deals with these matters below as well as with the Company’s proposals regarding rate mitigation.

7.1 ARE THE BILL IMPACTS AND MITIGATION PLANS APPROPRIATE?

7.1.1 The total bill impacts resulting from the Company’s proposals were based on the commodity price for RPP eligible customers of 5¢/kWh for the first 750 kWh and 5.8¢/kWh over 750 kWh. For RPP ineligible customers, commodity costs were assumed to be 5.2 ¢/kWh when calculating the class average impact.

7.1.2 For Hydro One legacy customers, the requested change in the revenue requirement results in an approximate 6% increase in the total bill on average. The total bill increases on a class basis for legacy customers range from 2.0% to 6.4% depending on consumption as shown in the table below.

Bill Impacts

| Class | Monthly Consumption | Range | |
|-------------|---------------------|-------|------|
| | | Low | High |
| Residential | 1000 kWh | 3.3% | 6.4% |
| GS < 50 | 2000 kWh | 3.3% | 4.9% |
| GS > 50 | 100,000 kWh | 2.0% | 4.9% |

7.1.3 Hydro One's mitigation measures included the following:

- Recovery of balances in Regulatory Asset accounts over a four year period, instead of the two years contemplated the Board's Regulatory Asset Phase II Decision (RP-2004-0117/0118);
- Foregoing recovery of the revenue shortfall resulting from the establishment of the new Fixed Service Charge for unmetered scattered load for Acquired General Service customers; and
- Reduction to the proposed distribution rates for 19 Acquired LDC customer classes to reduce the impacts to an average level below 10%.

7.1.4 Hydro One appears to have approached rate mitigation in a relatively responsible and thorough manner including doubling the recovery period for Regulatory Assets.

7.1.5 Aside from the bill impacts resulting from the proposed harmonization process, no concerns were raised specific to the bill impacts resulting from the mitigation methodology outlined above. The Board finds the proposed rate mitigation plan for Hydro One legacy customers to be acceptable.

7.2 SHOULD RATES FOR ACQUIRED UTILITIES BE HARMONIZED?

7.2.1 Hydro One applied for approval to harmonize the distribution rates of the 87 acquired local utilities over a period of two years. Hydro One's proposed harmonization plan process entails the following steps:

1. Identify the Distribution revenue attributable to Acquired Residential customers for each Acquired LDC based on current rates and 2006 sales volumes;
2. Round service charges downward (e.g., \$3.60 becomes \$3.00), which serves to reduce the number of rate classes;

3. Determine the target fixed and volumetric rates that would be applicable to the Acquired Residential customers group recovering the current Distribution Revenue as calculated in Step 1 above. The target rates would be the weighted average rates for all Acquired LDCs;
 4. Determine the incremental increase/reduction required to bring the rounded service charge to the target service charge;
 5. Divide the increment into two (assuming a two year phase-in plan);
 6. Apply the increment calculated in step 5 above to the rounded service charge to determine year one service charge;
 7. Calculate year two service charge in the same manner as the target service charge calculated in step 3 above;
 8. Determine a common volumetric charge for all Acquired LDCs to recover the remainder of Distribution revenue in each year of the plan.
 9. Maintain two of Caledon's Residential rate classes in 2006 since they are similar to the Legacy Retail Residential normal density and seasonal rate classes in Hydro One's Legacy Retail group.
- 7.2.2 The first step of harmonization would result in 13 residential class rate groups and 20 general service class rate groups for the Acquired LDCs. After taking into account the mitigation plan to reduce bill impacts to 10% or less, an additional 16 residential rate groups and three general service rate groups would be created.
- 7.2.3 The first phase of harmonization proposed by Hydro One would result in 52 rate groups – 29 residential and 23 general service groups. Approximately 61,000 of the Acquired Residential customers would experience lower distribution rates while about 75,000 would experience higher rates.
- 7.2.4 According to Hydro One, the rationale for not harmonizing its legacy urban residential (UR) and urban general service (UG) customer class rates with those of the Acquired LDCs is that Hydro One's legacy rates are based on density

considerations whereas the acquired LDCs' rates are not. In order to undertake such harmonization, Acquired residential customers would first have to be assigned a density categorization. Cost allocation studies including density categorization are not part of the 2006 EDR process, but are associated with the Board's current Cost Allocation process.

- 7.2.5 Of all of the increases resulting from the implementation of Hydro One's Application, the proposed harmonization process would generate the greatest bill increases. Resulting bill impacts of over 10% drove Hydro One to propose mitigation for 19 of the Acquired Distributors. After mitigation, the bill impact of Hydro One's proposed harmonization plan would be below 10% for each customer class as a whole, but would generally exceed 10% for individual customers with relatively low levels of consumption. For a number of the acquired utilities, the impacts are greater than 10% for the residential customer groups with typical usage levels such as 750 and 1000 kilowatt hours. Customers of some acquired utilities would see such increases in both successive years of the harmonization plan, as Hydro One has applied for approval on both years of the plan in 2006 and 2007.
- 7.2.6 The Distribution Rate Handbook (the "Handbook") intends that the bill impact considerations be focused on distribution rate changes alone when approving a utility's revenue requirement to ensure the utility remains economically viable. However, as this particular harmonization process is a revenue allocation matter, it has no effect on revenue requirement and therefore has no impact on Hydro One's economic viability. As Hydro One notes "Hydro One, of course, is quite neutral in this exercise. In fact, it would be better off if the Board decided not to harmonize". The latter statement is associated with Hydro One's proposal to absorb about \$300,000 in foregone revenue due to the mitigation.
- 7.2.7 While Hydro One submitted that the Handbook directs a utility that has acquired other utilities to harmonize their rates, the Board notes that Section 13.2 of the Handbook actually says "Distributors who have a merged, acquired, or

amalgamated service area ... may file a rate harmonization plan.” The Handbook is permissive in this instance because the Board expects distributors to take the timing of the harmonization and related circumstances into account.

- 7.2.8 Some intervenors took the position that rate harmonization and mitigation should take into account potential increases in commodity costs. If commodity costs are taken into account and the harmonization plan is implemented as requested, on May 1st some Acquired LDC customers could experience bill increases of 20% to 30% in the total bill.
- 7.2.9 Other intervenors were concerned about harmonizing rates before a cost allocation study is completed for the Acquired LDCs.
- 7.2.10 Concerns were expressed about the possibility that some customers might experience significant increases and decreases in their bills within a short period of time. For example, significant increases in distribution rates resulting from Hydro One’s proposed harmonization plan could be followed by a significant rate reduction resulting from the cost allocation process, or conversely, a decrease could be followed by an increase after cost allocation analysis.
- 7.2.11 A harmonization plan needs to be supported by evidence that harmonization is necessary and the rates, which result from harmonization, will be reasonable. While the Board supports the harmonization of distribution rates in principle, the timing of harmonization is important. This is particularly true when the applicant is requesting approval for a harmonization process with significantly high bill impacts extending over a two year period.
- 7.2.12 The Board finds that Hydro One's proposed rate harmonization plan for the Acquired LDCs is premature. There is insufficient evidence to determine that resulting changes to individual Acquired LDC customers would be fair and reasonable based upon costs. Obviously rates for all Acquired LDC customers will increase as a result of the combination of the cost allocation process and harmonization with Hydro One's legacy customers. For these reasons, the Board

has not been convinced that sufficient merit exists to justify the proposed interim harmonization among Acquired LDCs alone, based on the yo-yo effect that some customers will see in their rates.

7.2.13 Harmonization is a utility process aimed at ensuring that all of a utility's customers share fairly in the utility distribution costs. This interim harmonization proposal by Hydro One does not appear to accomplish that objective.

7.3 ARE THE PROPOSED LINE LOSS FACTORS REASONABLE?

7.3.1 The term "distribution line losses" refers to the difference between the amount of energy delivered to the distribution system and the amount of energy consumed by customers.

7.3.2 Hydro One applied for two schedules of proposed Loss Factors to become affective May 1, 2006. One schedule is applicable to Hydro One's legacy retail customers and LV system-connected customers, and the other to Hydro One's Acquired LDCs.

7.3.3 In effect, there is no change between the proposed line loss factor schedules, and those currently in use. The issue in this case concerns the ongoing use of factors perceived by parties to be potentially flawed or inaccurate.

7.3.4 In RP-2002-0023, the Board directed Hydro One as follows: "For the longer term, the issue is the extent to which the current pooling of costs and customers in determining loss factors, as opposed to determining customer-specific loss factors, remains appropriate. The Board expects the applicant to review these issues further and report to the Board at the time of its next main rates filing."

7.3.5 Despite the Board's direction, Hydro One did not address the issue of customer-specific loss factors in its evidence, and questions regarding the appropriateness of the existing loss factors remain. Hydro One did contract with Kinetrics to

perform a line loss study of their distribution assets, the results of which were included in the prefiled evidence.

- 7.3.6 The Kinetrics study estimated slightly higher distribution loss factors than Hydro One is currently using and Hydro One did not propose any change at this time. Hydro One also proposed to undertake programs to reduce losses, which are discussed in Chapter 4 of this decision.
- 7.3.7 ECMI agreed with Hydro One that there should be no change to the current loss factors, but did so for entirely different reasons. ECMI cited two reasons why the Kinetrics study may not generate accurate results. First, Kinetrics relied upon 1980 load profiles in its study, which seemed inconsistent with a recent OEB-mandated load research project in conjunction with the 2007 Cost Allocation project. Second, Kinetrics relied largely upon evidence from the United States and Britain to evaluate non-technical losses, resulting in an increase in loss factors ranging from 0.28 to 1.2 percentage points.
- 7.3.8 When asked why meters could not be installed by Hydro One to more accurately determine individual line loss factors, Hydro One cited two primary reasons: firstly, the cost of doing so, which is approximately \$80 million for approximately 3000 metering points; and secondly, the inability to reconcile meter readings taken on different reading dates over different reading periods.
- 7.3.9 The Board remains dissatisfied with the current application of distribution loss factors as a fair and reasonable allocation of costs to Hydro One's LV customers. The Board's thrust toward better cost allocation for electricity distributors in 2007 may be the catalyst for Hydro One to more accurately apportion line losses to specific customers in specific customer class.
- 7.3.10 The Board acknowledges that an \$80 million program of metering to more accurately estimate line losses does not appear to be a prudent approach. The Board is of the view that either a less expensive metering program, or a second effort to evaluate line losses using current load data and local experience, may

provide loss factor estimates that are more acceptable and credible to stakeholders.

7.3.11 For these reasons and because of the Board's lack of confidence in the reasonableness of the historic load data used in the determining the factors by Kinetrics, the Board agrees with the recommendation of Hydro One and ECMI to leave the loss factors unchanged at this time.

7.3.12 The Board expects Hydro One to continue its efforts to refine line loss factors as they affect the bills of individual LV customers. This may become a more expressed requirement as part of, or following, the upcoming 2007 OEB cost allocation review process.

8. RATE IMPLEMENTATION AND COMPLETION OF THE PROCEEDING

- 8.1.1 The only changes to the Company's proposals are those associated with the Board's finding to recalculate the interest for AFUDC, the pension costs deferral account and the MEU rate mitigation account. In addition, Hydro One's revenue requirement will increase by \$0.30 per residential customer per month as outlined in Chapter 6 of this decision, a result of the Board's generic decision on Smart Metering. The proposed allocation of the distribution revenue requirement to the various customer groups has been accepted by the Board, with the exception of the Company's proposal to harmonize the rates for the Acquired utilities. The Company's other proposed rates and charges are also accepted by the Board.
- 8.1.2 The Board directs the Company to file with the Board and all intervenors of record a draft rate order and its Tariff of Rates and Charges to reflect the Board's findings in this decision. The Tariff schedule shall have an effective date of May 1, 2006 and shall be final with the exception of the Standby Rate which shall be interim. The Company shall consult with Board Staff as to the form of the Tariff schedule so as to be consistent with the form approved or to be approved for the other electricity distribution utilities. Intervenors shall have five calendar days to respond to the Company's draft Rate Order. The Company should respond as soon as possible to any comments by intervenors.
- 8.1.3 A number of intervenors eligible for costs awards requested costs. These intervenors shall file their costs statements with the Board and Hydro One by April 27, 2006. Hydro One may respond by May 12, 2006 and intervenors may reply by May 29, 2006. Hydro One shall also pay the Board's costs upon receipt of the invoice.

DATED at Toronto, April 12, 2006

ORIGINAL SIGNED BY

Pamela Nowina
Vice Chair and Presiding Member

ORIGINAL SIGNED BY

Paul Vlahos
Member

ORIGINAL SIGNED BY

Bob Betts
Member

APPENDIX 1

HYDRO ONE NETWORKS INC.

2006 DISTRIBUTION RATES

DECISION WITH REASONS

BOARD FILE NO. RP-2005-0020/EB-2005-0378

PROCEDURAL DETAILS INCLUDING LISTS OF PARTIES AND WITNESSES

April 12, 2006

PROCEDURAL DETAILS INCLUDING LISTS OF PARTIES AND WITNESSES

THE PROCEEDING

On August 30, 2005, the Board issued a Notice of Application which was published and served in accordance with the Board's direction.

The Board issued Procedural Order No.1 on September 28, 2005, establishing the procedural schedule for a number of events prior to the oral hearing. These events included:

- Issues conference on October 4, 2005;
- Issues Day on October 7, 2005;
- Written interrogatories to the Applicant by October 18, 2005;
- Written interrogatory responses from the Applicant by November 1, 2005;
- Intervenor evidence filed by November 11, 2005.

On Issues Day, the Board heard submissions from the School Energy Coalition, Green Energy Coalition, Pollution Probe, the Schools Energy Coalition, the Low Income Energy Network, Consumers Council of Canada, Canadian Manufacturers and Exporters, the Vulnerable Energy Consumers Coalition, Energy Probe and Toronto Hydro Electric System Limited.

The Board issued Procedural Order No.2 on October 18, 2005, which included the Board's decision on the contested issues identified on Issues Day. The Issues List for the proceeding was attached to Procedural Order No. 2. The Board reminded parties that it considered the current Issues List to be a list of topics and expected a refined list of actual issues to be presented to the Board before the commencement of the oral hearing.

Procedural Order No. 2 also included the following scheduling dates:

- Filing of supplemental evidence by the Applicant on Line Loss Spending by October 21, 2005.
- Filing of written interrogatories to the Applicant on the Line Loss filing by October 26, 2005;
- Extending the date for submission of intervenor evidence to November 18, 2005.

The Board issued Procedural Order No.3 on November 16, 2005, which set the date for the Settlement Conference for November 28, 2005 and included the Board's direction that the Issues List be refined into a list of actual issues that the Board must determine. The Board set a filing date for the Settlement Proposal and/or refined issues list of December 15, 2005. A date of January 9, 2006 was set for the commencement of the oral hearing.

The Board received written evidence from the City of Sudbury on November 11, 2005.

Procedural Order No. 4, issued on November 30, 2005, outlined the interrogatory process for the evidence filed by the City of Sudbury. Interrogatories were due on December 2, 2005 and responses due on December 9, 2005.

The Board issued Procedural Order No. 5 on December 19, 2005 which included the revised Issues List and also provided the specific dates in January and February that the Board would not be sitting.

PARTICIPANTS AND REPRESENTATIVES

Below is a list of participants and their representatives who were active either at the oral hearing or at another stage of the proceeding. A complete list of intervenors is available at the Board's offices.

| | |
|---|--|
| Board Counsel and Staff | Donna Campbell Jennifer Lea Harold Thiessen Nabih Mikhail Chris Cincar Duncan Skinner |
| Pollution Probe | Murray Klippenstein |
| ECMI – Coalition of Small and Medium Sized Distributors | Roger White Andrew Bateman |
| Consumers Council of Canada (CCC) | Robert Warren |
| Green Energy Coalition (GEC) | David Poch |
| Canadian Manufacturers & Exporters (CME) | Brian Dingwall |
| Energy Probe | David Macintosh Tom Adams |
| School Energy Coalition (SEC) | Jay Shepherd Darryl Seal |
| Vulnerable Energy Consumer's Coalition (VECC) | John DeVellis Bill Harper |
| Federation of Northern Ontario Municipalities and the City of Timmins (FONOM) | Peter Scully |
| Federation of Ontario Cottagers Association (FOCA) | John McGee |
| City of Greater Sudbury | Peter Ruby Michael Stewart |
| Power Workers Union (PWU) | Richard Stephenson Judy Kwik |
| Inergi Inc. | Philip Tunley Mayank Sharma |

WITNESSES

There were 22 witnesses who testified at the oral hearing.

The following Company employees appeared as witnesses at the oral hearing:

| | |
|-----------------|---|
| Stanley But | Manager, Economics and Load Forecasting |
| Allan Cowan | Manager, Business Planning and Analysis |
| Steven Vance | Manager, Process Management |
| George Juhn | Manager, Lines and Right of Way Programs |
| Raymond Gee | Director of Work Management and Technical Services Customer Operations |
| George Carleton | Director, Business Integration Asset Management |
| Mike Penstone | Director, System Investment |
| Kevin Thompson | Manager, Business Planning |
| Mark Fukuzawa | Director, Customer Care |
| Sandy Struthers | Chief Information Officer |
| Don McInnes | Senior Manager, Contract Management |
| Greg Van Dusen | Director, Corporate Accounting Policies and Systems |
| Ian Innis | Manager, Regulatory Finance |
| Frank D'Andrea | Manager, Financial Reporting and Accounting Policy |

Judy McKellar

Director, Human Resources

Debra Vines

Manager, Compensation and Benefits

Ali Suleman

Vice President and Treasurer, Hydro One Inc.

Andy Poray

Director, Regulatory Policy and Support

Michael Roger

Manager, Strategic Support Distribution

In addition, the Company called the following witnesses:

Howard Gorman

Principal, R. J. Rudden Associates Inc.

Robert O'Brien

Principal, R. J. Rudden Associates Inc.

Witnesses called by intervenors:

David Courtemanche

Mayor, City of Greater Sudbury