RP-2004-0188

HYDRO ONE NETWORKS, INC

REPLY SUBMISSION

FEBRUARY 28, 2005

Hydro One Networks (Hydro One) relies on the positions expressed in its Argument-in-Chief submitted on February 14, 2005 in this submission. Hydro One provides comments on issues raised and positions taken in the Arguments filed by other stakeholders in this proceeding to assist the Board in designing the final version of the 2006 EDR Handbook. The main focus of this reply submission deals with the proposal to implement LV charges in 2006 and specific issues respecting Chapters 4, 6, 7 and 14.

Comments on the Recovery of Hydro One's LV Charges.

Some utilities and other parties have expressed concerns about the practicality and timing associated with implementation of ongoing LV charges in 2006. These costs are addressed in the draft 2006 EDR Handbook in Chapter 3, pages 18 – 20, under the heading, Tier 1 Adjustments: Distribution Expenses. In our Argument-in-Chief in this proceeding, and in response to Ms. Lea's request for information in her closing testimony at the hearing, Hydro One proposed a practical approach to implementing ongoing LV charges on May 1, 2006. For convenience, that proposal is appended to this submission as Attachment 1.

Hydro One proposes that embedded distributors use Hydro One's current approved LV rates to develop their own pass-through charges to recover these costs from their customers. Hydro One plans to file a cost allocation study in late 2005 to include cost allocation and rate design initiatives in its application for rates on May 1, 2006. Any changes to the LV rates that the Board approves for May 1, 2006 implementation will better reflect costs going forward. Variances between the pass-through charges implemented by embedded distributors and the actual LV charges they receive from Hydro One starting on May 1, 2006 will be captured in their RSVA connection accounts. This proposal will enable Hydro One to implement rates, which recover its approved costs, while holding the embedded LDCs harmless.

Comments on Specific Issues in the Draft Handbook

1. Interest Rate for Construction Work in Progress - CWIP (Chapter 4)

Several participants recommend the use of WACC to interest improve CWIP balances by adopting an AFUDC methodology. Although Hydro One has recommended Alternative 1, using the embedded cost of debt, it would not be opposed to the adoption of WACC. The key concern is that a long-term financing rate is the appropriate rate to use, whether it be WACC or the embedded cost of debt.

2. Level of Filing Detail (Chapter 4 and 6)

Hydro One notes general support for filing capital and operating expense information at an aggregated USofA level. It is not useful to file this information at a lower level as the different accounting practices used by the various LDCs complicate and slow down the review process without a corresponding regulatory benefit. Filing at the aggregate level

will average out these discrepancies and result in a useful analysis and review. For areas where more information is required, the interrogatory process would be the proper forum for more detailed reviews, within reasonable limits. Accordingly, Hydro One suggests that the Handbook should be modified to constrain the review of USofA account information to an aggregated level.

3) Taxes/PILs (Chapter 7)

Hydro One supports the evidence of the Coalition of Issue Three Distributors (CITD) with respect to the proper treatment of disallowed expenses. The CITD's reply argument addresses all the key areas of concern that Hydro One has respecting the evidence and argument of the School Energy Coalition (SEC) and the arguments of the Canadian Manufacturers and Exporters (CME) and the London Property Management Association (LPMA) which have endorsed SEC's positions.

Hydro One is very concerned with the evidence presented by SEC respecting this topic. SEC has used examples in support of its position that imply LDCs have undertaken, or would entertain conduct to gain tax credits that is in violation of their license conditions under: the Electricity Act, 1998; the OEB Act, 1998, Section 71; the Affiliate Relationships Code for Electricity Distributors and Transmitters; and the Municipal Act, 2001[1]. SEC also believes that the Board would turn a blind eye to such activities and therefore recommends that a punitive tax regime should be imposed by the Board to ensure such conduct will not take place.[2] The recommendations put forth by SEC are counter to any regulatory practice in North America and they violate four key regulatory principles: i) the stand-alone principle, ii) the no harm to ratepayers principle, iii) the level playing field principle, and iv) the principle that benefits should follow costs.

Adoption of SEC's proposition that the ratepayers are entitled to receive all or part of the tax savings associated with the activities listed in the table below would result in the utility's shareholder not being able to receive the level of equity return deemed reasonable by the Board. In Ms. McShane's undertaking response E-5-1, in her evidence filed at Exhibit B.9 and in her oral testimony, it is clearly demonstrated that this would indeed be the result of adopting SEC's proposals.

Hydro One submits that the Board should reject SEC's proposals. The subject areas of concern are summarized in the following Table along with a brief statement of Hydro One's position and a summary rationale for rejecting SEC's proposal. Based on Ms McShane's evidence and on regulatory precedent that Hydro One is aware of, tax savings associated with these items should be to the sole benefit of the shareholder.

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[1] Section 3(8) of O. Reg. 438/97 to the Municipal Act
[2] It is suggested that if the SEC has evidence of such actions being prevalent in the electricity industry, that they have a duty to present such evidence to the OEB. Electricity distributors cannot respond to innuendoes and statements that have not been supported by factual evidence.

Section and Topic Heading	Hydro One's Position	Rationale for Rejecting SEC's Position
7.1.2.2 Non-recoverable & Disallowed Expenses (including charitable and political donations)	100% of tax savings associated with Board disallowed expenses should be to the shareholder's benefit.	These costs are not included in approved cost of service of the LDC. Any such expenditure is made by the shareholder from the Board approved return on equity.
7.1.2.2 Eligible Capital Expenses	100% of tax savings associated with the October 1, 2001 fair market value adjustment should be to the shareholder's benefit.	The approved rates of LDCs are based upon NBV, not a value reflecting the 2001 FMV bump. In any case, the tax benefit is recaptured upon sale of the assets of the business or change in tax status of the LDC. Accordingly, if the ratepayer is to obtain the benefit, it will be necessary to incorporate a specific provision in the Handbook that would compensate the LDC for the recaptured tax benefit.
7.1.2.2 Purchased Goodwill	100% of tax savings associated with purchased goodwill and other intangible assets should be to the shareholder's benefit.	The approved rates of LDCs are based upon NBV, not a value reflecting any purchased goodwill.
7.1.2.5 Loss carry-forwards	100% of tax savings associated with loss carry-forwards should be to the shareholder's benefit.	A loss, whether due to a utility's revenue being less than the value included in the determination of revenue requirement or expenses incurred being greater than approved, is irrelevant to the 2006 tax calculation for utility purposes. The ratepayer has not contributed to this loss and is therefore not entitled to share in the associated tax savings.
7.1.2.7 Amortization of tangible assets and capital cost allowance	The calculation of 2006 CCA deductions should not include any estimate of 2005 and 2006 capital expenditures.	Calculating 2006 CCA based upon an adjusted UCC balance for 2005 and 2006 capital expenditures is totally inconsistent with an historical year rate base and book depreciation treatment.
7.1.2.8 Interest deduction	Interest deducted in computing the 2006 tax calculation should be the same as that allowed for recovery in 2006 rates, as established in Chapter 5 of the Handbook.	Only interest allowed for rate-setting purposes should be deducted for tax calculation purposes.

Assuming that a historical test year is used, the income tax component of revenue requirement is established by taking the test year rate base, multiplying that amount by the Board approved equity return component and grossing up the resulting amount for the tax impact. The other revenue requirement components, namely interest, depreciation and allowed OM&A expenses are added to this return component to determine overall revenue requirement. None of these components include any expenditures for a period beyond 2004 which is contrary to SEC's suggestion that the ratepayer should receive the associated income tax benefit.

SEC and LPMA try to rationalize their tax savings proposals under the guise of the debt retirement charge. These two issues are totally unrelated. PILs was established to maintain a level playing field between private and public electric utilities and possibly between gas and electric utilities. The fact that PILs is being used to pay down the stranded debt per current government policy is not relevant to how the amount of PILs to be paid should be calculated. If the ratepayer is not paying for certain commercial business activities in their rates, he or she should not be concerned with receiving any associated tax savings. For example, a ratepayer who is an individual cannot receive the tax savings associated with making an RRSP contribution if they do not make the RRSP contribution. The same principle should apply with respect to disallowed and non-recoverable expenditures.

4. Comparators and Cohorts (Chapter 14)

The Schools Energy Coalition (SEC) and Energy Probe (EP) have developed proposals which promote the use of benchmarking for comparing utilities in a number of areas including rate setting and cost analysis. Although Hydro One agrees that we should give consideration to benchmarking as a tool for streamlining and improving regulatory processes, the first step in benchmarking is to develop consistent definitions and accurate data gathering processes. A Comparators and Cohorts mechanism which uses poor quality or non-comparable data will not produce correct comparisons, thereby resulting in an ineffective and inefficient Regulatory process.

The Board has clearly stated that, given the preliminary nature of the methodologies and information sources, the use of Comparators and Cohorts will be limited to screening for the 2006 rate setting process. This was supported by evidence provided by Hydro One's benchmarking expert Dr. Mark Lowry. It is inappropriate to now indicate in Chapter 14 of the EDR Handbook that benchmarking should be used in setting rates.

Attachment 1

General Comments on LV Charges

To assist the Board in implementing on-going LV charges from Hydro One to Embedded LDCs the following proposal is being made. Ms. Lea raised this issue at the conclusion of the hearing on February 4, 2005 (Vol. 11, TR 886 – 891) and asked for assistance to the Board in whether the forward-looking elements should be included in the handbook.

Background on LV rates

The currently approved LV rates, established on the basis of 1999 costs, have not been implemented as a result of Bill 210. The bulk of the LV charges come from the Shared LV line charge that is applied to 1999 billing parameters. The LV charges that were approved in RP-2000-0023 were determined on the basis of a cost allocation study. The use of 1999 billing parameters was approved by the OEB as an interim measure in the interest of implementing unbundled electricity distribution rates for market opening. It is expected that the next generation of LV rates to be submitted by Hydro One to the OEB for review and approval will be based on more recent costs and charges and will be on going forward (i.e. 2006) consumption levels of Embedded customers.

It is expected that Embedded LDCs will have to submit their application for 2006 rates in the Summer of 2005, that is before Hydro One submits its own application for 2006 rates in the Fall of 2005. Hydro One's application will include new evidence on the cost of LV service and rates that will become effective in May 2006. Therefore, Embedded LDCs will not have the newly approved LV rates by the time they file their submissions to the OEB in the Summer of 2005. The issue then is what needs to be done to assist the Embedded LDCs in completing their obligations under the revised EDR Handbook requirements in respect of LV charges.

Hydro One Proposal

Hydro One proposes that Embedded LDCs use the current, approved LV rates, applied to their forecast 2006 consumption levels in their rate applications. Under this proposal, Hydro One would proceed as planned with its Distribution rate application in the fall of 2005 and Embedded LDCs would estimate their LV charges for 2006 based on the currently approved LV rates and would apply these rates to the LDCs' 2006 consumption estimates. Any variance that would arise as a result of the difference between Hydro One's new LV charges that come into effect in 2006 and the current LV rates applied as proposed above would be recorded in the RSVA Connection account and would be cleared in a future OEB proceeding.

The approach under this proposal would allow Embedded LDCs to proceed in a timely fashion with their 2006 rate applications. Use of this proposal as a starting point for the

implementation of LV charges is premised on the fact that a formal cost allocation study was prepared and there was significant debate on cost allocation with respect to the LV rates in the RP 2000-0023 proceeding. Given that the going forward distribution rates for Embedded LDCs in 2006 will not be cost based, the use of existing approved rates is not out of context in the general process of redressing the recovery of costs from the appropriate entities. This approach, although not perfect, at least moves all LDCs in the right direction of implementing on-going LV charges. It was generally argued in the Regulatory Assets Review hearing that recovery of the LV costs should be implemented in as timely a manner as possible to avoid further accumulation of deferred charges and related interest to be recovered in future rates.