Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

EB-2008-0205

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

BEFORE: Paul Vlahos
Presiding Member

Ken Quesnelle
Member

DECISION – PART II

June 10, 2009

Introduction

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

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

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

The Board had determined that it would consider OPUCN's application in two parts. The Board released its decision on March 20, 2009 on the first part dealing with the mechanistic aspects of the price cap adjustment and with certain aspects of the loss revenue adjustment mechanism (LRAM) and sharing services mechanism (SSM). Part II, the request rate relief under the incremental capital module would be considered at a later date.

The Part II proceeding included an oral hearing on April 6, 2009. Final written submissions were received by the Vulnerable Energy Consumers Coalition ("VECC"), the School Energy Coalition ("SEC") and Board staff, and written reply submissions by OPUCN. This is the Board's decision on Part II.

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

Overview of the ICM Framework and Assessment Criteria

The Board's objective in establishing the incremental capital module was to enhance the regulatory efficiency of the incentive rate mechanism, which is intended to be formulaic and simplistic in its application, by adding a method to accommodate extraordinary capital spending requirements should they arise during the term of the incentive rate mechanism. The ability to address extraordinary capital spending requirements within the IRM framework increases the efficiency opportunities without requiring a full cost of service rebasing review.

The incremental capital module was intended to address, in a prospective manner, extraordinary spending requirements that were identified during the course of the incentive rate mechanism term.

In that regard, in its Addendum to the Supplemental Report the Board established a threshold, below which recourse to the Incremental Capital Module would not be available. That threshold consists of the amount of the depreciation allowance reflected in rates, the additional revenues from the price cap mechanism adjustment and an assumed growth factor. To eliminate marginal applications the Board added 20% to the sum of the above parameters. The total amount serves as the threshold over which revenue requirement relief may be considered by the Board.

The Board also set out certain filing requirements or criteria to be used in assessing an applicant's request for capital expenditure relief over the threshold. These are set out on pages VI and VII of Appendix B in the Supplementary Report and are reproduced below.

- An analysis demonstrating that the materiality threshold test has been met and that the amounts will have a significant influence on the operation of the distributor

- A description of the underlying causes and timing of the capital expenditures including an indication of whether expenditure levels could trigger a further application before the end of the IR term

- An analysis of the revenue requirement associated with the capital spending (i.e., the incremental depreciation, OM&A, return on rate base and PILs associated with the incremental capital), and a specific proposal as to the amount of relief sought

- Justification that amounts being sought are directly related to the claimed cause, which must be clearly non-discretionary and clearly outside of the base upon which current rates were derived. This includes historical plant continuity information for each year of the IR plan term since the last Board-approved Test Year

- Justification that the amounts to be incurred will be prudent. This means that the distributor's decision to incur the amounts represents the most cost-effective option (not necessarily least initial cost) for ratepayers

- Evidence that the incremental revenue requested will not be recovered through other means (e.g., it is not, in full or in part, included in base rates or being funded by the expansion of service to include new customers and other load growth)

- A description of the actions the distributor will take in the event that the Board does not approve the application

The Application

OPUCN requested that the Board provide rate relief for four projects: Concrete Pole Replacement; Long Term Load Transfer Elimination; Distribution Reliability Improvement; Mobile Work Force. The total capital cost of the four projects was initially estimated at $3.5 million. As described below, the total estimated capital cost was later revised to $2.2 million.

A summary of each of the four specific projects is set out below.

Concrete Pole Replacement

The original application included a request for $1,521,800 in 2009 capital spending for replacing 220 concrete poles as these poles were of similar age and type as a pole that had failed therefore raising safety concerns for the public and OPUCN's employees. Following a more detailed inspection OPUCN determined that there were 30 poles that required immediate replacement and revised its capital spending estimate for this project to replacing only 30 poles at a cost of $210,000.

Long Term Load Transfer (LTLT) Elimination

Long Term Load Transfer (LTLT) arrangements came about to allow adjacent distributors to maintain service areas while providing connections to new customers from available facilities. Under a LTLT arrangement a customer requesting connection from the geographic distributor would be served by the adjacent physical distributor.

The Board had mandated in the Distribution System Code that all long term load transfers ("LTLT") be eliminated by January 31, 2009. OPUCN had applied to the Board for an extension to the deadline to December 31, 2011. The instant application included capital costs of $907,500 to complete the elimination of all 32 LTLT in 2009, currently served by Hydro One, as OPUCN's exemption application had not been dealt with by the Board at the time OPUCN filed its evidence in the instant application. Subsequently, on November 26, 2008, the Board approved OPUCN's request for an extension to the deadline to complete the removal of LTLT. Also, prior to the start of the oral hearing the Board published a notice proposing amendments to the Distribution System Code that would extend the deadline for LTLT removal to June 30, 2014. Despite these developments, OPUCN contended that it is still important to complete the LTLT removal in 2009. The rationale given is improved reliability for the customers concerned.

Feeder Replacement

An existing feeder has been identified by OPUCN as a poor performer. The estimated capital cost for replacing it is $850,000. OPUCN's rationale for pursuing this project in 2009 is that by replacing a poor performing distribution feeder the overall reliability statistics of OPUCN will improve and grounded this need on the Board's findings in the 2008 rates decision (EB-2007-0710). During the oral hearing OPUCN witnesses also noted that there are worker safety issues associated with the current feeder due to its sub-standard construction.

Mobile Work Force

The purpose of this proposed project is to automate the current manual processes used for creating work orders for field staff and for capturing the records of work performed. The estimated cost of the project is $254,000.

Regulatory Costs

At the oral hearing OPUCN informed the Board that it was now seeking to recover the estimated $25,000 in costs associated with this application. OPUCN also proposed that a variance account be used to track the costs and recoveries, to allow a true-up of those expenses and revenues at its next rate rebasing proceeding.

The Threshold Test

Based on the preliminary IRM parameters available in October 2008, OPUCN calculated the Incremental Capital Threshold at $6.6 million. OPUCN also provided calculations indicating a projected 2009 capital budget of $11.8 million submitting that there is $5.2 million of potentially eligible capital spending.

OPUCN then reduced this amount to $3.5 million, primarily due to carry-overs from the Board-approved 2008 capital budget.

During the course of the proceeding the Board-approved price escalator was updated and, as noted earlier, the capital spending requirement for the Concrete Pole Replacement project was reduced to $210,000 from the original $1.5 million. OPUCN claimed that the result of those changes is that capital spending potentially eligible for relief is $2.3 million and that the four proposed projects at $2.2 million fall under that level.

Submissions - VECC

VECC argued that the calculation of potentially eligible capital under the incremental capital module is overstated. The amount should be reduced to $1.7 million to account for the fact that not all the 2009 capital program has been clearly demonstrated as being non-discretionary.

VECC argued that while the concrete pole replacement program can be considered incremental, OPUCN did not spend $346,700 in the Board-approved 2008 capital budget allocated for spending for replacing wood poles.

According to VECC, the LTLT and the Feeder Replacement projects should be considered ineligible for funding on the grounds that OPUCN has not demonstrated that the projects are non-discretionary for 2009. A supporting consideration in both cases is the fact that there are incremental revenues/cost savings from these projects.

The Mobile Work Force project according to VECC should also be rejected on the basis that it is not non-discretionary and the savings over the IRM period can be expected to cover a significant portion of the costs.

VECC argued that the request for regulatory expenses should be rejected. The Board should apply the materiality threshold of 0.5% of distribution revenue as it does for Z-factors for the size of this utility OPUCN's distribution revenues are roughly $20 million which suggests a materiality threshold of $100,000, which is unlikely to be exceeded in this case.

Submissions – SEC

SEC submitted that OPUCN has not demonstrated that its capital budget, taken as a whole, meets the eligibility criterion under the incremental capital module. Also, the four specific projects do not meet the Board's criteria in that they are neither non-discretionary and/or represent expenditures designed to increase productivity which is not properly the subject of an incremental capital module.

While in SEC's view the pole replacement project is non-discretionary, the cost is offset by other projects in 2009 that are discretionary.

According to SEC, if OPUCN believed, as it did when it applied for the LTLT elimination extension that this project did not need to be completed in 2009, then the project is not non-discretionary. SEC submitted that the only reason OPUCN now seeks to accelerate this project is because the capital module exists to provide funding, which is not consistent with the purpose of the incremental capital module.

In SEC's view, the replacement of the feeder is not non-discretionary and it appears to be only driven by the existence of an incremental capital module.

In SEC's view, the Mobile Work Force project is driven by OPUCN's desire to achieve cost efficiencies, with the savings remaining within the utility for the duration of the IRM period, which is not the purpose of the incremental capital module but is the purpose of the IRM regime.

SEC argued that OPUCN's request for regulatory costs is a single-issue ratemaking; it ignores other cost reductions from 2009 forecast levels. Moreover, as it now appears that OPUCN will not be rebasing until 2012, the $53,000 in regulatory costs embedded in the current rates will result in over-collection by that amount as the year for rebasing has been extended by one year.

Submissions – Board Staff

Board staff questioned whether OPUCN has convincingly demonstrated that the feeder replacement, the Mobile Workforce project, and the LTLT elimination project are non-discretionary for 2009.

Board staff noted that the proposed replacement of the existing feeder has a risk mitigation ranking lower than all the other Reliability/Safety projects that were incorporated into OPUCN's 2009 budget. This implies that this project is discretionary.

With respect to the Mobile Workforce project, Board staff submitted that the explanation provided by OPUCN itself clearly demonstrates that this project is not non-discretionary; OPUCN's management has the discretion to implement it in a different time period.

Board staff submitted that, as the Board granted OPUCN its requests for an extension to eliminating LTLT to December 13, 2011, the proposed completion of the project during 2009 is not non-discretionary.

Board staff noted that, if the Board accepts the proposed projects as non-discretionary, three of the four projects will lead to savings or additional revenues. By replacing the feeder, there will be savings, which were not quantified, in the form of a reduced need for emergency response to power outages. The Mobile Workforce project, once fully implemented, would lead to estimated savings of $88,375 per year. The proposed elimination of LTLT in 2009 would lead to incremental revenues of around $10,000 per year starting in 2009. Board staff noted that none of the savings and additional revenues identified above had been netted from the requested revenue requirement relief, which should be done to be consistent with the filing requirements under the incremental capital module.

With respect to OPUCN's request for regulatory costs, Board staff noted that while OPUCN's regulatory expenses may be greater this year than the amount incorporated in its distribution rates, the reverse may occur in future years. Distribution rates are set to recover regulatory expenses in an "average year" and actual costs may deviate up or down in any given year. The fact that regulatory expenses are not tracked in a variance account is indicative of the Board's policy that under-recoveries should not be recovered and over-recoveries should not be refunded.

Applicant's Reply Submissions

OPUCN did not agree that the entire capital budget for 2009 must be proven to be non-discretionary as there is no reference to such requirement in the Board's reports. Even so, OPUCN argued that it has demonstrated that all capital spending contemplated in 2009 is non-discretionary.

With respect to VECC's position that OPUCN under-spent on its wood pole replacement program in the amount of $346,700 and that this money should now be available for replacing the failing concrete poles, OPUCN submitted that the pole replacement program was delayed due to emergency work but the amount approved in rate base was not left unspent; it was spent on other projects.

With respect to intervenors' and Board staff's arguments regarding the feeder project, OPUCN acknowledged that there may be savings, but cannot be estimated and they would not be material as they would only relate to a reduced need for emergency response. The feeder was excluded from the previous budget because of limited availability of funds. OPUCN disagreed with VECC's interpretation with regard to the Board's decision on reliability related spending. In OPUCN's view, the Board in its decision required OPUCN to make all possible investments to support reliability. OPUCN argued that the Board specifically contemplated life-cycle replacement of aging distribution plan to be a legitimate driver for this application.

With respect to the Mobile Work Force project, OPUCN argued that the drivers for this project go beyond cost savings. They go to the anticipated loss of experienced work force due to pending retirements, which can lead to safety concerns as new hires are less experienced.

With respect to Long Term Load Transfers, OPUCN re-iterated that the project is prudent and consistent with the incremental capital module.

With respect to its request for regulatory costs, OPUCN stated that it does not believe that there will be any over-recovery of regulatory costs embedded in current rates and that the regulatory costs and of the instant application should be considered separately.

Board Findings

In the Board's view, the issues that the Board first needs to address in this application are the following: Has the threshold test been applied in a manner consistent with the form and intent of the ICM and does the capital spending for which the applicant seeks relief satisfy the Board's other criteria?

From the earlier description of the evidence regarding capital spending and the threshold test, it is clear that OPUCN's approach is to calculate an amount that it deems to be "eligible" by adding its normally planned capital spending to the capital spending associated with the proposed projects and to then subtract the calculated threshold amount. This calculation is intended to illustrate that the capital spending for which relief is sought is less than the difference between the normally planned budget and the threshold amount.

The Board does not consider a result of such a calculation to be determinative in its consideration of the relief sought in an ICM application, for the following reasons.

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

> The Board notes that there are clearly differences in perception as to the purpose of the incremental capital module. Ratepayer groups perceive the capital module as a mechanism aimed solely at addressing extraordinary or special CAPEX needs by distributors. The distributors, on the other hand, perceive the module as a special feature of the 3rd Generation IR architecture which would enable them to adjust rates on an on-going, as-needed basis to accommodate increases in rate base.
>
> In the Board's view, the distributors' view is not aligned with the comprehensive price cap form of IR which has been espoused by the Board in its July 14, 2008 Report. The distributors' concept better fits a "targeted OM&A" or "hybrid" form of IR. This alternative IR form was discussed extensively in earlier consultations but was not adopted by the Board. The intent is not to have an IR regime under which distributors would habitually have their CAPEX reviewed to determine whether their rates are adequate to support the required funding. Rather, the capital

> module is intended to be reserved for unusual circumstances that are not captured as a Z-factor and where the distributor has no other options for meeting its capital requirements within the context of its financial capacities underpinned by existing rates**.**

OPUCN's approach turns the incremental capital module into the special feature that the Board warned against which would enable distributors "to adjust rates on an on-going, as-needed basis to accommodate increases in rate base". OPUCN's approach is to in effect true-up rate base, except for the Board's deadband provision. In fact the deadband would be neutralized by the provision in the module where the half year rule in recognizing capital expenditures in the test year is abolished in favour of the full year rule. The purpose of the IRM regime would be defeated and the calculated relief in the capital module would be overstated.

There is a dispute by the parties whether a distributor must demonstrate that all of the planned capital spending in a test year is non-discretionary (i.e., must be done in 2009 in this case). The Board does not need to consider the level or prudence of total planned spending for a test year. The Board only needs to consider whether the planned budget exceeds the threshold amount and, if so, whether the threshold amount can reasonably be viewed as the minimum level of non-discretionary capital spending in a given test year. It is only then that the Board's other criteria, such as the non-discretionary nature of the proposed capital projects and consideration of the specific rate relief, come in play.

OPUCN did not submit its application in this manner; indeed it submits that it need not prove that the entire 2009 budget is non-discretionary because the Board's Report did not include this requirement. Unless a distributor can demonstrate that the threshold amount is comprised of non-discretionary spending, the threshold as interpreted by OPUCN would be effectively meaningless as it could virtually always be met by a distributor by including in its spending plans sufficient discretionary spending to trigger the threshold.

There was however sufficient evidence adduced through interrogatories regarding the nature of the capital plans for 2009 as intervenors attempted to ascertain whether there was any discretionary spending in 2009 to demonstrate that, if discretionary spending was deferred, it would allow for the proposed non-discretionary spending to be accommodated within the applicant's current rates. The Board is prepared to accept that the applicant's threshold level consists of non-discretionary spending. It is in this context that the Board examines the merits of the applicant's proposed spending on a project by project basis.

The Board does not accept the applicant's claim that all four projects contained in this application are non-discretionary. For reasons provided below the Board does not consider the LTLT, Feeder Replacement and the Mobile Workforce projects to be non-discretionary and therefore they are not eligible for relief. The Board only considers the concrete pole replacement to be both incremental and non-discretionary and therefore eligible for relief.

The Mobile Work Force project

The Board finds that while the Mobile Work Force project is incremental, it is not non-discretionary and therefore not eligible for funding under the incremental capital module. OPUCN's attempt to present this project as a reliability and safety issue has not been sufficiently demonstrated. This is clearly an efficiency initiative, which will generate savings for the utility. Qualifying this efficiency type of expenditure under the ICM would undermine the very purpose of the incentive ratemaking regime. This is not to say that the project is not worthwhile; however it does not meet the eligibility requirements for the ICM. Since the Board is not accepting this project as being eligible for relief, the Board need not deal with the Board staff recommended adjustments to the relief sought because of the potential savings.

Long Term Load Transfer (LTLT) Elimination

On November 26, 2008, the Board approved OPUCN's request for an extension to the deadline to complete the removal of LTLT to December 31, 2011. Also, prior to the start of the oral hearing the Board published a notice proposing amendments to the Distribution System Code that would extend the deadline for LTLT removal to June 30, 2014. Despite these developments, OPUCN contended that it is still important to complete the LTLT removal in 2009. The rationale given is improved reliability for the customers concerned.

Accelerating the LTLT elimination project to 2009 when OPUCN has applied for and received the extension to December 31, 2011 on the basis of customer service reliability is a weak rationale for eligibility under the ICM. Clearly reliability considerations were not an issue as recently as at the time OPUCN asked for the extension. No new information has been provided that would suggest the reliability concerns have escalated such that the project must now be considered as non-discretionary for 2009. From the testimony given, the Board concluded that the reason this project has been advanced to 2009 is because of the provision of the incremental capital module within the IRM. While the project appears to be prudent and it will have to be completed by 2014 as the Board has since adopted that amendment in the Distribution System Code June 10, 2009, the project is clearly not non-discretionary for 2009 and therefore ineligible for funding under the incremental capital module.

The Feeder Replacement project

With respect to the proposed feeder, in its reply submission OPUCN states that at page 25 of the Supplementary Report contemplates that " the application would substantiate the need for incremental capital due to drivers that are non-discretionary in the control of the distributor's management such as: life-cycle replacement of aging distribution assets; .. ". That quote is found in the July 14, 2008 Board Report, not the Supplementary Report issued on September 17, 2008. More importantly, the above quotation is the Board's reference of Board staff's proposal to the May 6, 2008 stakeholder meeting. This is not where the Board settled on this matter in either the July 14, 2008 report or the September 17, 2008 report, the latter containing the framework and the details of filing under the incremental capital module. The Board's articulation of what should govern the incremental capital module is as the Board has set out in this decision above.

In proposing the distribution feeder project in its pre-filed evidence, OPUCN also relied on its interpretation of the Board's findings in the 2008 rebasing decision regarding reliability. The Board does not agree with OPUCN's interpretation of that decision. The Board did not say that OPUCN should increase capital spending in order to improve reliability. At page 3 of that decision the Board stated:

> "On the basis of the additional information provided, the Board finds that the Company's "scoring matrix" of prioritizing needs is a reasonable approach and accepts the proposed level of capital additions for 2008. In so finding, the Board has noted the Company's relatively poor performance in the reported reliability indices, which is discussed elsewhere in this decision, and the capital expenditures would improve reliability performance".

At page 25 of that decision discussing reliability indices, the Board stated:

> "… the Board expects the company to be vigilant about its service reliability performance going forward and to ensure that the capital expenditures authorized by the Board do result in substantial improvements in that regard".

The "scoring matrix" of prioritizing needs was OPUCN's own. The proposed feeder was not part of that "scoring matrix". There is no fresh evidence that the feeder should jump on the priority list of the scoring matrix. While the project is incremental, it is not non-discretionary for 2009 and therefore not eligible for funding under the incremental capital module.

The Concrete Pole Replacement project

No party argued that this project was discretionary. Having deemed the applicant's threshold level to be composed of non-discretionary spending the Board finds that the project is incremental and due to the potential for serious negative consequences of not initiating the project the Board finds that the project is also non-discretionary. OPUCN is entitled to revenue requirement relief associated with the $210,000 planned expenditure.

Regulatory Costs

The Board will not allow recovery of the costs associated with this application or the establishment of a variance account. The ICM process should not be used to selectively provide relief for OM&A costs. In any event, OPUCN's rates rebased in 2008 include $53,000 in regulatory costs and were calculated on the basis that the rates would be rebased in three years. Given the change in the Board's policy where under 3GIRM, OPUCN is not required to apply for rebasing until 2012, the provision in rates for regulatory costs is more than adequate.

Conclusion

The Board wishes to emphasize that OPUCN's application was appropriately framed under the incremental capital module in the manner that it identified specific projects. In this Decision the Board has re-emphasised the expectations contained in its Supplemental Report Board regarding the non-discretionary spending composition of the threshold level. Future applications are expected to provide substantiating evidence on this matter.

The denial to provide rate relief for the three projects does not mean that these proposed projects are not prudent. It will be up to the company to decide whether it should proceed with these projects in the timeframe it is contemplating. In that regard, it may be necessary for the company to review its priorities in capital spending for the remaining of 2009 and to consider the Board's findings in this decision when it develops its future capital budgets.

The rate relief associated with the $210,000 Concrete Pole Replacement project was calculated by OPUCN at $27,000 annually. Given the relative insignificance of this amount to OPUCN's total revenue of about $19 million, and to avoid frequent rate changes since OPUCN's rates were adjusted recently (May 1, 2009), the Board authorizes OPUCN to record the $27,000 amount in an appropriate deferral account and bring the balance, with interest, for inclusion in rates at the time it makes its next IRM application.

Cost Awards

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

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

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

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

DATED at Toronto June 10, 2009
ONTARIO ENERGY BOARD

Original signed by

Paul Vlahos
Presiding Member

Original signed by

Ken Quesnelle
Member