



EB-2011-0144

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 for an order approving just and reasonable rates and other charges for electricity distribution to be effective May 1, 2012, May 1, 2013 and May 1, 2014.

BEFORE: Cynthia Chaplin
Vice-Chair and Presiding Member

Paula Conboy
Member

Marika Hare
Member

**DECISION WITH REASONS AND ORDER
ON THE PRELIMINARY ISSUE**

January 5, 2012

Background

Toronto Hydro-Electric System Limited (“THESL”) filed an application with the Ontario Energy Board (the “Board”) on August 26, 2011 under section 78 of the *Ontario Energy Board Act, 1998*, (the “Act”) seeking approval for changes to the rates that THESL charges for electricity distribution, to be effective May 1, 2012, May 1, 2013 and May 1, 2014. The Board assigned the application file number EB-2011-0144.

The filing was a prospective three year cost of service application. If the application is fully approved, the distribution portion of the monthly bill for a residential customer (who consumes 800 kWh per month) will increase by 18.7% in 2012, followed by a further increase of 12% in 2013 and a further increase of 12% in 2014. The distribution portion of the monthly bill for a General Service customer consuming 2,000 kWh per month and having a monthly demand of less than 50 kW would increase by 16.9% in 2012, followed by a further increase of 11.9% in 2013 and a further increase of 11.3% in 2014.

At issue at this stage is the Preliminary Issue as to whether the application should be accepted or dismissed, based on a consideration of the early rebasing criteria that have been established by the Board.

Active participants in this Preliminary Issue proceeding included the Association of Major Power Consumers in Ontario (“AMPCO”), Building Owners and Managers Association of the Greater Toronto Area (“BOMA”), City of Toronto (“the City”), Consumers Council of Canada (“CCC”), Energy Probe Research Foundation (“Energy Probe”), School Energy Coalition (“SEC”) and Vulnerable Energy Consumers Coalition (“VECC”).

Policy Framework

The Board’s 3rd Generation Incentive Regulation Plan (“3GIRM”) for Ontario’s electricity distributors is outlined in the *Report of the Board on 3rd Generation Incentive Regulation for Ontario’s Electricity Distributors* which was issued July 14, 2008. The policy was further refined in the Board’s subsequent report *Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario’s Electricity Distributors* which was issued on September 17, 2008.¹ The 3GIRM framework is composed of a first year of rates set on the basis of a cost of service application (the rebasing year), followed by three years of rates set using a formula with an inflation factor and productivity factors (the IRM period).

The 3GIRM framework itself includes important elements designed to address potential needs of distributors during the IRM period, including the following:

- An Incremental Capital Module (“ICM”): The first report established the ICM mechanism to address the treatment of incremental capital investment needs

¹ These reports are available on the Board’s website: www.ontarioenergyboard.ca

that arise during the IRM period. The appendix to that document outlined the eligibility criteria for ICM applications. The supplemental report established the materiality threshold.

- “Z factor” adjustments: These are for events that are not within management’s control. A distributor facing such circumstances is expected to supply the details of management’s plans for addressing these events and how the specified eligibility criteria have been met in support of the request for special cost recovery.
- The “off ramp”: If the achieved annual return on equity (“ROE”) deviates from the allowed ROE by more than plus or minus 300 basis points, a regulatory review may be initiated. A distributor facing such circumstances is required to make a report to the Board no later than 60 days after the company’s receipt of its annual audited financial statements.

The Board’s 3GIRM policy has multiple objectives, among which are the following:

- Productivity incentives for the benefit of distributors and ratepayers;
- Predictability about the regulatory regime;
- Reduced regulatory burden on applicants through streamlined IRM applications; and
- Reduced resource requirements for the Board through staggered cost of service applications.

If a distributor applies using cost of service during the IRM period, it is considered an early rebasing, and hence a departure from the policy. The Board’s decision-making related to THESL’s application for early rebasing has been guided by the Board’s established regulatory policy, particularly as outlined for 3GIRM including the underlying objectives, and by the specific circumstances of the application.

The *Report of the Board on the Cost of Capital for Ontario’s Regulated Utilities* outlined the role that specific circumstances can play in the Board’s decision-making processes:

Board panels considering individual rate applications, however, are not bound by the Board’s policy, and when justified by specific circumstances may choose not to apply the policy (or a part of the policy).²

² *Report of the Board on the Cost of Capital for Ontario’s Regulated Utilities*, EB-2009-0084, December 11, 2009, p. 13.

Where requests for early rebasing by electricity distributors are concerned, the test to depart from the Board's 3GIRM policy is articulated in the Board's letter of April 20, 2010 regarding *Early Rebasing Applications*, which stated:

A distributor, including the four distributors referred to above, that seeks to have its rates rebased in advance of its next regularly scheduled cost of service proceeding must justify, in its cost of service application, why an early rebasing is required notwithstanding that the "off ramp" conditions have not been met. Specifically, the distributor must clearly demonstrate why and how it cannot adequately manage its resources and financial needs during the remainder of its IRM plan period. Distributors are advised that the panel of the Board hearing the application may consider it appropriate to determine, as a preliminary issue, whether the application for rebasing is justified or whether the application as framed should be dismissed.

Distributors are also advised that the Board may, where an application for early rebasing does not appear to have been justified, disallow some or all of the regulatory costs associated with the preparation and hearing of that application, including the Board's costs and intervenor costs. In other words, the Board may order that some or all of those costs be borne by the shareholder.

THESL's Rate Application History

THESL has had its rates set on the basis of cost of service applications for every year since 2006, with the exception of 2007, for which THESL filed an IRM application.

On August 23, 2010, THESL filed a cost of service application for 2011 rates which was assigned file number EB-2010-0142. On July 7, 2011, the Board issued a Partial Decision and Order (the "Partial Decision").

On March 1, 2011, the Board issued a letter entitled *Electricity Distributors Scheduled to Apply for Rebasing for 2012 Rates* with an attached Appendix A listing distributors scheduled to apply for 2012 rates. THESL was not included on this list. This letter advised distributors proposing to file a cost of service application for 2012 rates and who were not on the Appendix A list to so notify the Board in writing, as soon as possible, and in any event no later than April 29, 2011. On March 25, 2011, THESL sent a letter to the Board advising the Board and other stakeholders of its intention to file a non-IRM cost of service application for 2012 rates and providing the reasons supporting the need for this approach.

The Board's EB-2010-0142 Partial Decision, which was issued after the March 25 letter from THESL, rejected THESL's argument that there are two ratemaking frameworks, namely a cost of service framework and an IRM framework. The Board stated:

The Board's rate setting policies are not composed of the two separate frameworks that THESL describes. As stated above, the Board has clearly articulated the mechanics of the multi-year rate setting plan and its expectations of distributors. The Board believes that THESL's submissions mischaracterize the Board's rate setting policies and the Board does not accept the construct as described by THESL as a Board sanctioned framework.

The Board's Decision further concluded that:

The Board makes no determination as to what THESL is required to file in its subsequent rate application. It is for THESL to determine the manner in which it chooses to apply for any adjustment to its rates for 2012. The acceptability of the application will be determined by the Board at that time.

The Board notes that THESL is not included in the list of expected cost of service applicants for 2012, as per the letter issued by the Board on March 1, 2011.

Should THESL file a cost of service application for 2012 rates, the expectations of the Board are clear. As set out in the April 20, 2010 and March 1, 2011 letters, a distributor that seeks to have its rates rebased earlier than scheduled must justify, in its cost of service application, why early rebasing is required and why and how the distributor cannot adequately manage its resources and financial needs during the remainder of the 3rd generation IRM plan term.

Regardless of THESL's expectations in the past regarding the acceptability of serial cost of service applications, based on the EB-2010-0142 Partial Decision, as quoted above, the company could have been in no doubt as to the Board's expectations going forward. And indeed the company does not rely on past expectations in its arguments.

The Board, in its EB-2010-0142 Partial Decision did not direct THESL to file an IRM application. As some parties have noted, to have directed a particular form of

application would have been inappropriate. It is for the applicant to determine the form of application, in full knowledge of the Board's policy and in full knowledge of the test which must be met in the event the application departs from that policy.

On August 26, 2011, THESL filed the current application, which is a cost of service application, for 2012, 2013 and 2014 rates. As indicated above, THESL's application would result in significant increases to the distribution portion of a typical residential customer's monthly bill: 18.7% in 2012; a further 12% in 2013; and a further 12% in 2014. Similar increases would result for General Service customers less than 50 kW: 16.9% in 2012; a further 11.9% in 2013; and a further 11.3% in 2014.

The Preliminary Issue

On October 4, 2011, the Board issued Procedural Order No. 1 which determined that in advance of further procedural steps the Board would consider the question of whether the application filed by THESL is acceptable or whether it should be dismissed (the "Preliminary Issue"). The Board stated that it would allow an initial round of interrogatories to seek additional information specifically related to the Preliminary Issue and THESL's evidence on the Preliminary Issue and that oral submissions would follow.

On October 21, 2011, THESL filed a Notice of Motion (the "Motion") with the Board requesting that the Board vary Procedural Order No. 1 to allow THESL to present a witness panel to provide *viva voce* evidence relevant to the Preliminary Issue. On October 21, 2011, the Board issued Procedural Order No. 2 in which it determined that it would hear the Motion in writing.

On October 28, 2011, the Board issued its Decision and Procedural Order No. 3 in which it determined that it would grant the Motion and allow THESL to present a witness panel on the Preliminary Issue. The Board also noted that the submissions by parties raised issues related to the interrogatory responses provided by THESL on the Preliminary Issue, in particular that a number of the interrogatories were not answered. The Board stated that it would expect all parties and THESL to come prepared to speak to the issue of unanswered interrogatories on November 1, 2011, the date originally scheduled to hear submissions on the Preliminary Issue.

On November 1, 2011, at the commencement of the oral hearing, THESL provided to the Board a proposal which had been agreed to by intervenors whereby THESL would provide answers for all of the interrogatories which it had not previously answered, as

well as those interrogatories that had been clarified, or modified by parties in their correspondence of October 31, 2011. The Board accepted THESL's proposal and stated that further procedural direction beyond the phase of the interrogatory responses would follow.

On November 4, 2011, the Board issued Procedural Order No. 4 in which it determined that the hearing would resume on Friday November 11, 2011 with the presentation and cross-examination of THESL's witness panel, followed by oral argument-in-chief on the Preliminary Issue on Monday November 14, 2011, oral submissions from Board staff and intervenors on Thursday November 17, 2011, and oral reply submissions by THESL on Thursday November 24, 2011.

The Test

THESL agreed that the test as to whether or not an early rebasing application is justified is as outlined in the Board's letter of April 20, 2010. This test was also restated in the Board's EB-2010-0142 Partial Decision which was referenced in Procedural Order No. 1 of this proceeding:

Should THESL file a cost of service application for 2012 rates, the expectations of the Board are clear. As set out in the April 20, 2010 and March 1, 2011 letters, a distributor that seeks to have its rates rebased earlier than scheduled must justify, in its cost of service application, why early rebasing is required and why and how the distributor cannot adequately manage its resources and financial needs during the remainder of the 3rd generation IRM plan term.

The Standard

The Board is in agreement with staff's submission as to the nature of the standard that THESL must meet regarding this test. Staff submitted as follows:

...the Board needs to be persuaded, through clear, cogent, and credible evidence, that it is more likely than not that THESL will not be able to adequately manage its resources and financial needs if it is subject to IRM for rate-setting purposes.³

³ Tr4, pp. 59-60.

The Board notes that this test was substantially agreed to by all parties, including THESL, which maintained in its reply argument that it had met this test:

So, Madam Chair, to start, the Board has established a process here to consider and determine the preliminary issue. Toronto Hydro has followed that process and, in our submission, we have met and discharged the Board's test and standard.

The Board should decide that Toronto Hydro is entitled to proceed to have its application heard in a cost of service hearing, and Toronto Hydro submits that we have demonstrated in a clear and cogent way why it cannot adequately manage under IRM.⁴

Jurisdiction

BOMA submitted that the Board does not have the jurisdiction to dismiss THESL's application given the provisions of section 4.6(1) of the *Statutory Powers Procedure Act, R.S.O. 1990, Chapter S.22* ("SPPA") which states as follows:

Subject to subsections (5) and (6), a tribunal may dismiss a proceeding without a hearing if,

- a) the proceeding is frivolous, vexatious or is commenced in bad faith;
- b) the proceeding relates to matters that are outside the jurisdiction of the tribunal; or
- c) some aspect of the statutory requirements for bringing the proceeding has not been met.

As was noted by BOMA, this section of the SPPA is repeated in section 18.01 of the Board's *Rules of Practice and Procedure* ("the Rules").

The Board finds BOMA's argument is without merit. If the Board were to dismiss THESL's application based on its consideration of the Preliminary Issue it would not be doing so in contravention of either its own Rules or the SPPA. The provisions of the SPPA and the Rules refer to the dismissal of an application *without* a hearing. That circumstance does not apply in the current case. The Board has quite specifically held a hearing to determine the Preliminary Issue. The hearing has included pre-filed evidence, interrogatories, *viva voce* evidence and submissions.

⁴ Tr5, pp 3-4.

Summary of THESL's Position

THESL has argued that 3GIRM does not work for the company because of the level of its capital expenditure requirements and workforce renewal needs. THESL has stated that if it was to go on IRM rates and maintained its planned expenditure levels, there would be severe impacts on its key financial ratios with consequential impacts on its debt ratings and its ability to raise capital. The table below presents the deterioration in the ROE which THESL projects would occur by 2014.⁵

ROE Consequences under IRM Rates

	2011 Approved	2012	2013	2014
Equity Returns under IRM	\$88,068,069	\$52,435,771	\$5,437,489	\$(47,783,358)
Proposed ROE	9.58%	9.58%	9.58%	9.58%
ROE under IRM	9.58%	4.97%	0.45%	(3.41%)

THESL's comment on this scenario was that:

This analysis clearly shows that an unsustainable reduction in ROE would occur in the first test year and worsen substantially in the subsequent test years. However, by presenting the results of this analysis, THESL specifically does not imply that it would ever be possible in practice for THESL to undertake the proposed expenditures and investments without the corresponding revenue requirements.⁶

THESL, during its argument-in-chief, commented that by 2014 the shareholder would no longer be earning any return on the company's capital investment and the return would have fallen 1,299 basis points below the Board's allowed ROE. THESL argued that such a circumstance would be a clear violation of the fair return standard. But as indicated in the quote above, this scenario is hypothetical and not how the company would respond to rates set through IRM.

⁵ Reproduced from Mr. Couillard's evidence (p.5) and as amended by THESL (Exh A1/Tab 1/Sch 2/p.28)

⁶ Exh A1/T1/Sch 2, p. 28.

Mr. Couillard testified that if THESL was placed under IRM then a credit downgrade would be very likely, unless THESL reduced expenditures and activities. This downgrade would occur because leverage ratios would increase to unacceptably high levels since incremental capital would not be in the rate base. THESL maintained that IRM would also put THESL in the position of borrowing long-term capital without explicit regulatory approvals, resulting in regulatory risk due to the prudence of capital spending only being established by the Board in the future. Mr. Couillard testified that a credit downgrade would also increase interest costs on short-term working capital and increase significantly THESL's prudential requirements with the IESO.

THESL also provided an alternative scenario setting out the impacts if the Board did not approve the requested revenue requirements but rather set rates based on IRM. Under this scenario, THESL claimed that it would be necessary to make the referenced expenditure and investments reductions.

THESL maintained that under such circumstances it would only be able to fund capital expenditures to the extent of available depreciation, and ROE would be maintained at 8.10%. This level is below the current allowed return, but above the 300 basis point off ramp established in the 3GIRM framework. THESL maintained that the 8.10% level in 2012 is what results from the implementation of the half-year rule⁷ on the capital expenditures approved in 2011.

Mr. Haines described the consequences if the company reduced its spending, stating that in addition to the restrictions on THESL's capital expenditures outlined above, THESL "would be faced with the very real matter of essentially going into "survival mode"."⁸ Mr. Haines explained what this would mean:

THESL would be in the position of having an insufficient workforce and few-to-no contractors to do the capital work required, as well as no ability to efficiently raise capital. In short, the company would be severely financially challenged for an extended period of time, and the distribution system would be being maintained at unacceptable service levels.⁹

⁷ The Board recognizes that individual capital projects will be completed throughout the year. However, for purposes of setting rates, all projects are assumed to be completed in the middle of the year. This is the "half-year" rule.

⁸ Witness Statement of Anthony Haines, p. 11.

⁹ Ibid, p. 12.

Mr. Haines further explained that at the end of the IRM period in 2015 THESL would expect to need to spend approximately \$1.6 billion to “catch up” on its capital renewal program as well as the approximately \$660 million that would be required in 2015, resulting in a total 2015 capital program requirement of approximately \$2.2 billion. This was referred to as the "snowplough effect". The result would be an approximately 43% rate increase from the capital budget alone, before increases to the operating budget were taken into account.

THESL also argued that the ICM mechanism would not accommodate the company's needs. The company pointed to Mr. McLorg's testimony in which he expressed the view that ICM is designed for extraordinary and unanticipated capital spending requirements and therefore does not apply to THESL's operational spending requirements, nor does it apply to capital spending requirements that exceed depreciation, which THESL's do. Mr. McLorg concluded that ICM is meant for discrete one-off projects and not for broad-based infrastructure renewal programs of the type proposed by THESL.

Positions of the Intervenors

The City of Toronto, BOMA and AMPCO supported the company's position to have its three-year cost of service application heard by the Board. VECC, Energy Probe and SEC disagreed, and argued that THESL could have rates set based on the IRM mechanism, but accompanied with – or immediately followed by – a capital expenditure review. This review could take place as an ICM proceeding, perhaps with more lenient criteria, or possibly as a modified Z-factor proceeding. CCC submitted that the application should be dismissed completely at this stage and that THESL should be on IRM. The positions of parties are set out in more detail below.

The City of Toronto expressed concerns about the level of streetlighting rates charged by THESL that are developed using the Board's cost allocation model. The City submitted that THESL's application should be heard because an enquiry into streetlighting rates and the associated cost allocation would not be possible under an IRM application.

BOMA suggested that THESL's evidence indicates that IRM is not appropriate for the company. BOMA stated that it would be more prudent and better regulatory practice to

hear the case in its entirety. The Board could then decide, after hearing all the evidence, whether to approve the revenue requirement request in whole or in part for one year, two years, three years, or not at all.

AMPCO's view was that rates should be set based on a consideration of the specific circumstances of the applicant and as such agreed with THESL that the company should be free to choose the best regulatory construct for those circumstances. AMPCO submitted that based on the evidence presented to date, it could not accept THESL's level of proposed expenditures or the consequences that the company would suffer if placed under IRM. AMPCO further submitted that the Board is unable on the current record to make a determination of whether THESL has met the test for early rebasing, and AMPCO maintained that the test was largely arbitrary in any event. AMPCO concluded that THESL should not be denied the opportunity to present its cost of service application and in that way the Board could make a determination on the appropriate level and pace of capital expenditures as well as productivity improvements. However, AMPCO submitted that capital and workforce renewal plans should be excluded from any settlement process and would be best tested by a full hearing.

Board staff submitted that the Board has two options in determining this preliminary matter. The first is to apply the test articulated in the April 20th letter. Staff submitted that, based on the evidence, THESL has failed to meet the test and therefore should have rates set based on the IRM formula. The second option is that the Board could decline to determine the issue as a preliminary matter, and could hear the capital budget portion of the case and any other portions the Board may deem necessary. After that, the Board could determine whether the evidence supports THESL's capital expenditure claims and therefore whether rates should be set through a cost of service review rather than through IRM.

Board staff also suggested that under this second option the Board could set out its expectations for the scope of the remaining ICM adjustments that THESL might wish to include in years 2 and 3 of the IRM period should the Board find that THESL has not made its case for setting rates on a cost of service basis. This could result in a more efficient approach than re-hearing the evidence on the capital budget as part of an ICM application under IRM.

Board staff proposed that under this option the Board should consider whether most, if not all, issues should be excluded from settlement in order to ensure a full testing of the evidence and a clear and transparent analysis of that evidence.

Energy Probe submitted that THESL is not entitled to a cost of service application because it will not meet the 300 basis points off ramp until the end of 2012 which means the earliest entitled rebasing would be 2013. Energy Probe also submitted that THESL had not demonstrated its inability to manage its resources and financial needs mainly because the evidence could not be taken at “face value” and had not been scrutinized to determine its legitimacy. Energy Probe recommended that the Board conduct a comprehensive review of the capital expenditures before making its decision on the preliminary issue.

VECC submitted that the evidence presented by THESL demonstrates that the company would be operating within the acceptable bounds of financial management that are implicit when rates are set through IRM, at least through 2012. In VECC’s view, the 3GIRM policy should be applied equally to all distributors unless they qualify for an exception. However, VECC submitted that the potential consequences for the system, the company, and ratepayers under 3 years of repeated IRM are uncertain and that the magnitude of the capital expenditures warrants a thorough testing of the evidence. VECC therefore recommended imposing IRM on THESL for 2012, but allowing for a separate proceeding to address the 10 year capital plan which has changed significantly year over year and under which there is now no foreseeable decline in capital needs over a ten year period.

Similarly to VECC, SEC expressed concern over THESL’s “cycle of ever-increasing costs” coupled with no evidence of demonstrated productivity improvements. SEC rejected THESL’s argument that it could not be compared to any other distributor in Ontario and argued that THESL is the most costly utility in Ontario by almost every metric, including, for example, distribution revenue per customer, OM&A per customer, capital additions per customer, or distribution cost per delivered kWh. SEC agreed with VECC that THESL should be placed on IRM at least for 2012. SEC further argued that THESL must provide empirical evidence to demonstrate why it cannot operate under 3GIRM. SEC also argued that the Board should conduct a thorough review of THESL’s operations either through a cost of service or other proceeding.

CCC concluded that THESL has not met the test established by the Board and that the application should be dismissed completely at this threshold stage. CCC argued that THESL did not demonstrate that it could not manage under an IRM regime because the company’s case is based on a single assertion of a unique need for capital spending and what would hypothetically happen if it were subject to IRM. CCC strongly cautioned

the Board against adopting a “hybridized regulatory model” but instead urged the Board to maintain the integrity of the regulatory regime. CCC argued that this regime is working well for most utilities and the Board and has important benefits for ratepayers, including:

1. incentives for distributors to reduce costs;
2. stable prices and the benefits of savings and efficiencies gained at the end of an IRM period; and
3. reduced regulatory burden to the Board, distributors and ratepayers who ultimately pay for rates proceedings.

Board Findings

In considering the Preliminary Issue, the Board must consider the interests of ratepayers and the interests of THESL. The Board must also consider these interests within the context of the Board’s 3GIRM policy and its objectives, as well as the Board’s statutory objectives. The Board’s 3GIRM policy is well established and is being implemented by almost all distributors. The Board finds that THESL has not met the test for a departure from the 3GIRM policy. The reasons are detailed below, but in summary:

- THESL is under no current financial stress; nor do the reliability measures show evidence of system deterioration.
- The company did not provide cogent and compelling evidence showing significant prospective financial or operational distress under IRM rates. Such evidence would necessarily include a robust analysis of the planning, project prioritization and/or productivity measures undertaken in response to the incentives and parameters of 3GIRM. THESL has only put forth two scenarios which the Board has found are not credible.
- The company has not attempted to use the ICM as a means of funding additional non-discretionary capital expenditures beyond the level already incorporated in rates.

THESL argued that if the Board concludes that the company has not met the test for the Preliminary Issue, the findings must not be based on considerations beyond the limits of the Preliminary Issue hearing. Mr Rodger explained in reply argument:

So if the Board were to decide that Toronto Hydro has not satisfied your test because, for example, witnesses did not go into the sufficient level of detail for workforce renewal, let's say, but the entire preliminary issue itself, it's been heard in a context that is much narrower than a full cost of service hearing, where all the five volumes of evidence is read, presented, and tested, then that outcome, in our view, would be inappropriate and would raise procedural fairness concerns.

But you can avoid this issue by acknowledging in your decision the limits associated with this preliminary issue process when you consider the issue, and then when you decide whether it is more likely than not that Toronto Hydro will be unable to adequately manage its resources given its situation and given how IRM works.¹⁰

As set out in the findings below, the Board has based its conclusions solely on matters before the Board during the Preliminary Issue hearing. As THESL acknowledged, the scope of the proceeding did not include a full examination of the company's cost of service application but the onus was on the company to show that it cannot adequately manage its resources and financial needs under IRM. THESL presented two scenarios of the potential consequences of being placed on IRM rates, and neither was sufficiently credible to meet the Preliminary Issue test; nor were the other arguments put forward sufficiently persuasive to meet the test.

The Board therefore will dismiss the application. It remains open to THESL to file an IRM application for 2012, including an ICM application. The Board encourages THESL to do so.

The examination of the Preliminary Issue focussed on a number of areas of THESL's application which provide a useful framework for the Board's findings:

- Workforce Renewal
- Streetlighting Rates
- Productivity
- Capital Expenditures
- The Incremental Capital Module (ICM)

¹⁰ Tr. 5, p. 11.

Each of these is discussed below.

Workforce Renewal

THESL has maintained that workforce renewal is one of the key drivers for its need to have rates set on the basis of cost of service, rather than IRM. Workforce renewal relates to the recruitment, training and retention of new personnel to address the aging demographics of the company's workforce. The Board finds that this reason is insufficient to warrant a departure from the Board's 3GIRM policy. THESL presented no evidence to suggest that its requirements in this area are in any way unusual in comparison with other Ontario distributors and did not claim to be unique. The Board notes that workforce management, and an aging workforce, is an issue which is being addressed by all distributors – almost all of whom are currently under the 3GIRM framework.

Streetlighting Rates

The City of Toronto expressed concerns about the level of streetlighting rates and the cost allocation underpinning those rates. The City submitted that THESL's application should be heard because an enquiry into streetlighting rates and the associated cost allocation would not be possible under an IRM application. This is not a compelling reason to conduct a cost of service application. THESL's rates for streetlighting are set in accordance with the Board's cost allocation policies, and while the level of rates are of significance to the City, the magnitude of the issue is not such that the time and resources required for a cost of service hearing would be warranted to hear this issue alone.

Productivity

The 3GIRM framework imposes a discipline on a distributor which serves to benefit ratepayers and shareholders by providing incentives for the company to find efficiencies and manage costs during the period rates are set using IRM. The situation may arise where despite significant productivity improvements a distributor finds itself in a position where it cannot manage its arrangements under IRM rates. Alternatively, a distributor

might face unique and unusual cost pressures which result in it being unable to make the productivity improvements that other distributors are expected to achieve under IRM rates. THESL did not make either of these claims as part of its analysis of the impact of operating under IRM rates.

On the contrary, the evidence suggests that THESL has not made significant productivity improvements in comparison to other Ontario distributors. Customer bills for each of THESL's main rate classes are higher than for any other urban distributor in Ontario with more than 30,000 customers. In addition, THESL's ranking in terms of OM&A per customer, capital additions per customer, and property, plant and equipment per customer is amongst the poorest in Ontario based on analysis derived from data in the Board's statistical yearbooks.

THESL maintained that it is highly problematic to compare its performance with that of other Ontario distributors – to the point of being of questionable value. THESL would prefer that the Board compare the company's own performance over time. The Board agrees that there are limitations in cross-sectional comparisons. However, there are also limits on the value of comparisons over time of one company. In both cases there may be differences in circumstances, physical characteristics, market factors, etc. Both types of analyses have value; both have limitations.

The Board remains of the view that comparisons with other Ontario distributors are relevant. Although there may not be another utility in Ontario with the exact same characteristics as THESL, urban distributors share many similarities in terms of cost drivers. In fact, although THESL maintained that it could not be usefully compared to other Ontario distributors, it did not take the position that it was unique or that the conditions it was facing (in terms of workforce, assets, customer growth) were particularly unusual among Ontario distributors. In addition, it is always open to applicants to bring forth alternative benchmarking evidence which incorporates comparators from other jurisdictions if the distributor believes those comparisons are more relevant. THESL brought forth no such independent analysis.

THESL maintained that it could not conduct its business under IRM rates as that business has been planned for under an annual cost of service approach. But IRM is not intended to result in a status quo approach. The expectation is for changes in the way a distributor conducts business – not to do less – but to find efficiencies and drive productivity improvements.

The company's evidence as to its productivity improvements was not compelling. THESL pointed to the fact that capital spending has increased from \$132 million to \$260 million (an almost 100% increase), while employee numbers have grown from 1,650 to 1,750 (a 6% increase). The Board accepts that this *might* be evidence of productivity growth, but there might be alternative explanations that do not involve productivity improvements. Spending more capital dollars per employee is not necessarily a sign of increased productivity. The company also explained that the staff levels and the number of job descriptions have been reduced since amalgamation. However, there was no quantification of the impact of these initiatives. In addition, no independent studies of productivity have been performed.

The Board concludes that THESL has not brought forth evidence regarding its productivity performance which would substantiate the company's claim that it cannot manage its resources and financial needs under IRM.

Capital Expenditures

THESL's current application indicates that it plans to spend in the order of \$600 million per year on capital projects for the next ten years. This far exceeds historical levels, and significantly exceeds current levels which were agreed through settlements in prior proceedings: \$350 million for 2010 and \$378.8 million for 2011.

THESL maintained that the planned level of expenditures cannot be accommodated under the 3GIRM framework. THESL asserted that the operation of 3GIRM, and in particular the half-year rule for ratebase additions¹¹, results in inadequate return for any capital expenditures in excess of depreciation during IRM years. The company went so far as to suggest that imposition of the IRM model could lead to a breach of the fair return standard.

The Board does not agree that IRM creates a structural deficit for distributors dealing with replacing aging infrastructure; nor does it accept that IRM would lead to a breach of the fair return standard. As the Board stated in its Hydro Ottawa decision:

Asset management and workforce planning are ongoing issues for distributors and the company should be able to accommodate those

¹¹ The Board recognizes that individual capital projects will be completed throughout the year. However, for purposes of setting rates, all projects are assumed to be completed in the middle of the year. This is the "half-year" rule.

requirements – indeed is expected to do so – within the IRM framework; there is no evidence that it cannot do so.¹²

The level of capital expenditures within the 3GIRM framework was closely considered while the policy was under development. The 3GIRM framework recognizes that funding for capital expenditures is available beyond the level of depreciation during the IRM phase of the rate making scheme, and clearly many distributors have spent in excess of depreciation under 3GIRM. THESL asserted that adverse credit impacts would result from capital spending for projects that do not go into rate base until after the IRM period. However, THESL provided no evidence of adverse credit impacts for any other distributor which has made capital expenditures beyond the level of depreciation during the IRM period. The 3GIRM policy also incorporates the ICM to address specific requirements during the years rates are set using IRM. (The ICM is discussed further below.) There is also the off-ramp and the z-factor adjustment. All three of these mechanisms are designed to provide flexibility within the policy framework to address distributor-specific situations.

The theoretical arguments which THESL has presented were previously considered by the Board during the 3GIRM policy consultation process. THESL has not put forth any new evidence for the Board's consideration regarding the structure and operation of the framework. These arguments therefore provide no basis for the Board to depart from its established policy. The Board has already considered the issue of capital spending in the development of its 3GIRM policy and has ensured that the policy is flexible through the inclusion of the ICM, the z-factor, and the off-ramp. It is this suite of mechanisms which ensure appropriate treatment for distributors while ensuring cost discipline benefits for customers. THESL has not presented evidence that its operating circumstances (in terms of aging infrastructure, limited customer growth and aging workforce) are markedly different from those of other distributors, almost all of whom are under 3GIRM. The Board finds therefore that no case has been made that the 3GIRM framework as it would be applied to THESL is flawed.

THESL has provided evidence as to how the 3GIRM framework would operate in its specific circumstances, and it is those circumstances which are more germane to the Board's consideration of THESL's early rebasing request than the theoretical arguments.

¹² Hydro Ottawa Limited, *Decision*, EB-2010-0133, October 27, 2010, p. 11.

THESL has identified two scenarios describing the implications for the company if it were placed under IRM rates. The company argued that both scenarios demonstrate that the company meets the test for the Preliminary Issue.

In the first scenario, THESL continues to spend as proposed, and the result is a precipitous drop in its financial performance, resulting in the off ramp being triggered by the end of 2012 and a negative ROE by 2014. Given the magnitude of the growth in expenditures this is not surprising. Distributors are expected to operate differently under 3GIRM than under annual cost of service rates: they are expected to manage their resources in light of customer growth and system priorities and to seek out efficiencies and productivity improvements aggressively, and where warranted make applications using the additional 3GIRM tools of the ICM, or z-factor, or off-ramp. The Board therefore finds that this scenario is not credible because it does not incorporate the sort of prioritization and productivity innovation which would be expected to take place under IRM rates. Nor does this scenario substantiate the company's claim that 3GIRM could lead to a breach of the fair return standard. If THESL were to operate according to this scenario, which it has stated clearly it would not, the off-ramp would be triggered at the end of 2012, and therefore even if the company did not come forward the Board itself would initiate a review. The Board finds that this scenario does not demonstrate that the company meets the test for the Preliminary Issue.

In the second scenario, THESL responds to the 3GIRM framework by reducing spending substantially, down to a level characterized by the company as an "unsustainable mode of bare survival,"¹³ while maintaining an ROE of 8.1%. In this scenario capital expenditures are deferred, creating what the company referred to as a "snowplough effect" which leads to large future rate impacts. In addition, the workforce would be cut by between 300 and 400 employees. The Board finds that this scenario is not credible. The 3GIRM framework is designed to instil cost management discipline through shareholder incentives for the benefit of ratepayers. THESL's scenario assumes that the company can only respond by spending less with no prospect of productivity improvements to do the same (or more) with less. It also implies that THESL would refuse to expend capital beyond the level of depreciation even though the company claims this could lead to a deterioration of its system. Good utility practice would necessitate a consideration of priorities and planning to accommodate the needs of the system.

¹³ Ex R1, Tab 1, Schedule 1, p. 3.

The 3GIRM framework accommodates spending beyond the level of depreciation, including through the operation of the ICM. If additional spending for genuine system needs is required, beyond that available through the 3GIRM framework, including the ICM, then it is possible that the spending could result in a decline in earnings sufficient to trigger the off-ramp. But this happens after genuine effort is expended to operate within the parameters of the framework. The Board concludes that this scenario is not sufficiently credible to demonstrate that the company meets the test for the Preliminary Issue.

The Incremental Capital Module (ICM)

Under neither scenario does the company consider the option of pursuing an ICM application. In fact, the company largely dismisses the ICM as a potential tool. This is particularly remarkable given the company's assertion that without pre-approval for capital expenditures it risks adverse credit consequences.

The ICM was developed to address the circumstances of increased capital needs within 3GIRM. In its Report on 3GIRM, the Board set out the framework for the ICM and identified the eligibility criteria: materiality, need and prudence.¹⁴ In the Supplemental Report, the Board established the ICM materiality threshold and set out the associated filing guidelines and reporting requirements. In considering a distributor's eligibility for the ICM, the Board stated:

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.¹⁵

Hydro One Networks Inc. made the first application under the ICM, and in its decision the Board stated:

In fact, what the Board requires in considering an application under the incremental capital module is a demonstration that the distributor is facing

¹⁴ *Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors*, July 14, 2008.

¹⁵ *Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors*, September 17, 2008, p. 31.

extraordinary and unanticipated capital spending requirements; i.e. something other than the normal course of business.¹⁶

While the Board did not accept the application for relief under the ICM for Hydro One Networks Inc., it did provide substantial relief by increasing the revenue requirement by more than half of what was originally requested (\$20.3 million was requested; \$12.1 million was granted).

In a decision regarding an Oshawa PUC Networks Inc. ICM request, the Board determined that some of the projects were discretionary (including a feeder replacement project) and therefore not eligible for relief, but that the concrete pole replacement project was non-discretionary and therefore eligible for relief.¹⁷ The relief was granted through a deferral account.

In the Board's 2011 IRM decisions for Guelph Hydro¹⁸ and Oakville Hydro¹⁹ the Board allowed for municipal transformer stations to be funded through the ICM.

The Board's thinking in this area has evolved, and in the recent ICM decisions the Board has granted rate relief for discrete, material and non-discretionary projects which cannot be funded through the normal operation of the 3GIRM mechanism.

While the Board cannot determine at this time the level of spending under THESL's capital plan that would be eligible for the ICM, it appears that two projects, the Bremner station and contributions to Hydro One Networks Inc. for the Leaside-Birch transmission reinforcement (which together total \$86.6 million in 2012), are directly analogous to projects that the Board has previously approved under ICM for other distributors. These projects represent approximately 15% of the total proposed budget for 2012. (There is a further \$49.4 million for these two projects in the 2013 budget.) Further amounts might also qualify.

THESL's witness Mr. McLorg asserted "it's certainly our view that a case cannot be made to characterize the bulk of Toronto Hydro's spending as being in any sense extraordinary."²⁰ However, the fact is that planned spending is increasing significantly. Whereas over 2010 and 2011 capital expenditures averaged \$364 million, the average

¹⁶ Hydro One Networks Inc., *Decision*, EB-2008-0187, May 13, 2009, pp. 8-9

¹⁷ Oshawa PUC Networks Inc., *Decision – Part II*, EB-2008-0205, June 10, 2009.

¹⁸ Guelph Hydro Electric Systems Inc., *Decision and Order*, EB-2010-0130, March 17, 2011 (corrected)

¹⁹ Oakville Hydro Electricity Distribution Inc., *Decision and Order*, EB-2010-0104, June 10, 2009.

²⁰ Tr. 2, p. 36.

planned level of expenditures over the period 2012-2014 is \$615 million, which VECC characterized as a “remarkably large capital plan.”²¹

It may also be that the full planned spending is not imperative to ensure appropriate system reliability. Although THESL asserted that the high level of expenditures are driven by pressing system needs, the Board notes that on the existing capital spending level the company’s reliability statistics show no marked deterioration, and the number of “worst performing feeders”²² (a more important criteria than the reliability statistics, according to Mr. Haines) has been reduced by half – from 80 to 40.

If there really is nothing unusual about THESL’s capital expenditures in terms of the nature of the activities, then the spending should be managed within the parameters of the 3GIRM framework, just as spending is managed by almost every other distributor. If the company is facing unusual non-discretionary requirements, then the appropriate course is an ICM application.

THESL has explained that it did not conduct its planning in contemplation of a year or years with rates set using IRM. It may be that a re-analysis of its capital plan will result in other expenditures which are potentially eligible for ICM treatment. The Board notes that were THESL to apply for an ICM adjustment for 2012, the half-year rule would likely not apply as the expectation would be that 2013 rates would also be set using IRM. This adjustment would have the effect of including the expenditures in rate base from the beginning of the year.

Next Steps

Some intervenors would have the Board set rates for 2012 using IRM in the expectation that the company would return with an ICM application, or that the Board would conduct a capital program review of some sort in the same timeframe. The objectives of these approaches are to instil greater cost discipline on THESL, reinforce the integrity of the policy, and still provide the opportunity for a review of the capital spending. On the other hand, CCC argued against a “hybridized” approach of combining IRM for a year and some sort of capital expenditure review.

CCC summarized the benefits of the IRM framework for ratepayers and highlighted that the Board needs to consider the interests of ratepayers and the impact of its decision on

²¹ Tr. 4, p. 102.

²² Mr. Haines described “worst performing feeders” as those feeders that have more than 7 outages per year.

them. CCC concluded that the Board should dismiss THESL's application so as to apply some cost discipline on the company. SEC made similar arguments.

As THESL has noted, the Board has initiated a comprehensive review of its ratemaking framework: the Renewed Regulatory Framework for Electricity. When the consultation is completed there may well be changes to the ratemaking framework involving planning, capital expenditures, and performance metrics (as well as other parameters). The Board therefore agrees with THESL that it would not be appropriate or efficient to develop a customized approach for THESL at this time.

The Board will not direct THESL to file a 2012 IRM application; however, the Board invites THESL to do so, and to consider whether it would be appropriate to file an ICM module as part of the application. With respect to 2013 rates, if THESL chooses to file a cost of service application, the Board will likely again consider the early rebasing request as a Preliminary Issue. For the company's next cost of service application, the Board will expect to see external evidence related to productivity and capital planning. The productivity evidence could be in the form of a benchmark study which includes potential comparators from other jurisdictions and/or an external study of THESL's productivity achievement over time. The Board encourages the company to review the studies in which Hydro One Networks or Ontario Power Generation have been involved to determine whether similar studies might be appropriate for THESL. The capital planning evidence could be an efficiency expert's analysis of THESL's capital spending prioritization and cost/benefit analysis.

Cost Awards

The Board may grant cost awards to eligible stakeholders pursuant to its power under section 30 of the *Ontario Energy Board Act, 1998*. When determining the amount of the cost awards, the Board will apply the principles set out in section 5 of the Board's *Practice Direction on Cost Awards* (the "Practice Direction"). The maximum hourly rates set out in the Board's Cost Awards Tariff will also be applied.

In assessing requests for cost awards, the Board will be mindful of the criteria outlined in Procedural Order No. 1 which were designed to ensure that costs are only awarded where the party seeking costs provides assistance to the Board in examining relevant issues and that only reasonable costs are awarded. Parties intending to make cost award claims in this proceeding should review these criteria before filing their claims.

THESL will be required to absorb the costs of this application, including intervenor costs and the Board's costs, within its current revenue envelope; no incremental recovery will be allowed.

All filings with the Board must quote the file number EB-2011-0144, and be made through the Board's web portal at www.errr.ontarioenergyboard.ca, and consist of two paper copies and one electronic copy in searchable / unrestricted PDF format. Filings must be received by the Board by 4:45 p.m. on the stated date. Parties should use the document naming conventions and document submission standards outlined in the RESS Document Guideline found at www.oeb.gov.on.ca. If the web portal is not available, parties may e-mail their documents to the attention of the Board Secretary at BoardSec@ontarioenergyboard.ca. All other filings not filed via the Board's web portal should be filed in accordance with the Board's *Practice Directions on Cost Awards*.

THE BOARD ORDERS THAT:

1. Intervenors shall file with the Board and forward to THESL their respective cost claims within 21 days from the date of this Decision.
2. THESL shall file with the Board and forward to intervenors any objections to the claimed costs within 28 days from the date of this Decision.
3. Intervenors shall file with the Board and forward to THESL any responses to any objections for cost claims within 35 days of the date of this Decision.
4. THESL shall pay the Board's costs incidental to this proceeding upon receipt of the Board's invoice.

DATED at Toronto, January 5, 2012

ONTARIO ENERGY BOARD

Original signed by

Kirsten Walli
Board Secretary