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

EB-2005-0421

IN THE MATTER OF AN APPLICATION BY

TORONTO HYDRO-ELECTRIC SYSTEM LIMITED

FOR ELECTRICITY DISTRIBUTION RATES 2006

DECISION WITH REASONS

APRIL 12, 2006

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EB-2005-0421

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 Toronto Hydro-Electric System Limited pursuant to section 78 of the *Ontario Energy Board Act, 1998* for an order or orders approving or fixing just and reasonable rates for the distribution of electricity, to be implemented on May 1, 2006.

BEFORE: Gordon E. Kaiser
Vice Chair, Presiding Member

Ken Quesnelle
Member

Cathy Spoel
Member

DECISION WITH REASONS

April 12, 2006

1. INTRODUCTION

1.1 THE APPLICATION

1.1.1 Toronto Hydro-Electric System Limited ("THESL" or "Toronto Hydro") filed an application on August 2, 2005, with the Board pursuant to section 78 of the Ontario Energy Board Act, 1998, for orders approving or fixing just and reasonable rates for the distribution of electricity effective May 1, 2006.

1.1.2 The applicant utility seeks approval of a revenue requirement of $481.5 million, which if granted would result in an average reduction of distribution rates for a typical residential customer of approximately 6.1%.

1.1.3 In 1998 the former cities of Toronto, Scarborough, North York, York, Etobicoke, and the Borough of East York, were amalgamated to form the new City of Toronto. Toronto Hydro-Electric System Limited represents the amalgamation of the six municipal electric utilities that served those predecessor municipalities. In this application for approval of rates for the distribution of electricity by THESL, to be implemented on May 1, 2006, THESL has filed on a forward test year basis.

1.1.4 A number of intervenors opposed certain aspects of the Application including the Consumers Council of Canada, the Canadian Manufacturers and Exporters Association, the School Energy Coalition, the Green Energy Coalition, the Vulnerable Energy Consumers Coalition, Pollution Probe, and Energy Probe. Board staff also made submissions.

1.2 THE SETTLEMENT CONFERENCE

1.2.1 A draft Issues List was provided to the parties in Procedural Order No. 1, November 2, 2005. On December 12, a Settlement Conference was held with the objective of reaching settlement of as many of the issues as possible, and 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.

1.3 THE MOTIONS

1.3.1 Two Preliminary Motions were heard by the Board during the course of this rate application. The first was heard before the hearing commenced, while the second arose following the conclusion of the hearings.

1.3.2 The first Motion was filed by the utility on January 10, 2006, seeking an order on whether the guidelines and rate-making principles decided by the Board in its 2006 Electricity Distribution Rate Handbook and the May 11,2005 Report of the Board in respect to the Handbook applied to Toronto Hydro's forward test year application for 2006 electricity distribution rates and the extent to which Toronto Hydro could rely upon them in its application.

1.3.3 In large part, the motion related to the calculation of return on equity. The issue arose from the Board's Procedural Order on December 8, 2005 in this proceeding when the Board made a finding to include the return on equity as an issue in the rate case. That was over the objection of the utility. The Board did that following similar findings in two other related cases, those dealing with Ottawa Hydro and Hydro One. The applicant stated that it had filed its case on the basis that it was entitled to assume that the rate of return on equity would be that set out in the Handbook, namely 9%. Toronto Hydro argued that if they can rely on the values stated in the Handbook, return on equity cannot be an issue in the case. Not only could it not be a contested issue, the utility was not required to file any evidence in support of its position. The utility argued that it would have presented an entirely different case if it had known that they could not rely on the Handbook.

1.3.4 In this case there has been no settlement of any issues. All of the issues are contested. Moreover, the utility has filed on the basis of a forward test year and has chosen to update certain cost parameters.

1.3.5 The Board ruled on the Motion[1] that once a utility filed on a forward test year basis, it was open to any party to question any element of the filing, to call evidence with respect to that, and to make submissions concerning the utility's position. It is incumbent on the utility to defend its position as the utility carries the burden of proof throughout the case.

1.3.6 The Board did acknowledge that the Handbook could become a default position where there was no evidence on the matter or where the issue was not contested. Where the issue was contested, which is the case here, any of the parties are open to make submissions that the return on equity should be different than that proposed by the utility even when the utility relies on the Handbook. Board Staff in this case did propose that that certain elements of the rate of return should be updated which would result in a lower rate of return than the 9% rate contained in the Handbook.

1.3.7 As a result of the Board's Decision, submissions were heard from a variety of parties on the appropriate rate of return on equity.

1.3.8 The second Motion related to an application by the Consumers Council that the hearing should be re-opened to consider investment by the utility directly or indirectly, in certain unregulated affiliates. This concern arose from press announcements following the conclusion of the hearing indicating that Toronto Hydro Telecom, an unregulated affiliate, was expanding its telecommunications operations to include a wireless data network in the City of Toronto. There was also reference to investment in another unregulated affiliate relating to gas-fired generation of electricity in the City of Toronto at a site known as the Portlands Energy Centre.

1.3.9 The Board has issued a Decision[2] that the hearing would not be re-opened on the grounds that no essential new evidence was likely to result. The Board concluded that the issue of the

[1] Exhibit K 1.1, and Tr. Vol. 1, p 113 – 123.
[2] RP-2005-0020 / EB-2005-0421, April 10, 2005

allocation of common costs between the regulated utility and its unregulated affiliates was squarely before the Board, and the disposition of that issue would not be altered by evidence that one of those unregulated affiliates was apparently expanding its operations. Moreover, the Board pointed out that there were alternative proceedings for parties claiming cross-subsidization of unregulated activities by the utility pursuant to the Affiliate Relationships Code.[3]

1.4 THE HEARING

1.4.1 The hearing took place at the Board's offices in Toronto on January 17, 18, 20, 24, 26, 27, 30, and 31. Arguments were filed in writing, with reply argument on February 21. Transcripts of the proceeding along with copies of exhibits and evidence are available to view at the Board's offices.

1.4.2 The Board deals in this Decision mainly with matters raised as issues by the 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 in the company's evidence should not be construed by the company as acceptance of these matters beyond the cost consequences for the test year.

1.5 ADEQUACY OF THE EVIDENCE

1.5.1 A number of parties to this proceeding questioned the adequacy of the evidence filed by the Applicant. Board staff submitted that "the thinness of the evidentiary material may cause the Board to have concerns over the approval of the sought levels of expenditures and the resultant rates as they relate to both aspects of the stated Board objective." Energy Probe Research Foundation stated, "The paucity of evidence presented by the Applicant makes it impossible to make reasonable judgements about the consequences of such cuts. The Applicant only provided routine and absolutely essential financial information after persistent efforts by intervenors."

[3] Affiliate Relationships Code for Electricity Distributors and Transmitters, www.oeb.gov.on.ca/documents/affiliatecode_amendedcode.112403.pdf

1.5.2 The Consumers Council was equally critical and argued that the Board should remind the utility that it has an obligation to file thorough and detailed evidence in support of the relief it requests. Council argued that the filings by Toronto Hydro in this proceeding were deficient compared by the standard of the two regulated gas companies and the filing by Hydro One Networks in a parallel proceeding.

1.5.3 Accordingly, the Consumers Council argued that Toronto Hydro should not be allowed to recover costs in this application. They also argued that the Board should implement an earnings sharing mechanism because the utility has failed to provide adequate evidence to support its application. They pointed to past decisions of the Board where earnings sharing mechanisms were imposed on Union and Enbridge in years when their rate increases were based on a formulaic basis rather than on the basis of evidence about forecasted cost levels.

1.5.4 There is no question that the evidence was, putting it politely, "light". The Board has some sympathy with submissions of the Consumers Council when they state:

> "The difficulties intervenors faced were compounded when THESL chose to pre-file so little evidence. One of the signal characteristics of this case, and one of its lasting ironies, is that virtually all of the essential evidence was produced, not by THESL in chief, but in response to written interrogatories and questions in cross-examination. There are numerous examples of this phenomenon."

1.5.5 While the evidence may have been light there may be mitigating circumstances. This is the first time this Applicant is before the Board in a full oral hearing. And it is certainly the first time it has applied on a forward test year basis. Additional confusion arose from the misapprehension on the part of the utility regarding the extent they could rely upon the Rate Handbook in a forward test year filing. And to be fair, the utility did file a motion, as they were entitled to, seeking clarification by the Board. It is also fair to say that there was some legitimate basis for this confusion or lack of clarity. The position was not unique to Toronto alone. Other utilities such as Ottawa Hydro had similar arguments.

1.5.6 It may be that Toronto Hydro conducted its case differently than Hydro One. This panel is in no position to judge that. We can agree that the evidence is light. However, as indicated above, it does not warrant the cost consequences argued by the Consumers Council. Hopefully the situation is clarified by the Decision on the Motion. The Board would expect

in the future that Toronto Hydro will take guidance from these rulings. That will not only assist the Board. It will assist the utility in obtaining the relief it requests in a timely manner.

1.5.7 In order to assist the utility, the Board has issued seven Directions in this Decision. Those directions require the utility to file certain studies as part of its next rate case. They are summarized in Chapter 8 of this Decision.

1.6 THE DECISION

1.6.1 Toronto Hydro in this application applied for a revenue requirement from rates of $ 456.8 million. This would result in a reduction of distribution rates for the typical residential customer of approximately 6%. The Board, for reasons outlined in this Decision, is granting the utility a revenue requirement from rates of $436.5 million. This will result in a decrease for the typical residential customer of approximately 10%.

1.6.2 The Decision is summarized in Table 1.1.

Table 1.1

Summary of Decision with Reasons*

Issue	Board Decision
• OM&A $163.7 million • Compensation Costs • Pension Costs • PILs $48 million	• Approved • Approved • Approved • Recalculate PILs liability for change to Smart Meters
• Load Forecast • LRAM	• Approved • Not approved
• Revenue from other Services $24.5 million	• Approved
Corporate Cost Allocation	• Approved, with direction given
• Depreciation Costs $128.5 million	• Approved, except adjusted for Smart Meters
• Rate Base $1,885 million • Working Capital Allowance $ 308 million • Capital budget $203 million • Additional Line Loss Expenditures	• Approved • Approved • Approved, except adjusted for Smart Meters • Approved, with direction given

• Service Quality Performance	• Approved
• Capital Structure D:E 65:35 • Rate of Return on Equity of 9% • Debt Rate of 6.7%	• Approved • Approved • Not Approved
• Regulatory Asset Recovery	• Approved
• Smart Meters $7.2 million	• Adjusted
• Standby Rates	• Interim approval
• LV Rates Allowance	• LV Rates Increased
* This summary does not form part of the Decision nor does it itemize all findings. It is not to be relied on for the purpose of applying or interpreting the Decision.	

2. REVENUE AND LOAD FORECAST

2.1 REVENUE FORECAST

2.1.1 The Applicant forecasts revenue from rates for the 2006 rate year in the amount of $456.8 million. This is based upon a load forecast of 26.7 TWh.

2.2 LOAD FORECAST

2.2.1 The load forecast proposed by the Applicant is set out in Exhibit 9.2.1. Using the results from the model and applying certain judgement, the company estimates a load in 2005 of 26.6 TWh and a 2006 load of 26.7 TWh. The percentage increase in 2006 is 0.4% compared to the previous year, which compares with an average annual increase over the 1998 – 2004 period of approximately 0.6%.

2.2.2 There were two areas of concern with respect to the load forecast, the first with respect to methodology, and the second with respect to the accuracy of the forecast.

2.2.3 As indicated, the Applicant made judgemental adjustments to the projections yielded by the model in five of the twelve months. The accuracy of the forecast model compared to actual load after the fact indicates that the results in six of the seven months were substantially above the forecast. None of the intervenors nor Board staff presented an alternative methodology or forecast.

2.2.4 The Schools Energy Coalition submitted that the load forecast should be increased to 28.615 TWh, but admitted there was little evidence the Board could use to adjust the forecast. Instead, Schools relied on the questionability of certain judgemental adjustments made by the company.

2.2.5 The Board notes that the increased load forecast is in keeping with the actual results over the six-year period 1998 – 2004. There is general agreement that there is not enough evidence on

the record to make any meaningful adjustments to the load forecast. The company acknowledged that further adjustments to the model could be made. Under the circumstances, the Board accepts the load forecast proposed by the Applicant.

3. DISTRIBUTION EXPENSES

The distribution expenses that concern intervenors and Board Staff are compensation and benefits, distribution expenses paid to affiliates, taxes and line losses.

3.1 COMPENSATION AND BENEFITS

3.1.1 Energy Probe, VECC, SEC and Board Staff argued that the utility's compensation levels are either too high or at least there is a lack evidence to determine if they are reasonable. Pollution Probe, the Green Energy Coalition and CME took no position on the issue.

3.1.2 The utility testified that it is engaged in a salary and compensation study intended to determine the appropriateness of the existing compensation levels for executives and management employees.

3.1.3 Energy Probe argues that because the compensation study only pertains to management it will deal only with a small portion of THESL's overall labour costs. Energy Probe urges the Board to specifically require THESL to file a benchmarking analysis of overall costs for union labour well in advance of the expiry of the current labour agreement.

3.1.4 VECC presented a Statistics Canada survey (Exhibit 6.3) to draw comparisons to THESL's unionized work force. VECC's interpretation of the survey was that THESL's unionized work force is paid 52.6 % more than the Ontario average for unionized workers. VECC further argued that the survey demonstrates that THESL's unionized work force (the lowest paid category in the Company) has a higher average hourly wage than all categories of wage earners in the labour force survey. As a result, VECC argued that increases in non-union compensation should be held at an inflationary 2.5% for 2006. VECC estimates that the reduced increase in wages would lower the 2006 distribution expense by $1.5 million.

3.1.5 VECC further submitted that THESL should be required to complete and file, in its 2007 rates application, the results of a comprehensive compensation benchmarking study comparing THESL's compensation levels with like utilities and other applicable comparators.

3.1.6 Consumers Council of Canada expressed concern with what they characterized as THESL's "odd" corporate structure. Their concern is based on what they see as a very top-heavy organization, coupled with compensation levels that they claim are excessive, particularly for senior management. The Consumers Council specifically questioned the increases in compensation levels for the Managerial and Executive categories since 2003 and argued that there was no evidence provided as to why those categories of employees should receive compensation increases well above inflationary levels.

3.1.7 The Consumers Council proposes that the 2006 revenue requirement be reduced by $2 million in compensation expenses which they claim reflects the fact that THC and THESL have overlapping executive responsibilities, and that overall compensation for Managerial and Executive groups should be held to inflationary increases.

3.1.8 SEC submits that even though THESL did not provide sufficient detail to do a thorough analysis, comparisons with other utilities and consideration of absolute numbers is sufficient to conclude that THESL's compensation levels are high.

3.1.9 SEC's argument included an analysis of compensation increases for the period 2006 to 2007. Their analysis purports to demonstrate that increases for the various employee categories range from close to inflationary to 14.4% over inflation. SEC's analysis is put forward in support of their submission that THESL's revenue requirement should be reduced by $1.8 million to reflect excessive cash compensation increases for the Managerial and Executive levels of employees.

3.1.10 SEC prepared a comparison of THESL's compensation with that of Hydro Ottawa. Using average cash compensation per employee comparisons, SEC argues that THESL's compensation levels are 12.51% higher than Hydro Ottawa's. SEC argues that if THESL's cash compensation were set at the same level as Hydro Ottawa's the total cash compensation

would drop by $14 million in the test year. SEC's further submits that a 60/40 split of the $14 million reduction between Distribution Expenses and Capital Expenditures would result in a total reduction in revenue requirement of $9 million. SEC agrees that the $1.8 million arrived at in the increases over inflation analysis referred to above, would be included in the $14 million disallowance.

3.1.11 SEC submitted a similar comparative analysis of THESL's benefit costs to those of Hydro Ottawa's. Using the same average cost per employee methodology and extrapolating THESL's revenue requirement if their benefit costs per employee matched Hydro Ottawa's, SEC submits that THESL's benefit budget be reduced from $39.2 million to $12.1 million, a reduction of 27.1 million. This would result in a revenue requirement reduction for the test year of $17.4 million, when allocated in the same 60/40 proportion between Distribution Expenses and Capital Expenses.

3.1.12 Board Staff note that a comprehensive study of compensation is planned and argue that the results of this study should be required as part of the next rate filing by THESL.

3.1.13 The utility claims that its compensation levels are not high compared to other public sector employers and Greater Toronto Area private sector employers. The Applicant argued that comparisons with Hydro Ottawa average employee salaries are not determinative as there are inconsistencies in the way staff are categorized in the two organizations.

3.1.14 The Board finds that there is sufficient indication of high wages to warrant a thorough examination. While the Toronto labour market may be unique, this does not reduce the need for detailed examination. The Board therefore directs the utility to file the independent compensation study that is currently under way prior to the next rate case. This study should include benchmarks with other North American utilities of similar size.

3.1.15 Energy Probe urged the Board to require THESL to file a benchmarking analysis of overall costs for union labour well in advance of the expiry of the current labour agreement. The Board agrees that this analysis should be completed to provide the same level of information for the unionized employees of THESL that the proposed study of Managerial and Executive

levels is intended to supply. The Board directs the Applicant to conduct the study proposed by Energy Probe and submit the findings in the nest rate case.

3.1.16 In the absence of compelling evidence to the contrary the Board accepts the Applicant's submission that compensation levels are not high compared to other public sector employers or Greater Toronto Area private sector employers. The Board will therefore not reduce the revenue requirement associated with compensation and benefits.

3.1.17 The submissions of the intervenors reflect a serious concern. The Applicant should be guided by these in the presentation of the presentation of the compensation study in the next rate application.

3.2 DISTRIBUTION EXPENSES PAID TO AFFILIATES

3.2.1 Toronto Hydro Corporation (THC), the parent of the utility, provides common services to the utility and other affiliates. The Applicant states that 78% of Toronto Hydro Corporation's cost of $55 million is recovered from the utility. Various parties including Board staff questioned the lack of support for these calculations.

3.2.2 While some of the costs are allocated on the basis of time, in the case of employees, or actual usage, in the case of assets, 97% of Toronto Hydro Corporation's remaining costs are recovered from the utility. The allocation of costs is based on the percentage of gross revenues that each of the regulated and unregulated affiliates contributes to the consolidated revenues of Toronto Hydro Corporation. These common costs relate to corporate governance, shareholder relations, financial reporting, internal control, executive compensation, and IT. The amount charged to the utility for these services is $12 million.

3.2.3 It is readily apparent to the Board that allocating these costs based on gross revenues produces an unwarranted bias against the ratepayers. The revenues of the utility are inflated by the high cost of wholesale power. That is an ever increasing amount. Because these costs are increasing, it does not follow the utility's share of the overhead costs should be increasing. In short, there is no necessary relationship between revenue share and the share of overhead cost.

3.2.4 Over the years, the Board has dealt with this issue in the context of gas utilities. In a number of Decisions, the Board has made it clear that where services are purchased from the affiliates, and not by arm's length transactions, the burden shifts to the utility to demonstrate that the cost have been properly allocated. No such allocation study has been offered in this proceeding.

3.2.5 The flaw in the revenue allocation method is seen in the most recent controversy regarding the expansion of the unregulated activities in wireless data and gas-fired electricity generation. Both initiatives likely involve significant corporate management time and yet, there will be no revenue associated with these projects at this time. Hence, no cost would be recorded or allocated.

3.2.6 All of the intervenors argue that the evidence to justify the share of common costs or shared services to be paid by the utility is weak. Some claim it is non-existent.

3.2.7 Most parties propose that this expense be reduced, with the corresponding reduction in the revenue requirement. Pollution Probe would reduce it by $5 million, CME by $10 million, SEC by $2.4 million, and Energy Probe by $5.1 million, while the Consumers Council would cut the expense by 25%.

3.2.8 Most intervenors agree that cost should not be allocated on the basis of revenue but rather on the basis of time allocation. Some suggested other methods such as dividend (Pollution Probe) and EBITDA (SEC)

3.2.9 The Board agrees. The evidence is very weak, allocation by revenue has a clear bias against the utility and time allocation is not only a more accurate method but is the standard methodology that the Board has used in the past.

3.2.10 The Board does not accept THESL's argument that relative revenue generation is an acceptable proxy for attraction of costs. The Board shares the view of most intervenors that actual time based assessment should be utilised whenever possible. There is strong precedent for this approach in the Board's gas decisions. Allocator proxies should only be used as a last resort. Given the nature of the shared service arrangements, in that they are by nature

under the same corporate umbrella, processes to track effort by time should be relatively easy to implement.

3.2.11 The need for transparency of Affiliate transactions is a matter of public confidence and is at least as important as ensuring appropriate allocation.

3.2.12 The Board directs THESL to develop a time based shared service allocation methodology for non-direct corporate costs that incorporates the following elements:

- Time/cost tracking of individual staff efforts
- Description of THESL's need for the service
- Assessment protocol and allocation of non-time related expenses

3.2.13 A detailed report on the shared service allocation rationale and methodology is to form part of THESL's next rate application. This process is to augment the existing shared service agreements and is in no way intended to diminish or replace THESL's existing arrangements.

3.2.14 Some intervenors have argued that the Board should reduce the revenue requirement by disallowing of a portion of the shared service costs allocated to THESL in the application. The Board finds that the proposed methodologies to be no less arbitrary than the relative revenue method currently being used. The Board accepts that there is sufficient reason to direct an improvement to the current methodology but insufficient evidence to disallow a portion of the costs.

3.3 TAXES/PILS

3.3.1 The issue at hand is centred on changes that are thought to be imminent in the tax treatment of depreciation of Class 47 assets, that if enacted will decrease THESL's PILs obligation. The estimate of difference in the PILs cost is just over $3 million.

3.3.2 SEC argued that the Board should rely on the best available information to determine reasonable expenditures in a test year. SEC argued that THESL's revenue requirement should be reduced accordingly by $3.2 million.

3.3.3 Board Staff argued that the 2006 PILs Variance Account 1592 exists to capture precisely these types of differences.

3.3.4 The Board finds that the differences in PILs, in the event that the planned tax treatment changes do occur, should be tracked in variance account 1592.

3.4 LINE LOSSES

3.4.1 Pollution Probe and GEC submitted that THESL should have a financial incentive to reduce line losses. They both argued that the current pass-through of the costs of line loss will not lead to any reduction.

3.4.2 Pollution Probe argues that the Board should reject THESL's request for the continued use of the variance account methodology, claiming that any associated risks to THESL are trivial in comparison to its revenue risks as a result of fluctuations in weather or the business-cycle. GEC submitted that most of the volatility for larger utilities is due to weather and the measurement of the loss impact.

3.4.3 It is common ground that transmission and distribution line losses in Ontario account for about 7.5% of the electricity generation. That, all parties agree, is a substantial cost. In the case of Toronto Hydro the distribution losses in 2005 are estimated to be 3.1% of their electric sales.

3.4.4 A number of parties have argued that there is no incentive for Toronto Hydro to reduce its losses. That is because Toronto Hydro proposes a variance account and any variance between actual and forecasted losses will be accommodated in that account. Toronto Hydro will not be at risk if it does not achieve any of its goals with respect to line loss reduction.

3.4.5 The Board's report relating to the EDR Handbook (RP-2004-0118) acknowledged that line losses is a serious waste of electricity and the distributors in the province have no direct financial incentive to reduce those losses. At the time, the Board stated that it would study the problem in greater detail but that in the short term, no workable solution was evident. That study is yet to be completed.

3.4.6 Pollution Probe and GEC argue that there has to be an incentive to reduce line losses. The only concrete plan advanced was to eliminate the variance account. That simply puts the utility at risk. The Board believes that may not provide a complete solution because the utility may simply adjust the forecast upward to provide enough cushion and is unlikely to exceed the line loss forecast.

3.4.7 The better view, in the Board's opinion, is to require utilities to file a plan to reduce line loss. If the plan fails to forecast any reduction in line losses, it can be subject to scrutiny and may or may not be accepted by the Board. If at the time of the next rate case, the utility fails to meet its goals, any losses above those forecasted reduction can be treated in a different fashion and possibly be disallowed as a regulatory cost. In short, line losses need to be considered on a utility specific basis. But there must be a plan. And the results must be measured and examined as part of the regulatory process. It is no longer acceptable to ignore the issue because the problem is complex. The costs to the province-wide distribution system are too great. Millions of dollars are at stake.

3.4.8 Accordingly, the Board directs Toronto Hydro to file a plan within 90 days of this Decision to reduce its line loss by at least 5%. This plan should include concrete estimates of the costs of achieving this goal as well as the anticipated benefit. Upon review, the Board will determine a procedure to evaluate that proposal and the terms and conditions of implementation.

4. RATE BASE

THESL's distribution rate base for the 2006 test year consists of net fixed assets of slightly less than $1,577 million, plus a working capital allowance of nearly $308 million

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

- Working Capital Allowance
- Capital budget
- Adequacy of funding for Service Quality Performance
- Although the following items were on the Issues List, they were not addressed by any of the parties in argument:
- Allowance for funds used during construction
- Overhead Capitalization

4.1 WORKING CAPITAL ALLOWANCE

4.1.1 The issue the Board faces concerning working capital allowance is whether the Handbook approach used by THESL creates a higher working capital allowance than is necessary.

4.1.2 THESL applied for a working capital allowance of $307,855,312, derived in accordance with the formula set out in the Handbook, using 2006 forward test year data, rather than the 2004 historical test year data. THESL argued that this approach is appropriate as it represents 15% of the distribution cost of power, and other power supply expenses and controllable expenses.

4.1.3 VECC expressed a concern that while THESL has used the Handbook approach, it had substituted 2006 numbers in some case and argued that THESL should not be able to pick

and choose which aspects of the handbook methodology to apply. VECC recommended correcting the working capital allowance by applying the 2004 historical test year calculation [eg (2004 Cost of Power + Distribution Expenses) x 0.15]

4.1.4 VECC and Energy Probe argued that the Handbook approach was too costly to ratepayers, and recommended that the Board order THESL to prepare a lead/lag study to compare to the 15% allowance set out in the Handbook in time for the next rate case.

4.1.5 The Board accepts THESL's use of the Handbook formula for the purposes of this application. As the working capital allowance pertains to the capital expenditures for the forward test year, it seems reasonable to use the 2006 capital budget rather than the 2004 historical test year data. The Board agrees however that it would be useful to have a lead/lag study and directs the utility to file such a study prior to the next rate case.

4.2 CAPITAL BUDGET

4.2.1 THESL proposed a capital budget of $203 million for the test year 2006 with projected expenditures in 2005 of $131 million. The 2006 capital budget includes $50 million for smart meter spending. The capital budget was presented in Schedule 4-1 under the headings Intangible Plant, Distribution Plant, General Plant, Capital Contributions and CWIP as shown in Table 4.1.

4.2.2 The main concerns expressed by board staff and the intervenors were

- the lack of a long term capital plan,
- whether the increased budget was the result of under spending in previous years,
- whether there was adequate spending to replace aging plant, and
- whether there was adequate information for the board to accept the capital budget.

Table 4.1				
Category / Year	2003 ($'000's)	2004 ($'000's)	Projected 2005 ($'000's)	Projected 2006 ($'000's)
Intangible Plant	4,728	6,848		
Distribution Plant exclusive of smart meters	137,446	120,575	117,171	144,423
Smart Meters				49,670
General Plant	11,366	9,575	18,069	25,231
Capital Contributions	-18,334	-28,519	-16,281	-22,000
CWIP	-36,647	-6,989	11,995	5,892
Total	93,831	94,642	130,954	203,216
Total Exclusive of Smart Meters	93,831	94,642	130,954	153,546

4.3 LONG TERM CAPITAL PLAN

4.3.1 Board Staff and several of the intervenors (VECC, Energy Probe, CCC) argued that a long term capital plan should have been presented in this case, and that THESL should be required to file one in time for the next rates case.

4.3.2 A significant part of the evidence in this case related to the challenges faced by THESL in amalgamating six utilities, and the progress that has been made in areas such as deployment of staff, and integration of systems including control room functions. The evidence was that significant efficiencies have been achieved.

4.3.3 Mr Haines, Mr Black and Mr Bailey all gave evidence on the capital budget. On this issue their evidence was consistent that since amalgamation in 1999, THESL has to a large extent been occupied with consolidating the functions of the six predecessor utilities and that the information required to prepare an integrated long term capital plan is only now becoming readily available in a form that can be used. For example, mapping of the system is not yet complete. The evidence was that the first stage, the long term asset assessment plan, has a target completion date of mid-2006.

4.3.4 The Board accepts THESL's evidence that it was not possible to have a long term plan in place for this rates case, but agrees with Board Staff and the intervenors that one should be prepared in time for the next rates case. The Board does not agree with Energy Probe's suggestion that the Board require THESL to make it available for peer review, and will not order that it do so.

4.4 IS THE INCREASED BUDGET THE RESULT OF UNDER SPENDING IN PREVIOUS YEARS?

4.4.1 Board staff argued that there appeared to have been underinvestment in physical plant over the past several years

4.4.2 Energy Probe argued that proposed drastically increased spending in 2006 is prima facie evidence of underspending in prior years.

4.4.3 CME argued that the underspending during times of PBR allowed the corporate shareholder to maximize its returns during that period.

4.4.4 One of the questions raised by intervenors is whether there should be any adjustment for underspending on capital during the PBR period. SEC's position was that a long term capital spending plan is needed to make this determination.

4.4.5 THESL's evidence was that the capital projects required to be completed in previous years were completed, although at a cost less than originally budgeted. This was attributed to efficiency improvements in the organization in the years following amalgamation of the 6 former utilities.

4.4.6 The Board heard considerable evidence from THESL on the need for the proposed capital budget and the reasons for relatively large increases from previous years, some of which was somewhat inconsistent as noted above.

4.5 IS THERE ADEQUATE SPENDING TO REPLACE AGING PLANT?

4.5.1 Energy Probe argued that the evidence indicated that in recent years, THESL had been spending well below the level required to keep up with the aging of its distribution plant, and that system reliability may be affected as a result

4.5.2 VECC argued that THESL may not have the capacity to ramp up its procurement and work force to accommodate a major increase in capital expenditures in 2006, and therefore recommends a reduction in the proposed 2006 capital expenditure budget.

4.5.3 The need for increased capital expenditures was initially addressed by Mr Haines who testified that 30 to 40 percent of the plant that's in service today has exceeded its expected life, and that will continue even with the increased budget that forms part of this application.

4.5.4 However, Mr Black testified that despite this, THESL had concluded that there was no need to spend more than the amount applied for as the long term reliability trend had been continuously improving over the past three years, and that the plant is performing reasonably well, on average. He testified that he was not concerned about falling behind over the past few years as reliability has been good, however, they increased the level of spending in 2005 and they expect to do so again in 2006.

4.5.5 THESL’s witnesses testified that they had a ongoing plan in place to hire and train sufficient staff to undertake the necessary work.

4.6 IS THERE ADEQUATE INFORMATION FOR THE BOARD TO ACCEPT THE CAPITAL BUDGET?

4.6.1 The Consumers Council and Schools argued that there was insufficient evidence before the Board to support a conclusion that any particular capital investment was either reasonable or even necessary, and, as noted above, that some of the THESL witnesses gave inconsistent evidence on the specific need for capital spending.

4.6.2 Schools argued that evidence with respect to the capital budget was sparse and lacking in detail. Schools argued that the capital budget should include at least the following, some of which the applicant does not have and some of which it has not shared with the Board:

a) line by line, year over year spending, with variance explanations;

b) summaries of material individual projects planned, both in absolute terms and relative

c) to prior years;

d) capital budget strategy; and

e) long term capital spending plan, and how the test year budget fits within it.

4.6.3 However, the Consumers Council also acknowledged that the Board has an obligation to the ratepayers of THESL to ensure that there is sufficient capital investment to ensure the safe and reliable delivery of electricity. It argued that the Board has to assume responsibility for the appropriate level of capital expenditure in light of these apparent contradictions and the lack of information on the state of THESL's plant and the need to invest to replace or upgrade it.

4.6.4 The Consumers Council therefore recommended a 10% reduction in capital expenditures, matching their recommendation for OM&A costs. It argued that this budget would recognize inflation, customer growth, and a need to replace aging assets, but would also reflect that THESL has not provided sufficient evidence to support a 50% increase over 2004 levels.

4.6.5 The Consumers Council argued that THESL would have to manage its expenditures within the budget and decide which budget items to give priority. For example, the Consumers Council suggested that if THESL decided to put a priority on expenditures related to Underground Conduit and Line Transformers, other capital projects such as Pole Replacements or Software may have to be deferred. It suggested that any capital expenditures beyond the approved budget will be subject to the Board approval before being added to rate base.

4.6.6 Energy Probe supports the proposed capital budget, and expressed a concern that system reliability may be affected if capital spending is reduced.

4.6.7 Schools argued that it was not in the interests of ratepayers to have THESL continue to underspend on its plant. However, it recommend that the Board reduce the amount of capital spending to be included in revenue requirement, but that the Board direct THESL to spend the full budget, the difference being at the expense of the shareholder.

4.6.8 CME recommended s that the capital budget be reduced to the 2005 level of $135 million on the basis that there does not appear to be any clear plan to scope or prioritize the expenditures.

4.6.9 VECC noted that capital spending levels for 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.

4.7 CONCLUSION

4.7.1 While the Board shares the intervenors' concerns about the apparent contradictions in the evidence given by THESL witnesses, it is not persuaded that the solution is to reduce THESL's capital budget from the amount sought. The Board accepts THESL's evidence that the primary reason for under-spending in 2004 and 2005 was THESL's realization of efficiencies as a result of amalgamation. The Board also accepts THESL's evidence that increased capital spending is required to address the issues of aging plant.

4.7.2 The Board does not agree with the Consumers Council that the solution to the lack of a long term plan is to require THESL to pick priorities from among the items it has put in its capital budget. There is no reason to risk jeopardizing the reliability and performance of the system by requiring THESL to defer certain parts of its capital spending.

4.7.3 The Board does agree with the intervenors that a long term plan is required and directs the utility to file such a study prior to the next rate case. THESL has advised the Board that it will be ready in mid-2006 and will be filed as soon as possible.

4.7.4 The Board finds THESL's proposed capital budget for the test year to be reasonable.

4.8 ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION

4.8.1 While Allowance for Funds Used during Construction was on the Issues List, THESL does not use any in its account balances. Rather THESL uses the OEB approved interest rate on Construction Work in Progress (CWIP). The amount of CWIP projected in 2006 in Schedule 4-1 of the application is $5.892 million.

4.8.2 None of the intervenors took any issue with the approach used by THESL, and it is acceptable to the Board.

4.9 OVERHEAD CAPITALIZATION

4.9.1 In its original evidence, THESL filed its capitalization policy for property, plant and equipment and its Computer Software Capitalization Policy.

4.9.2 No intervenor took issue the with THESL's policies. The Board accepts the cost consequences for the test year flowing from THESL's policies.

4.10 ADEQUACY OF EXPENDITURES FOR SERVICE QUALITY PERFORMANCE

4.10.1 As noted above, Board Staff and some intervenors expressed concern about whether the level of capital expenditures had been and would be adequate for THESL to maintain system reliability and adequate levels of performance.

4.10.2 THESL's evidence was that it had significantly improved its system reliability since the time of restructuring, as shown on the reliability metrics filed as Schedule 15-1 to the application. THESL's evidence was that it has also significantly improved customer service including shorter call waiting times and faster restoration response. Despite the lack of a long term capital spending plan, THESL's witnesses expressed confidence in their ability to maintain and improve their performance in the 2006 year.

4.10.3 THESL's performance statistics were the filed and were discussed in some detail during the hearing. The material filed by THESL was adjusted for

a) the actual 2005 numbers

b) the 2003 numbers would excluding the impact of the August 2003 blackout; and

c) what the 2005 numbers would be excluding the severe storm in August 2005.

4.10.4 Table 4.2 below incorporates all of the information provided in cross-examination

Table 4.2

Service Reliability Indicators Performance Measures (all events)	1999 Actual	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Actual	2005 Projected	2006 Projected	Target
SAIDI (# of minutes of interruption per customer)	70.12	92.40	77.60	81.00	88.00	66.09	72.51	70.00	82.00
SAIFI (# of interruptions per customer)	1.71	2.08	1.88	1.59	2.00	1.60	1.80	1.60	2.10
CAIDI (# of minutes per interruption)	41.03	44.51	41.26	50.94	44.00	41.31	40.29	43.75	48.00

4.10.5 The final 2005 numbers without adjusting for the August 2005 storm are SAIDI: 104.9; SAIFI: 2.0; and CAIDI: 40.5.

4.10.6 None of the intervenors expressed any particular concern about the adequacy of these performance statistics.

4.10.7 In the Board's view, these statistics demonstrate that THESL's performance to date based on these indicators has been satisfactory, and tends to support the evidence that capital spending to date has been adequate.

4.10.8 However, the Board notes that the projections for 2006 are not an improvement over 2004 despite the proposed increase in capital spending. Therefore, the Board finds that the in the interest of maintaining system reliability, THESL should be increasing its capital spending as proposed. The Board also expect the long term capital plan to properly include a strategy to maximize the benefits of ongoing capital spending.

5. CAPITALIZATION AND COST OF CAPITAL

5.1 CAPITAL STRUCTURE

5.1.1 In this application, Toronto Hydro uses the deemed capital structure of 35% equity and 65% debt as set out in the Rate Handbook. None of the intervenors object. In the absence of any evidence or argument to the contrary the Board sees no reason to deviate from the Handbook position.

5.2 RETURN ON EQUITY

5.2.1 The Applicant seeks a return on equity of 9%, and claims it is entitled to that rate because that is the rate defined in the Electricity Distribution Rate Handbook. The Applicant argued earlier in these proceedings that this rate could not be contested for the same reason; it was entitled to rely upon the Handbook amount.

5.2.2 The Applicant brought a Motion on January 16, 2006 seeking a ruling on this issue. The Board held that the Handbook was intended for those applicants that were filing on a historical year basis.[4] The Board did, however, find that where the issue was not contested and where there was no contrary evidence, the Handbook values could be relied upon by utilities filing on a forward year basis[5].

5.2.3 However, that is not the case here. This is a contested issue. The Board staff and others have proposed a mechanistic update based on updating the long Canada bond rate. Where an applicant files on a forward test year basis it proposes current data as opposed to outdated data. It does that, of course, for those items where its costs have increased, in order that it might recover those costs. It becomes a problem if the utility can unilaterally determine which of the costs should be updated. As the Board stated in its Decision on the Motion:

[4] EB-2005-0421, transcript Volume 1, p. 113 - 123
[5] Transcript, pp. 118-119

> "it is not unreasonable to assume that with respect to those variables, where automatic, simple updating can be implemented, that should be accomplished as opposed to sticking with outdated '04 data when that's not necessary."

5.2.4 In this case new data has been presented by Board staff. Updating the return on equity based upon current data with respect to the long bond rates yields a return on equity of 8.36% as opposed to 9%. This results in a reduction of the revenue requirement of approximately $3.5 million.

5.2.5 This does not account for any change in the equity risk premium, which is the other component. The Applicant argued that if the return on equity is to be updated to reflect a current long Canada bond rate then the equity risk premium should be updated in the manner proposed by Ms. McShane[6]. That results in a return on equity of 8.65%. The Board believes that both adjustments are legitimate updates.

5.2.6 However, other matters intervene with respect to the return on equity. The return on capital is a different type of cost parameter than operating costs. Operating costs, like many costs a utility faces, are unique to the specific utility and within its control. The cost of capital, however, is determined on a formula basis. Past practice is to have these rates similar for groups of utilities. In other words, the return on equity, and for that matter the cost of capital generally, is usually determined on a generic basis.

5.2.7 While there is a strong argument that the return on equity should be updated utilities that file on a forward year basis, the Board is concerned that this will create confusion on capital markets. It may be perceived that a utility is penalized because it chose to file on a forward year basis. Utilities of course compete with each other in capital markets, which adds another dimension to the problem. And, as a matter of law, utilities are entitled to earn a rate of return that not only enables them to attract capital on reasonable terms but is comparable

[6] Transcript, Volume 4, p. 3

to the return granted other utilities with a similar risk profile[7] The manner in which they file their application does not fall within the jurisprudence.

5.2.8 Toronto Hydro also argues that if the Board only looks at the economic variables in the ROE it amounts to “cherry-picking”. The utility claims that it is improper to isolate economic variables without looking at other cost of capital issues such as debt to equity ratios. Toronto Hydro says that it is the most highly leveraged utility in the province with a debt toequity ratio of 65:35. That ratio was initially established in the Board’s March 2000 Distribution Rate Handbook.

5.2.9 Toronto Hydro notes that a historic test year filer with a 50/50 debt to equity ratio would attract a 9% return on a higher equity base than Toronto Hydro. The higher equity base and rate, they say, creates an unfair advantage in capital markets. Toronto Hydro believes that a 60/40 ratio would be more appropriate in its case, but accepted the 65/35 debt to equity ratio “as part of the bundle of the OEB’s rate-making policies contained in the new Handbook for this next generation of LDC rates.”

5.2.10 The Board accepts this argument. The long Canada bonds are just a part of the picture. The cost of capital should be updated to reflect current market conditions, but it should be done on a comprehensive and generic basis. Dealing with it piece-meal just leads to confusion in the markets with potential unfairness to investors, the utility, and ultimately the customers.

5.2.11 Having considered the generic aspect of this particular cost item – the consequences for the financing costs of particular utilities and the consequences of that in turn to ratepayers – the Board has determined it will accept the 9% rate of return on equity for Toronto Hydro. The Board would emphasize that this ruling applies to the 2006 rate year only and should not be taken as a precedent beyond that.

5.2.12 In making this determination the Board is attempting to balance the interests of all parties. It is also relevant that the Board has announced its intention to review the cost of capital, including the equity risk premium, for electricity distributors before 2008.

[7] Northwestern Utilites v Edmonton [1929] SCR 186 at 193; British Columbia Electric Railway Co v British Columbia Utilities Commission [1966] SCR 837 at 854; Federal Power Commission v Hope Natural Gas Co, 320 US S41 (1944) at 603..

5.2.13 In short, cost of capital is one item that is better dealt with on a generic basis. This ruling should not be interpreted as departing from our ruling on the motion with respect to the application of the Rate Handbook to forward test year filers. This ruling relates to the unique aspect of cost of capital, and then only for the 2006 rate year. The manner in which the cost of capital will be updated for all utilities will be addressed by the Board in the near future.

5.3 DEBT RATE

5.3.1 The Toronto Hydro application uses the Handbook's methodology for calculating the weighted average debt rate.

5.3.2 A number of parties were concerned that THESL is paying interest on a loan to its parent, Toronto Hydro Corporation, at an interest rate in excess of current market rates. This loan is in the amount of $980 million at an interest rate of 6.8%. There was general consensus that the current market rate is 5% and the extra 1.8% interest amounts to approximately $16 million per year.

5.3.3 When asked why the utility had not refinanced the debt at a lower rate, the witnesses responded that the decision was solely up to the City of Toronto.

5.3.4 The fact that the Board and most of the parties in this proceeding were concerned about the above-market interest rates during the course of this hearing would have been apparent both the utility and its shareholder the City of Toronto. The response by the City was interesting, to say the least. Once the hearing was over, they chose to extend the note to 2013.

5.3.5 The utility's defence of this interest rate is that it is the deemed rate specified in the Handbook. Toronto Hydro acknowledges that it would be subject to a lower deemed debt rate for any new debt but argues that the 6.8% rate on the existing note should be left in place because it was compliant at the time the note was put in place. Appendix A of the promissory note defines the debt rate applicable to the note as "the rate of interest per annum that at all times is equal to the debt cost rate that is prescribed from time to time by the Ontario Energy Board in its Electricity Distribution Rate Handbook for utilities in the same rate base class."

5.3.6 The Handbook did re-set the deemed debt rate for debt issued to affiliates on or after May 13, 2005 as the lesser of the actual rate or 5.8%. Accordingly, the utility argues that the Board has addressed the issue of interest rates that are higher than market: they should be adjusted on a going forward basis only.

5.3.7 As indicated, the Applicant argues that this debt was put in place in 2001 and that at that time 6.8% was the appropriate rate. The debt however, was replaced on May 7, 2003, when Toronto Hydro Corporation issued a promissory note in favour of the City of Toronto in the amount of $980 million. This replaced the December 1, 2001 promissory note issued by the utility in favour of the City in the same amount. The utility now has a corresponding debt obligation to Toronto Hydro Corporation. This refinancing however, would still not qualify as new debt because the Handbook defines new debt as debt issued after May 13, 2005.

5.3.8 Of some concern to the Board (and to the intervenors) is the decision by the City of Toronto following the calculation in this case to extend this note to 2013. It is also apparent that the financing decisions are being made unilaterally by the City, which is the sole shareholder of the utility. The result is that interest is being paid above the market rate and the excess, some $16 million, is being borne by the ratepayers.

5.3.9 The intervenors argue that a utility, like Toronto Hydro, that is filing on a forward test year cannot rely on the Handbook. Put differently, the definition of new debt as debt issued after May 13, 2005 relates only to historic test year filers. With respect to future test year filers the intervenors argue that the Board is entitled to review the matter on the basis of first principles.

5.3.10 This matter is dealt with in greater detail in the section of this Decision dealing with Return on Equity, where it was the subject of a specific Motion. Where a utility chooses to file on a forward test year basis it must accept the consequences. Moreover, even in those areas where it is not seeking change (but relies on the Handbook) it must support its position in contested matters. The utility continues to have the burden of proof throughout the case.

5.3.11 There is no question on the evidence that the market rate is below the rate that THESL is paying its parent. So there is an evidentiary basis that the existing rate is not the market rate and should be adjusted to reflect the market rate.

5.3.12 The utility argues that this is retroactive rate-making, or alternatively that they should be entitled to rely on the Handbook. As indicated, a forward test year filer can rely on the Handbook only if the issue is not contested and there is no evidence. Where the issue is contested here, as it is here, and there is clear evidence that the cost is the wrong cost, the result is different.

5.3.13 Nor is there any basis for claiming that it is retroactive rate-making. It is true that the agreement was put in place a number of years ago and at the time the rate was the correct rate. However, the rate is not the correct rate now.

5.3.14 The utility also argues that investors are entitled to rely upon the terms of the note that they originally signed. There is some merit to that, but this is debt to an affiliate.

5.3.15 Ratepayers are entitled to just and reasonable rates. That is the over-riding principle, not that the City of Toronto as sole shareholder should be able to extract from ratepayers above-market returns. There is little logic to that, and the logic cannot be defeated by the bald assertion that the Handbook is being followed. This is particularly the case where the utility is filing on a forward test year basis.

5.3.16 Aside from the relevance of the Handbook to a utility that files on a forward test year basis, there is a more important consideration. That is that this is debt to an affiliate. It is not only debt to an affiliate, but it is debt clearly above the market rate.

5.3.17 There is extensive jurisprudence by this board in gas cases that with respect to transactions between the regulated utility and an affiliate[8]. The Board pays careful attention to ensure that there are no over-charges. In fact, the jurisprudence indicates that the burden shifts to the utility to defend its position to ensure that fair market values are being used. The Board

[8] For example, Enbridge RP-2001-0032

has also established the Affiliate Relationships Code[9] with a separate compliance procedure to guard against just this issue. It makes no sense in this case to ignore these fundamental principles on the basis of the "Handbook" argument.

5.3.18 Nor is it any defence to say this is not a decision of the utility but is being made unilaterally by the City of Toronto. That is exactly the problem. In fact it could be argued that this is part of a pattern. The City has extracted extensive dividends from this utility in recent years. It is likely one of the rare occurrences in Canadian financial markets where the level of dividends exceeds the net income. This policy is reviewed separately in another aspect of this Decision.

5.3.19 In the end, the Board's responsibility is to ensure that rates are just and reasonable. That does not include ratepayers paying an additional $16 million here in order that the City of Toronto can receive interest income from the utility at above market rates. The Board will accordingly, as of the effective date of this Decision, disallow as a regulatory expense any interest charges above the current market level which it finds to be 5%.

5.3.20 The utility argues that the financial markets will be upset by the Board meddling in loan agreements and re-setting the terms of a loan. The Board disagrees. Financial markets understand that the Board has a responsibility to regulate utilities to ensure that they are not incurring above-market costs, particularly where those costs are being charged by an affiliate. In fact, the language in the note suggests the rate is subject to Board adjustment where policy warrants.

[9] Affiliate Relationships Code for Electricity Distributors and Transmitters, www.oeb.gov.on.ca/documents/affiliatecode_amendedcode.112403.pdf

6. OTHER ISSUES

6.1 SMART METERS

6.1.1 Toronto Hydro proposes in the 2006 rate year to install 150,000 smart meters for residential customers and 7,500 for general service customers. The installed cost of the residential meters is $250 while the installed cost of the general service meters is $1500. The installed cost of the residential meters is consistent with the Board's generic Decision. The Board's generic Decision did not deal with General Service meters.

6.1.2 In the case of the residential customers Toronto Hydro proposed a capital expenditure of $40,307,000 with an associated depreciation expense of $1,534,033. This is set out in Table 6.1 of this Decision. The resulting increase to the rate base is $19,716,259. The allowed return on rate base would be $1,479,995 with an operating expense of $2,198,500 and a depreciation expense of $1,534,033, all of which is set out in Table 6.1.

6.1.3 The above expense yields a revenue requirement in the utility's application of $6,062,115. The utility has followed the terms of the generic Decision in terms of operating costs and capital costs of installed residential meters. This is $2.47 per month in terms of capital costs and $1.03 per month in terms of operating costs, for a total of $3.50 per month.

6.1.4 The generic Decision, however, states that utilities can, for the purpose of 2006 rates, include these costs based upon the number of months in which those meters are installed. Toronto Hydro has apparently assumed in its application that all meters are installed on Day 1. The Board believes that it is more reasonable to assume the meters will be installed on a continuous basis over the year as set out in the generic Decision. This results in a disallowance of $2,649,615, and a new revenue requirement of $3,412,500 as set out in Table 6.1.

6.1.5 In addition, Toronto Hydro includes in its application some $3 million in IT costs, and a $300,000 expense for advertising related to Smart Meters. These costs were not addressed in

the generic Decision. However, the Board in this case finds these costs to be proper and includes them in the revenue requirement.

6.1.6 With respect to the general service customers, Toronto proposes to install 7,500 meters. The question of smart meter for general service customers was not addressed in the generic Decision. The $3.50 cost per meter per month is for the residential meters. The Board acknowledges the cost of smart meters for general service customers is significantly greater and accepts the cost estimate proposed by Toronto Hydro in this regard. However, in this case as well, Toronto Hydro assumes that all of the meters are installed on the first day of the rate year. Accordingly, an adjustment has been made in the allowed cost recovery to reflect the installation pattern over the course of the year in the same fashion as the adjustment was made with respect to residential customers.

6.1.7 The result is a rate rider of $0.48 in the case of residential customers and a rate ride of $1.05 in the case of the general service customers, as set out in Table 6.1. In keeping with the generic Decision a variance account will be established, the details of which will be communicated in due course.

Table 6.1

Toronto Hydro

Smart Meter Application

	Residential	General Service	Incidental	Total
Meters Planned	150,000	7,500		157,500
Meter Months (Straight Line)	975,000	48,750		1,023,750
Capital Applied For	$ 37,450,000	$ 11,227,000	$ 3,000,000	$ 51,677,000
Depreciation Expense	$ 1,248,333	$ 374,233	$ 300,000	$ 1,922,567
Net Fixed Assets	$ 36,201,667	$ 10,852,767	$ 2,700,000	$ 49,754,433
Net Fixed Assets (1/2)	$ 18,100,833	$ 5,426,383	$ 1,350,000	$ 24,877,217
Working Capital Allowance	$ 278,100	$ 13,905	$ 51,675	$ 343,680
Rate Base	$ 18,378,933	$ 5,440,288	$ 1,401,675	$ 25,220,897
WACC *	6.52%	6.52%	6.52%	6.52%
Return On Rate Base	$ 1,197,755	$ 354,544	$ 91,347	$ 1,643,646
Operating Expenses	$ 1,854,000	$ 92,700	$ 344,500	$ 2,291,200
Depreciation	$ 1,248,333	$ 374,233	$ 300,000	$ 1,922,567
PILs	$ 690,642	$ 205,360	$ 166,985	$ 1,062,987
Revenue Requirement	$ 4,990,730	$ 1,026,837	$ 902,832	$ 6,920,400
Net Amount Disallowed	-$ 1,578,230	-$ 42,488	$ -	-$ 1,620,718
New Revenue Requirement	**$ 3,412,500**	**$ 984,349**	**$ 902,832**	**$ 4,396,849**

Metered Customers		
Regular Residential	597,210	
Less than 50 kW		66,505
50 to 1000 kW - Interval		1,682
50 to 1000 kW - Non Interval		9,550
Intermediate Use (1000 - 5000 kW)		511
Large Use (> 5000 kW)		47
Total Metered Customers	597,210	78,295
Monthly Fixed Rate Adder	**$0.48**	**$1.05**

* WACC adjusted to reflect the Board's Decision for the reduciton of Debt Rate

6.2 STANDBY RATES

6.2.1 Toronto Hydro has five standby rates applicable to distributor generators in its service area. The Board has considered this matter in the generic hearing and has determined that separate proceeding should be established for standby rates for all Ontario electricity distributors. In order to protect the interests of all parties, all standby rates which are applied for as part of the rate application for 2006 rates are approved on an interim basis.

6.2.2 Toronto Hydro proposed to harmonize its standby rates in the respective rate classes. The Board accepts Toronto Hydro's proposed rates. As noted, the approval is interim.

6.3 LOW VOLTAGE RATES

6.3.1 Toronto Hydro included in its Application recovery of ongoing Low Voltage ("LV") charges that Hydro One Networks will be levying on Toronto Hydro for Low Voltage wheeling distribution services provided to it.

6.3.2 The Board notes that this estimate reflects Hydro One Networks' current approved LV rate of $0.56/kW. The Board further notes that Hydro One Networks has applied for an LV rate of $0.63/kW in its 2006 rate application RP-2005-0020/EB-2005-0378, and the Board has approved this rate.

6.3.3 The Board is of the view that the LV adjustment that Toronto Hydro has included in its Application is insufficient to recover its expected LV charges in 2006, as this amount does not reflect the updated Hydro One Networks rate. Although the Generic Decision provides that embedded distributors are to track differences between LV costs charged by the host distributor(s) and corresponding revenues recovered from ratepayers, the Board seeks to minimize systematic sources of variance. The Board is of the view that Toronto Hydro's rates should reflect the LV rates authorized by the Board for the host distributor.

6.4 DIVIDENDS

6.4.1 Considerable discussion in the Toronto Hydro Application concerned the relationship between utility and its parent, the City of Toronto. As indicated previously in this Decision, this concerned payments for shared services and the above market rate of interest the utility was paying the City of Toronto. It also concerned the extremely high dividend payout made to the City. Much of the information has been filed in confidence. It is sufficient to say that there was a very dramatic increase in the dividend payouts in 2004 and 2005. The level of dividends appears to be greater than the net income of the utility over at least a two year period.

6.4.2 At one time, there was a shareholder direction that limited the dividend payout to 40% of the utility's income, but that was changed to 50% of consolidated income. Moreover, it appears that there were special dividends over and above that amount.

6.4.3 In addition, the utility purchased the street lighting business from the City of Toronto. A number of intervenors questioned the prudence of that investment, which totalled $50 million. The information filed with the Board indicated that the business would not be yielding a positive income for sometime. The utility's explanation was that they had front loaded certain costs.

6.4.4 The question arises as to whether the Board should restrict the dividend payout by the utility. To the extent a utility pays all of its retained earnings to the shareholder, it will become more dependent on borrowing and this may have an adverse effect on its credit rating.

6.4.5 A related question is the independence of the directors. The evidence in the hearing is that the directors of the utility and the parent, Toronto Hydro Corporation are currently identical. And none of the members of management are to be on the Board. This is an unusual situation.

6.4.6 There is a requirement that at least one third of the directors of the distributor[10] must be independent but that rule will not apply to this utility until July 1, 2006. In the course these hearings the utility has confirmed that it will comply with the requirement and at that time, the independent directors will be appointed.

6.4.7 Given the unusual high level of dividend payout and the concern expressed by a number of parties, the Board believes that it is appropriate that any dividend paid by the utility to the City of Toronto should be approved by a majority of the independent directors.

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[10] Under section 2.1.2 of the Affiliate Relationships Code for Electricity Distributors and Transmitters ("ARC"), a licensed electricity distributor must ensure that at least one-third of its Board of Directors is independent from any affiliate. For distributors that are "municipal utilities" as defined in the ARC, this requirement comes into effect on July 1, 2006. The following persons are not considered independent within the meaning of section 2.1.3 of ARC: a shareholder, director, officer or employee of an affiliate; and where the affiliate is a municipality, the mayor, a member of the municipal council, a member of a "local board' as defined in the *Municipal Act, 2001* or an employee of the municipality. See Compliance Bulletin 200601, February 24, 2006.

6.4.8 Much of the controversy in this case has been dominated by discussion about non arms length transaction between the utility and the City of Toronto, whether it relates to dividend payouts, payment of interest on loans or the purchase of goods and services. The introduction of independent directors will be a step in the right direction. The requirement that independent directors approve dividend payouts to affiliates will give the public greater assurance that the interests of ratepayers are not subservient to those of the shareholders. The Board believes this is in keeping with the policy intent of Section 2 of the ARC.

6.4.9 This provision will be reviewed by the Board in the next rate case. At a minimum it will signal the Board's serious concern with the state of inter-affiliate relations.

7. RATE IMPLEMENTATION

7.0.1 Toronto Hydro applied for a distribution revenue requirement of $456.8 million. Reductions to this amount result from the Board's finding reducing the interest payments to the utility's affiliate, and the finding in Chapter 5 that reduces the revenue requirement associated with the smart meter initiative. These, with other minor adjustments result in a revised revenue requirement of $436.5 million, as indicated in Table 7.1.

7.0.2 The proposed allocation of distribution revenue requirement of the various customer groups has been accepted by the Board.

7.0.3 The Board directs the company to file with the Board and all intervenors of record a draft Rate Order and the tariff and rates to reflect the Board's finding in this Decision. The tariff and rates schedule shall have an effective date of May 1, 2006 and shall be final with the exception of the standby rates which will be interim. The company shall consult with Board staff as to the tariff and rates schedule so as to be consistent with form approved or to be approved for the other electricity distribution utilities. The intervenors have five calendar days to respond this draft Rate Order. The company should respond as soon as possible to any comments by the intervenors.

7.0.4 A number of intervenors eligible for costs have requested costs. These intervenors should file their cost statements with the Board and Toronto Hydro within 15 days of issuance of this Decision. Toronto Hydro should respond within 15 days of receipt. Any reply submissions should be delivered within five days of Toronto Hydro's response. Toronto Hydro is also directed to pay the Board's cost upon receipt of the invoice.

Table 7.1

Toronto Hydro
Revenue Requirement Adjustments per Decision

	Per Application	Interest Adjustment	Removal of Residential SM	Removal of GS SM	LV Adjustment	Smart Meter Rate Rider	Per Decision	Change	*% Change*
Current Year Assets	$ 1,613,253,772		-$ 36,201,667	-$ 10,852,767			$ 1,566,199,339	-$ 47,054,433	
Prior Year Assets	$ 1,540,670,360						$ 1,540,670,360	$ -	
Net Fixed Assets	$ 1,576,962,066		-$ 18,100,833	-$ 5,426,383			$ 1,553,434,849	-$ 23,527,217	*-1.5%*
Working Cap Allow	$ 307,855,312		-$ 278,100	-$ 13,905			$ 307,563,307	-$ 292,005	*-0.1%*
Rate Base	$ 1,884,817,378		-$ 18,378,933	-$ 5,440,288			$ 1,860,998,156	-$ 23,819,222	*-1.3%*
Return On Rate Base	$ 141,483,242	-$ 18,649,694	-$ 1,197,755	-$ 354,544			$ 121,281,249	-$ 20,201,993	*-4.4%*
OM& A Expense	$ 163,565,697		-$ 1,854,000	-$ 92,700			$ 161,618,997	-$ 1,946,700	*-0.4%*
Amortization Expense	$ 128,513,000		-$ 1,248,333	-$ 374,233			$ 126,890,433	-$ 1,622,567	*-0.4%*
PILs	$ 47,634,254		-$ 690,642	-$ 205,360			$ 46,738,252	-$ 896,002	*-0.2%*
Low Voltage	$ 104,360				$ 13,045		$ 117,405	$ 13,045	*0.0%*
Smart Meter Rate Rider RES						$ 3,412,500	$ 3,412,500	$ 3,412,500	*0.7%*
Smart Meter Rate Rider GS						$ 984,349	$ 984,349	$ 984,349	*0.2%*
Revenue Offsets	-$ 24,504,437						-$ 24,504,437	$ -	
Toronto Hydro Application	**$ 456,796,116**	**-$ 18,649,694**	**-$ 4,990,730**	**-$ 1,026,837**	**$ 13,045**	**$ 4,396,849**	**$ 436,538,749**	**-$ 20,257,367**	*-3.9%*

8. DIRECTIONS OF THE BOARD

8.0.1 In addition to disallowing certain expenses and adjusting the revenue requirement, the Board has in this Decision, issued specific directions to the utility. They can be summarized as follows:

1. Direction that the utility file two compensation studies as specified in the Decision (Section 3.1);

2. Direction that the utility file a lead-lag study prior to the next rate case (Section 4.1);

3. Direction that the utility conduct proper cost allocation study with respect to corporate overhead cost (Section 3.2);

4. Direction that the utility file comprehensive capital budget prior to the next rate case (Section 4.2);

5. Direction of the utility ensure that at least one third of its Board of Directors is independent from its affiliates as of July 1, 2006 in accordance with Compliance Bulletin 200601 (Section 6.5);

6. Direction that any dividend payout by the utility to an affiliate be approved by a majority of the independent directors (Section 6,4); and

7. Direction that the utility file a proposal to reduce its line losses by at least 5%. (Section 3.4)

DATED at Toronto, April 12, 2006

Original Signed by

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Gordon E. Kaiser
Vice Chair and Presiding Member
Signed on Behalf of the Board Panel