EB-2012-0064

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch.B, as amended;

AND IN THE MATTER OF an Application by Toronto Hydro-Electric System Limited pursuant to the *Ontario Energy Board Act* for an Order or Orders approving just and reasonable rates for the distribution of electricity commencing June 1, 2012

PHASE 1 FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

January 15, 2013

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1 INTRODUCTION AND SUMMARY

1.1 *Introduction*

1.1.1 On May 10, 2012 Toronto Hydro-Electric System Limited filed an Application for new distribution rates, effective June 1, 2012, May 1, 2013 and May 1, 2014. The Application was subsequently updated on October 31, 2012, and among other things the request for May 1, 2014 rates was deferred until a subsequent phase of this proceeding. The prior and subsequent process included extensive interrogatories, a technical conference, an unsuccessful ADR, and a detailed oral hearing over five days.

1.1.2 This is the Final Argument of the School Energy Coalition.

1.1.3 The ratepayer groups who intervened in this proceeding have followed their normal practice of working together throughout the hearing to avoid duplication, including discussing issues and exchanging drafts or partial drafts of their final arguments. We have been assisted in preparing this Final Argument by that co-operation amongst parties. We have also been assisted by the filing of the Board Staff submissions on January 10, 2013, allowing us time to review those submissions prior to finalizing our own.

1.1.4 Periodically in this Final Argument we use the term "No submissions". This is not intended to mean that we agree with the positions of the Applicant. Rather, we use that terminology either where an issue has little material impact on the members of SEC, or where we are confident that other parties will canvass all of the components of the issue thoroughly.

1.1.5 We have not followed our normal practice of organizing our submissions under the issues in the Board-approved Issues List. Because our submissions focus on a small number of issues, and those issues each have a number of sub-components, it is easier to follow if organized based on the topics being considered. Therefore, after this summary section, we first provide an overall context for the Applicant's spending proposals. There follow sections on the four main issues in dispute: 2011 Closing Rate Base, the interpretation of the Board's ICM policy, the specific capital spending proposals, and a potential Review and True-up.

1.2 *Summary of Submissions*

1.2.1 This Final Argument contains an analysis of some of the issues arising in this proceeding. The following are the main recommendations resulting from that analysis.

1.2.2 ***Context***. The Applicant already has among the highest distribution rates of any LDC in the province, and those rates have been growing since 2006 at an average of almost

5% per year. Their rate increases far outstrip those of the other large LDCs, yet the Applicant admits it has no plan to change this pattern in the foreseeable future.

1.2.3 Further, the Applicant has the highest cost existing capital infrastructure of all of the large LDCs (except Hydro One, with its rural base), yet proposes to add an amount to its rate base equal to about 40% of its high existing PP&E over just the 2013 and 2014 years, with more high spending to come in the future. This level of spending is unprecedented among Ontario LDCs, and only would make sense if the Applicant had a badly underinvested system. The Applicant's high existing PP&E demonstrates that its system cannot be "badly underinvested".

1.2.4 The Board's jurisdiction in this Application is to set "just and reasonable rates". SEC submits that, in the exercise of this jurisdiction, and in keeping with the Board's regulatory objectives including "cost effectiveness", the Board should expect the Applicant to meet a very heavy burden of proof before accepting capital spending proposals totaling $1.3 billion over three years.

1.2.5 Making high rates even higher, by adding massive capital spending to an existing very high capital base, is *prima facie* NOT "just and reasonable". Unless the Applicant can overcome that obvious conclusion, it is submitted that no incremental rate increases can be justified.

1.2.6 ***2011 Year-End Rate Base.*** The Applicant seeks to ignore the Board's clear policy with respect to the structure of IRM, primarily because the Applicant simply disagrees with the policy.

1.2.7 This request should be denied. The Applicant has shown no compelling reason why the Board should depart from its stated policy.

1.2.8 ***ICM Policy.*** The Board has been consistent, in both stated policies and individual applications, in calculating the ICM based on in service additions, not capital spending. The Applicant's proposal to include CWIP in the ICM is inconsistent with the Board's policy, and should be denied.

1.2.9 Much of the spending characterized as ICM projects by the Applicant is admittedly "business as usual" spending. The Board could not have been clearer in its 3rd Generation IRM Supplemental Report, bluntly rejecting the inclusion of business as usual spending in ICM. The Applicant says that policy has since changed, and now any non-discretionary spending above the threshold attracts incremental rate increases.

1.2.10 SEC believes this is not the Board's current ICM policy. Further, if the Board were to accept the Applicant's argument, the entire structure of both 3rd Generation, and now 4th Generation, IRM would be substantially undermined.

1.2.11 In place of the "fund everything we ask for" approach advocated by the Applicant, SEC proposes specific criteria to be applied on an individual project (job) basis. SEC also proposes a method of decision-making that integrates a top-down analysis or reasonable capital levels with the project-specific analysis, while seeking to avoid a line by line approval that could amount to micro-managing the Applicant's capital program.

1.2.12 ***ICM Implementation Issues***. The evidence raises a number of concerns regarding the Applicant's lack of capital planning and prioritization and uncertainty regarding its ability execute on its proposed ICM program. Its basis for justifying certain project portfolios, segments and jobs - primarily reliability and safety - are overstated. While SEC has not proposed a specific reduction of the ICM capital additions due to these issues, they should be considered in the context of the evidence justifying each project portfolio and segment.

1.2.13 ***Feeder Investment Model.*** The Feeder Investment Model is a tool for 'prudence' not 'need'. While a concept that should be encouraged by the Board, at this stage it is not detailed enough, and too flawed, to be a useful indicator even of prudence.

1.2.14 ***ICM Project Portfolios, Segments and Jobs.*** Based on a detailed analysis of the project portfolios, segments and jobs, SEC proposes a total of $189 million downward adjustments in the 2013 capital additions budget, as set out in Section 8 of this Final Argument, and summarized in Appendix A.

1.2.15 ***SEC ICM Recommendation***. SEC recommends that the Board decide as follows:

(a) Toronto Hydro has insufficient qualifying projects in 2012 to exceed the threshold, and it has not demonstrated that its entire 2012 capital additions budget is non-discretionary. Therefore, there should be no ICM for 2012.

(b) The maximum reasonable capital additions budget for Toronto Hydro in 2013 should be $270 million, and the maximum 2013 ICM amount should therefore be $97 million.

(c) Toronto Hydro be directed, in its Draft Rate Order, to identify through its own prioritization processes the specific project portfolios, segments and jobs that it will complete in 2013 within the above budget envelope.

(d) In that prioritization process, the adjustments proposed by SEC in its detailed project portfolio, segment and job analysis, and in Appendix A, be taken into account.

1.2.16 ***Review and True-up.*** The Applicant has stated that it believes its ICM spending will be subject to a symmetrical true-up later for both over-spending and under-spending.

It has proposed a consultation with Board Staff and stakeholders to work out the details of this mechanism.

1.2.17 SEC believes that the Board should make clear that there is no true-up for overspending that would recover additional amounts during the IRM period. The prudence of overspending is considered on rebasing on a going forward basis only. Failure to spend all of the funding provided by ICM is subject to true-up, both for the IRM period and for rate base going forward.

1.2.18 With that guidance, the Applicant, Board Staff and stakeholders can develop review and true-up proposals for later implementation on rebasing.

1.2.19 ***Effective Date***. SEC submits that there are no qualifying ICM projects for 2012. Therefore, the effective date for any ICM (which would be for 2013) should be May 1, 2013. In light of the filing history of this Application and the previous one, SEC believes that it is reasonable to have the IRM price cap adjustment effective as of June 1, 2012.

1.2.20 ***2014 ICM***. Given SEC's position on the other issues, this part of the proceeding ends up being for the most part a straightforward ICM application for 2013 only. We agree with Board Staff that, under RRFE, this kind of multi-year ICM is best handled as a Custom IR application. Since the Applicant's next rate adjustment is expected to be May 1, 2014, SEC believes that Phase 2 should be abandoned by the Applicant, or rejected by the Board, and a Custom IR application for 2014-2018 should be filed.

1.2.21 ***Bremner TS.*** In addition, the Applicant is seeking approval to proceed with Bremner TS, even before Phase 2 arises. SEC notes that Guelph Hydro, Oakville Hydro, and others, much smaller utilities, have managed to proceed with similar multi-year transformer station projects without getting prior Board approval. Toronto, for whom this size of expenditure is even less material, should make its own determination and proceed accordingly. Establishing a new precedent of capital pre-approvals of this type is, in our view, not a good regulatory direction for the Board.

1.2.22 In the event that the Board determines, due to the advanced state of consideration of Bremner in this proceeding, to complete that review, SEC submits that the Board should make clear that it is not creating a new regulatory for pre-approval of major capital projects.

2 CONTEXT AND IMPLICATIONS

2.1 *Introduction*

2.1.1 The Board's jurisdiction in this matter is granted by the OEB Act, which provides that the Board has the power to approve "just and reasonable rates". While the focus of the proceeding has been on the specific capital spending proposals of the Applicant, SEC submits that those proposals can only be considered in the context of their rate impacts, since the jurisdiction is entirely rate-driven.

2.1.2 In the process of establishing rates, the Board must of course have regard for the objectives set out in Section 1(2) of the OEB Act. In particular, SEC believes that the Board's review of this Application - and the rates proposed within it - is required to include consideration of the cost-effectiveness of the Applicant and its spending proposals. Cost-effectiveness is a results-oriented concept, and therefore it is appropriate to compare the Applicant's capital spending, and resulting rates, to its peers to test whether the Applicant is being appropriately cost effective.

2.1.3 Further, even within the spending proposals themselves, the Applicant's approach is entirely bottom-up. If an individual dollar of spending has a justification, it is included in the budget, no matter what the overall total. No effort appears to have been made to take a top-down approach to the capital plan, assessing what a reasonable total capital spending level would be for a utility in the position of the Applicant. SEC believes that, in keeping with longstanding Board policy, such an analysis is essential.

2.1.4 Finally, the context of this Application includes the recent evolution of the regulatory policies for LDC rates, and the potential impact of a decision in this proceeding on the regulatory choices of other distributors. A decision in this proceeding that could influence inappropriate regulatory choices by others should, it is submitted, be made only with great hesitation. The existence of inappropriate consequences may be an indication that the proposed decision has an unidentified and unintended problem embedded within it.

2.1.5 This section of SEC's Final Argument therefore attempts to put the Application within the broader context by considering the above issues.

2.2 *The Toronto Hydro Context – Rates*

2.2.1 ***High Existing Rates.*** SEC has long been concerned that the Applicant's rates are higher, in virtually every rate class, than those of essentially all of its peers, and continue to be higher year after year. For example, the following table, which was filed by SEC in EB-2011-0144, compares rates for the ten largest LDCs:

Annual Distribution Bill Comparison - Top Ten LDCs 2011 Rates
(monthly charge and volumetric rate)

Utility	*Residential*		*GS<50*		*GS>50*		*Large*		*Overall*
	800 kwh	*% of Avg*	*2000 kwh*	*% of Avg*	*250 KW*	*% of Avg*	*10 MW*	*% of Avg*	*Ranking*
Powerstream	$271.32	92.69%	$616.68	96.02%	$11,423.52	94.13%	$150,572.04	37.37%	80.05%
Hydro One Brampton	$253.32	86.54%	$583.32	90.83%	$8,547.36	70.43%	$308,266.20	76.52%	81.08%
Veridian	$282.72	96.58%	$569.88	88.73%	$10,687.32	88.07%	$298,353.48	74.06%	86.86%
London Hydro	$287.64	98.26%	$570.24	88.79%	$8,306.22	68.45%	$516,621.00	128.23%	95.93%
Horizon	$309.72	105.81%	$587.52	91.48%	$9,621.42	79.28%	$432,013.20	107.23%	95.95%
Kitchener-Wilmot	$278.28	95.07%	$596.04	92.81%	$14,769.48	121.71%	$333,957.24	82.89%	98.12%
Hydro Ottawa	$301.20	102.90%	$621.12	96.71%	$12,128.52	99.94%	$509,337.84	126.43%	106.49%
EnWin	$320.40	109.45%	$691.44	107.66%	$15,070.26	124.19%	$353,362.68	87.71%	107.25%
Enersource	$254.52	86.95%	$750.96	116.93%	$13,334.10	109.88%	$512,472.24	127.20%	110.24%
Toronto Hydro	$368.11	125.75%	$835.13	130.04%	$17,464.55	143.92%	$613,803.96	152.36%	138.02%
AVERAGE	$292.72		$642.23		$12,135.28		$402,875.99		

2.2.2 This table, which remains applicable today, shows that in each of the major rate groups, the bill for a typical customer from Toronto Hydro is higher, and often significantly higher, than any of the other large distributors.

2.2.3 ***High Rate Increases in Recent Years.*** During the course of the oral hearing, the following exchange between SEC counsel and the Applicant's witnesses appeared to cast doubt on the usefulness of this comparison [Tr.5:86-7]:

> *"MR. SHEPHERD: …Your rate increases -- except for the year in which you had the big change in depreciation -- your rate increases have always been in the last several years well above inflation, right? Except for that one year?*
>
> *MR. SEAL: That's not my exact recollection. In fact, I think the distribution portion of a customer's bill over the last five, six years has been relative flat, especially when you compare it to other components of a customer's bill. So* ***when you take into account all of our distribution rates, our rate riders that are basically clearing balances in accounts, deferral and variance accounts, that they have been relatively flat over that 2005 to 2011 period.***
>
> *MR. SHEPHERD: Your distribution rates, how much you charge your customers for the services you provide -- not the clearance of things that you're required to clear through, like the RTSRs and things like that, just how much you charge -- has gone up well in excess of inflation for the last several years, right?*

[Witness panel confers]

MR. SEAL: Mr. Shepherd, I was the -- the figures that I was mentioning are -- as I mentioned, do include the distribution component and some of the regulatory and deferral and variance accounts components, some of which are pass-through items, but which are the distribution part of the bill. ***So as I've mentioned, between 2005 and 2011 that portion of the bill has remained relatively flat."*** *[Emphasis added]*

2.2.4 Immediately following that exchange, the Chair pursued the narrower question of distribution rates, but the witness was unable to answer as the information was not readily available. Counsel advised that SEC would include the data in argument. The Applicant did not file any further material on this question, and no mention of it is found in Argument in Chief.

2.2.5 To that end. SEC has gone back to the rate schedules for both the Applicant and its peers from 2005 to 2011. The following information for Toronto Hydro was found:

(a) For a residential customer with 800 kwh. of load, the monthly charge plus volumetric charge for each 30 day period increased from $27.68 to $30.68, an increase of 10.83%.

(b) For a GS<50 customer with 2000 kwh. of load, the 30 day bill increased from $59.94 to $69.59, a 16.11% increase.

(c) For a GS>50 customer with 250 KW of demand, the bill <u>decreased</u> from $1,457.68 to $1,455.38, a 0.16% decrease.

(d) For a Large User with 10 MW of demand, the bill increased from $43,191.54 to $51,150.33, an 18.43% increase.

2.2.6 While these increases are clearly not "relatively flat", they are increases that are on average only a small amount above inflation for the same six year period. On this data, therefore, it would appear that Toronto Hydro may in fact be holding the line on costs.

2.2.7 It is only when you dig a little deeper that you realize using the period of 2005 through 2011 results in a misleading impression of the rate trajectory. (We note that we are not in any way intending to say that the Toronto Hydro witness was being deliberately misleading. What we are saying, instead, is that the 2005 to 2011 period does not provide a useful comparison with respect to rates**.)**

2.2.8 The Applicant's statement with respect to rate increases, which it has repeated many

times elsewhere[1], is misleading in at least three key ways.

2.2.9 First, the starting point used is 2005, the year before the Board started to regulate Toronto Hydro rates on a cost of service basis. In 2005, the Applicant had distribution revenue of $482.6 million, based on legacy rates that were the result of a rate freeze. When the Board had an opportunity to look at the Applicant's costs for its 2006 rates (in EB-2005-0421), the base revenue requirement was set at $436.5 million, a reduction of more than $46 million. As a result, rates dropped on average from 2005 to 2006 by about 11.5%.

2.2.10 There were a number of reasons for the drop from 2005 to 2006, but two stand out. In 1998 the six Toronto-area distributors were forced to amalgamate as part of the amalgamation of the City. As a result of that amalgamation, there were considerable cost savings (as have been seen in many other LDC amalgamations), which ultimately got included in rates in 2006. In addition, until 2006 Toronto Hydro was paying above-market interest to its shareholder, the City of Toronto. In the EB-2005-0421 case, the recovery of that excess interest – about $16 million annually - from ratepayers was disallowed [page 37 of that decision].

2.2.11 It thus appears clear that starting from 2005 will give the wrong impression of the rate trajectory of Toronto Hydro. To test that, SEC compared rate increases for the same four typical customers (outlined above) for Toronto Hydro and its peers from 2006 to 2011. The following is the result of that comparison[2]:

Cumulative Rate Increases 2006 to 2011
Monthly Charge plus Typical Volumetric

LDC	Residential	GS<50	GS>50	Large User
Toronto Hydro	25.44%	31.18%	13.13%	32.15%
Kitchener-Wilmot	17.90%	13.74%	10.49%	-2.48%
Powerstream	15.30%	-4.34%	-0.04%	-33.49%
EnWin	12.90%	12.52%	17.85%	27.16%
Hydro Ottawa	11.85%	14.64%	14.72%	5.60%
London Hydro	7.01%	-8.03%	23.74%	54.49%
Horizon	2.18%	25.67%	40.19%	93.93%
Enersource	2.02%	8.38%	-3.66%	5.26%
Hydro One Brampton	-10.78%	-15.22%	2.92%	-25.73%

2.2.12 As can be seen, Toronto Hydro has been increasing rates at about 5% per year for

[1] Including on their website, which currently says "Since 2005, distribution charges (the portion of your bill that goes to Toronto Hydro) have actually decreased."
[2] All data from Rate Orders published on the Board's website. Veridian has been excluded because it does not have an appropriate 2006 comparable.

those five years, while its peers have been increasing rates at much lower levels, closer on average to inflation than to the Toronto Hydro level.

2.2.13 This comparison is still, however, too favourable to the Applicant. The second reason that the Applicant's rate change comparison is misleading is that 2011 included an accounting adjustment for Toronto Hydro of $26.2 million. This was the net downward impact on revenue requirement of changes to its capitalization policy and its depreciation rates. While Toronto Hydro did not ultimately go to IFRS as its accounting standard, it did make the two main IFRS-driven changes in 2011, before any of the other utilities in the table above.

2.2.14 The effect of the accounting adjustment was a reduction in base revenue requirement of 4.8%, and so a reduction in rates of a similar amount. Were it not for this adjustment, the average rate increase for the Applicant from 2006 to 2011 would have been more than 6% per year. Since the other utilities in the above table did not make that change until 2012, the difference between the Toronto rate increases, and those of its peers, is even greater.

2.2.15 There is a third reason why the rate change comparison puts the Applicant in too favourable a light. In 2006, the total of all cost of capital components – interest, ROE, and PILs – was $206.7 million, 43.4% of total revenues ($475.9 million). In 2011, the total of those components, $177.5 million, was only 32.2% of revenues ($550.9 million). This is an overall cost reduction of more than $60 million that was the result of external factors, not management cost control.

2.2.16 While declining interest rates played a part in that reduction in costs, the biggest single contributor was the reduction in income taxes, which went from $54.2 million in 2006 to $9.0 million in 2011, a reduction of $45.2 million of costs. This was in large part the result of government policy decisions that reduced tax rates on corporations over that period.

2.2.17 But for the reduction in taxes, rate increases over the period 2006 through 2011 would have been more like 8% per year. While it is true that the other utilities in our comparison table above also had tax reductions, the overall effect would still be that Toronto Hydro's effective rate increases in those five years have been at least double those of the Applicant's immediate peers, and at least four times the rate of inflation over the same period.

2.2.18 It is submitted that the combination of

(a) rates that are higher than all distributors in the province (except a couple of rural utilities), as well as much higher than any of the Applicant's peers, and

(b) very high rate increases in the last five years, increases that are at least double

those of all of the Applicant's immediate peers,

should be cause for significant concern by the Board. Unless the Applicant is able to put forward a clear and thorough explanation for this combination of high rates and high increases, it is difficult for SEC to understand how the Board could justify allowing further exceptional rate increases in this Application.

2.2.19 ***What's the Plan?*** To follow up on this question, and after discussing the fact that Toronto Hydro's rates are higher than those of their peers, SEC asked the Applicant's witnesses what the plan is to bring rates back in line with the peer group. The answers showed a shocking inability to understand the importance of the rate result in making spending decisions:

> *"MR. SHEPHERD: …Where will we find and where will we see -- this is what all the ratepayer groups are asking -- a plan to get Toronto Hydro's rates back in line with the other LDCs? Where will we see that plan where we'll see all of this spending, this new spending coming, ending up with rates getting back in line with everybody else? We haven't seen that yet, right?*
> *[Witness panel confers]*
>
> *MR. McLORG: Mr. Shepherd, we're at a disadvantage, because we really can't comment on, much less control, the costs of other utilities. We come to the Board with an application in which we present what we consider to be and believe to be prudent costs incurred to serve the public. And of course we make the best case we can to persuade all parties, including the Board, of course, that those costs are justified.* ***So as to a plan that Toronto Hydro has to somehow equalize its rates with those of other utilities, no, we, to my knowledge, certainly don't have such a plan.*** *Our plan is, rather, to serve our customers at appropriate levels of safety, reliability and adequacy, at a cost that is prudent." [emphasis added]*

2.2.20 In SEC's submission, it would be legitimate for the Applicant to come to this Board with substantial spending proposals, and foundational evidence that the Applicant's costs should, for good reasons, be higher than those of its peers. The Board could then assess that evidence and, if it was solid, make a determination as to how much higher the Applicant's costs and rates should be in the long term relative to other LDCs in this province.

2.2.21 Alternatively, it would be legitimate for the Applicant to come to this Board with the same substantial spending proposals, but with evidence showing that, over time, the capital invested today will result in rates in line with other LDCs. The Board could then assess that evidence, and make a determination whether the proposal is the most cost effective way of getting to just and reasonable rates for Torontonians in the long

term.

2.2.22 What is not acceptable, it is submitted, is to come to the Board with rates that are already very high, and with a history of high rate increases, and propose a billion dollars of incremental spending with no rate analysis whatsoever.

2.2.23 Toronto Hydro can get their costs and rates into line with other comparable LDCs, or they can show this Board why they shouldn't have to. They cannot simply ignore their high rates entirely.

2.2.24 We note that this is not the first time Toronto Hydro has been advised to make an effort in this direction. In EB-2011-0144, the Board in its decision dealt squarely with the Applicant's refusal to compare itself to other utilities, and commented as follows [p.17]:

> *"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."*

2.2.25 Recently, the Board has reiterated its view that good utility management requires external benchmarking and comparisons. In EB-2012-0033, Enersource sought to resist comparisons of its rates and costs to other large distributors. In response, the Board said in its decision [pp. 34/5]:

> *"Enersource explained in its evidence that it had used a "bottom-up" approach to budgeting.* ***The Board is concerned that there appeared to be little, if any, analysis of the reasonableness of the overall OM&A budget and its effect on rates and ratepayers.*** *Throughout its evidence, Enersource repeatedly spoke of its budgeting approach as being built from the bottom up; there was little or no evidence of any process of overall or "top down" review of the budget. This is particularly significant given the level of total increase which the company is seeking.* ***A review of overall costs should be a critical part of any method of budgeting chosen by a utility. Such a review is an important component of the budgeting process as it demonstrates that some level of overall restraint has been considered, and***

> ***potentially brought to bear.*** *The Board finds that Enersource has not demonstrated a sufficient level of review of its overall budget level, including the magnitude of the increase." [emphasis added]*

2.2.26 The Board went on to say [p. 37]:

> *"**The Board has on numerous occasions identified the importance of benchmarking and comparative analysis. It is one of the most effective tools the Board has to assess the relative level of efficiency of distributors.** Enersource repeatedly resisted the suggestion that it should look to other utilities to assess its own level of efficiency and to examine whether more efficient approaches are available. The Board understands that no two distributors are exactly the same, but that does not mean that comparisons are irrelevant. The Board notes that within competitive industries companies routinely examine their competitors in an attempt to increase their own efficiency. The Board as an economic regulator acts as a proxy for competition, and therefore it is not surprising that comparative analysis would play a part in the Board's analysis. Enersource maintained that it could demonstrate its level of efficiency by comparing its own performance over time, and the Board agrees that this is one approach to examining efficiency; however, it says nothing about whether the company is as efficient as it could be. For that type of analysis, some form of external comparison or external analysis is required." [emphasis added]*

2.2.27 In our submission, the Applicant's refusal to test its capital spending proposals by looking at rate impacts, and by comparing the Applicant's overall rates to similar utilities, is a glaring gap in this Application. Lacking a reasonable explanation for the Applicant's high rates and high rate increases, the Board is left able only to conclude that the Applicant is not sufficiently controlling its own spending. In the face of that apparent fact, it is submitted that approving incremental spending – particularly in such sizeable amounts – would not be reasonable except for individual projects that are demonstrably extraordinary.

2.3 ***The Toronto Hydro Context – Capital Needs***

2.3.1 The second part of the Toronto Hydro context is the size of the capital spending proposals relative to existing distribution infrastructure. This is made more problematic by the high level of that existing PP&E.

2.3.2 ***High Levels of Existing Capital Investment***. As SEC has commented in other proceedings, the Applicant has a high level of existing capital investment relative to its peer group. Measured on a PP&E per customer basis, the Applicant's cost of existing distribution infrastructure is higher than all of the other large utilities (except Hydro One). The following table, which is a subset of material filed by SEC in the Renewed

Regulatory Framework Consultation and EB-2011-0144, but updated to 2011 data, shows that comparison (all figures from the 2011 Electricity Distributors' Yearbook):

PP&E per Customer

Utility	*PPE/Customer*	*% of Average*
London Hydro Inc.	$1,363	69%
Horizon Utilities Corporation	$1,463	74%
Veridian Connections Inc.	$1,565	79%
Kitchener-Wilmot Hydro Inc.	$1,780	90%
Hydro Ottawa Limited	$1,852	93%
Hydro One Brampton Networks Inc.	$2,060	104%
PowerStream Inc.	$2,221	112%
EnWin Utilities Ltd.	$2,126	107%
Enersource Hydro Mississauga Inc.	$2,320	117%
Toronto Hydro-Electric System Limited	$3,442	173%
AVERAGE (excluding Toronto)	$1,986	

2.3.3 At 73% above the average of its peers, Toronto Hydro appears to have a substantially higher cost system than any of the other large urban utilities. The only other large utility to have a higher PPE/Customer is Hydro One, at $4,545. However, Hydro One also has a density of 10.3 customers per km. of line, compared to 70.5 for Toronto Hydro, so that is clearly not a reasonable comparator[3].

2.3.4 There are probably some legitimate reasons why Toronto would have a somewhat higher cost system than average, including for example its higher number of office buildings and multiple-unit residential buildings, and its high percentage of undergrounding in the downtown core. On the other hand, for each one of those reasons there is an LDC on the above list that has a similar factor. The fact that Toronto Hydro has a substantially more expensive distribution infrastructure than ALL of its peers, not just the AVERAGE of its peers, suggests that the Toronto Hydro system is heavily invested already.

2.3.5 ***High Proposed Increases in Rate Base.*** This is important because the Applicant continues to propose large scale capital spending in a broad range of components of its system. On top of an increase in the distribution plant component of rate base from the beginning of 2006 to the end of 2012 of 39.5% [4], the Applicant now proposes incremental capital investments that would add a further 37.6%[5] to rate base over the

[3] The others on the list above have customer densities ranging from 37.8 to 72.3, so are more reasonable comparators.
[4] $1.541 billion 2006 opening rate base from EB-2007-0680 Ex D1/6/1. $2.149 billion 2012 closing rate base from this case, K4.2.
[5] $2.677 billion 2014 closing rate base and $2.149 billion 2012 closing rate base from K4.2, plus $300 million assumed in service additions for 2014 on 2014 capital spending, less $20 million in 2014 assumed depreciation on 2014 additions. Assumed 2014 closing rate base including 2014 additions is $2.957 billion.

two years 2013 and 2014. The result is that, over the nine years 2006 through 2014, the Applicant proposes to almost double rate base[6]. SEC believes that increasing rate base at an average of 10% per year, for a utility that already has a relatively expensive system, is prima facie not justified.

2.3.6 To test this, SEC looked at the increases in distribution plant of the industry as a whole (excluding Toronto Hydro and Hydro One) for the period 2005 through 2011. The industry as a whole is increasing rate base at a level of about 4% per year over that six year period[7]. Against that backdrop, the Applicant has already increased rate base at a faster rate to date (about 5% per year), and proposes to increase it by a further 17% per year over the next two years.

2.3.7 We note, in this context, that the Applicant has approached this entire Application as a bottom-up exercise, in which the overall totals are irrelevant. The assumption is that the only question to be addressed is whether each individual spending proposal can be justified. If it can, it is in, as far as the Applicant is concerned, and whether the total is $500 million, $1 billion, or $10 billion, is not something the Board should consider.

2.3.8 In our submission, this is not the correct way to consider this capital budget plan. In every utility, management can identify good reasons why capital spending at various levels can be justified. Distributors rarely do completely unnecessary projects. Why would they?

2.3.9 But the same utility that routinely does $150 million of capital additions annually can usually justify a $200 million capital program in any given year. The question is not whether each component of in-service spending should be done. The question is the pace of spending. In the Toronto Hydro view of the world, a budget of $150 million, or $200 million, or $250 million, would in each case be entirely non-discretionary. As many distributor witnesses have stated over the years, "there is always more to do than you have money or resources to do".

2.3.10 What stops most utilities from going hog-wild on their capital plan is application of a reasonableness test by senior management or the board of directors. Utilities as a matter of course prioritize their necessary projects based on an assessment of a reasonable level of capital spending in light of rate impacts, personnel and contractor availability, etc. This top-down analysis is what ensures that most utilities are not seeking to double the size of their rate base over nine years.

2.3.11 That exercise appears to be lacking in this case. Toronto Hydro seeks the Board's approval to add assets at a pace well in excess of other distributors, notwithstanding that it is not currently suffering from a deficiency in its existing capital invested.

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[6] $1.541 billion increased to $2.957 billion, a net increase of 91.9% over 9 years.
[7] Based on PP&E in the Yearbook data. Increase from $4.087 billion in 2005 to $5.186 billion in 2011, all year end figures net of accumulated depreciation.

2.3.12 On this issue, we note that the Board has for many years been telling utilities that this kind of prioritization and top-down analysis is a necessary part of their planning. In addition to the Enersource decision, which we have quoted earlier, we note the Board's comments on this question in the Enbridge 2006 rate case. Enbridge had proposed a substantial capital budget of $458.8 million, which would have added 11% to rate base in one year. The budget was justified based on individual projects that were, on Enbridge's evidence, each necessary and non-discretionary. In the case of most of it, the justifications focused on public safety.

2.3.13 The Board did not accept that bottom-up justifications should control their decision. In deciding that a level of $300 million capital spending was appropriate, not $458.8 million, the Board had this to say about how to set the overall level of capital spending [EB-2005-0437 Decision, p. 9]:

> *"2.2.1 It is not the Board's role in a rates case to micro-manage Enbridge's capital spending plans for any given year. Generally, Enbridge must determine for itself what level of spending is appropriate for a relevant period. This process within the Company must involve a thoughtful and programmatic assessment and prioritization of projects that have ripened to the extent that there is confidence that they can and should be accomplished within the period.* ***This is particularly so in an environment that has seen significant increases in energy prices and where the Company is seeking a very substantial increase in overall capital spending.*** *It may be that the Company will have to make choices about which projects are most critical, and which may have to await completion until future periods.*
>
> *2.2.2 The Board's role is to ensure that the Enbridge's total spending program is balanced in that it is not so low as to threaten the orderly maintenance and development of the system, nor so high as to place undue upward pressure on rates, either in the test year or some future period.* ***In fulfilling this role the Board attempts to place the capital spending plans within historical norms,*** *which can be presumed to have found that appropriate balance."[emphasis added]*

2.3.14 In our submission, the current spending proposals, which exceed the average of the last few years' spending by Toronto Hydro by a considerable amount, and which exceed the spending by all comparable LDCs, should evoke a similar response.

2.3.15 ***Conclusion***. SEC submits that a) the data on existing rates and rate increases, and b) the data on existing distribution infrastructure, and proposed increases in that infrastructure, all lead inexorably to the conclusion that the Applicant's spending proposals are excessive and out of step with the rest of the industry.

2.3.16 In our submission, unless Toronto Hydro can demonstrate that it is in a different situation from all of its peers, and the industry as a whole, - neither of which it has done or attempted to do - the Board can only conclude that the Applicant's capital spending plan is not necessary, and is not the product of real capital needs, but instead the product of insufficient cost controls and lack of prioritization.

2.4 ***Implications for Future Applications***

2.4.1 All applications before the Board have, to a greater or lesser extent, some amount of precedential value. It is something that every Board panel has to consider when they make their decisions on the issues, and then when they choose the wording they use to express those decisions. Thus, the impact of a decision as a precedent is not something on which SEC would normally make any comments.

2.4.2 The situation is somewhat different here. Over the last few years, one of the key bugbears of the distributors has been their concern that they were not able to recover sufficient rate revenue under IRM to cover their capital spending requirements. This was an issue that generated considerable attention in the Renewed Regulatory Framework, and subsequently led the Distribution Regulation Review Task Force to write the Board [see K4.7, pp. 2-5] asking for clarification of the Board's policies relating to the Incremental Capital Module.

2.4.3 Cross-examination on that letter, exploring the broader implications of this Application, let to the following exchange with Toronto Hydro witnesses [Tr.5:3-4].

> *"MR. SHEPHERD: Do I understand that this application is essentially a test case or is potentially, in the context of the task force, a test case to determine what the rules are for ICM?*
> *[Witness panel confers]*
>
> *MR. McLORG: I think, Mr. Shepherd, my best response to you is that Toronto Hydro has put forward its own application under its -- under its best lights in accordance with the ICM framework. It wouldn't be in our mouths to determine how the Board would treat that as being in any sense a precedent, but I think that there are two applications, one from Toronto Hydro and one from Hydro One, that could serve to provide indications to the general community as to how the Board is responding to the applications that are before it.*
>
> *MR. SHEPHERD: And am I right in understanding that -- that's a fair answer. Am I right in understanding that -- obviously we all know that everybody is watching to see what the result is in this case, right, because it is important? But am I right in understanding that part of people's decisions about whether next year they ask for custom IR or one of the*

> *various options in the renewed regulatory framework is going to be based on what the scope of ICM is; is that fair? And that will be described in this case or may be described in this case?*
>
> *MR. McLORG: I think that it is fair to say that the outcome of this case will be of interest to other distributors, and they may take it as a signal as to what is acceptable, from the Board's perspective, within an ICM framework and what might lie outside of that."*

2.4.4 The Hydro One case referred to, EB-2012-0136, has been resolved through a comprehensive Settlement Agreement that has been approved by the Board. While some distributors will undoubtedly see the terms of that settlement, and the Board's acceptance of those terms, as guidance on the ICM, the Board has regularly cautioned parties not to put undue emphasis on the precedential value of Board-approved settlements.

2.4.5 There remains, then, one contested application that deals with the ability of a distributor to access the ICM to fund their capital spending program – this one.

2.4.6 The reason the impact of this case as a precedent is so important is that it is being made in the context of major changes to how distribution rates are set. The Renewed Regulatory Framework, which considered many of the issues discussed in this proceeding, has established three ratemaking options for distributors.

2.4.7 The RRFE option specifically designed for distributors with major capital programs is called Custom IR, which is essentially a five-year cost of service application. It has the advantage that all impacts – positive and negative - of high levels of capital spending can be addressed over a relatively long period of time. Indeed, the application by Toronto Hydro in EB-2011-0144 essentially anticipated this direction, although that application was only for three years. It was rejected because it was premature; under the policies then in existence this option was not available to Toronto Hydro.

2.4.8 The RRFE also includes an IRM option, which is basically identical to 3rd Generation IRM, but with updated productivity, inflation, and other factors. It continues to include the ICM.

2.4.9 The question in the minds of the distributors is twofold. The first is whether, if they plan a major capital spending program, they have to elect Custom IR, or whether they can obtain similar results to Custom IR through IRM plus ICM. If they are allowed to get the IRM adjustment (which supposedly includes increases for both capital and operating costs), plus additional rate recovery for their entire capital plan, that may well be an attractive, if somewhat roundabout, method of achieving the rate levels they want without a full review.

2.4.10 On this first question, where a distributor plans a break from their past, with capital spending in excess of historical norms, in our view Custom IR is the appropriate rate-setting method, for the reasons outlined in the Board's RRFE Report. This has already been discussed, and the Board has reached a conclusion. It is submitted the Board's conclusion should be implemented.

2.4.11 The distributors' second question is more problematic. The average distributor in Ontario had capital additions of more than 180% of depreciation in 2011, the last year for which data is available. Despite that, the average ROE for all distributors was close to the Board-approved level.

2.4.12 If the Board accepts the formulation of the ICM proposed by the Applicant in this case, the effect would be that any distributor with a capital spending plan in excess of about 120% of depreciation would be able to get ICM funding in addition to their IRM increase. The result would be the decoupling of capital funding from operating funding, something the Board has consistently rejected as being inconsistent with comprehensive incentive regulation.

2.4.13 In SEC's submission, it is imperative that the Board in this decision make clear that ICM is not for routine capital spending programs in excess of depreciation, whether they exceed historical norms or not. If the capital spending program is a significant expansion, the Board has created Custom IR for that purpose. If the capital spending plan is similar to historical norms, the normal IRM formula should apply.

2.4.14 Whether or not it is appropriate, it appears clear that the decision in this case will be taken by many in the industry as expressing the Board's current policy on the ICM, including any changes to the policy since it was first established. Decisions by many distributors on 2014 rate applications will likely be based on their assessment of that policy. If the policy expressed in this case expands ICM as requested by the Applicant, the two effects would be:

(a) Undermining of the use of Custom IR for those utilities that should be electing that option; and

(b) Decoupling of capital funding from operating funding within the IRM framework, and thus systematically allowing higher rate increases in the future than have been allowed in the last four years.

3 RECOGNITION OF 2011 YEAR END RATE BASE

3.1 *The Proposal*

3.1.1 The Applicant proposes that the Board provide incremental relief on the basis that its year-end rate base in its rebasing year, 2011, exceeds the average rate base for that year on which rates were set. The Applicant initially alleged that this would create a structural shortfall in funding of rate base during IRM.

3.1.2 During the oral hearing, the Applicant conditionally withdrew this request [Tr.4:74], but there was some doubt as to whether that withdrawal was actually being made.

3.1.3 In the end, it appears that the Applicant's withdrawal of this part of the Application is only relevant if the Board accepts calculation of the ICM on a capital spending basis, rather than on the basis of in-service capital additions. As it appears to SEC that the use of a capital spending basis has no foundation, we are therefore treating the claim for a special rate increment relating to 2011 closing rate base as continuing to be a live issue.

3.1.4 Below, we provide our analysis of this issue, in which we conclude this proposal:

(a) Is contrary to clear Board policy, which has been reiterated many times including very recently. It is time to stop wasting the Board's time by continually debating this issue. The Board has decided it. Let's move on.

(b) Is based on math that is both simplistic and fundamentally flawed. The "funding gap" alleged does not exist.

3.2 *Analysis - Board Policy*

3.2.1 ***General.*** When the 3rd Generation IRM Framework was established, the structure did not include an adjustment because only half of the rebasing year capital additions ended up being included in rate base. Many distributors made the argument that this underfunded capital, but that argument was not accepted by the Board.

3.2.2 This is not surprising. As we note later, there is no reason to think that the structure underfunds capital spending. Because the 3rd Generation mechanism tracks overall utility costs to inflation, the fact that assets are added and subtracted each year was implicitly captured in the trend line from the past data. The past is predictive of the future in this case. If the past data picks up the effect, the future formula will do so as well.

3.2.3 The interesting thing is that this is true whether or not the past methodology was half-

year rule (i.e. average of opening and closing rate base), or full year rule (closing rate base only). As long as it was consistent, the addition and deduction of assets would be captured by the combination of total cost escalators and the rate base calculation methodology.

3.2.4 Notwithstanding this obvious fact, distributors have continued to argue for some kind of adjustment to reflect the use of average rate base in the rebasing year. This argument was again made during the Renewed Regulatory Framework for Electricity, and was again rejected by the Board.

3.2.5 The Board Report on 3rd Generation IRM does not include any adjustment for this effect. That fact appears to be undisputed, so the Board policy is likely not in dispute. While distributors like Toronto Hydro disagree with the Board policy, thinking that on this point the Board got it wrong, we are not aware of any distributors who believe that this is not the Board policy.

3.2.6 ***Recent Decisions***. If there was any doubt about the Board's policy, two recent decisions of the Board have laid any such doubts to rest.

3.2.7 In EB-2012-0033, Enersource 2013/14 Rates, the utility sought to have rates set for the second year to adjust for the half-year/averaging impact in the first (rebasing) year. The Board rejected that argument, saying [pages 6 and 8 of the Decision]:

> *"The Board has been clear that rate base re-calibration is generally not part of a multi-year ratemaking framework. Distributors are expected to respond to the incentives in the framework and the result will determine the returns shareholders earn.*
>
> *…Having considered the two criteria, whether the proposed approach is superior to the Board's policy in the circumstances and whether Enersource can manage its resources and financial needs under the current policy, the Board finds that there is no compelling reasons to depart from the Board's policy. On that basis, the Board rejects Enersource's proposal that the Board set rates for 2014 as part of this proceeding. As parties will be aware, the Board has now released its RRFE Report, which sets out the Board's new policy for rate-setting and provides three options for distributors. The Board notes that Enersource's proposal is not aligned with the approaches contained in that Report for the same reasons as set out above."*

3.2.8 In EB-2012-0161, Powerstream 2013 Rates, the utility sought to have the full year rule applied to depreciation in the rebasing year, on similar grounds. Their stated rationale was that in the years following rebasing, they would not get full funding of their rate base due to the underlying structure of IRM. Although not exactly the same issue, it is

analogous, but the Board rejected that argument as well, saying [page 5 of the Decision]:

> *"The use of the half-year rule for depreciation is a long-standing policy of the Board. The policy was recently reviewed in the context of the RRFE and remains unchanged in this area. The Board finds that PowerStream has not justified its request for full year depreciation and does not accept it. The increase in revenue requirement (about $2.5 million) as a result of full year depreciation is unsubstantiated.*
>
> *…It is clear to the Board that the nature of this issue is generic. The half year rule is integral to the Board's rate making framework and is generally applied to all distributors.* ***The manner in which the Board applies its policies is to allow for departures from the normal practice where the specific circumstances of any given situation dictate that an alternative approach would be more appropriate****." [emphasis added]*

3.2.9 These are not the only examples of distributors that have sought to convince Board panels that the half-year rule, and the averaging of rate base in a rebasing year, are unfair to the distributors. The Board has consistently rejected those arguments, both in policy consultations like the 3rd Generation IRM and the RRFE, and in individual rate cases. It is no surprise. Those arguments are simply incorrect (see below).

3.2.10 As a result, SEC submits that Board policy has often and clearly refused to adjust for the half-year impacts in the rebasing year. Those impacts are already captured in the 3rd Generation model, and now in the 4th Generation model. Any further adjustment would be double counting.

3.2.11 ***Conclusion***. SEC concludes from the above analysis that Board policy on IRM does not include an adjustment such as that sought by the Applicant, and that Board policy has a sound foundation in reality. The Applicant has not demonstrated special circumstances that would allow the Board to make an exception in their case. They have also failed to demonstrate that the Board's policy is wrong.

3.2.12 In these circumstances, it is submitted that the Board policy should be applied, and there should be no adjustment to permit extra recovery for the difference between average and closing rate base in the rebasing year of 2011.

3.3 ***Analysis – Available Funding***

3.3.1 Even if the Board's policy were not so clear, and had not been affirmed so bluntly in recent Board decisions and policies, the argument that averaging of ratebase in the rebasing year must be adjusted would fail mathematically.

3.3.2 There are two parts to this argument based on the underlying principle:

(a) As we have argued a number of times in the past, a simple mathematical example can show that the rate base and depreciation amounts in the test year are already taken into account in the underlying math of IRM. One such example is set out in SEC's submissions on the RRFE.

(b) This Applicant actually provided numerical examples to show their "problem" with capital underfunding. When those examples are looked at with care, they show that IRM does not contain any systematic underfunding of capital, and that in fact on the Applicant's own numbers they do not have a funding problem despite their increases in capital spending.

Each of those parts of the argument is discussed below.

3.3.3 ***SEC RRFE Submissions on CEEDs and the Half Year Rule for Depreciation.*** The claim by distributors, often led by Toronto Hydro (who coined the "CEEDs" acronym), is that IRM has a fundamental flaw that results in underfunding of capital. Part of this is the half-year rule, but it is really part of a larger argument on the math of IRM. The following twelve paragraphs are taken directly out of SEC's April 20, 2012 submissions in EB-2010-0377/8/9, the Renewed Regulatory Framework for Electricity. This describes the results of modeling the effect of year after year of rate base additions and depreciation, using averaging, half-year depreciation, etc. After considering these and other submissions of ratepayer groups, and opposing submissions by distributors, the Board did not change the way IRM handles either the averaging of rate base or the use of the half year rule for depreciation.

3.3.4 "At a simplistic level, utilities argue that the only funding in rates for new capital is the depreciation on the existing assets, but new assets cost more than old ones because of inflation. The term Capital Expenditures in Excess of Depreciation (CEEDs) has been coined to express this. Those same utilities argue that the half year rule in the rebasing years builds in a further shortfall that is not recoverable under IRM.

3.3.5 This basic argument is simply wrong. On the CEEDs issue, the argument fails to reflect the fact that while new assets do indeed cost more than old assets, the annual cost of old assets (when depreciation, cost of capital, and related PILs is totaled) is going down every year because the undepreciated capital cost is dropping, and the depreciation provision is going up annually as new assets are included.

3.3.6 The easiest way to see this is to assume a situation in which there is no inflation, and assets all have a 30 year life. The replacement obligation this year will be $1/30^{th}$ of the original cost of the existing assets. The depreciation this year will also be $1/30^{th}$ of the original cost of the existing assets.

3.3.7 But there is inflation. How does that change this equation? The answer is a net of zero. The depreciation provision is no longer 1/30th of the cost of the assets being replaced. It is 1/30th of the cost of the existing assets, which have vintages from 1 year to 30 years. The depreciation provision will (ignoring compounding for simplicity) reflect, on average, assets that are 15 years old.

3.3.8 Further, the remaining costs associated with the capital being replaced have been going down year by year, as rate base is shifted from the balance sheet to the income statement through depreciation. This means that each year, while new capital assets are more expensive, and therefore the carrying cost increases, the old capital assets are less expensive, and therefore the carrying cost decreases.

3.3.9 It has been demonstrated algebraically, financially, and in a full model that, if the annual increase in the cost of capital assets due to inflationary forces is exactly equal to the net increase in the X factor, the IRM formula includes in rates exactly the amount necessary to replace the assets being retired (including the impact of compounding).

3.3.10 Take a simple example. Assume $100,000 of capital assets added each year, with a life of 10 years, and annual cost increases of 2%. What does the math show?

(a) When it comes time to replace the first assets in year 11, the 2% cost increase compounded annually will increase the cost from $100,000 to $121,899. That is the replacement cost.

(b) Depreciation on the pool of assets, which will include assets from 1 to 10 years old, will be $110,592 in the year the replacement of the first assets has to take place. The reason for this is that while the depreciation on the oldest assets is lower ($10,000), the depreciation on the most recent assets is higher because their original cost is higher. Not surprisingly, the increase in annual depreciation is roughly equal to the rate of cost increases, compounded for half the period.

(c) A 2% annual rate increase results in rates available to cover capital costs equal to 110.22% of depreciation.

(d) Multiplying the current depreciation by 110.22% gives you exactly $121,899, the cost of the new assets to replace the 10 year old ones.

(e) If the assets have a 20 year life, the cost of the replacement assets at 2% a year is $148,590, the depreciation in the current (replacement) year is $122,702, the rate increases provide funding for 121.10% of depreciation, and that nets a funding amount of – you guessed it - $148,590.

3.3.11 The above calculation works on any assumption as to cost increases, and any assumption as to the life of the assets.

3.3.12 It is also true that the same results follow if the half year rule is included in the calculations of first year depreciation. (In fact, the above numbers were initially derived using the full model, including the half year rule, and later checked removing the impact of the half year rule.)

3.3.13 Why doesn't the half year rule have an impact? The simple answer is that those promoting that argument are forgetting that in the last year of an asset's life, the remaining half a year of depreciation is charged. That impact offsets the impact in the first year. In any given year, some assets are depreciated at 50% because they are new, and some at 50% because they are old, and these are offsetting effects.

3.3.14 There are numerous objections that can be made to this simple analysis, including:

(a) 3rd Generation doesn't fund at inflation levels, but at much lower levels. That is true, but as long as the IRM escalator fairly reflects annual increases in utility unit costs, the conclusions above remain valid. The conclusions will only be invalid if the escalator does not correctly reflect the long-term annual escalation in the cost to LDCs of capital assets. That, then, would not be a problem with the structure of the capital funding, but rather a problem with the cost escalator used. We talk about this question further, later in these submissions.

(b) Replacement of assets is often not like for like. The new assets may have increased capabilities or functionality. Those come at an incremental cost. That is likely true, although offset in whole or in part by greater efficiencies in new assets and the resulting downward impact on other costs. In any case, this is again not a problem with the structure of the capital funding. It reflects instead either productivity investments or a higher level of service to customers. These have to be quantified if they are to be reflected separately in rates.

(c) There are many additional capital costs associated with government directives and other external forces. Again, this is not a problem with the structure of the capital funding, but is a separate issue. We discuss this further below.

3.3.15 SEC has been saying for some time that if there is a problem with capital funding, it must be identified with more precision. The erroneous arguments based on CEEDs and the half year rule are complicating the Board's review unnecessarily. It appears to us that those making those arguments either have to step up and demonstrate their arguments mathematically (they can't), or drop them and allow the Board to focus on the real issues."

3.3.16 ***The Applicant's Example.*** In K4.2, the Applicant purported to show how inclusion of

the difference between average and closing rate base in 2011 would be necessary if they are to be fully funded for 2011 capital expenditures in the 2012 and subsequent IRM years.

3.3.17 SEC has reviewed in detail the "IRM funding" issue presented by the Applicant. Section 4.5 of this Final Argument does a full analysis of K4.2 and what it really implies. The two alternative formulations of the correct conclusion, in both cases assuming that the entire Toronto Hydro capital spending program proposed by the Applicant is approved by this Board, are as follows:

(a) The IRM formula fully funds, over 2013 and 2014, the 2011 rate base differential, plus almost all of the proposed capital additions program for 2012 and 2013, except a shortfall of$12.4 million of funding. This implies that, in addition to the bump in rate base in 2011 of $103.7 million, $345 million of the $469 million capital additions in 2013 are fully funded without resort to an ICM.

(b) The IRM formula fully funds the entire capital additions program, plus some of the 2011 rate base differential, leaving a funding shortfall of $12.4 million for the rate base differential issue.

3.3.18 ***Conclusion.*** It doesn't really matter what way you approach the numbers. The 3rd Generation IRM model funds capital spending during IRM at an appropriate pace.

3.3.19 As with other parts of this discussion, this should not be a surprise. Ontario distributors are on average spending 175% to 180% of depreciation on new capital additions. If the IRM model had serious flaws, as alleged by Toronto Hydro and others, it would simply not be possible for distributors to do that without significantly undermining their returns. Average distributor returns have not, in fact, been suffering in any material way during their IRM years.

3.4 ***Conclusion***

3.4.1 Based on the foregoing, SEC submits that the Applicant's request for a special rate incremental to reflect the difference between average and closing rate base in 2011 should be denied, because:

(a) It is demonstrably contrary to Board policy, and no evidence supporting an exception has been provided, and

(b) The underlying mathematics does not support the argument that the current IRM is unfair or flawed.

4 ICM POLICY ISSUES

4.1 *Introduction*

4.1.1 In this section, SEC will consider the various issues of policy and policy interpretation that may arise in considering this Application. There appear to be four such issues:

(a) The Application has been filed on the basis that ICM funding is available for capital expenditures incurred in a year, rather than capital additions in the year.

(b) There is a question as to whether the Applicant has provided sufficient evidence that the threshold has been met in 2012. Related to that, the Applicant has proposed an alternative in which the threshold for both years is reduced to 100% of depreciation.

(c) The Applicant proposes to extend the concept of the ICM to a much broader range of capital, in essence rejecting prior Board policy and proposing new ICM criteria.

(d) In oral testimony, the Applicant argued that the ICM does not provide proper funding for its legitimate capital program.

4.1.2 We will deal with each of these in turn.

4.2 *Capex vs. ISAs*

4.2.1 The Applicant has proposed that the ICM be calculated based on the capital expenditures in each year, not the capital additions (in-service additions, or "ISAs") in each year. In 2012 and 2013, proposed capital expenditures total $862.09 million, while proposed ISAs total $653.11 million [both figures from J5.1]. Thus, from the point of view of calculating the ICM, the difference in approach is highly material, representing an additional average rate increase of more than 3%.

4.2.2 We note that the Applicant is clear that they are not seeking a change in Board policy on this point. The capital spending basis was their understanding of Board policy, and they were simply seeking to apply in compliance with Board policy [Tr.5:41-2, 56].

4.2.3 SEC agrees with Board Staff that the Board's policy is clear: the ICM is calculated on the basis of ISAs. There appear to be five main facts in support of this conclusion:

(a) Every ICM to date has been calculated based on in-service additions.

(b) The ICM policy requires calculation of a revenue requirement, which only

applies to in-service additions.

(c) Any true-up would either have to adjust back to revenue requirement, or leave accounting and regulatory rate base out of whack.

(d) The Filing Requirements make clear that CWIP is not included in the account used for the ICM.

(e) The use of capital expenditures would imply a rejection of, or limitation on, the "used and useful" rule for rate recovery, and it is not the Board's practice to implement such a major change in regulatory philosophy without first publishing a full analysis, and then making a clear statement of the nature and purpose of the change.

We will deal with each of the above facts in turn.

4.2.4 ***Prior Decisions.*** For many small and mid-sized distributors, there is very little CWIP at the end of the year. A capital program is planned in the fall and winter, with a view to implementing it through the following spring, summer and fall. In many cases the only exception to this will be the very large projects, for which ICM treatment was designed.

4.2.5 As a result, the ICM decisions to date include a number of cases in which spending over multiple years was afforded ICM treatment in the year the asset came into service. In the oral hearing, SEC tabled a couple of examples [at pages 6 and 7 of K4.7]:

(a) In EB-2010-0104, Oakville Hydro sought ICM treatment for a transformer station brought into service in 2011, but made up of capital spending over three years 2009 -2011.

(b) In EB-2010-0130, Guelph Hydro similarly sought ICM treatment for a transformer station brought on-line in 2011, but comprising three years of capital spending.

In both cases, the ICM was calculated on the basis of the total in-service cost in the ICM year, not simply the amount spent in that year.

4.2.6 When questioned about this [Tr.5:47-8], the Applicant's witness initially suggested that the ISA basis was not used in the Guelph case, but after some discussion it appeared that he had mis-stated his intent. In the end, no evidence was put forward by the Applicant that any part of the EB-2010-0130 decision was based on capital spending rather than ISAs. SEC submits that any proper review of that case – in which SEC was one of the intervenors - shows that all calculations were on an ISA

basis.

4.2.7 A slightly different example arises in the case of Woodstock, EB-2011-0207**.** In that case, the LDC paid a $4.1 million capital contribution, and incurred related connection expenses, with respect to the Commerce Way TS owned by Hydro One. Woodstock originally included the spending in its 2011 rebasing application, but withdrew it because the in-service date of the TS was 2012. This application was for the utility's first IRM year after rebasing, and the in-service year for the TS.

4.2.8 In this case, a substantial amount of the capital contribution, and much of the direct spending, actually took place in the rebasing year, 2011 (and some prior to that) [EB-2011-0207, Application p. 12-13]. Notwithstanding that, the Board included all of it in the 2012 ICM, saying that it should be treated like any other capital addition.

4.2.9 SEC has reviewed all of the ICM cases that have been decided by the Board. In none of those cases was an ICM granted based on capital spending not brought into service in the ICM year. In many of those cases, the ICM included capital spending in prior years that was brought into service in the ICM year.

4.2.10 This fact was put to the Applicant, who after some confusion with respect to Guelph (see above) was unable to show an example where an ICM was based on capital spending rather than ISAs.

4.2.11 It is submitted that the result is not really in dispute: the Board has never based an ICM on capital spending. All ICMs have been based on ISAs. For the Board to use capital spending in this case would be a change in Board policy and practice. The Applicant has said they did not intend to request a change in policy or practice on this point.

4.2.12 ***Revenue Requirement.*** The Board has consistently made clear that the ICM is based on the revenue requirement during IRM for the incremental capital spending. In the Board Report, for example, the Board says, at page III of the Appendix K4.7, p. 33], that ICM applications must include:

> *"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."*

4.2.13 This was inserted into the Filing Requirements in 2008, as directed by the Board in its IRM policy, and has been continued up until the present time. For example, page 11 of the current Filing Requirements [K4.7, p. 45] makes clear that the rate adders are calculated based on the revenue requirement of the ICM projects.

4.2.14 In cross-examination [Tr.5:36-7], the Applicant admitted that none of these revenue requirement components can be calculated on CWIP, i.e. assets that are not in service. In all cases, the components of revenue requirement for capital projects can only be calculated when something goes into service, and thus is added to rate base.

4.2.15 ***True-Up.*** To similar effect, the Applicant's own proposals are not consistent on this point. For example, the Applicant proposed a true-up based on revenue requirement [Original Manager's Summary, p. 22], but admits that such a calculation would necessarily be based on in service additions [Tr.5:42-44].

4.2.16 Indeed, if it were not trued up on a rate base approach, then regulatory and accounting records would diverge. Asked about this, Mr. McLorg made clear that the Applicant seeks congruence between ICM rate adders and revenue requirement calculation [Tr.5:43-4]:

> *"MR. SHEPHERD: …If the true-up is based on ISAs, doesn't that mean you would have collected too much? It is a hypothetical.*
>
> *…MR. McLORG: I think that is fair, Mr. Shepherd.*
>
> *MR. SHEPHERD: Okay. And, conversely, if the true-up is based on capital spend each year, doesn't that mean that your rate base is going to diverge from your accounting treatment, because you can't do that for accounting purposes, right? You can't treat depreciation as happening on your assets on the basis of capital spend, can you?*
> *[Witness panel confers]*
>
> *MR. McLORG: There's no indication at all in our application that we intend to change anything to do with accounting, Mr. Shepherd. We would not.* ***Clearly I think this is simply a matter of two things. One is the methodology under which the ICM rate adders will now be determined, and the determination of the methodology under which the ultimate revenue requirement would be determined. And we're on record as having said that we don't want there to be a structural difference between those two methodologies.****" [emphasis added]*

4.2.17 Thus, apparently even the Applicant admits that, if the true-up is based on revenue requirement, the ICM projects must be based on in-service additions.

4.2.18 ***Filing Requirements.*** If these indirect statements are not enough, the current Filing Requirements make clear that capital spending on ICM projects only qualifies for Account 1508 – which is the account used to capture the ICM calculation – when it is used and useful. The Filing Requirements dated June 28, 2012 state as follows at page 10 [K4.7, p. 44]:

> *"The distributor will record eligible ICM amounts in Account 1508, Other Regulatory Asset, sub-account Incremental Capital Expenditures,* ***subject to assets being used and useful****. For incremental capital assets under construction, the normal accounting treatment will continue in the construction work in process ("CWIP") prior to these assets going into service and hence eligible for recording in the 1508 sub-account."[emphasis added]*

4.2.19 It is submitted that this can only be interpreted as requiring that ICM treatment arises when and only when an asset goes into service. If that were not the case, Account 1508 would at all times be wrong for multi-year capital projects.

4.2.20 ***"Used and Useful" Rule.*** Finally, SEC notes that the "used and useful" rule is a fundamental rule of regulated ratemaking. The principle is that the ratepayers start to pay for an asset only when it is being used in a useful way, i.e. to provide service to them. On the capital side, it is one of the most widely accepted aspects of the calculation of revenue requirement.

4.2.21 SEC agrees that it is probably within the Board's jurisdiction to suspend, alter, or even replace the "used and useful" rule, despite its long history and universal acceptance.

4.2.22 However, it is submitted that a regulatory policy change that fundamental should not – and in the Board's consistent practice, would not – be implemented without a direct and thorough review of the rationale for, and implications of, that change. Once convinced that the principle should change, the Board should and would very clearly explain what it was changing, and why.

4.2.23 None of that has happened here. The Board has given no indication that it has called the used and useful rule into question, or that the ICM was intended to modify or replace that rule. It is, in our submission, inconceivable that the Board would take such a step indirectly, without analysis and without a clear statement of its intent.

4.2.24 ***Conclusion.*** For the above reasons, SEC submits that the Board's ICM policy is based on ISAs that meet the ICM criteria and exceed the threshold in each year.

4.2.25 On that basis, SEC has reviewed the Applicant's evidence, including in particular J5.1, and believes that the proposed capital plans for 2012 and 2013 are, if restated on the basis of in-service additions, as follows:

Toronto Hydro ICM Application on the basis of In-Service Additions

Projects (i.e. Portfolios of Projects/Jobs)	*Number*	*Segments (i.e. Groups of Projects/Jobs)*	*In-Service Additions 2012*			*In-Service Additions 2013*			
			Pre-2012 Spending (December 31, 2011 CWIP)	*2012 Spending*	*Total ISAs*	*Pre-2012 Spending (December 31, 2011 CWIP)*	*2012 Spending*	*2013 Spending*	*Total ISAs*
Underground Infrastructure and Cable	B1	Underground Infrastructure	2.88	12.74	**15.62**	15.06	16.01	35.87	**66.94**
	B2	PILC Cable - Piece-outs and Leakers		0.04	**0.04**		0.05	3.30	**3.35**
	B3	Handwell Replacement	2.57	6.05	**8.62**	1.30	7.60	10.13	**19.03**
Overhead Infrastructure and Equipment	B4	Overhead Infrastructure		4.02	**4.02**	3.94	5.05	34.01	**43.00**
	B4	Box Construction		0.26	**0.26**		0.32	14.02	**14.34**
	B6	Rear Lot Construction	4.45	7.25	**11.70**		9.11	17.91	**27.02**
	B7	Polymer SMD-20 Switches						0.93	**0.93**
	B8	SCADA-Mate R1 Switches						0.87	**0.87**
Network Infrastructure and Equipment	B9	Network Vault and Roofs		1.26	**1.26**		1.58	11.42	**13.00**
	B10	Fibretop Network Units		0.65	**0.65**	0.34	0.82	4.69	**5.85**
	B11	ATS and RPB						1.99	**1.99**
Station Infrastructure and Equipment	B12	Stations Power Transformers		0.17	**0.17**		0.21	2.12	**2.33**
	B13	Stations Switchgear - MS and TS		0.77	**0.77**	4.67	0.96	13.28	**18.91**
	B14	Stations Circuit Breakers	0.28	0.34	**0.62**		0.42	0.34	**0.76**
	B15	Stations Control and Comm. Systems		0.06	**0.06**		0.08	0.61	**0.69**
	B16	Downtown Station Load Transfers		0.30	**0.30**	0.66	0.38	1.30	**2.34**
Bremner TS	B17								
Hydro One Capital Contributions	B18			3.69	**3.69**	7.72	1.68	9.02	**18.42**
Feeder Automation	B19			1.02	**1.02**		1.28	12.58	**13.86**
Metering	B20		0.49	2.10	**2.59**	2.60	2.64	5.11	**10.35**
Plant Relocations	B21		2.47	4.50	**6.97**	1.29	5.66	15.12	**22.07**
Grid Solutions	B22								
Engineering Capital	BXX	ICM Understatement of Capitalized Labour		3.69	**3.69**		4.63		**4.63**
Operations Portfolio Capital	C1		40.52	53.95	**94.47**	7.88	66.56	77.44	**151.88**
Information Technology Capital	C2		9.87	9.25	**19.12**		12.75	8.72	**21.47**
Fleet Capital	C3		0.34	0.29	**0.63**		0.51	0.25	**0.76**
Buildings and Facilities Capital	C4		3.14	3.76	**6.90**		1.24	1.65	**2.89**
AFUDC				0.15	**0.15**		1.05	1.09	**2.14**
Totals			67.01	116.31	**183.32**	45.46	140.59	283.77	**469.82**

4.2.26 It is submitted that it would be helpful to the Board if the Applicant would confirm the accuracy of this table in their Reply Argument.

4.2.27 We note that Board Staff, in their submissions, have not included the CWIP at the end of 2011 in the ISAs for 2012 and 2013. In our submission, this is incorrect. The Board's policy is a consistent approach, and includes no rationale for excluding amounts spent in a prior year but brought into service in the relevant ICM year. This would be unfair to the LDC, and inconsistent with the "revenue requirement" approach to the ICM.

4.2.28 In addition, we note that prior ICMs have included CWIP at the end of the preceding year, and some of that CWIP is from prior rebasing years [see pages 6 and 7 of K4.7, which show that the Oakville EB-2010-0104 and Guelph EB-2010-0130 ICMs both include spending in the prior rebasing year; see also the Board's decision in Woodstock EB-2011-0207].

4.2.29 Therefore, it is submitted that the table set forth above, which includes 2011 CWIP closed to rate base in 2012 and 2013, is the correct re-statement of the Applicant's ICM proposal on an ISA basis.

4.2.30 Later in these submissions SEC will provide analysis with respect to the project portfolios, segments and jobs, and the extent to which they should be considered qualifying for the purposes of the ICM.

4.3 ***Threshold***

4.3.1 There do not appear to be any major issues associated with the calculation of the threshold in each year, except one.

4.3.2 ***Meeting the Threshold in 2012.*** The Board's policy clearly requires that it is the total non-discretionary capital budget that must exceed the threshold, and the maximum total of capital additions that can qualify for ICM treatment is the amount of that excess.

4.3.3 A problem arises in this case because the Applicant calculated everything based on capital spend, rather than based on in service additions. As a result, the Applicant provided no evidence as to what proportions, if any, of the CWIP at the end of 2011 that was expected to come into service in 2012 ($67 million) was discretionary vs. non-discretionary.

4.3.4 This creates a fundamental problem for the Board. The onus clearly rests on the Applicant to demonstrate that the ICM criteria are met, and one of those criteria is the total non-discretionary capital additions. The Applicant provided evidence that it said showed that $116.3 million of the 2012 capital additions was non-discretionary. This is the capital spending in 2012 that is expected to close to rate base in the same year.

4.3.5 For the remaining $67 million, representing 2011 CWIP closing to rate base in 2012, no evidence was provided that all or any of it was non-discretionary. Failing any evidence on this point, in our submission the Board is prevented from making any finding that there are capital additions in 2012 in excess of the threshold. There is therefore, on the face of it, no qualifying ICM amount in 2012.

4.3.6 We note that, for 2012, in addition to this evidentiary problem, we have later in these submissions identified ICM project portfolios, segments and jobs that do not qualify, so that independently of the evidentiary problem the capital spending in 2012 does not exceed the threshold.

4.3.7 ***Dispensing with the Threshold.*** We note that the Applicant has provided an alternative formulation of the ICM module that would be based on in-service additions, but would also dispense with the threshold.

4.3.8 This is clearly incorrect. The Applicant cannot pick and choose which aspects of the ICM module it will use, and which it will not. It cannot say "We will apply the threshold, but only if you change the calculation from in-service additions to capital expenditures." Similarly, it cannot say "We will accept in-service additions as the calculation basis, but only if you change the threshold to 100% of depreciation, instead of the Board-mandated formula."

4.3.9 Therefore, SEC does not believe that there is a legitimate issue of whether there should or should not be a threshold. The Board's policy is not in dispute, and the only reason the Applicant offers for why the threshold should not apply is that it results in insufficient funding for its capital program. We demonstrate that this is incorrect in Section 4.5 below.

4.4 ***The ICM Criteria***

4.4.1 ***Is this an Issue in Dispute?*** As noted earlier, the Applicant in Tab 2 of the Application lists five "Special Issues", saying [2, p. 3-4]:

> *"THESL proposes that **the Board consider a modified and/or new approach** with respect to the following matters:"*
>
> *…(d) Application of ICM Criteria: Having considered the IRM/ICM Material, THESL described how its proposed ICM projects satisfy the criteria in THESL's circumstances…" [emphasis added]*

4.4.2 When asked in what way the application of the criteria was intended to be "modified or new", the Applicant's witnesses denied that anything of the sort was intended, saying instead [Tr.5:13-14]:

> *"MR. MCLORG: I don't think the intention here at all was to suggest that we are diverging from Board policy…*
>
> *MR. SHEPHERD: So unlike the other special issues, this issue doesn't propose modified approaches to address distinctive needs and doesn't propose any new approaches?*
>
> *MR. MCLORG: I think that's fair."*

4.4.3 The witness went on to apologize for any confusion the wording generated [Tr.5:14].

4.4.4 However, when we discussed the letter sent on behalf of the Applicant and others, as members of the Distribution Regulation Review Task Force, Mr. McLorg, the Applicant's representative on the DRRTF, said [Tr.5:2]:

> *"I think it is fair to say that distributors feel that there would be substantial benefit if the rules around the criteria for ICM were expressly clarified by the Board, but we recognize that the ICM mechanism has been an evolving regulatory instrument."*

4.4.5 It would appear to SEC that the Applicant is, in fact, attempting to propose a different interpretation of the ICM. It is not a new one at all, but an interpretation that Toronto Hydro has been pushing for years, despite having already had it rejected by the Board. This is simply another attempt to put forth a ratemaking model that the Board has already considered and denied.

4.4.6 ***The Conceptual Basis of the ICM***. The starting point for the analysis of the ICM is the Board's Supplemental Report dated September 17, 2008 in EB-2007-0673. The Supplemental Report, which had as one of its key goals establishing the ICM criteria, identified the critical conceptual issue that had to be addressed at the outset [page 30-31, excerpted in K4.7, p 36-31]:

> *"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."*

4.4.7 The underlying logic forming the foundation of the Board's comments is compelling. The Board was invited to develop rates based separately on capital and non-capital components, and declined to do so. Instead, the Board adopted a formula that escalates rates in one calculation that covers capital and non-capital elements. To then allow, on a routine basis, an additional escalation in rates to cover capital costs would be double counting.

4.4.8 In the face of this very clear statement of Board policy on the ICM, it was somewhat surprising to hear the Applicant express a view of the ICM that is essentially identical

to the rejected paradigm:

> *"MR. MCLORG:…I think that the way distributors see it now, it is a mechanism that provides for essential capital that goes to the core responsibilities of distributors that's not otherwise funded." [Tr. 5:2]*
>
> *"MR. MCLORG: Mr. Shepherd, Toronto Hydro has come through this process to see the ICM as a vehicle through which essential capital spending that goes to the utility's core requirements as a distributor, and which is not otherwise funded, can be accommodated." [Tr.5:69]*

There are many other examples in the evidence and the transcripts of this approach to the ICM.

4.4.9 But what of the Board's stated policy? After some jousting, the Applicant admitted that their Application was put forward on the basis that the quote we gave from the Supplemental Report is no longer Board policy [Tr.5:69-70]:

> *"MR. MCLORG: …I think that there has clearly been an evolution, since the Board's production of that report that you just read from, in the Board's interpretation of the ICM.*
>
> *MR. SHEPHERD: So you're saying this is not the policy anymore?.....When you selected the projects and segments and jobs that you considered meet the ICM criteria, you did it on the basis that this [the quote in para. 4.4.6 above] is no longer the policy; the policy has evolved to something different, which you just described, right?*
>
> *MR. MCLORG: **Yes we did.** We understood and formed an application around essential capital that was not otherwise funded." [emphasis added]*

4.4.10 What the Applicant thereby admits is that, if the conceptual basis of the policy remains as the Board described it in 2008, as quoted above, the projects proposed by the Applicant in this Application have not been selected on that basis, and some or all of them would not qualify for ICM treatment.

4.4.11 The reason the conceptual basis is so important is that the Board has clearly not changed their view on the fundamental concept behind IRM. In the Board's recent decision in EB-2012-0033, Enersource Rates, on December 13, 2012 the Board comments as follows [page 5-6 of the decision]:

> *"…[O]ne of the central principles of incentive ratemaking frameworks is the separation of costs from prices. Multi-year incentive schemes are established without an annual re-calibration of rate base.*

> *…The Board has been clear that rate base re-calibration is generally not part of a multi-year ratemaking framework. Distributors are expected to respond to the incentives in the framework and the result will determine the returns shareholders earn. The Board therefore concurs with Energy Probe's submission: 'Enersource already has the ability to compensate its shareholders for investments that are made every year during an IRM term. This ability is called productivity and efficiency improvements.'"*

4.4.12 In that same decision, the Board quoted from its own RRFE Report dated October 18, 2012, which says, in part [page 11]:

> *"Going into PBR [i.e. IRM], distribution rates are set based on a cost of service review. Subsequently, rates are adjusted based on changes to the input price index and the productivity and stretch factors set by the Board.* ***PBR decouples the price (the distribution rate) that a distributor charges for its service from its cost.*** *This is deliberate and is designed to incent the behaviours described by the Board in 2000. This approach provides the opportunity for distributors to earn, and potentially exceed, the allowed rate of return on equity.* ***It is not necessary, nor would it be appropriate, for ratebase to be re-calibrated annually****." [emphasis added]*

4.4.13 These two current expressions of Board policy continue to support the same conceptual basis for IRM as is expressed in the Supplemental Report. Toronto Hydro believes the Board's views have changed. They have not. IRM remains a method of decoupling rates from costs, and the Toronto Hydro approach – seeking funding for capital-related costs from rates during IRM – is out of step with the Board's overarching policy.

4.4.14 ***The Specific Criteria.*** Once it is accepted that the concept of IRM, and therefore the role of the ICM within it, has not changed, there remains a question of whether the specific criteria used to determine whether projects qualify for ICM treatment have changed over time. If so, what are those criteria today?

4.4.15 In this regard, we note that the actual criteria imposed by the Board - need, prudence, and materiality – have not changed, nor are they in any way in dispute. However, the interpretation of the "non-discretionary" requirement (part of need), and the question of prudence, are being questioned. In addition, a change to the type of "project" to which the criteria are applied is being proposed by the Applicant.

4.4.16 At one extreme, qualification for ICM treatment could be something akin to a Z factor analysis. A requirement for incremental capital spending would have to "come out of the blue", in essence, to qualify.

4.4.17 This is undoubtedly what many ratepayer groups sought in the 3rd Generation IRM consultation. In fact, until June 2012 the Filing Requirements related to ICM included the following requirement [June 2011 Filing Requirements, Chapter 3, p.12]:

> *"Demonstration that the proposed non-discretionary capital projects are unusual and unanticipated;"*

4.4.18 That requirement was removed in the June 2012 Filing Requirements. As well, the Board had already, in more than one decision, granted ICM treatment to projects that clearly did not meet that requirement (such as Kingston EB-2011-0178 and Centre Wellington EB-2011-0160, discussed below).

4.4.19 It is therefore submitted that limiting the ICM to projects that are similar to Z-factor items, if it was ever the Board's interpretation of the policy, has not been the rule for at least a couple of years.

4.4.20 If it is clear what is no longer included in the criteria, it is equally clear that at least one class of project has always qualified and continues to qualify. That class is major projects that do not arise on a regular basis, and have a significant impact on the financial situation of the distributor. The classic example is a transformer station.

4.4.21 The Board has affirmed, in the Guelph [EB-2010-0130] and Oakville [EB-2010-0104] decisions, that a transformer station will usually be sufficiently out of the normal course of a utility's capital planning that it will qualify for ICM treatment. Similarly, the Board has affirmed, in the Woodstock EB-2011-0107 decision, that a capital contribution to Hydro One, and related spending, supporting a new transformer station owned by Hydro One is also ICM qualifying.

4.4.22 In EB-2011-0160, Centre Wellington, a very small utility, proposed ICM treatment for the rehabilitation of its Fergus municipal substation. The cost of the rehabilitation was $1.2 million, incremental to a threshold of about $850,000. For many distributors, substation work is something that is scheduled every year, and while sometimes material is not a massive undertaking relative to the overall capital budget. For Centre Wellington, this is a substantial project, akin to a major transformer station for a larger utility. This project was approved by the Board.

4.4.23 The most unusual case was EB-2011-0178, in which Kingston Hydro sought approval for ICM funding for four projects totaling $3.5 million, on a threshold of $2.9 million.

4.4.24 In this case, the projects were each major undertakings with a specific purpose. They were clearly in addition to the normal capital spending program of the distributor. The Board's conclusions on the four individual projects were as follows:

> *"1. <u>King Street 44kv Underground Rebuild</u>: Kingston Hydro has evaluated*

> *risk, liability, health and safety matters relative to its assets and after several years of repair and monitoring Kingston Hydro submits and the Board accepts that this asset has reached a point of criticality and the applied-for capital expenditures can no longer be delayed.*
>
> *2. Transformer Vault (TV 6) Rebuild: Kingston Hydro confirmed and the Board accepts that the TV 6 project is planned to coincide with the City of Kingston's work on Princess Street.*
>
> *3. Substation No. 15 Circuit Breakers Retrofit: In its submission, Kingston Hydro identified this project as a priority with no discretion for further delay. Kingston Hydro stated and the Board accepts that it has monitored this facility and has provided "work around solutions" in order to avoid capital expenditures. Kingston Hydro stated that clips and other parts are dislodging from the switchgear during maintenance and operation presenting a potential safety risk to workers and extended power outages.*
>
> *4. Transformer Vault 11 (TV11) Rebuild: In accordance with its condition assessments performed on the civil works, worker safety issues and the reliability of the current electrical equipment, Kingston Hydro submits and the Board accepts that this project must be completed this year."*

4.4.25 This is clearly not in the same category as a single transformer station.

4.4.26 However, what can be seen from the Board's comments is that each of these projects was a discrete piece of work (what Toronto Hydro refers to in their Application as a "job"), separately justified, and not a continuation of a program of spending from a prior year. What is also clear is that in each case there was specific evidence for why the project was not only needed at some point, but had to be carried out in the IRM year.

4.4.27 The only other ICM application that may be relevant is Hydro One [EB-2012-0136], which was settled and subsequently approved by the Board. In that case, there was a list of ICM projects approved similar to Kingston. Each one was a discrete piece of work, separately justified, and not a continuation of a program of spending from a prior year. In each case the timing of the project in the IRM was justified in the evidence.

4.4.28 ***Proposed Project-Specific Criteria***. Based on the ICM cases that have been decided to date, and the conceptual basis underlying the IRM framework and how ICM fits within it, SEC proposes that the Board assess the ICM qualification of individual projects based on the following criteria and principles:

(a) IRM is supposed to provide a reasonable revenue envelope for a distributor in

any circumstance in which the future is similar to the past. On that basis, projects that are "business as usual", in the sense that the future is similar to the past, should not qualify for ICM treatment. An example would be something that is a continuation of a spending program already approved in the rebasing year.

(b) Only discrete projects that can be individually described and justified will qualify. Every project that has been approved to date has been discrete, in that it had a reason to be done, it had a starting date and a forecast in-service date, and the costs could be forecast with some specificity. To qualify, it must be possible to calculate the revenue requirement impact of the project. An entire category of spending is not a discrete project, and ICM was not created for this purpose.

(c) The Applicant must demonstrate not only that the project must be carried out, but also that it must be carried out in the ICM year in question. If it could be deferred until a subsequent year, it is not non-discretionary.

4.4.29 ***Proposed Top-Down Criteria.*** This Application is the first in which a distributor has proposed, not a few projects, but basically everything in their capital plan, for ICM treatment. As noted above, the specific criteria should weed out some of this stuff, but SEC believes that in addition there is a question of the overall level of capital budget being proposed.

4.4.30 As we have noted earlier in this Final Argument, it is our basic conclusion that granting any funding for incremental capital where a utility is already heavily invested in capital, and has high rates, is not justified. We believe that Toronto Hydro has not demonstrated that they need to embark on a massive capital spending boom.

4.4.31 In addition to whether the Board should exercise its discretion to grant any ICM funding at all, the size of the capital budget is a separate issue that, in our submission, should be considered by the Board.

4.4.32 There are two aspects to this:

(a) The extent to which the Board feels it is appropriate to engage in a line by line review and approval of a utility's capital budget; and

(b) The establishment of a reasonable absolute level of capital spending for a regulated entity.

The two aspects are connected but still separate.

4.4.33 It has generally been the Board's preference not to do line by line reviews of spending

proposals. The Board has often said that it does not believe in "micro-managing" the operations of the entities it regulates. We have quoted in Section 2.3 of this Final Argument from the EB-2005-0437 Enbridge decision to that effect.

4.4.34 The ICM is a little unusual, because it is project-specific, but all of the past applications have avoided the line by line problem because there was only one or a small number of large, separately defined and justified, projects.

4.4.35 In this Application, a similar review would involve hundreds of individual projects (called "jobs", but essentially identical to the "projects" in Kingston case, for example)**.** In our submission, this may not be an appropriate exercise for the Board to undertake.

4.4.36 The second aspect is that of overall reasonableness. We have previously quoted [para. 2.2.25] from the EB-2012-0033 Enersource decision about the importance of establishing an overall level of reasonableness. The EB-2005-0437 Enbridge decision is to similar effect. Neither of these is surprising. The Board's jurisdiction is based on "just and reasonable rates". Fundamental to everything the Board does in looking at any spending proposals is assessing the overall reasonableness of those proposals in the context of rates.

4.4.37 Just as was the case in the Enbridge case cited, SEC believes that in this case the Board should establish a reasonable level of capital additions for the Applicant in any given year. In that case, Enbridge had strong justifications for a $458.8 million capital budget. The Board did not challenge those justifications. Instead, the Board said that despite the proposed budget, the default should be that utility capital spending should generally remain within historical norms.

4.4.38 In that case, the Board allowed a capital budget of $300 million, and expressly directed Enbridge management to prioritize its capital spending needs within that envelope. The Board said [at page 9]:

> *"…the Company will have to make choices about which projects are most critical, and which may have to await completion until future periods."*

4.4.39 ***SEC Recommended Process***. SEC is therefore proposing two tests for the ICM for Toronto Hydro: a project-specific test using the ICM criteria outlined above, and a top-down test that considers the overall level of capital spending.

4.4.40 This gives rise to an obvious question of how to do this from the practical point of view. SEC proposes that the Board's decision-making follow these steps:

(a) Establish an overall level of capital additions that is reasonable for a utility in the circumstances of Toronto Hydro. This level could be based on the most

recently approved capital additions (2011), the most recent actuals (2012), an average of the last several years, etc. In Section 5 of this Final Argument we will make our own specific proposals on this number.

(b) Identify in the decision any projects (in this context, the Toronto Hydro terminology would be jobs or segments) that the Board believes clearly do not qualify for ICM treatment, or qualify only with respect to a portion of the budget proposed. The Board does not need to go through every job, because this process is just seeking to exclude those for which the evidence is clear. This would leave a list of projects and amounts that could qualify.

(c) Direct the Applicant, in the draft rate order, to provide a list of projects, segments, and jobs within segments, that it has prioritized as the work that it should do in the relevant year within the overall capital additions envelope established by the Board.

4.4.41 SEC notes that, in proposing the three steps above, SEC is attempting to apply the Board's reasoning in the EB-2005-0437 Enbridge decision to the somewhat different circumstances of an ICM application. The purpose is to avoid a full line by line review, leaving prioritization to management as is the normal Board practice, but still setting a spending level and allowing the identification of specific projects (jobs) within that level.

4.5 ***Funding Available During IRM***

4.5.1 The Applicant took the position in this proceeding that 3rd Generation IRM does not provide appropriate funding for their capital program. There are two reasons why this is wrong:

(a) As the Board has emphasized numerous times, and we have discussed elsewhere in this Final Argument, the whole purpose of IRM is to decouple rates from costs, providing an overall revenue envelope to the utility and expecting utility management to manage within that envelope. Discussion of "funding" of costs during IRM is to entirely miss the point.

(b) The Applicant's own evidence shows that, in 2012 and 2013, IRM does provide more than sufficient funding for their planned capital program. Just as has been the case at times in the past, the Applicant's math is simply wrong.

4.5.2 It is important to remember that the Applicant originally sought four things for 2012 through 2014:

(a) An ICM adder for 2012 incremental spending, about $11.0 million per year [we are using the figures in K4.3 wherever possible for both simplicity and

consistency].

(b) An ICM adder for 2013 incremental spending, about $40.6 million per year.

(c) An ICM adder for 2014 incremental spending, which in the context of this Final Argument is not relevant.

(d) A special adder for 2011 "unfunded" in service additions, which according to the Applicant are lost under IRM due to the half year rule (see Section 3 of this Final Argument).

4.5.3 As the Board can see from the first page of K4.3, the Applicant was seeking, for (a) and (b) above, $114.2 million of additional rate relief. As well, the Applicant was seeking $37.7 of additional rate relief for (d) above [Tr.5:9]. Over the three years, the result was a $151.9 million total rate recovery.

4.5.4 ***The Calculation of the "Funding Shortfall" by Toronto Hydro.*** Working with the Toronto Hydro team, Mr. Williams did an analysis to show that the actual shortfall in funding for the 2012 and 2013 spending (this is not in-service additions, but all spending) was only $93 million, including the effect of the 2011 half year rule [K4.3, p. 2]. As a result, Mr. Williams recommended that the Applicant withdraw their request for (d) above, since the incremental funding was not required [Tr.4:114].

4.5.5 We note that, even with that change, the Applicant continued to seek $114.2 million of incremental rate recovery for a total "funding" shortfall of $93.0 million, i.e. knowingly seeking to overcollect to the tune of $21.2 million [Tr.4:115].

4.5.6 ***Errors in the Calculation.*** The problem, however, is much worse than this. The second page of K4.3, which calculates the "funding shortfall" of $93.0 million, is incorrect in many material ways. When it is corrected, it is apparent that in 2012 and 2013, the years currently before the Board, there is no "funding shortfall" at all.

4.5.7 To analyse this, SEC has looked only at 2012 and 2013. Assets that come into service in 2014 must be dealt with in an application for 2014 rates, and the fact that rate riders for an ICM would extend beyond 2013 is irrelevant when the calculation is being done on an annual revenue requirement basis, as Mr. Williams proposed.

4.5.8 K4.3 shows a "funding shortfall" of $39.6 million in 2012 and 2013, based on projected rate base additions for each of those years, and the "funding" provided by the IRM framework.

4.5.9 ***Exclusion of Productivity and Stretch Factors.*** The first error in K4.3 is the assumption that existing rate base funding increases by 0.68% per year, i.e. the net IRM X factor after deducting the stretch factor and the productivity factor.

4.5.10 Use of 0.68% necessarily implies that the Applicant is not expected to achieve normal productivity, or any stretch, in its capital program. If the Board had intended that to be the expectation, SEC believes the Board would have said so.

4.5.11 In our submission, 3rd Generation IRM provides an inflationary increase in funding for any utility that meets its productivity and stretch targets. On the assumptions by the Applicant, this would mean a 1.8% annual increase in funded rate base. In K4.3, this would mean that the 2012 figure of "Net Fixed Assets funded through rates" would be $2,037.5, not $2,015.1, and the 2013 figure would be $2,074.2, not $2,028.8.

4.5.12 Using the 10% proxy revenue attraction factor proposed by Toronto Hydro, this reduces the 2012 shortfall from $11.2 million to $9.0 million, and reduces the 2013 shortfall from $28.4 million to $23.8 million.

4.5.13 ***Funding Through Existing Depreciation Provision.*** The second error in K4.3 is to ignore the fact that the depreciation provision built into rates to cover all assets in-service prior to 2012 is not fully utilized in 2012 and 2013.

4.5.14 The depreciation provision included in existing rates is $138.816 million [EB-2010-0142, DRO, App. A, p. 4]. Not all of that is needed for depreciation on existing rate base in 2012, only $134.7 million [K4.3]. Similarly, only $122.5 million of that depreciation is needed for pre-2012 rate base in 2013.

4.5.15 This is a normal factor of depleting assets. As assets reach the end of their useful lives, or are taken out of service, they are no longer depreciated.

4.5.16 The result is that, in 2012, there is $4.1 million of incremental funding available, which reduces the $9.0 million "shortfall" in 2012 to $4.9 million.

4.5.17 In 2013, there is $16.3 million of incremental funding available, which reduces the $23.8 million "shortfall" to $7.5 million.

4.5.18 In both of these cases, the assumption is that 100% of the Applicant's massive capital program is approved by the Board. In those circumstances, on the Applicant's own numbers they have a "funding shortfall" of $12.4 million.

4.5.19 ***The 2011 Half Year Rule - Impact.*** The interesting thing about this is that, because it is calculated based on an annual revenue requirement, it includes recovery of the 2011 in service additions on a full year basis, thus catching up for the alleged shortfall due to the half year rule. K4.3 says the incremental rate base effect of the 2011 half year rule is $103.7 million of rate base, which at the 10% proxy revenue attraction factor is $10.37 million per year of funding shortfall, $20.75 million over 2012 and 2013. This exceeds the total funding shortfall of $12.4 million.

4.5.20 The math is clear. The only actual funding shortfall in 2012 and 2013, on the Applicant's own analysis, and assuming their massive spending is all approved, would be **part only** of the 2011 half year rule impact, i.e. $12.4 million of the $20.75 million impact. The actual incremental capital program planned is already fully funded, and more, from the IRM framework.

4.5.21 Or, if the Board looks at this from another perspective, the 2011 averaging of rate base, and half year depreciation, are both fully funded, and most of the expanded capital program is fully funded. There is a shortfall of $12.4 million of funding on the expanded capital program, but only if all of it is approved. If at least $124 million of the in-service additions are not approved, then IRM without an ICM fully funds the implicit revenue requirement of the Applicant.

4.5.22 ***Additional Sources of Incremental Capital Funding.*** We note that we have not included in the above analysis all of the factors that provide incremental rate funding to the Applicant in 2012 and 2013 for rate base. Two additional factors that are likely material are the declining cost of capital being experienced by the Applicant, and the increasing Capital Cost Allowance available on the higher spending, which would reduce the PILs obligation. Neither of these has been factored into the calculations done by the Applicant and presented to the Board.

4.5.23 ***Conclusion.*** SEC therefore concludes that the Applicant does not really have a "funding shortfall" problem at all in 2012 and 2013. Assuming that the Board sticks with the current Board policy, and elects not to provide incremental funding to adjust for the 2011 half year rule, the Applicant has no need for any ICM rate riders. Alternatively, the Applicant's analysis can be interpreted as concluding that there is full funding for the 2011 half year rule already built into the IRM framework, but the proposed capital program requires at the very most ICM rate riders totaling $12.4 million if the entire capital program is approved.

4.5.24 In SEC's submission any incremental rate recovery over 2012 and 2013 in excess of $12.4 million is demonstrably unnecessary, and likely all or most of that amount is unnecessary as well. For 2014, any incremental rate recovery needed can and should be addressed through a Custom IR application by Toronto Hydro covering at least the years 2014-2018.

5 ICM IMPLEMENTATION ISSUES

5.1 *Introduction*

5.1.1 This section of our Final Argument deals with three generic ICM implementation issues:

(a) The Applicant's apparent lack of capital planning and prioritization.

(b) Uncertainty about its ability execute on its proposed ICM program.

(c) The justifications for certain projects, segments and jobs - primarily reliability and safety – appear to be overstated.

While SEC has not proposed a specific reduction of the proposed ICM capital budget due to these issues, they should be considered in the context of its evidence justifying each project and segment.

5.2 *Capital Planning*

5.2.1 The Applicant's evidence is that after the Early Rebasing Decision (EB-2011-0144), it reviewed its entire capital program to determine which projects met the Board's ICM criteria [App 6E/10-6. Tr.1:28). It stated that after completing its review, the capital program presented in the current application "has been significantly curtailed relative to the early rebasing application" [Updated and Corrected Manager's Summary Tab 2, p.23].

5.2.2 SEC submits that, at least with respect to 2013, the Applicant has not "significantly curtailed" its capital budget at all. It is still seeking 94.2% of its proposed revised capital budget for 2013 [Updated and Corrected Manager's Summary, Tab 2, p.23]. When compared to its original capital budget in this application, it sought 76% and 87% in 2012 and 2013, compared to its proposed early re-basing capital budget [Original Manager's Summary, Tab 2, p.23].

5.2.3 The Board in its Early Rebasing Decision stated that while it could not determine the level of spending under Applicant's capital plan that would be eligible for an ICM. It did state that two projects, Bremner TS and the capital contribution for Leaside-Birch Transmission Station, would seemingly meet the criteria [EB-2011-0144, p.22]. The Board further wrote that, "[i]t may be that a re-analysis of its capital plan will result in other expenditures which are potentially eligible for an ICM treatment." [EB-2011-0144, p.23] The Board provided guidance to the Applicant in that it should review its spending to determine which spending meets the Board's ICM requirements. The Applicant did not do that.

5.2.4 In its review process to determine which spending to present in this application, the Applicant did not look at each job to determine if it met the ICM requirements. It determined which types or categories of activities it believed met the criteria (the project portfolios) and then determined which segments, and jobs should be included [Tr.1:p28-29]. A top-down approach is important, and as noted earlier in these submissions should be required to determine the reasonableness of the overall level of spending. However, at the stage of determining which individual projects/jobs meet the criteria for 'need' and 'prudence', planning must be on a bottom up basis.

5.2.5 SEC submits that the Board intended the ICM to include rigorous bottom up planning. Distributors are to look at their specific jobs (the Applicant's equivalent to projects) to determine if they meet the ICM criteria of 'need' and 'prudence'. Then as a whole the Board can determine if the eligible jobs meet the 'materiality' criteria. The Applicant did not do that.

5.3 ***Lack of Prioritization***

5.3.1 The Board's *Filing Requirements for Electricity Transmission and Distribution Applications* require that an applicant provide details about the actions the distributor will take in the event the ICM is not granted [Filing Guidelines p.10]. Due to the unique nature of this application, SEC (as well as other intervenors) sought to understand what the Applicant would do if the Board only approved apportion of its ICM application [Tr.1:54-55, Tr.TC.2:43-45. Ex 6A/1-10). The Applicant repeatedly refused to provide information about which project portfolios, segments and jobs it would undertake if it was granted only some of the ICM funding requested.

5.3.2 SEC submits this raises an important concern. While the Applicant may claim that all of its proposed ICM spending is based on a non-discretionary 'need', it is simply not credible for it to claim that all of the proposed projects and segments are of equal 'need'. It must clearly understand that the Board's blanket approval of this Application is far from certain, especially in light of the Early Rebasing Decision. Yet, the Applicant has seemingly not done any planning as of the date of the oral hearing in late 2012, about how it will handle a Board decision that does not grant it some or all of its requested ICM. A prudent utility would plan for this very reasonable contingency.

5.4 ***Reliability***

5.4.1 The Applicant's position is that almost all of its ICM projects, segments and jobs are required to deal with maintaining reliability [6E/10-6]. The need for an ICM for over $800 million in capital spending for 2012-2013 to address these concerns is not credible. In the Early Rebasing Decision the Board found that:

> *"Although THESL asserted that the high level of expenditures are driven by pressing system needs, the Board notes that at the existing capital spending level the company's reliability statistics show no marked deterioration, and the number of 'worst preforming feeders' (a more important criteria than the reliability statistics, according to Mr. Haines) has been reduced by half – from 80 to 40. (EB-2011-0144, p.23)."*

5.4.2 Since that decision was released, reliability has improved, and has been better than the Applicant had expected [Tr.1:48-49, Tab 6F/1-12, Tr.TC1:165]. The evidence is that "2011 year-end reliability was on par with what was expected, and 2012 year to date (end of August) reliability indicators have been lower (i.e.) than expectations." [6F/1-23]

5.4.3 SEC submits that overall, the Applicant's reliability is not a concern that would warrant Board approval of the level of expenditures sought.

5.5 ***Safety***

5.5.1 For a given project to meet the ICM criteria for 'need', the project must be non-discretionary. The Applicant is claiming that almost all of its ICM segments are non-discretionary on the basis of safety [Tab 6E/10-9]. While both public and employee safety must one the foremost concerns for the Board, the Applicant must not be allowed to wrap its entire ICM program in the guise of safety completely uncritically. The Applicant's own witnesses acknowledged that there "will always been risks associated with high-voltage or medium voltage distribution" [Tr.4:57].

5.5.2 Generally speaking, it should not be open to a distributor to apply for funding for an ICM project that is ostensibly to deal with a safety issue if that risk is not new and could have been raised (or was raised and ultimately not included in the final capital budget approved by the Board) at its last cost-of-service application. To allow this is to invite utilities to game the system, holding back safety-related projects until an IRM year, when they can be packaged as an incremental rate increase through the ICM.

5.5.3 SEC submits that to meet the requirement of non-discretionary in the context of safety:

(a) First, the safety concern must be material.

(b) Second, the driver must be something the applicant would not have been aware of at the time of its last cost-of-service application, or something related to a specific program or direction by the Board in a previous proceeding (e.g. handwell replacement).

(c) Third, the safety concern must need to be addressed within the IRM period.

If the safety issue does not meet these three requirements, then SEC submits that it is a risk that is "business as usual" for an electricity distributor, and should be included in the normal capital budget funded through the IRM framework.

5.6 ***Executability***

5.6.1 SEC has concerns about the Applicant's ability to execute its proposed ICM capital program. In its original application filed on May 10th 2012, the Applicant sought spending approval for $448.7 million in 2012, and sought in its updated application filed on October 31 2012, a revised spending amount of $274.7 million [Original Manager's Summary, Tab 2, p.23, Updated and Corrected Manager's Summary, Tab 2, p.23]. This represents a decrease of approximately 39%.

5.6.2 The Applicant has claimed that the revised amount is based on executability issues that were outside its control, such as lead times for material and the availability of a contract workforce [Tr. 2, p.58]. While there will always be factors outside the control of a distributor in planning a large capital spending program, a responsible utility should be able to account for most of them in their planning.

5.6.3 Lead times and contractor availability are normal, predictable issues. A distributor would normally be expected to contact its various vendors about the availability of materials and labour. The Applicant did not do this. SEC submits this brings into question their ability to accurately forecast the amount of capital spending they will be able to do in 2013.

5.6.4 The Applicant also claims that the Board can have confidence that it can execute on a capital program of the size proposed for 2013 since it has executed on programs of similar size in the past [Tr.1:50-51), SEC submits that ICM spending is very different from cost-of-service capital spending. ICM spending is directly tied to specific capital projects (in the case of the Applicant 'jobs').

5.6.5 In cost-of service, a distributor has the ability to spend money on different capital projects, rather than those that have been approved. Ultimately the prudence of those alternative projects under cost of service will be reviewed for the purpose of inclusion in rate base at the next rebasing.

5.6.6 That is not the case in the ICM context. The Board in an ICM application approves the specific spending in much greater detail, and the incremental revenue approved for that purpose is tied to that capital project. If the Board does not have faith in the Applicant's ability to execute the level of spending sought in this application on the specific portfolios of projects identified, or feels it does not have enough information to give itself confidence that each specific proposed job will be executed, then it must reject the corresponding job.

6 FEEDER INVESTMENT MODEL

6.1 *Overview*

6.1.1 The Applicant's Feeder Investment Model (and Cost of Ownership Model) is a calculation to help it identify the economically *optimal* time to replace assets. It is a measure to balance the costs associated with risk of failures against the cost of replacing the asset (either like-for-like or otherwise) [Tab 2/Appendix 4, p.1-7].

6.1.2 SEC raises two overarching concerns with the Feeder Investment Model:

(a) First, while the Applicant has relied on the Feeder Investment Model to determine the need to replace some of its assets, it is in fact not a tool for determining 'need'. It is designed for, and should only be used for the purposes of, demonstrating 'prudence'.

(b) Second, even in determining 'prudence', the Feeder Investment Model is a flawed and unreliable indicator.

6.2 *Prudence Not Need*

6.2.1 The Applicant's has been unclear on for exactly what purpose it is relying on the Feeder Investment Model. In both the pre-filed evidence and interrogatory responses, it states that "a material increase in cost" is a basis for 'need'.

6.2.2 Just because an expenditure would cost more if carried out next year, or the year after that, does not mean that you "need" to spend the money this year. If a car dealer is having a great sale, and you can get the car you need next year now, but at a discount, that does not mean you "need" to buy it now. That is merely one of the considerations. Another is how much money you actually have available. Another is the competing uses for that money, and their relative urgency. Another is the risk of overextending today, and having less flexibility in the event of unexpected contingencies. Another is the possibility that new facts will show that the cost will be even cheaper next year. There are many examples of these other considerations.

6.2.3 With unlimited resources, it may be prudent to optimize the life cycle cost of spending. It may be better to own a home, rather than to rent. It may be better to prepay a long term obligation to get a special deal. It may be better to pay cash for everything, and never buy on a credit card. But utilities do not have unlimited resources, and are forced to prioritize spending decisions. Not everything that is prudent can be done right now. The Applicant doesn't "need" to proceed with all of its prudent projects this year.

6.2.4 SEC submits that, at best, the Feeder Investment Model is a tool to help determine 'prudence' of a given ICM job. [Updated and Corrected Manager's Summary Tab 2, p.16-17, Tab 6E/10-9]. The Applicant's witness appears to agree [Tr.1:131]:

> *"MR. MILLAR: And Mr. Rubenstein asked you about this, and I'm not quite sure I got the answer, so I am going to try and come back to it. I want to get a sense from you as to what reliance Toronto Hydro is actually placing on the Feeder Investment Model. Is this part of your discretionary versus non-discretionary analysis, or is it just sort of useful and interesting background information?* ***How does this feed into the test for whether or not an incremental capital module should be approved?***
> *[Witness Panel confers]*
>
> *MR. OTAL:* ***It would be part of that ICM eligibility criteria in terms of the prudence."*** *[emphasis added]*

6.2.5 SEC agrees with Mr. Otal. The Feeder Investment Model speaks to prudence. <u>*Optimal*</u>, which is what the Feeder Investment Model attempts to determine, is very different than non-discretionary, a key requirement of the 'need' criteria. In fact, the Applicant's witness Mr. Paradis also apparently agreed with this [Tr.1:47].

6.2.6 The Feeder Investment Model (and Cost of Ownership Model) are tools intended to help determine 'prudence', not 'need'. Cost is important in determining what is the most prudent way to address an issue that has already been determined to meet the requirements of 'need'. Conversely, among a group of demonstrably prudent projects (in the sense that they are optimal), not all will "need" to be carried out in a given time period.

6.3 <u>*Underlying Issues*</u>

6.3.1 SEC submits that the particular Feeder Investment Model used by the Applicant is fundamentally flawed, and therefore should be disregarded by the Board as an accurate indicator of prudence.

6.3.2 While SEC supports a detailed cost-benefit approach to determining prudent replacement of distribution assets, that approach must be rigorous. While FIM is an important beginning, it is not detailed or rigorous enough to be an accurate indicator. Instead, it has built-in biases and errors that swamp any informational benefits that might be achieved in its use.

6.3.3 There are several examples this, including four set out below.

6.3.4 ***Treats each customer class the same.*** The method of calculating the outage cost per customer is not accurate enough to be meaningful. The Feeder Investment Model does not recognize that different classes of customers have different outage-related costs. It

uses a universal value of $15kVa (event cost) and $30/kVa (interruption cost) irrespective of which feeder and customer class is impacted [Tr.1:138]. Different customer classes have very different costs in an outage. Different feeders, in different parts of the city, serve very different customer groups. Outages do not occur on a uniform basis, and so it would be important for purposes of determining the real costs per customer to know what customers are being served by a given feeder.

6.3.5 ***Does Not Take Into Account Time of the Outage.*** Since the Feeder Investment Model is based on load, it does not differentiate between customer outage costs based on the time of the outage [Tab 2/4/p.3). An outage in the middle of the night has very different costs to customers from an outage in the middle of the day.

6.3.6 ***No Toronto Specific Cost Information***. Applicant did not use or undertake any Toronto specific surveys or data in determining the cost per outage [Tr.1:13]. It simply used a collection of studies that have been undertaken worldwide. SEC submits that different cities and countries have very different customer make-ups and specific costs that are unique to each sample city (such as climate). Without Toronto specific outage costs, it is very hard to rely on the Feeder Investment Model.

6.3.7 ***Does not take into account important Non-Asset Risk Costs.*** The Applicant's calculation of the Non-Asset Risk Costs - failure costs that are not attributable to the asset itself, for example because of weather or human interference - are wholly inadequate.

6.3.8 Many potential Non-Asset Risk Costs were not included in the Feeder Investment Model. For example, as shown in great detail during the oral hearing, in calculating the projected Non-Asset Risk Costs for replacing existing overheard rear lot with underground front lot, the Applicant calculated the cost at $0 [Tab 4/B5/p.72, Tr.1:70-73, Tr. 2:49-50, Tr.3: 42-43]. This is simply not credible. At the very least there are *some* Non-Asset Risk Costs related to the underground front lot system. This would include risks such as vehicles hitting pad-mounted transformers, and road salts and other contaminants seeping into the enclosed vaults. The Applicant did not take into account *any* of these Non-Asset Risk Costs for underground front lot systems, its proposed option.

6.3.9 SEC therefore submits the Feeder Investment Model is not a reliable indicator, since it does not include important and likely risk factors in calculation of the Non-Asset Risk Costs.

7 ICM PROJECT PORTFOLIOS, SEGMENTS, AND JOBS

7.1 *Overview*

7.1.1 SEC has reviewed the Applicant's project portfolios, segments and jobs to determine if they meet the requirements for an ICM. Since no individual project portfolio, segment or jobs meets the criteria of 'materiality', SEC has deferred that consideration until the total eligible ICM amounts based on 'need' and 'prudence' are determined.

7.1.2 After a review, a number of projects portfolios/segments do meet the requirements for both 'need' and 'prudence' and are for the purposes of this section considered ICM eligible. For other project portfolios/segments only some of the jobs, or some of the budget, meet those criteria.

7.1.3 Based on the detailed analysis below, SEC submits that the total eligible ICM amount for 2012 does not exceed $122.67 million, and $280.14 million for 2013 (see Appendix A). In both cases, these are maximums, and it is reasonable to assume that a lower level would actually qualify.

7.1.4 The 2012 total is below the threshold, resulting in no ICM available. For 2013, and subject to our comments on overall budget, an ICM could result.

7.2 *Underground Infrastructure (B1)*

7.2.1 The Applicant is seeking funding for in-service additions of $12.74 million for 2012 and $51.88 million for 2013 for 27 separate jobs to replace direct buried cable and air-insulted switchgear. They are to be replaced with new cable in concrete-encased ducts and new SF_6 insulated pad-mounted switchgear units. At the same time, the Applicant is seeking to replace a number of submersible transformers which are part of the same feeder that are being replaced.

7.2.2 SEC submits a significant amount of this spending is discretionary. The evidence shows that the failures per kilometre metric for direct buried cable has only increased slightly since 2007 [Tab 4/B1, p.5]. While that still may indicate that the Applicant should replace some of its direct buried cable, it would not indicate a need for capital spending, for most of these jobs, in excess of "business as usual". Replacing direct buried cable should generally be managed within the Applicant's normal capital program. The evidence does not show that the Applicant has met the ICM requirement for 'need'.

7.2.3 If the Board believes that some portion of the Underground Infrastructure segment is eligible for an ICM, SEC submits that significant reductions should be made based on

the analysis below. SEC estimates that those reductions should be at least 50% of proposed in-service capital for both 2012 and 2013.

7.2.4 The Applicant should be granted an ICM for this segment of no more than $7.81 million for 2012 and $33.47 million for 2013.

7.2.5 ***Submersible Transformers***. During the cross-examination by Board Staff, it became clear that there is no need to replace perfectly good submersible transformers, simply because it avoids a return trip in some future year.

7.2.6 Board Staff prepared a useful table during the oral hearing that showed that submersible transformers do not create much of a reliability concern generally, nor are a driver for reliability concerns on the feeders being replaced [K3.1]. The Applicant's evidence showed that of the feeders to be replaced in this Application; the number of feeders where submersible transformers caused 25% or more of total feeders Customer Interruption ("CI") and Customer Hourly Interruptions was only 2.

7.2.7 The Applicant's own Asset Condition Assessment indicated that based on a sample size of over 90% of its submersible transformers, only 0.02% are in poor condition Tab 4/D1 p.42-43]. The Applicant's position is that the proper comparison is submersible transformers with multi-taps, because 20.3% of those are in poor condition [J3.1].

7.2.8 ***Multi-Tap Issue:*** Even if the multi-taps are more susceptible to problems, the Applicant can replace the multi-tap without replacing the entire submersible transformer [J3.2]. The cost inclusive of labour of replacing both, as the Applicant proposes, is $11,973 per unit, compared to a cost of just $3,713.55 per unit to replace the multi-tap. SEC submits that if all 596 multi-taps had to be replaced (an unrealistic scenario), then the cost would be $2.13 million, compared to unnecessarily replacing both the submersible transformer and the multi-taps at a cost of $7.14 million. Since only 20.3% of the submersible transformers with multi-taps are in poor condition, then only 121 would be replaced at a total cost of $0.45 million. A total difference between what is proposed, compared to replacing just the 'poor' condition multi-taps, is $6.69 million.

7.2.9 ***Concrete Duct Banks.*** Further, SEC has concerns with the prudence of the Applicant's proposal to replace the direct buried cables. The Applicant is seeking to install new underground system in concrete duct bank. Installing new concrete duct banks instead of a flexible duct using directional boring appears to unnecessarily increase the cost by 26%[8]. The Applicant's witnesses rejected directional boring, stating that other services such as gas and telephone create obstructions that would make directional boring not feasible. According to the Applicant's own expert

[8] Calculation based on difference of costs set out in Ex.6F/7-24 and J2.4.

Navigant, who undertook a study of Distribution Design Practices, "the preferred method for single phase lines is to use directional boring in combination with the installation of flexible conduit"[Ex.4/D3]. The Applicant during the oral hearing could not provide reasons why its system in this regard is any different from others [Tr.2:128].

7.2.10 SEC submits that the Applicant could use flexible duct instead of concrete duct banks. This would lead to a reduction in cost of approximately 25% based on Interrogatory responses 6F/7-24.

7.2.11 ***Summary:*** The Applicant should be granted an ICM capital approval for this segment of no more than $7.81 million for 2012 and $33.47 million for 2013.

7.3 ***Paper Insulated Lead Covered Cable-Piece ("PILC") Outs and Leakers (B2)***

7.3.1 SEC submits that while replacing PILC cable is necessary, it is not a new project. It is, instead, a routine maintenance issue and thus is "business as usual". The Board should not grant an ICM for this segment.

7.4 ***Handwell Replacements (B3)***

7.4.1 While the handwell replacement program is a continuation of a program that began in 2010, SEC agrees that it is needed and is not "business as usual". The segment is in response to certain contact voltage problems that occur with non-conductive handwell units. SEC's concern with this program is that while there is a 'need' for the replacement of certain handwells on Applicant's system, there is no 'need' to replace *all* of the handwells.

7.4.2 The Applicant's witness stated that their own internal threshold for safety is 4.5 volts [Tr.2:61]. Yet, the majority of handwells being replaced are at very low voltages [Tr.2:62].

> *"MR. FAYE: So of the total population here, how many times do you get 4-1/2 volts or more?*
>
> *MS. BYRNE: The majority of the findings are at very low voltage.*
>
> *MR. FAYE: Below four-and-a-half?*
>
> *MS. BYRNE: Correct."*

7.4.3 SEC submits that only handwells with voltage issues of 4.5v or greater meet the ICM criteria of 'need'. It is only those that provide a safety risk and thus are non-discretionary. Based on Ms. Byrne's statement at the very least 50% of the handwells are for voltages below 4.5v. SEC submits that at most only 50% of the budgeted

segment should be approved.

7.4.4 The Applicant should be granted an ICM for this segment of no more than $4.31 million for 2012 and $9.52 million for 2013.

7.5 ***Overhead Infastructure (B4)***

7.5.1 The Applicant is seeking ICM funding for various overhead infrastructure work consisting of discrete jobs relating to (1) Wood Pole replacement, (2) Complete Self-Protected (CSP) transformer replacement, (3) overhead conductor replacement and (4) porcelain switch replacement. SEC submits that a portion of the amount sought should not be granted.

7.5.2 SEC has reviewed Energy Probe's Final argument and adopts its submissions with respect to this segment.

7.5.3 Many of the jobs are either wholly discretionary, or contain a significant portion that is. As an example the Applicant, while doing other work, will be replacing poles that are not in poor condition. The Applicant's witness candidly admitted that [Tr.2:76]:

> *"MR. FAYE: But it sounds like you're out there for another reason. I thought that this program was, as in line 5, pole replacement program is an initiative aimed at replacing poles that are in very poor and poor condition.*
> *Now it sounds like you're doing it in conjunction with some other project, whatever that might be. Which one of those is correct? Is this a program all of its own, or is it sort of blended into other overhead projects?*
> *MR. KERR: I would say it is a little bit of both."*

7.5.4 The same type of work is done with respect to replacing CSP transformers. The Applicant replaces all the assets when it does *some* work in a given area [Tr.2:84]

> *"MR. FAYE: …..Okay, let me go back to the way I phrased it before. Is it a case of being out doing some work and you look way down the line and think, That's a CSP. It is because the CSP is right in the section of work you're working on?*
> *MR. KERR: That's right. It is because the CSP is in the area with the other porcelain infrastructure and it is mounted on a pole in poor condition."*

7.5.5 Much of the work in this segment is therefore clearly discretionary.

7.5.6 SEC agrees with Energy Probe that a reduction of $17.5 million[9] for 2013 is appropriate. Using the same proportion of reductions for 2012 would yield a reduction of $1.6 million. The Applicant should therefore be granted an ICM of no more than

[9] $12.5m for pole replacements and $5m for CSP replacements.

$2.4 million for 2012 and $25.5 million for 2013.

7.6 ***Box-Construction (B5)***

7.6.1 The Applicant is seeking an ICM to replace and convert 4kv overhead feeders with 13.8kv overhead feeders.

7.6.2 SEC has reviewed the submissions of Board Staff, and agrees that it is a discretionary decision to replace *all* municipal stations feeding box construction feeders. The Applicant did not undertake analysis (dissolved gas) to determine if Keele MS, Dupont MS and St. Clair MS need to be replaced. Without that information the Applicant has not met its burden to show that replacing those stations meets the ICM criteria of 'need'. SEC submits that as a result the box-construction segment should be reduced by 3/8th of what is sought.

7.6.3 The Applicant should therefore be granted an ICM for this segment of no more than $8.96 million for 2013.

7.7 ***Rear Lot Construction (B6)***

7.7.1 The Applicant is seeking an ICM to replace rear lot overhead service with front lot underground direct buried service. In the Applicant's view, this project portfolio meets the requirements for need as there are non-discretionary reliability concerns with some of its rear lot overhead lines. Further, in their view the prudence criterion is met because of safety and cost (shown through the Feeder Investment Model).

7.7.2 SEC has reviewed the very detailed arguments of Energy Probe and generally adopts its analysis, with one difference. SEC submits the Board should not grant an ICM for any amount for this segment, since it does not meet the criteria of need and prudence.

7.7.3 The Applicant has overstated both the safety and the reliability concerns of its current rear-lot overhead system. Energy Probe's argument has provided a detailed analysis in this area.

7.7.4 In addition, the proposed capital work is clearly routine "business as usual" infrastructure replacement work for a distributor. The Applicant has been working on replacing some of its rear lot overhead system that's deteriorating for some time, and likely will continue to do so long-after this ICM [EB-2010-0142, Ex. D1/8/1p.14, K3.1, p.16, Capital Program Comparison, p.2].

7.7.5 Further, it appears that the Applicant's method of replacement is not prudent. Front lot underground service is not generally the most prudent method of replacement, since it is roughly nine times more expensive than like-for-like [Tab 4/B6]. While the Applicant relies on its Feeder Investment Model to show that in fact it is the most cost-

effective, as discussed earlier and set out in detail in Energy Probe's argument, the analysis did not consider some very important non-asset risk costs. Further, the Applicant did not even consider some other alternatives such as replacing the existing rear-lot overhead lines with new insulted cables and animal guards.

7.7.6 In addition, even if the FIM analysis were correct, the solution proposed by the Applicant is not a foregone conclusion. It may be possible to prove that, on a life cycle basis, and taking safety and reliability into account, it is better to buy a $100,000 Mercedes than a $30,000 Chevy. For most people, the right decision is still to buy the Chevy.

7.7.7 SEC submits that the Applicant should not be granted ICM funding for this segment.

7.8 *Polymer SMD-20 Switches (B7)*

7.8.1 SEC agrees that this segment is generally appropriate to be funded through an ICM. The replacement of these switches is non-discretionary and not "business as usual" for the Applicant. SEC accepts the evidence of the Applicant that the manufacturing defects were only discovered in 2011.

7.8.2 SEC notes that the Applicant has committed to returning to ratepayers any compensation that it receives from the manufacturer, as a revenue offset in its next cost-of-service application [Tab 4/B7].

7.8.3 The Applicant should be granted an ICM for this segment of no more than $0.93 million for 2013 (no in-service addition amount for 2012).

7.9 *SCADA-Mate R1 Switches Segment (B8)*

7.9.1 SEC agrees that this segment is appropriate to be funded through an ICM. The replacements of these switches are non-discretionary and not "business as usual" due to the safety risks and defects that arose beginning in 2011 [Tab 4/B8/p.2].

7.9.2 The Applicant should be granted an ICM for this segment of no more than $0.87 million for 2013 (no in-service addition amount for 2012).

7.10 *Network Vaults and Roofs (B9)*

7.10.1 The Applicant is seeking an ICM for a number of jobs to decommission or rebuild network vaults and network roofs. SEC agrees with the Applicant that there is a non-discretionary need to replace some very poor network vaults and roofs due to safety concerns. Additionally, SEC agrees that it would not be prudent to replace assets within some of these vaults without properly securing the vaults themselves.

7.10.2 SEC raises only the issue of pace. While many of the very poor condition vaults and roofs should be replaced, it may not be necessary to replace some of the poor condition vaults and roofs in 2012 and 2013.

7.10.3 Based on the above, SEC has not proposed a reduction to these ICM amounts. However, we believe that, consistent with our general recommendations below, this may be one of the areas in which the Applicant can get its overall capital additions budget to a more reasonable level through prioritization and pacing.

7.11 *Fibertop Network Units (B10)*

7.11.1 The Applicant is seeking an ICM for a number of jobs to replace existing Fibertop Network Units with submersible ones. SEC submits that this segment should not be granted an ICM as it is not 'non-discretionary'.

7.11.2 In the response to undertaking J4.1, in which the Applicant was to confirm whether any of its proposed fibertop replacements are in locations that are also part of proposed vault or vault-roof rebuilds (B9), the Applicant stated that only two of the replacements are in vaults that will be replaced [J4.1]. The importance of this undertaking was to determine if there was any double counting, as fibertop network unit replacement would in any case occur if the entire vault was being replaced.

7.11.3 In the undertaking response, the Applicant's reaction to this double counting was not to revise its ICM ask for 2013, but rather to move two further fibertop network jobs forward into 2013 [J4.1]. SEC submits that this approach is inappropriate, and brings into question the entire amount sought in this segment. If the two jobs bring brought forward to 2013 were truly non-discretionary, then they would have been proposed originally in 2013. Further, the two replacement jobs seem to be added to 2013 arbitrarily.

7.11.4 The undertaking response is illustrative of much of the Applicant's ICM application. It is seeking additional funding for "business as usual" discretionary capital work. While much of the capital work is required, it is not a 'need' as set out in the Board's policy on ICM. The work is not non-discretionary.

7.11.5 SEC submits the Applicant should not be granted an ICM for this segment.

7.12 *ATS and RPB Segment (B11)*

7.12.1 The Applicant is seeking an ICM to replace Automatic Transformer Switches ("ATS") and Reverse Power Breakers ("RPB"). Its evidence is that the segment is non-discretionary because of the effect on reliability caused by their degrading asset condition. SEC submits that the Applicant has met the requirements of the ICM.

7.12.2 During the Applicant's 2011 cost-of-service application, the Asset Condition Assessment data showed that the issue was not the degrading condition of the assets, but that this equipment was becoming "obsolete" [EB-2010-0142 Ex. D1/8/p.22. K3.1, p.24].

7.12.3 A review of the most recent Asset Condition Assessment shows that the situation has materially changed. The ATS units that were in 'Poor' or 'Very Poor' condition increased from 4.8% to 37.3% in just one year [Tab 4/B11, p.10]. Replacing roughly 10% of these ATS units is required.

7.12.4 The Applicant should therefore be granted an ICM for this segment of no more than $1.99 million (no in-service addition amount for 2012).

7.13 ***Station Power Transformers (B12)***

7.13.1 The Applicant is seeking an ICM to replace 12 municipal substation transformers. SEC submits that replacing municipal substation transformers is "business as usual" spending for most distributors, especially one as large as the Applicant, which has 276 transformers (at its municipal substations) [Tab 4/B12, p.12].

7.13.2 The Applicant's evidence shows that not all the 12 transformers even require replacing at this time. 5 of the 12 transformers are considered in 'fair' condition. [6F/2-22, Vol.TC1:137]. The remaining transformers in less than fair condition are less than what the Applicant sought to replace in 2011 [EB-2010-0142, Ex. D1/8/p.28, K3.1, p.30].

7.13.3 While the Applicant has said that there are oil leaks that would indicate degradation in the seals and gaskets of some of the 12 transformers, those issues can be fixed as part of the Operations Portfolio Capital. That portfolio is for these types of reactive issues that require some remediation.

7.13.4 SEC submits this project is "business as usual" spending for the Applicant, and once the 5 'fair' health transformers are removed, the level of spending is ordinary and is close to what was budgeted to be spent in 2011[10] [EB-2010-0142, Ex. D1/8/1/p.28, K3.1, p.31].

7.13.5 The Applicant should not be granted an ICM for this segment.

7.14 ***Station Switchgear – MS and TS (B13)***

7.14.1 The Applicant is seeking an ICM to replace certain switchgears on its municipal and transformer stations. SEC submits that the proposed budget for this segment should be

[10] Budget based on the forecasted number of transformers sought to be replaced in 2011 (7).

reduced.

7.14.2 SEC has reviewed the submissions of Board Staff regarding this segment, and adopts those submissions. SEC submits that it is only non-discretionary to replace switchgears on 4 of the 12 proposed municipal stations, based on the overall health index outlined in the Asset Condition Assessment, as well as specific municipal stations that have operational problems [Tab 4/D1/p.31-32, Tab 6F/1-4]. This would lead to a reduction of $3 million dollars.

7.14.3 In replacing the station switchgear, the Applicant is installing SCADA RTUs. SEC agrees with the submissions of AMPCO that installing these SCADA RTUs is discretionary. The reasoning is similar to SEC's comments on the Station Control and Communications System Segment (B15). Since the Applicant has not provided a breakdown of the cost of the SCADA RTUs separately, SEC has estimated the cost to replace at $70k per unit ($840k in total)[11].

7.14.4 SEC submits that the Applicant should be granted an ICM for this segment of no more than $0.77 million for 2012 and $15.06 million for 2013.

7.15 ***Station Circuit Breakers (B14)***

7.15.1 The Applicant is seeking an ICM to replace some transformer station oil circuit breakers. SEC submits that an ICM should not be granted for this segment.

7.15.2 While the proposed circuit breakers to be replaced are almost all over their useful lives, the Applicant has provided no evidence that these circuit breakers are actually contributing to reliability issues. It relies instead on what it describes as "imminent reliability degradation". No empirical evidence of actual risk is provided.

7.15.3 Further, SEC submits that this segment consists of activities that are classic "business as usual". In its last cost-of-service proceeding, the Applicant explained its planned replacement of oil circuit breakers as follows [EB-2010-0142 Ex. D1/8/1/p. 26, K3.1, p.28]:

> *"Over and above planned replacement of circuit breakers within switchgear, THESL is also replacing nine oil circuit breakers as part of its 2011 transformer station investments. The units are expensive to maintain as they require more frequent maintenance intervals as compared to other interrupting technologies. Removal of these units from service decreases the amount of flammable oil present in a situation and reduces the amount of oil that may be spilled into the environment."*

[11] 70k average derived from total cost of replacing 10 MS SCADA RTUs for jobs in segment B15 [Tab 4/B15, Table 2]

7.15.4 SEC submits that this segment does not meet the requirements of non-discretionary need. An ICM for this segment should not be granted.

7.16 *Station Control and Communication Systems (B15)*

7.16.1 The Applicants is seeking an ICM for a number of discrete jobs to improve and upgrade its SONET capacity and install SCADA RTUs. SEC submits an ICM should not be granted as this segment has not been shown to be non-discretionary.

7.16.2 All the proposed jobs are to improve the Applicant's SONET redundancy, which are ways the Applicant communicates information to various station and assets in its SCADA system.

7.16.3 SEC submits that while the proper operation of its SCADA system is important, installing redundancies in systems that are otherwise properly operational is not a non-discretionary need. There is no evidence of any wide spread issues of SCADA unreliability, and any isolated issues are routine maintenance work that should be done within the context of its operating plan and its operations capital portfolio (C1).

7.16.4 SEC submits that an ICM should not be granted for this segment.

7.17 *Downtown Station Load Transformers (B16)*

7.17.1 The Applicant is seeking an ICM for a number of jobs to construct new feeder ties. SEC submits that a portion of this amount should not be approved by the Board.

7.17.2 The Applicant's jobs related to the Dufferin-Bridgman feeder ties are not prudent. During the question at the Technical Conference by Board Staff, it became apparent that the jobs would only be able to provide relief during outages to 15 to 30% of the stations' capacity [Tr.TC1:143-146]. SEC submits that while generally feeder ties can be an important component in a distributor's system, especially one with the type of downtown density as in Toronto, it is not non-discretionary. Considering the cost of the jobs meant to provide support for an event that itself is of low probability, the expenditure does not meet the ICM criteria of prudence.

7.17.3 The Applicant should not be granted an ICM for this segment.

7.18 *Hydro One Capital Contributions (B18)*

7.18.1 As a principle, ratepayers should not have to pay for assets that are not "used and useful". This why the Board only requires ratepayers to fund assets (cost of capital, depreciation, PILS) once they are in service. The same principle should apply to capital contributions paid to Hydro One. Ratepayers should only have to pay for the capital contribution in rates when the underlying asset to which it relates goes into

service.

7.18.2 While the Applicant may be required to pay amounts to Hydro One well in advance of the asset coming into service, that is no different than what occurs when it constructs its own assets. It is required to pay for materials, design, and any other costs sometimes years in advance of the asset being energized and coming into service.

7.18.3 An example of this principle in the ICM context is the Woodstock case, EB-2011-0207, in which capital contributions for the Commerce Way TS owned by Hydro One were recognized for ICM purposes in the year the TS came into service. The same principle should, it is submitted, apply in this case.

7.18.4 A review of the Applicant's capital contributions to Hydro One reveals that no underling asset will go into service in 2012, and only two in 2013, the Malvern TS and Leslie MS [J3.3]. SEC submits it is only appropriate that an ICM be granted for capital contributions related to those two projects, in the amount of $1.48 million, all in 2013.

7.19 *Feeder Automation (B19)*

7.19.1 The Applicant's Feeder Automation project involves installing automated switches, software and communications devices on selected trunk feeders. The Applicant contention is that this will help with reliability concerns in certain neighbourhoods and it meets the criteria for need based on what it describes as 'imminent reliability degradation [6E-10/9].

7.19.2 As described earlier, the Applicant is not experiencing overall reliability concerns. In fact, the situation has gotten better over the past year. The Applicant has not demonstrated that there is imminent reliability degradation, and to an extent that very specific areas of their system have concerns, it should be corrected by replacing those faulty assets. This is exactly what the Applicant is seeking to do in all of its other ICM segments, and through its Operations Portfolio Capital.

7.19.3 Further, at its core the feeder automation itself is a discretionary capital project. In the Applicant's 2011 cost-of-service application (EB-2010-0142), it sought approval for this capital under its Smart Grid portfolio for a "demonstration" that would go live in 2011 [Ex. G1/Tab 1, p.10, K3.1p.50]. SEC does not believe that a project that was only a demonstration project two years ago can be properly characterized as a non-discretionary capital expenditure now.

7.19.4 SEC submits that the Board should not grant an ICM for the Applicant's Feeder Automation project.

7.20 *Externally-Initiated Plant Relocations and Expansions (B20)*

7.20.1 The Applicant is seeking an ICM for various capital projects required to be undertaken or coordinated with construction work done by the City of Toronto or the Province (and their various agencies).

7.20.2 SEC's concern is that it is hard to have confidence in the timing and cost of this work. The very nature of some of this work, especially projects undertaken by Waterfront Toronto and Metrolinx, creates a great deal of uncertainty about not only the timing, but whether the work will in some cases be undertaken at all. As an example, during cross-examination, the Applicant's witness explained how even at this time, they do not have purchase orders for jobs relating to the Dunn Avenue and Dundas Street work [Tr.2:105-106].

7.20.3 Due to the way the Applicant has historically tracked this category of expenditures, it is hard for SEC to get a good sense of what is the usual spending pattern. The Applicant states that it has only began tracking the expansion portion of the externally initiated plant relocations and expansions in 2011, but they have been tracking the relocations portion for some time. [Capital Program Comparison, p. 5. EB-2010-0142, Ex. D1/9/5-1.p.4. K3.1, p.60].

7.20.4 Some of the externally-initiated work is quite obviously "business as usual". The Applicant, like all distributors, is required to do work when its municipality or transit agency is constructing or rebuilding new roads or services. What differentiates the work that is "business as usual" and that would not qualify for an ICM, from work that would, is the unique nature of the project.

7.20.5 SEC submits that the Applicant's jobs driven by work regarding the proposed Go Transit Georgetown South Service Expansion, and the major work required for the Queens Quay rebuild undertaken to revitalize the Toronto waterfront initiated by Waterfront Toronto, are ICM-type projects. Both of these categories of jobs are not routine work undertaken by either the Applicant or other agencies.

7.20.6 SEC submits that based on the above analysis, the Applicant should be granted an ICM for these two specific projects, on an in-service additions basis, of $2.58 million for 2012 and $17.3 million for 2013.[12]

7.20.7 It is important to note that the amount that ultimately will be spent by the Applicant may vary considerably. The requesting agency or government in many of these cases is required to contribute funding. Additionally, since not all the work will end up being done (due to reasons outside of the Applicant's control), on the true-up, it is important for the Applicant to be aware that it may have to return a considerable amount of the funds collected through an ICM rider to ratepayers.

[12] The number was derived by using the % of capex amount (37% for 2012 and 69.4% for 2013) that should be included and applying it to the proposed in-service additions.

7.21 ***Wholesale Metering (B21)***

7.21.1 The Applicant is seeking an ICM for (1) installing new wholesale meters for the purpose of market settlement compliance on certain transformers that are being replaced, and (2) replacing expiring meters to comply with certain Measurement Canada and *Electricity Gas and Inspection Act* requirements.

7.21.2 ***Market Settlement Compliance:*** SEC submits that this part of the project does not meet the requirements for an ICM. It is a "business as usual" activity and rates are based on an amount which was unspent. Distributors, including the Applicant, every year have to install or replace some of their wholesale meters for new transformers or stations. While the total costs do vary per year, over a longer period of time the cost is normalized. In fact, it would appear that the cost has been decreasing on average from 2008 till 2012 [Capital Program Comparison, p.10]. Only in 2013 is there an increase.

7.21.3 The Applicant's evidence is that it spent no money for this type of work in 2011. Yet in its last cost-of-service application, the Applicant sought, and the resulting settlement would have implicitly included, the $4.9 million it had forecast to spend in its 2011 Test Year. Further, it was projected in 2010 to spend $6.9 million, but according to the Applicant's evidence from this proceeding only spent $1.8 [Capital Program Comparison, p.10, EB-2010-0142 Ex.. D1/8/7/p.1, K3.1, p.55].

7.21.4 Ratepayers should not have to pay through an ICM for projects that the Applicant has historically underspent, most importantly during and prior to its last of cost-of-service Test Year.

7.21.5 ***Expiring Seal Meters:*** SEC submits that this part of the project does meet the requirements for an ICM. The Applicant is required by IESO and Measurement Canada to re-seal and verify certain meters. This is non-discretionary. While it would normally be "business as usual", the Applicant received an temporary exemption from this requirement from 2008-2011 during the implementation of [Smart Meters Capital Program Comparison, p.11].

7.21.6 ***ICM Amount:*** Since the proposed spending by each part of the program is not broken down on an ISA basis, SEC has calculated the qualifying ICM amount by applying the percentage of the total capex spending for this program (44%) to the total ISA amount per year.

7.21.7 The Applicant should be granted an ICM for this segment of $1.14 million for 2012 and $4.6 million for 2013.

7.22 ***Engineering Capital -- Understatement of Capitalized Labour (BXX)***

7.22.1 SEC submits that the Applicant should not be granted any amount for what it calls an

understatement of capitalized labour – a calculation error understating the allocation of engineering capital to ICM projects [Tr.5:95-97]. The Applicant has not provided any supporting materials for their updated calculation, including the breakdown by ICM job, segment or even project [Tr.5:97]. Without such the information, there is no way for the Board to verify the calculation is correct. SEC submits the amount should be denied.

7.23 *Operations Portfolio Capital (C1)*

7.23.1 Applicant's evidence is that due to lead times for material, if it was required to reactively address an issue regarding one of the types of assets that are the subject of the ICM projects/segments, it would "rejig the work program and free up materials we [Applicant] had on hand to do that work" [Tr.1:83].

7.23.2 SEC submits that a predictable consequence of that decision would be that the jobs which the material was taken from would be significantly delayed or cancelled. The Operations Portfolio Capital is a significant amount ($246.35 million over 2012-2013), and it is reasonable to assume that, without the use of materials initially earmarked for Operations Portfolio Capital, a significant amount of the capital spending and the in-service date for many of the ICM projects will be delayed.

7.23.3 Since the proposed ICM segments (Tab B1-B21) consist of much of the overall capital work that a distributor would do, a portion of the Operations Capital Portfolio should be discounted to reflect that undertaking this work will delay some of the ICM jobs because of the use of resources for reactive work. Further, the material itself will have been allocated to the ICM segment already.

7.23.4 SEC submits that a 20% reduction is appropriate. SEC submits that the only reasonable way to reflect this is that the Operations Capital Portfolio capital additions should be reduced to $75.6 million for 2012 and $120.8 million for 2013. This will result in a reduced ICM amount in excess of the threshold in 2013.

7.24 *Summary*

7.24.1 Based on this detailed review of the evidence, SEC submits that the total amount eligible ICM for 2012, before applying the threshold, is a maximum of $122.67 million, and $280.14 million for 2013 (see Appendix A).

8 SEC ICM SYNTHESIS AND RECOMMENDATION

8.1 *Structure*

8.1.1 SEC has proposed, in Section 4.4 above, an approach the Board can take in dealing with this Application, comprising three steps:

(a) Determination of a reasonable top-down capital additions budget;

(b) Identification of project portfolios, segments, and/or jobs that, in the Board's view, do not qualify for ICM treatment, or do so only at a lower level of spending;

(c) Prioritization by the Applicant of the remaining project portfolios, segments, and jobs within the Board's overall budget limit.

8.1.2 In this section of our Final Argument, we provide an analysis of a reasonable top-down budget, a summary of our detailed analysis of the work proposed, and a synthesis recommendation.

8.1.3 We note that, in the discussion below, we deal only with 2013. As indicated earlier, as a result of the specific work done in 2012, it does not appear to us that there is a qualifying amount in excess of the threshold for that year. In addition, as the Applicant failed to file information showing that the total in-service capital additions are non-discretionary (limiting their evidence to the capital spending during the year, $116.2 million, and refusing to deal with the December 31, 2011 CWIP to be brought into service in 2012), in our submission there is insufficient qualifying budget to exceed the threshold, even if all 2012 capital spending were non-discretionary (with which we do not agree).

8.2 *Top-Down Analysis*

8.2.1 We have argued earlier [see Section 4.2 above] that the Board should apply its standard practice of establishing a reasonable overall budget for a utility. This top-down approach is, as stated in the Enbridge EB-2005-0437 case (and many other places), based on historical norms.

8.2.2 The same philosophy has been expressed directly to this Applicant in a prior case. In EB-2007-0680, the Board was asked to approve a large increase in capital spending over three years, and ultimately approved a lesser amount, over two years, saying [page 12-13 of the Decision]:

"In other recent Board decisions, and elsewhere in this Decision, the Board

> *has emphasized the importance of placing spending proposals within historical norms. The guiding principle is that extraordinary spending proposals must be supported by compelling evidentiary support which is commensurate with the extent of the increases sought."*

8.2.3 In looking at historical norms, SEC has gone back to 2006, and has identified Board-approved, actual, and percentage of depreciation for each year 2006-2012 inclusive. All figures are based on in-service capital additions, of course.

8.2.4 The results are as follows:

Approved and Actual Capital Spending by Toronto Hydro			
($ millions)			
Year	*Board Approved*	*Actual*	*Percentage of Depreciation*
2006	$203.2	$198.1	159.0%
2007	NA	$303.6	221.6%
2008	$260.0	$227.9	152.9%
2009	$260.0	$261.1	167.9%
2010	$350.0	$421.2	255.4%
2011	$378.8	$470.7	321.4%
2012	$183.3	$183.3	132.1%
Averages	$272.6	$295.1	201.5%
Sources:			
Yearbooks for Actual Capital Additions and percentage of depreciation			
Board Approved from prior decisions/settlement agreements			
2012 uses the proposed budget for both approved and actual;			
percentage of depreciation is based on Board-approved 2011 dep'n			

8.2.5 We note that for every year, the actual capital additions reported in the Yearbook, which we have used above, are significantly greater (typically 10% or more) than the actual capital additions reported by the Applicant in regulatory filings [e.g. CCC#9 in this proceeding]. We have not been able to identify the reason for this, but the implication is that the columns "Actual" and "Percentage of Depreciation" may be overstated.

8.2.6 SEC also points out that the prior years include very large expenditures for smart meters, a program that has now been completed. If those expenditures were removed, average spending would be close to the Board-approved average, and percentage would be closer to the industry average of 180%.

8.2.7 Based on our analysis of the past history, and keeping in mind the high value of the capital already in the ground for this utility (i.e. the high PP&E per customer,

discussed earlier in these submissions), SEC concludes that the maximum reasonable level of capital additions for Toronto Hydro in 2013 is about $270 million, which we expect would work out to about 180% of forecast 2013 depreciation. This would end up being roughly equal to the average Board approved over the last several years, the average actual capital additions net of smart meters for those years, and the average capital additions as a percentage of depreciation, again net of smart meters, for those same years.

8.2.8 SEC therefore recommends that, subject to our comments earlier and below on individual project portfolios, segments and jobs, the Board approve capital additions of no more than $270 million for 2013, and therefore an ICM of no more than $97 million (based on a threshold of $173 million).

8.2.9 We note that, even at that level, the result would be a rate increase of about 2%, added to the rate increase under the IRM formula, thus continuing the Applicant's pattern of total rate increases in excess of inflation.

8.3 ***Summary of Project Analysis***

8.3.1 SEC has provided a detailed analysis of the project portfolios, segments and jobs in Section 7 above.

8.3.2 The result of that analysis for 2012 is that there are insufficient capital additions to exceed the threshold, and therefore the question of an ICM does not, in our submission, arise.

8.3.3 In the case of 2013, we have proposed a number of adjustments from the ICM capital additions proposed by the Applicant. A summary of those adjustments, by segment, is attached to this Final Argument as Appendix A.

8.3.4 We note that Appendix A only shows our adjustments and their impacts. Other parties, Board Staff, and the Board itself, may identify other adjustments. The right hand column of Appendix A is not intended to reflect amounts that SEC believes qualify for ICM treatment, but rather the maximums possible subject to further analysis by the parties and the Board.

8.4 ***Recommendation***

8.4.1 Based on the analysis in this Final Argument, SEC recommends that the Board decide as follows:

(a) For 2012, the Applicant's total non-discretionary capital spending does not meet the ICM threshold, so no ICM is required.

(b) The maximum reasonable capital additions budget for Toronto Hydro in 2013 be $270 million.

(c) Toronto Hydro be directed, in its Draft Rate Order, to identify through its own prioritization processes the specific project portfolios, segments and jobs that it will complete in 2013 within the above budget envelope.

(d) In that prioritization process, the project portfolio, segment and job adjustments proposed by SEC in Appendix A and the analysis in Section 7 be taken into account.

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9 REVIEW AND TRUE-UP

9.1 *Proposal*

9.1.1 The Applicant has proposed a symmetrical true-up that would, in effect, treat the revenue requirement impact of capital additions during IRM as a flow-through to ratepayers. The Applicant has also proposed that the true-up take place on a total budget basis, not on an individual project portfolio, segment or job basis.

9.1.2 SEC disagrees with both of these proposals.

9.2 *Issues and Analysis*

9.2.1 ***The Flow-Through Concept.*** SEC believes that the Board's policy on review (and potentially true-up) of the ICM spending is intended to protect the ratepayers from collection of funding in rates, followed by underspending with no recourse for the overcollected amounts. It is not intended to allow the Applicant to overspend, and collect the revenue requirement impact of that overspending retroactively from ratepayers.

9.2.2 The Board's standard practice is that capital budgets are set on a forecast basis, whether in a rebasing year or as an ICM during an IRM year. When the next rebasing arises, the rate base is reviewed to determine whether opening rate base for the new rebasing year is at the level previously expected and approved by the Board, i.e. was capital spending as expected.

9.2.3 If capital additions during the intervening period were greater than expected, a classic prudence review is undertaken to determine if all of the capital additions should be recoverable from ratepayers on a going forward basis.

9.2.4 SEC believes it is that prudence review that is the first part of what has consistently been referred to by the Board and individual Board panels in past comments on ICM review and true-up: "Is the overspending recoverable from ratepayers on a going forward basis?" It is not a true-up of revenue requirement during the IRM period.

9.2.5 The second part is about underspending, and applies only to ICM. The question there is "Did the utility collect money from ratepayers for a particular purpose – capital additions funding – and then not spend it for the purpose intended?" This is a completely different type of question.

9.2.6 ***The Global Budget Concept***. The Applicant's proposal to treat ICM as a global budget is inconsistent with the fundamental structure of ICM. The Board's ICM policy makes very clear that each project is assessed based on prudence and need, and

ICM funding is granted for projects that pass that assessment by the Board.

9.2.7 It necessarily follows from this that the Applicant cannot identify one project that it shows is prudent and needed, then change its mind and do something else. If a project is prudent and needed, by definition the Applicant has to do it. If facts change, and the project is no longer prudent, or the need has otherwise gone away, then the Applicant no longer needs the ICM funding that the Board provided for that purpose.

9.2.8 We note that the Applicant's freedom to re-allocate priorities on an ongoing basis as it operates the utility is not being challenged in any way. IRM provides for an overall revenue requirement, and distributors are expected to make spending decisions within that envelope. They are not required to use OM&A dollars only for OM&A, or IT dollars only for IT. If they can save in one area, they can spend that money in another area, or even pay it as a special dividend to the shareholder. All of that is normal and expected.

9.2.9 However, when a utility is given a budget that is specifically earmarked for a purpose, that freedom to spend it on something else does not apply. The essence of the ICM is that the utility is saying "We need this extra money for this particular purpose." Unlike the revenue requirement coming out of IRM, it is not an envelope. Where IRM generally decouples rates from costs, the ICM is clearly at the other end of that spectrum.

9.2.10 Therefore, any true-up must, in our submission, be on a project by project (which in THESL terminology, is either jobs or segments) basis.

9.2.11 By way of example, if the ICM in this case includes a project with a $10 million capital cost, and thus $1 million per year over two years of ICM adder, what happens if Toronto Hydro decides not to do that project, but to spend $10 million on some other capital project? In our view, on the ICM the $2 million collected is refunded, as it was not used for the purpose intended.

9.2.12 The new project may still be fine, however. Like any capital spending during IRM, it will be reviewed for prudence on rebasing, and if accepted by the Board will be included in rate base and recovered on a going forward basis from ratepayers. The Applicant will not collect depreciation, cost of capital and PILs related to the project during IRM. This is no different from the situation if there was no ICM.

9.3 ***Conclusion***

9.3.1 SEC therefore submits that, if the review of the ICM spending finds overspending, the test for review is prudence, and applies only in the new rebasing year and going forward. On the other hand, if the review of ICM spending finds underspending for any project portfolio, segment or job, the test for review is overcollection of ICM

amounts. That applies retrospectively during the IRM period to which the ICM relates.

9.3.2 We note that our conclusion is consistent with the asymmetrical wording on this point in the Board Report, where the Board says at page IV of the Appendix [K4.7, p. 34], dealing with the review and true-up concept:

> *"If the forecast costs exceeded actual amounts spent, the difference should be returned to ratepayers. Cost overruns will be reviewed at the time of rebasing."*

10 NON-CAPITAL ISSUES

10.1 *IRM/PCI Adjustment*

10.1.1 No submissions.

10.2 *Group 1 Deferral and Variance Accounts*

10.2.1 No submissions.

10.3 *Suite Metering Implementation*

10.3.1 No submissions.

10.4 *Account 1562 PILs Disposition*

10.4.1 No submissions.

10.5 *Interim Rates for Street Lighting*

10.5.1 During the course of the proceeding it became clear that the City of Toronto would seek an order that rates for the Street Lighting class be made interim as of May 10, 2012 [Decision on the Issues List, p.6]. SEC submits that such an order should be denied.

10.5.2 Cost allocation is an inexact science, and improvements develop with subsequent iterations of Board policy. It would be unfair to single out one class of customers (Street Lighting), for one distributor (the Applicant), to have their rates set pending the final outcome of the next iteration of Board policy. All customer classes have their own specific issues with cost allocation methodology, but are not seeking a period of interim rates until it is resolved to their satisfaction.

10.5.3 Making one class of rates interim also would necessitate all classes of rates being interim. This is because the approved revenue requirement would not change. Ratepayers seek finality when it comes to rate setting, and distributors seek finality when it comes to revenue requirement, and neither should not be left uncertain on what they will have to pay or collect for an indefinite period of time.

11 OTHER MATTERS

11.1 *Effective Date*

11.1.1 ***ICM Adjustment.*** SEC believes that the Applicant does not qualify for any ICM funding for its 2012 fiscal year. The first year to which ICM funding should apply is 2013, and rates for 2013 are expected to be effective May 1, 2013.

11.1.2 One implication of this is that the timing and effective date issues on ICM no longer apply. As long as this Application is being treated as, from all practical perspectives, a 2013 ICM/IRM application, then it was filed in a timely manner, and will be decided in time to implement on the normal May 1, 2013 schedule.

11.1.3 ***IRM Price Cap Adjustment.*** There remains a question of the effective date of the normal IRM price cap adjustment.

11.1.4 Normally, in SEC's view a utility that files in May for an IRM adjustment for that same year should get their adjustment effective at the end of the Board's process. The delay in filing results in a delay in rates.

11.1.5 This is a more unusual situation. Toronto Hydro applied in EB-2011-0144 for rates based on cost of service. Whether or not that application should have been filed at all (in our view an unproductive debate to engage), it was filed, and it was not until January of 2012 that the Board made a determination rejecting that application on the threshold issue. The internal and external reaction of the Applicant to that decision again may not have been optimal, especially when looked at with hindsight. On the other hand, whether or not that is true there is no suggestion that the current Application was delayed unreasonably after the EB-2011-0144 decision. It was filed four months later.

11.1.6 Based on these unique circumstances, SEC believes that the effective date of the IRM Price Cap adjustment for 2012 should be June 1, 2012, the date the current rates were declared interim.

11.2 *Phase 2 – 2014 ICM*

11.2.1 There are two issues related to the proposed 2014 in service additions.

11.2.2 ***Phase 2 of this Proceeding.*** The Applicant sought to hive off the 2014 capital plan to a separate phase of this proceeding, and the Board provisionally accepted that request in Procedural Order #3, saying as follows:

"The Board accepts THESL's proposal that the 2014 component of this

> *application, with the exception of that relating to the Bremner Station project, be incorporated into a separate phase of this proceeding.* ***The Board will provide further direction on the issues relating to this subsequent phase prior to the conclusion of this phase of the proceeding****." [emphasis added]*

11.2.3 In SEC's submission, the first phase of this proceeding has brought into stark relief the appropriateness of the RRFE Custom IR option for utilities with major capital programs. This 80-page argument, and the hundreds of pages of other arguments today being filed with the Board, is necessary primarily because the Applicant is trying to fit a "square peg" capital plan into a "round hole" ICM mechanism.

11.2.4 The irony of the situation is not lost on us. The Applicant applied on a multi-year cost of service basis in EB-2011-0144, but the application was directly contrary to Board policy. The Board had no reasonable choice but to reject it. The Applicant has then tried to accomplish a similar result under ICM, only to find that the Board has changed its policy, fairly dramatically, to accommodate applications conceptually similar to EB-2011-0144, as long as certain conditions are met. A large part of the reason for that policy change is the inappropriateness of ICM as a method of considering large, comprehensive multi-year capital programs.

11.2.5 SEC agrees with Board Staff that a multi-year capital plan of the type envisaged by Toronto Hydro is best considered in the context of the Custom IR option in RRFE. This allows consideration of overall rate levels, pacing of major spending, balancing of operating and capital costs, and payoffs for ratepayers resulting from capital investments, among other things.

11.2.6 Therefore, in considering how to deal with Phase 2, SEC believes the Board should very strongly encourage Toronto Hydro to withdraw that part of the Application, and come back in the summer with a comprehensive Custom IR application for the years 2014-2018 or longer.

11.2.7 ***Bremner TS***. Also related to 2014 is the Bremner TS, on which construction is expected to start Q1 2013, targeting a 2014 in service date. The Applicant has asked for pre-approval of this project, saying that the uncertainty of proceeding without pre-approval is too much risk for Toronto Hydro to take.

11.2.8 The Board does not have a mechanism for pre-approving most capital projects by electricity distributors. Sometimes approval happens indirectly, in that major projects are included in a cost of service capital budget, even though they will be in-service in a future year. Parties debate the pros and cons of the project, and in the end the utility is able to assess whether the project will meet a prudence test when it is included in rate base.

11.2.9 There are two considerations here, in our view.

11.2.10 First, a distributor does not normally need or have access to prior approval for the construction of a transformer station. We have referred earlier to the ICM applications for Guelph Hydro EB-2010-0130, and Oakville Hydro EB-2010-0104. In both cases, these much smaller LDCs built transformer stations over three year periods, with no prior approval, and sought ICM treatment in the in-service year. In both cases the capital costs of these projects were significantly larger than the utilities' total annual capital budgets.

11.2.11 For Toronto Hydro to say that it cannot take the same approach appears, on the face of it, to be counter-intuitive. The cost is a much smaller component of the Applicant's annual capital budget, and the main spending is over only two years, not three.

11.2.12 Second, and on the other hand, the Board is already aware that the Bremner TS is opposed by some stakeholders. While the preferred action plan by a distributor in that circumstance should be to engage its stakeholders, outside of the regulatory process, as part of its decision-making process for the capital project itself, it may now be too late for that.

11.2.13 SEC concludes that the best result would be for the Board to advise Toronto Hydro that it should assess for itself whether the proposed project and budget is prudent, and the Board will review it after the fact in the normal course.

11.2.14 In the alternative, and given where we already are in the process, SEC submits that the Board should make very clear to the Applicant and the parties that, in considering pre-approval, it is making an exception for this particular project, and that procedure will not likely apply to other major capital projects.

11.3 ***Costs***

11.3.1 The School Energy Coalition hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

Jay Shepherd
Mark Rubenstein
Counsel for the School Energy Coalition

12 APPENDIX A

Toronto Hydro - Proposed Segment Maximums for ICM Purposes

Projects (i.e. Portfolios of Projects/Jobs)	*Number*	*Segments (i.e. Groups of Projects/Jobs)*	*In-Service Additions 2012*				*In-Service Additions 2013*				
			Pre-2012 Spending (December 31, 2011 CWIP)	*2012 Spending*	*Total ISAs*	*SEC Segment Maximums 2012*	*Pre-2012 Spending (December 31, 2011 CWIP)*	*2012 Spending*	*2013 Spending*	*Total ISAs*	*SEC Segment Maximums 2013*
Underground Infrastructure and Cable	B1	Underground Infrastructure	2.88	12.74	**15.62**	**7.81**	15.06	16.01	35.87	**66.94**	**33.47**
	B2	PILC Cable - Piece-outs and Leakers		0.04	**0.04**	**0.00**		0.05	3.30	**3.35**	**0.00**
	B3	Handwell Replacement	2.57	6.05	**8.62**	**4.31**	1.30	7.60	10.13	**19.03**	**9.52**
Overhead Infrastructure and Equipment	B4	Overhead Infrastructure		4.02	**4.02**	**2.40**	3.94	5.05	34.01	**43.00**	**25.50**
	B5	Box Construction		0.26	**0.26**	**0.00**		0.32	14.02	**14.34**	**8.96**
	B6	Rear Lot Construction	4.45	7.25	**11.70**	**0.00**		9.11	17.91	**27.02**	**0.00**
	B7	Polymer SMD-20 Switches							0.93	**0.93**	**0.93**
	B8	SCADA-Mate R1 Switches							0.87	**0.87**	**0.87**
Network Infrastructure and Equipment	B9	Network Vault and Roofs		1.26	**1.26**	**1.26**		1.58	11.42	**13.00**	**13.00**
	B10	Fibretop Network Units		0.65	**0.65**	**0.00**	0.34	0.82	4.69	**5.85**	**0.00**
	B11	ATS and RPB							1.99	**1.99**	**1.99**
Station Infrastructure and Equipment	B12	Stations Power Transformers		0.17	**0.17**	**0.00**		0.21	2.12	**2.33**	**0.00**
	B13	Stations Switchgear - MS and TS		0.77	**0.77**	**0.77**	4.67	0.96	13.28	**18.91**	**15.06**
	B14	Stations Circuit Breakers	0.28	0.34	**0.62**	**0.00**		0.42	0.34	**0.76**	**0.00**
	B15	Stations Control and Comm. Systems		0.06	**0.06**	**0.00**		0.08	0.61	**0.69**	**0.00**
	B16	Downtown Station Load Transfers		0.30	**0.30**	**0.00**	0.66	0.38	1.30	**2.34**	**0.00**
Bremner TS	B17										
Hydro One Capital Contributions	B18			3.69	**3.69**	**0.00**	7.72	1.68	9.02	**18.42**	**1.48**
Feeder Automation	B19			1.02	**1.02**	**0.00**		1.28	12.58	**13.86**	**0.00**
Metering	B20		0.49	2.10	**2.59**	**1.14**	2.60	2.64	5.11	**10.35**	**4.00**
Plant Relocations	B21		2.47	4.50	**6.97**	**2.58**	1.29	5.66	15.12	**22.07**	**17.30**
Grid Solutions	B22										
Engineering Capital	BXX	ICM Understatement of Capitalized Labour		3.69	**3.69**	**0.00**		4.63		**4.63**	**0.00**
Operations Portfolio Capital	C1		40.52	53.95	**94.47**	**75.60**	7.88	66.56	77.44	**151.88**	**120.80**
Information Technology Capital	C2		9.87	9.25	**19.12**	**19.12**		12.75	8.72	**21.47**	**21.47**
Fleet Capital	C3		0.34	0.29	**0.63**	**0.63**		0.51	0.25	**0.76**	**0.76**
Buildings and Facilities Capital	C4		3.14	3.76	**6.90**	**6.90**		1.24	1.65	**2.89**	**2.89**
AFUDC				0.15	**0.15**	**0.15**		1.05	1.09	**2.14**	**2.14**
Totals			67.01	116.31	**183.32**	**122.67**	45.46	140.59	283.77	**469.82**	**280.14**