

1 **PROPOSED INCREMENTAL CAPITAL MODULE**

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3 Hydro One is requesting recovery for required capital under the Incremental Capital
4 Module (“ICM”). Hydro One requires incremental revenue of \$26 million in 2013
5 associated with required in service capital additions. Hydro One requests that a 2013 rate
6 rider be established to recover this revenue requirement. The resulting average increase
7 for customers, as a result of this rider, is approximately 2.3%. Hydro One will
8 demonstrate that it has passed the Threshold Test that allows access to the ICM. Hydro
9 One will also provide information on some of the issues related to the ICM and the
10 approach that Hydro One has taken with this application. This approach is consistent
11 with Hydro One’s submission in the Renewed Regulatory Framework proceeding (EB-
12 2010-0377, EB-2011-0043 and EB-2011-0004) filed with the Board on April 20, 2012.

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14 ***Threshold Test:***

15 The Board has provided a formula for the Threshold Value which determines whether or
16 not a distributor is able to access the ICM. The Board’s formula is as follows:

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18 **Threshold Value = 1 + (RB/d) * (g + PCI * (1 + g)) + 20%**

19 Where:

20 **RB** = rate base included in base rates (\$4,987 million)

21 **d** = depreciation expense included in base rates (\$284 million)

22 **g** = distribution revenue change from load growth (-1.04%)

23 **PCI** = price cap index (0.88%)

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25 The values for “RB” and “d” are the Board-approved amounts from Hydro One’s EB-
26 2009-0096 proceeding. The negative growth factor of 1.04% is calculated using the
27 Board’s approach. It is calculated as the percentage difference between Hydro One’s
28 2011 approved revenue of \$1,149 million and the 2010 revenue at 2011 rates of \$1,161

1 million. The PCI of 0.88% has been specified by the Board for use in 2012 IRM
2 applications and is calculated by subtracting the productivity factor of 0.72% and the
3 stretch factor of 0.40% from the price escalator of 2.00% (note that the Board specified
4 2013 PCI should be issued and will be utilized when the Decision in this proceeding is
5 put into effect). The resulting Threshold Value of 117% is applied to the depreciation
6 expense included in base rates of \$284 million to determine Hydro One's Capital
7 Threshold of \$332 million.

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9 The Capital Threshold for Hydro One is \$332 million while the in service capital
10 requirement for 2013 is \$644 million. Hydro One has passed the Threshold Test and is
11 therefore able to access the ICM for its 2013 IRM application.

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13 ***Types of Investment:***

14 Hydro One has defined three categories of capital investment that make up the \$644
15 million in required in-service additions: "Typical" capital spending; "Escalated Issue"
16 capital spending; and "Non-typical" capital spending.

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18 The first category is Typical capital spending which includes historically approved levels
19 of sustainment, development and shared services and other spending. Sustainment
20 spending includes categories such as wood pole replacements, transformer replacements,
21 investments in distributing and regulating stations, repairing storm damage and the
22 replacement of meters. Development spending includes categories such as new load
23 connections, and upgrades and system capability reinforcement. Shared services and
24 other spending includes information technology, fleet, and work and office equipment.
25 Typical capital spending is reviewed in detail at Cost of Service ("COS") rebasing
26 hearings and does not require detailed further review during the period of the IRM.

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1 The second category is Escalated Issues capital spending. This category covers spending
2 on typical categories but at a substantial increase over historically approved levels. The
3 higher level of capital spending is required to address an identified escalated issue. For
4 example, a distributor may require a substantial increase over historically approved levels
5 to address a quality issue related to certain poles. This quality issue may relate to asset
6 age or a manufacturer issue. Escalated Issue capital spending requires a more detailed
7 review when introduced during the period of an IRM. This review covers the need and
8 timing of the proposed level of spending. The Escalated Issue category of capital
9 spending is further described in Exhibit B, Tab 2, Schedules 1 to 3.

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11 The third category covers Non-typical capital spending for 2013. This category covers
12 the cost to replace Hydro One's Customer Information System ("CIS"). Non-typical
13 capital spending requires a full review by the Board when introduced during the IRM
14 period. The Non-typical category of capital spending is further described in Exhibit B,
15 Tab 3, Schedule 1.

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17 ***Capital Recovery under ICM:***

18 The current ICM provides a mechanism for recovering Escalated Issue and Non-typical
19 capital spending during an IRM period. There is also a requirement to recover Typical
20 capital spending, in excess of approved depreciation, during the period of an IRM. The
21 Board's examination under the Renewed Regulatory Framework recognizes that one of
22 the major challenges facing the sector today, and the most significant driver of costs, is
23 the scale of capital spending expected over the next number of years to modernize the
24 system and to provide for new demand. Table 1 calculates the amount of capital that
25 Hydro One needs to recover through the ICM for Typical capital.

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Table 1
Incremental Capital Required for Typical Capital Spending (\$millions)

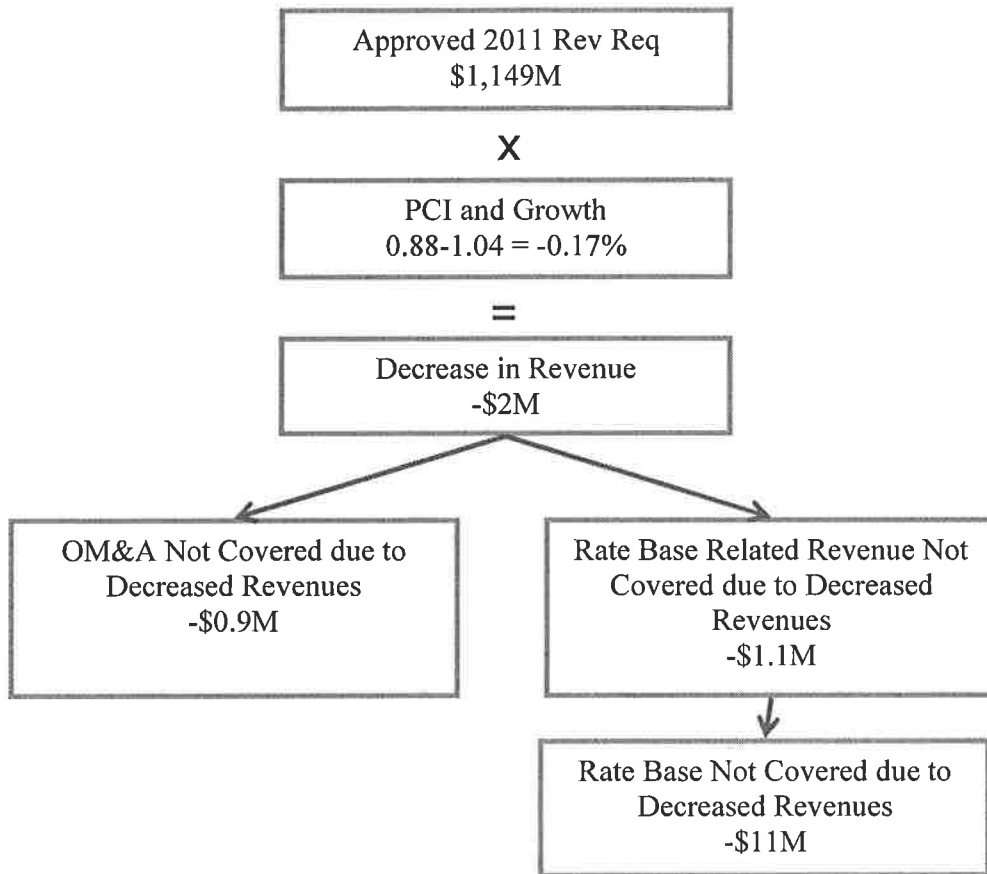
Line #		COS 2011	IRM 2013
1	Typical capital spending	\$438	\$414
2	Rate base impact of in-service capital		\$414
3	Less rate base funded by depreciation		-\$283
4	Add rate base no longer funded resulting from decrease in revenue		\$11
5	Growth in rate base for Typical capital (line 2 + line 3 + line 4)		\$142
6	Revenue required due to growth in rate base for Typical capital		\$14

Line number 1 in Table 1 provides Hydro One's typical capital spending for 2013 of \$414 million. To determine the growth in rate base for typical capital of \$142 million one must deduct the approved rate base funded by the approved depreciation amount of \$283 million and add back the \$11 million in rate base that is no longer funded as a result of decreased revenues. The approved rate base funded by depreciation can be found in Hydro One's Board approved rate order for its EB-2009-0096 proceeding. Line 6 provides the revenue required due to growth in rate base for Typical capital of \$14 million. The revenue required covers depreciation, cost of capital and taxes.

Figure 1 provides the derivation of the rate base which is no longer funded as a result of decreased revenues.

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Figure 1
Derivation of Rate Base No Longer Funded due to Decreased Revenues



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5 To determine the Rate Base adjustment required as a result of decreased revenues one
6 must start with the 2011 approved revenue requirement of \$1,149 million and apply the
7 PCI plus growth percentage. The PCI of 0.88% plus the negative growth of 1.04%
8 ¹results in negative 0.17% to be applied to the approved revenue requirement. The
9 resulting decrease in revenue of \$2 million is apportioned to OM&A and Rate Base based
10 on the percentage of OM&A and rate base related revenues that make up the approved
11 revenue requirement. This results in rate base related revenue requirement not covered

¹ The supporting calculations for PCI and negative growth can be found on page 1 of this Exhibit.

1 due to decreased revenues of \$1.1 million. This in turn results in rate base not covered
2 due to decreased revenues of \$11 million. As a result of the decrease in revenues, \$11
3 million in rate base is no longer recovered in approved rates.

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5 ***ICM Issues:***

6 It is critical that Hydro One recover Typical, Escalated Issue and Non-typical capital
7 spending during the period of an IRM. Hydro One is not in a position, due to credit rating
8 issues, to invest in rate base for which there is no cost recovery. Any negative impact to
9 Hydro One's credit rating would result in borrowing challenges and increased borrowing
10 costs for our customers. In order to avoid any negative credit rating impacts, Hydro One
11 must maintain its earnings metrics including rate of return. Adding to this pressure,
12 Hydro One was recently downgraded by Moody's by one notch. Also, Standard and
13 Poors has revised Hydro One's outlook from stable to negative. These reports are filed at
14 Exhibit A, Tab 6, Schedule 1, Attachments 1 & 2.

15
16 An unintended outcome of not being in a position to invest in rate base for which there is
17 no return is lower reliability as Hydro One would have less ability to replace or refurbish
18 assets prior to breakdown. A common industry term for this is the "harvesting" of assets.
19 Another unintended outcome is not replacing or refurbishing assets when it is
20 economically beneficial to do so. Planning for replacement and refurbishment and
21 executing the plan is less costly than simply replacing or refurbishing assets when they
22 break. The harvesting of assets would certainly result in increased contract and employee
23 labour costs as Hydro One would be unable to levelize work based on the most efficient
24 use of resources.

25
26 Finally, recovery of Typical, Escalated Issue and Non-typical capital spending during the
27 period of an IRM avoids step increases in rates at COS rebasing hearings. This is
28 particularly important given the capital intensive nature of the electricity distribution

1 business and the pressing need for Hydro One to renew and modernize its system to meet
2 the needs of its customers.

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4 ***Hydro One's Approach:***

5 In this application, Hydro One requests the approval of a rate rider based on the full
6 capital program for in-service additions in 2013 based on a review of forecast changes to
7 rate base.

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9 Hydro One will apply the 2013 Board approved cost of capital in determining the revenue
10 requirement when it is available, as outlined in Exhibit B, Tab 1, Schedule 2. Hydro One
11 believes that this is appropriate because the new investments should earn returns that are
12 consistent with the anticipated returns during the period of the investment. This treatment
13 results in a lower return than would be realized if Hydro One applied the 2011 Board
14 approved cost of capital as specified at page 11 in Chapter 3 of the Filing Requirements
15 for Transmission and Distribution Applications dated June 22, 2011.

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17 The extent of the capital investment review is determined by the nature of the
18 investments that are driving the change in rate base. Typical capital spending is reviewed
19 in detail at COS rebasing hearings and should not require detailed review during the
20 period of the IRM. The Typical category is very familiar to stakeholders. The general
21 level and type of Typical capital spending continues during the IRM period. This is
22 similar to the treatment of OM&A costs during an IRM period.

23
24 For Hydro One, Typical capital includes the capital spending approved in the most recent
25 COS application (i.e. net of any OEB directed reductions) less all capital spending
26 associated with renewable generation and smart grid investments as spending in these
27 areas is recovered through rate riders and deferral accounts. Table 2 shows the Typical
28 capital spending for the historic, base and IRM years.

Table 2
Summary of Typical Capital
(\$ Million)

	Historic			Base Year	IRM Year
	2008	2009	2010	2011	2013
TOTAL	435.3	455.5	430.5	437.6	451.9

The amount of revenue requirement that a utility requires to recover its capital investments in a particular year results from the in-service capital additions in the year, not the capital expenditures in the year as some projects require several years before they are completed. The in-service capital additions in the year are added to rate base and therefore are included for recovery in rates. The in-service capital additions in 2013 for the Typical capital are \$414 million.

The Escalated Issue category includes increased spending on stations, pole replacements and the capital contribution for a transmission station to address pressing issues. Hydro One has filed three years of historic investment information to establish the typical spending pattern for these types of investments. Detailed age and asset condition information has been provided to defend Hydro One's spending to address the Escalated Issues. The evidence is detailed and is consistent with the high quality of evidence that has been filed in previous COS filings for these types of program investments.

Finally, the Non-typical category includes spending to replace Hydro One's current Customer Information System. Hydro One has provided detailed evidence that is consistent with the high quality evidence that has been filed in previous COS filings for this type of project investment.

In summary, Hydro One requests recovery of Typical, Escalated Issue and Non-typical in-service capital additions as outlined in the following table.

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Table 3
Typical, Escalated Issue and Non-Typical Investment Recovery

Line #	(All \$ in millions)	2013 Capital	Associated ICM Revenue	% Distribution Rate Impact
1	Typical	\$414	\$14	1.2%
2	Escalated Issue	\$75	\$6	0.5%
3	Non-typical	\$155	\$7	0.6%
4	Total in service additions	\$644	\$26	2.3%

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The revenue increase required for each category is provided in the second last column and the associated rate impact for a typical customer is provided in the last column. The derivation of the required revenue associated with Typical in service capital is \$14 million and the supporting calculation is contained in Table 1 of Exhibit B, Tab 1, Schedule 2. The derivation of the required revenue associated with Escalated Issue and Non-typical in service capital is also provided in the same exhibit.

In summary, Hydro One has met the Threshold Test for the ICM and is requesting an associated increase in revenue requirement of \$26 million to recover required expenditures on Typical, Escalated Issue and Non-typical capital. Hydro One proposes that this required increase in revenues be recovered through a 2013 approved rate rider as detailed in Exhibit E1, Tab 2, Schedule 1.

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