EB-2016-0105

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 Thunder Bay Hydro Electricity Distribution Inc. pursuant to the *Ontario Energy Board Act* for an Order or Orders approving rates for the distribution of electricity commencing May 1, 2017

FINAL ARGUMENT
OF THE
SCHOOL ENERGY COALITION

July 13, 2017

SHEPHERD RUBENSTEIN
Professional Corporation
2200 Yonge Street, Suite 1302
Toronto, Ontario M4S 2C6

Jay Shepherd

Tel: 416-483-3300
Fax: 416-483-3305
jay@shepherdrubenstein.com

Counsel for the School Energy Coalition

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1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 On September 19, 2016 the Applicant Thunder Bay Hydro Electricity Distribution Inc. filed an application to set just and reasonable rates for the distribution of electricity for the period commencing May 1, 2017. The Application sought an increase of $4.1 million in its revenues, representing a 21.0% weighted average rate increase.

1.1.2 The parties settled most of the issues in this proceeding, and on May 4, 2017 the Board accepted the Settlement Agreement. As a result of the Settlement Agreement, the requested revenue increase was reduced to $3.5 million, and the requested weighted average rate increase to 17.8%.

1.1.3 Three issues remain to be determined:

(a) OM&A in the test year.

(b) Rate base, i.e. capital additions and the capital spending plan.

(c) Cost of Capital.

1.1.4 An oral hearing was held on June 29 and 30, 2017, and undertaking responses were filed July 6, 2017. The Applicant's Argument-in-Chief was filed on July 5, 2017.

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

1.1.6 The ratepayer groups who intervened in this proceeding have worked together throughout the proceeding to avoid duplication, including discussing their final arguments, positions they would be taking, and areas of emphasis. We have been assisted in preparing this Final Argument by that co-operation amongst the parties.

1.1.7 In this proceeding we did not have the usual opportunity to review the submissions of OEB Staff before filing intervenors submissions. We therefore are not in a position to comment on OEB Staff positions on the issues, as we normally would.

1.1.8 The numbering of Sections and Subsections in this Final Argument is not consistent with the numbering in the Issues List, as the issues that arose in the course of the proceeding, the ones left unsettled, and the development of this Final Argument made a different logical structure appropriate.

1.2 *Theme of These Submissions - Outcomes*

1.2.1 In SEC's submission, the central issue in this proceeding is whether the Applicant has a sufficient focus on achieving outcomes its customers value. The evidence indicates

that the most important outcome for customers – cost and therefore rate control – is not a focus, and further the Applicant does not think that it has an obligation to make it a focus.

1.2.2 Instead, the Applicant rejects the standards developed by the Board, and believes that it (like other LDCs) has higher cost pressures than everyone else in Ontario, including its own customers. Those cost pressures justify rate increases well above the ability of its customers to pay for them. This has been hidden from the customers for many years, because customers continue to believe that the Rate Minimization Model is providing them with very low rates – among the lowest in the province. That is no longer true.

1.2.3 ***Cost and Rate Increases.*** The Applicant has, at this point in the proceeding, proposed a weighted average rate increase of 17.8%, down from the 21% originally proposed. When the IRM increases for 2014, 2015, and 2016 are added in[1], the total weighted average rate increase for the last four years is 23.2%, a compound annual growth rate (CAGR) of 5.37%[2].

1.2.4 The reasons for this are several, but a key one is that the Applicant's OM&A proposed for the test year, after adjusting for customer growth of 2.01% over the last four years, and applying the PEG elasticity factor of .4448[3], is the equivalent of $15,590,678. This is an increase in OM&A from the actual OM&A expended in 2013[4] of 17.82%, a CAGR of 4.19% per year.

1.2.5 Part of the OM&A increase is the result of the average annual compensation per employee increasing from $93,340 in 2013 to $103,248 in 2017[5], a CAGR of 2.55% per year. That masks, though, a bigger increase. Prior to the decision in EB-2012-0167, the Applicant's last cost of service proceeding, executive compensation was forecast to average $184,835 in 2013. As soon as the decision came out, that was increased to $194,305, and in the test year is forecast to be $214,285, a 15.93% increase over four years. That is a CAGR of 3.75% per year.

1.2.1 ***Increases in Customer Ability to Pay.*** The Average Weekly Earnings in Ontario has increased 7.44% in the last four years, a CAGR of 1.82% per year[6]. The Consumer

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[1] EB-2013-0173 Decision and Order – 1.4% for 2014. EB-2014-0114 Decision and Order – 1.3% for 2015. EB-2015-0103 Decision and Order – 1.8% for 2016.
[2] The Applicant's 2016 rates were about 89% of provincial averages: 1.0-SEC-3. With the rate increase proposed in this proceeding, rates would go up to slightly above the provincial averages, despite the continuing 5% rate benefit arising out of the vestiges of the Rate Minimization Model. This suggests lack of cost control.
[3] First introduced in evidence through an expert report by PEG in the Oshawa CIR proceeding, but since used numerous times to show the increase in OM&A expected to result from customer growth. Here, 2.00% customer growth over four years equates to 0.08928% OM&A growth. That reduces the proposed test year OM&A from $15,729,872 to $15,590,678 because that component of proposed OM&A is growth-driven.
[4] $13,232,884, from Appendix 2-JC updated.
[5] Derived from Table 4-12, included in K2.4 at page 64.
[6] StatsCan AWE (Ontario) 2012 is $906.17, 2016 is $973.56.

Price Index (Ontario All Items), a reliable proxy for increases in fixed income payments, which are usually based on CPI, has increased 6.49% in the last four years, a CAGR of 1.58% per year[7].

1.2.2 The average increase in rates currently proposed – 5.37% per year over four years - is thus a little more than three times the increase in the customers' ability to pay.

1.2.3 When asked about this, the CEO of the Applicant professed to have no knowledge of these or any other details of the increases in his customers' ability to pay bills from the utility[8]:

> *"MR. SHEPHERD: In the last four years, what has been the average increase in weekly earnings in Sudbury [sic]?*
> *MR. MACE: Weekly --*
> *MR. SHEPHERD: Or, sorry, not in Sudbury, in Thunder Bay. How did I put Sudbury there?*
> *MR. MACE: I am sorry, weekly earnings of...*
> *MR. SHEPHERD: Of residents of Thunder Bay.*
> *MR. MACE: I don't know.*
> *MR. SHEPHERD: Shouldn't you know that? Those are your customers. Does 1.5 percent sound about right?*
> *MR. MACE: I don't know.*
> *MR. SHEPHERD: Okay. In the same period what has been the average annual increase in old age security and other government transfer payments for your customers over those four years?*
> *MR. MACE: I don't know.*
> *MR. SHEPHERD: Does 1.7 percent sound right?*
> *MR. MACE: I don't know."*

1.2.4 ***Customer Preferences.*** The Applicant pointed out numerous times that in their view customers are concerned with both reliability and cost, and understand that the utility has to spend more to improve reliability[9].

1.2.5 What the evidence showed is that, at least for residential and small commercial customers, cost control is valued much more highly than reliability[10]. The opposite is true of large users.

1.2.6 The Applicant led no evidence to demonstrate that customers believe they should pay more without getting any improvement in reliability or service quality.

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[7] StatsCan CPI (Ontario All Items) 2012 is 121.8, 2016 is 129.7.
[8] Tr.2:164.
[9] E.g. Tr.2:12, 13, 14, and many other places.
[10] Which the Applicant admits: Tr.3:36.

1.2.7 ***Utility Approach is Not Customer Focused.*** Part of the problem here is that the Applicant appears not to understand at all the need to look at things from the customers' perspective. This is exemplified in the following exchange[11]:

> *"MR. SHEPHERD: And you say, "As a consequence of the shareholder foregoing their financial return, we have among the lowest distribution rates in Ontario for residential customers." Do you?*
> *MR. MACE: If you used last year, the OEB's rate calculator, and put in residential rates for 800-kilowatt-hours, which is what our -- which we did, you would have seen that we were the fourth lowest distribution rate for residential customers -- sorry, total bill for residential customers in Ontario.*
> *That was also featured in, I believe, two of the large provincial media outlets.*
> *MR. SHEPHERD: Of course that's not going to be true in 2017, is it?*
> *MR. MACE: I expect that it will change somewhat, yes.*
> *MR. SHEPHERD: And in fact, your ranking will go down substantially if you get what you are asking for.*
> *MR. MACE:* ***Or up, depending on which perspective you have.*** *Our rates will be higher."[emphasis added]*

1.2.8 During cross-examination, this problem with understanding the customer perspective was tied directly to the issue of the customers' ability to pay. The following exchange is supposedly about management discussing customer affordability with the board of directors, but it is clear that the Applicant's CEO cannot see affordability as exterior to the Applicant's own "cost pressures". We have included the whole, lengthy exchange because we kept trying to give the Applicant the opportunity to show that they understand customer affordability and ability to pay. They did not[12]:

> *"MR. SHEPHERD: What role does your board of directors play in keeping rate increases within the means of your customers?*
> *MR. MACE: Ultimately, our board approves our operating budget annually. The board of directors does not approve IRM increases. The board of directors reviews our strategy related to the cost of service application.*
> *MR. SHEPHERD: And do you discuss with your board of directors how much your customers can afford to pay each year?*
> *MR. MACE: I have discussed with my board of directors the rate increases that we're requesting and the drivers behind it.*
> *MR. SHEPHERD: So the answer is no, you haven't discussed the ability to pay?*
> *MR. MACE: Yes. Have I discussed -- we discuss as a -- sorry, ask me*

[11] Tr.2:184-5.
[12] Tr.2:168-70.

the question again, please.
MR. SHEPHERD: Have you discussed with your board of directors your customers' ability to pay your rate increases?
MR. MACE: We have discussed in general terms the need for increased spending and why. We have discussed that it's a significant rate increase to customers.
MR. SHEPHERD: That's still non-responsive to my question. Either you discuss with your board of directors the fact that your customers have limits on their ability to pay, or you haven't. Have you?
MR. MACE: We have discussed -- we have discussed our customers' ability to pay. We have discussed it in terms of rate increases. We have discussed it in terms of other hydro-related impacts on the total bill. I am not sure quite what your question is.
MR. SHEPHERD: Well, the reason I ask that is because you don't seem to know how quickly wages are growing in Thunder Bay, your customers. You don't seem to know how people on fixed income, how their income is growing and those are your customers.
So how did you discuss this with your board? Explain this discussion.
MR. MACE: I am not sure I can relate the discussion with any accuracy.
MR. SHEPHERD: You went to your board of directors and you said we are going to ask for a 21 percent rate increase. At that point, you might have said, "And our customers are only getting less than 2 percent more income this year than last year. What are we going to do to bridge that gap?"
You never had that discussion, did you?
MR. MACE: I have had discussions yearly when we do the budget about the efficiencies that we have undertaken and achieved in the organization."

1.2.9 SEC believes that the evidence of the Applicant shows a company that still thinks like a municipal department, i.e. only concerned with its own perspective. That company – the Applicant – does not appear to have internalized the "outcomes" paradigm, based on the customers' perspective, that the Board has been trying so hard to communicate to Ontario electricity distributors and other regulated entities.

1.2.10 ***Cost Control Not Considered an Imperative.*** Part of this is that the Applicant simply doesn't believe that the Board is on the right track with its rate-making approach, i.e. the RRFE. Although it took us some time to get there, ultimately this was admitted in multiple ways.

1.2.11 For example, the Applicant believes that the purpose of a cost of service proceeding is to build into rates all of the LDC's cost pressures in excess of the IRM formula. This is what they have told their board of directors[13], and they have admitted it in cross-

[13] K2.4, p. 6.

examination[14]:

> *"MR. SHEPHERD: Well, in fact your pattern has been to fund cost of service, you ask for a lot and then you limp along and then you ask for a lot again, right?*
> *MR. MACE: Yes.*
> *MR. SHEPHERD: And that's not just for capital, is it? It's also for operating costs, right?*
> *MR. MACE: I suppose in some instances the purpose of the cost-of-service application is to scrutinize your operating costs, so* ***if you had cost pressures between cost-of-service applications, as I believe the industry has had and as we have had, then the cost-of-service application is the time to evaluate those and build them into your rates… I believe that's the purpose of the cost-of-service process****."[emphasis added]*

1.2.12 It was more difficult to get the Applicant to admit directly that they think the Board's IRM formula is wrong, but in the end they did[15]:

> *"MR. SHEPHERD: Didn't the Board do a whole study on what the appropriate annual increase in rates for an LDC is, a whole empirical study?*
> *MR. MACE: Yes.*
> *MR. SHEPHERD: Which the EDA was actively involved in, I think maybe when you were chair. And as a result, the Board concluded with a formula; right?*
> *MR. MACE: The Board has concluded with a formula, yes.*
> *MR. SHEPHERD: And you don't agree with that formula; do you?*
> *MR. MACE:* ***I think the formula does not necessarily take into account all costs that are faced by utilities****."[emphasis added]*

1.2.13 Of course, Mr. Mace is absolutely entitled to his opinion, and to expressing it, including in the hearing. What matters in the rate context, however, is the next sequence, when he went on to admit[16]:

> *"MR. SHEPHERD: And as a result, when you do your budgeting every year, you make no effort to live within the Board envelope; do you? None.*
> *MR. MACE: I don't think that's accurate.*
> *MR. SHEPHERD: Well, so when was the last time that your budget presented to your board of directors was within the OEB's formula? The*

[14] Tr.2:159-60.
[15] Tr.2:160-1.
[16] Tr.2:161.

answer is "never", but I would like you to say it.
MR. MACE: I don't recall. I can say "never."
MR. SHEPHERD: You don't recall any time?
MR. MACE: I do not recall any time, no.
MR. SHEPHERD: And have you ever said to your board of directors, well, we have to live within this envelope that the Ontario Energy Board has given us, and so we can't spend more money than that? Have you ever said that?
MR. MACE: I take every step I can reasonably to reduce our costs. The issue that I find is that the IRM formula in particular does address a lot of inflationary costs but does not address new cost pressures that get put on to the industry."

1.2.14 SEC submits that, while the Board of course understands that budgeting is not entirely formulaic, the Board should and does expect utilities to have regard for the Board's research and conclusions on appropriate increases as part of their budgeting. When the Board says that LDC costs should typically go up by a particular amount, it is not speaking just to hear itself talk. It is communicating an expectation to the utilities it regulates. It expects them to pay attention.

1.2.15 In this case, that does not appear to be true. The Applicant does not appear to consider the Board's benchmarking, IRM guidelines, or anything else to be influential in what it should be spending.

1.2.16 The end result is a utility that believes the cost of service proceeding is their periodic opportunity to get a big rate increase. Their understanding of the regulatory game is that there is a time to ask for more money, and this is it[17].

1.2.17 What we saw throughout this proceeding is that, while the utility talks a lot about efficiencies and keeping costs down, the facts are that costs are increasing at a rapid rate, and the utility admits they do not believe that customer affordability, or the Board's guidance on appropriate cost increases, should drive their actual spending. They should be as efficient as they believe they can be. Whatever spending arises after that, so be it. Let the chips fall where they may.

1.2.18 ***SEC Recommended Approach.*** SEC believes that the starting point for "just and reasonable rates" should be

[17] The exchange on approval of their test year budgets is indicative of the cynicism with which the Applicant appears to look at the regulatory process. See Tr.2:170-176. Perhaps even more striking is Mr. Mace's rueful comment that he should have loaded up 2013 spending with extra outlays so that it created a higher base for future rate applications: Tr.3:3:97-8.

(a) empirically demonstrated reasonable increases in overall costs, which in the context of the Board is indicated by the IRM formula; and
(b) levels of increase in rates that match increases in the customers' ability to pay.

Increases in excess of these amounts should only be allowed, subject to some exceptions (see below), where the utility can demonstrate that it is spending more money to achieve outcomes that are

(c) an improvement over the outcomes already achieved through current rates, and
(d) desired by the customers and valued by customers at the level comparable to the incremental costs.

Our understanding of the RRFE is that rate increases that do not meet these tests should not be allowed.

1.2.19 SEC does agree that there is an exception, which would apply to this Applicant. Where rates are lower than a just and reasonable level, for example because of the impact on current rates of the Rate Minimization Model[18], it is reasonable to allow additional increases to move them up. The Board still, of course, would be concerned with the impact on customers, but it is a different perspective when rates are moving towards a reasonable level, rather than above.

1.2.20 SEC therefore submits that, subject to the increase in rates arising out of the continuing evolution of the Rate Minimization Model[19], the Board should approve rate increases for the Applicant only for inflationary increases as assessed by the IRM model, and cost increases to deliver better outcomes that are valued as such by the customers.

1.3 ***Summary of Submissions***

1.3.1 ***Cost of Capital***. The Board should allow the increase in the ROE from 7.00% embedded in rates, to 8.78%, the Board standard level.

1.3.2 The combined impact of the increase in ROE, the declining percentage of long term debt that is represented by interest-free debt to the City, and the increasing PILs as a result of the higher ROE, is a rate increase of $1,344,000, or 6.8%. The ratepayers are still benefiting from $26.5 million of interest free City debt, with a value of about $1.1 million.

1.3.3 ***OM&A.*** The Board should approve an OM&A budget of $14,521,074, a reduction from the current proposal of $1,208,798. This is a CAGR of 2.35% per year for the

[18] Or, for some utilities (although likely not for this Applicant), because of a demonstrable pattern of past underinvestment in the system.
[19] Discussed in detail in Section 2 of this Final Argument.

last four years, well in excess of inflation (let alone productivity or stretch), but justified by specific cost increases outside of the control of the utility.

1.3.4 Although this is a 9.73% increase of 2013, it does not result in any rate increase, because the amount embedded in rates for OM&A was so much higher than the actual OM&A spending. With the IRM increases in the interim period, the resulting OM&A budget would be roughly the same as the budget being proposed by SEC.

1.3.5 ***Capital Spending Plan***. The increases in System Renewal capital spending proposed by the Applicant should be denied, as they have not been justified in the evidence. This would reduce capital additions by $1.7 million. This still leaves a substantial increase in rates arising out of past capital spending in excess of reasonable levels. However, it would, if accepted by the Board, flatten out the continuing increases in rates due to out of control capital spending increases.

1.3.6 ***Communication to Customers.*** SEC proposes that, for this rate order only (and not as a general practice, whether for this utility or any other), the Board should closely supervise the communications from the Applicant to its customers explaining the drivers and impacts of the rate increase.

2 COST OF CAPITAL

2.1 *Rate Minimization Model*

2.1.1 The City of Thunder Bay is famous in the electricity sector for its Rate Minimization Model. As described in the history below, the City – whether for political, altruistic, or other reasons – decided that the corporatization of the LDCs was not going to result in higher electricity bills for local residents.

2.1.2 The reality is that the shift from municipal government agency to corporation meant every LDC had to have some cost of capital. It was not actually possible to act as a quasi-non-profit, as the Applicant quickly found out.

2.1.3 The result, as set out below, has been a series of incremental shifts to the conventional capital structure and cost of capital. To their credit, the Applicant and the City of Thunder Bay continue to resist, but the result is inevitable.

2.2 *Historical Context*

2.2.1 The cost of capital of the Applicant in 2004 was zero[20]. It was zero in dollars, and it was zero in percentage of rate base. Its weighted average cost of capital was, of course, also zero. Its entire capitalization was represented by a note payable to the City of $31.6 million, which was interest free[21].

2.2.2 Two things have happened over time.

2.2.3 ***Debt and Cost of Debt.*** First, new debt had to be obtained to fund capital spending and other requirements. The municipality was prevented from providing that debt, so interest had to be paid. Today, many years later, about 49.4% of the Applicant's debt is commercial interest-bearing debt from third parties, and the weighted average cost of debt, including the interest-free City component, is 2.10%[22].

2.2.4 It would be unfair to discuss this issue without noting that ratepayers would be paying $1.1 million more in rates this year if the City debt, instead of being at zero, was at the Board's default interest rate[23] of 3.72%.

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[20] And continued to be zero until at least 2009. See EB-2012-0167, Chapter 2 Appendices. By 2013 it was up to 1.9%, because 40.5% of long term debt was from third parties, and interest rates were higher than they are today.
[21] And as a result, for a long time Thunder Bay Hydro had among the lowest rates in the province: Tr.2:209.
[22] See Updated RRWF in this proceeding, also found at K2.4, p. 28.
[23] See Appendix 2-OB, updated February 8, 2017. The 0% debt to the City, now reduced to $26.5 million, is 50.6% of total debt, and 40.5% of deemed debt. If the City debt were at the Board's deemed rate, the cost of interest on long term debt would be 3.93% (similar to other LDCs), or about $2.43 million rather than the $1.35 million included in the Application as currently updated. The figure of $985,000 proposed by SEC and discussed in the transcript at Tr.2:200 is incorrect. It failed to take account of the fact that deemed debt is higher than actual debt.

2.2.5 Nonetheless, the debt component of cost of capital has increased over time from zero to 2.1%, when it has been declining for all other distributors, because the Applicant needed to borrow more money, and borrowing is not free.

2.2.6 ***Return on Equity.*** The Applicant started with an ROE of zero, and therefore an expected PILs of zero[24].

2.2.7 In EB-2004-0529[25], the Applicant proposed to increase its allowed ROE to 3.75% (as part of the third tranche proceeding), and it was allowed to do so because regulatory policy allowed a higher amount. The requirements of that proceeding were that the incremental revenues from the additional ROE had to be spent, in the first year, on CDM activities. Without adding at least some ROE, the Applicant would not have been able to engage in CDM that would provide significant benefits to the local community.

2.2.8 In EB-2012-0167, the Applicant requested and was granted an increase from 3.75% to 7.00% allowed ROE[26]. The rationale – which was entirely correct – was that capital spending requires, under the Board's rules and under normal banking requirements, a certain level of shareholders equity to avoid being over-leveraged, and at 3.75% ROE the Applicant would not be able to provide a sufficient equity base for its capital assets.

2.2.9 The increase to 7.00% did not include any incremental amount for PILs, because it coincided with the move from CGAAP to MIFRS. This resulted in a substantial temporary tax shelter for the Applicant, and the PILs provision in that proceeding was zero[27].

2.2.10 In the current proceeding, the ROE is moving for the first time to the full allowed rate, in this case 8.78%. While nominally the reason is to form a foundation for further debt to fund capital, that does not actually appear to be true[28], except in a longer term sense.

2.2.11 That having been said, the customers do not have any "right" to an ROE break from this Applicant, and it would be unfair to ask it. The customers have benefitted

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[24] Confirmed in EB-2004-0529.

[25] The Applicant sought a $1.6 million increase in rates to add the "third tranche" of ROE, even though it did not have the first two tranches. The Board in the decision in that matter allowed the equivalent of one third of then-allowed ROE in lieu of bringing total ROE up to the full Board-approved level. This was confirmed in EB-2005-0079, which also authorized the inclusion of a PILs proxy of another $1.6 million.

[26] See Ex.5/1/2 in that proceeding.

[27] See Revenue Requirement Work Form in that proceeding, which shows that the Applicant had $2.6 million of ROE but a negative tax obligation. The revenue requirement would have been at least $900,000 higher had the ROE not been sheltered by the excess of CCA over depreciation.

[28] See exchange at Tr.2:198-9.

immensely over the years from the Rate Minimization Model[29], and the fact that the free ride is close to its end is not a justification for complaint. As one customer said to us the other day, "We got what we got. It was good. Move on."

2.3 *Impact in Test Year*

2.3.1 In the test year, three things have happened to increase rates as the Rate Minimization Model evolves.

2.3.2 ***Cost of Debt.*** First, relative to EB-2012-0167, the percentage of debt that is interest free has continued to decline, from 68.0% in that year, to 50.6% this year. This is costing the customers $460,000 million per year[30].

2.3.3 On the other hand, interest rates have continued to decline, so that the weighted average cost of long term debt in 2017 is 3.93% compared to 4.20% in 2013. This saves the customers $167,000 per year.

2.3.4 The effect of the long term debt changes is therefore an increase in rates of $293,000, of which $460,000 is the continuing evolution of the Rate Minimization Model, partially offset by an economy-wide decline in interest rates with an impact of $167,000.

2.3.5 ***Return on Equity***. The return on equity in this proceeding is 8.78%, versus the 7.00% approved in EB-2012-0167, and thus embedded in rates. The difference between the two, based on the most recent RRWF, is $787,000[31]. This is a direct increase in rates as a result of the increase in the ROE level to the full Board rate.

2.3.6 ***PILs.*** In addition, the added ROE will have to be grossed-up to cover PILs on that amount. The increase in PILs from 2013 to today already included in the Application is currently $264,024. Without the additional income from the higher ROE, the PILs would be zero.

2.3.7 Thus, the increase in ROE is an increase in revenue requirement of about $264,000.

2.3.8 ***Total Impact on Deficiency.*** The combined impact of the three changes to the Rate Minimization Model seen in this Application is $1,344,000. This by itself is a rate increase of 6.8%, or about 38% of the rate increase currently being proposed by the Applicant.

2.3.9 SEC notes that none of this is an unfair inclusion in customer charges. The fact that

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[29] The Applicant says the impact is tens of millions of dollars: Tr.2:18. That is likely true. It may actually be as high as $50-$60 million.
[30] If zero rated debt were at 68% in this proceeding, the weighted average cost of debt would be 1.33%, and the total interest cost on long term debt would be $824,000, a reduction of about $460,000.
[31] 1.78% on $44.31 million of deemed equity, from most recent RRWF.

the ROE is increased to the full rate, and that has tax consequences, and the fact that the break customers are receiving on interest free debt is declining as a percentage of the total, are factors that drive rates up this year. However, they drive rates up because the Applicant and its shareholder had in the past been willing to accept less than full rates in order to benefit their customers. This $1.3 million increase is most fairly looked at as $1.3 million of $2.4 million of the rate benefits customers would otherwise have received but for the evolution of the Rate Minimization Model. In 2017, customers will receive $1.1 million of benefits (the remaining value of the interest free debt) rather than the $2.4 million that would have been available if the other benefits still remained. No part of this is unfair.

2.3.10 The total cost of capital including PILs in 2017 is proposed to be $5.5 million, or 4.97% of rate base. This amount – 23.4% of current rates - compares to zero in 2004. From a customer perspective, rates have gone up by that much as the value of the Rate Minimization Model has naturally eroded over time.

2.3.11 However, the proposal in the Application also compares to $6.6 million total cost of capital including PILs, or 5.97% of rate base, at normal rates comparable to any other LDC. Rates are still lower by about 4.7% because of the Rate Minimization Model.

2.4 ***Communications to Customers***

2.4.1 In Section 5 of this Final Argument, SEC discusses how the impacts of cost increases have been communicated to customers. The most glaring of these communications issues is probably the Applicant's failure to communicate in a forthright manner its changes to the Rate Minimization Model.

2.4.2 Instead, the Applicant continues to tout the Rate Minimization Model as if it continues to protect the ratepayers unchanged; as if Thunder Bay Hydro continues to have the lowest rates in the province. This is misleading[32].

2.4.3 The Applicant's customers are still getting a benefit from the Rate Minimization Model, and that benefit should be explained fairly to those customers. What is not appropriate, in our submission, is to let customers continue to believe that they are getting the much higher benefits they had in the past.

2.5 ***SEC Recommendation***

2.5.1 SEC submits that the proposed cost of capital is reasonable in light of the Board's policies, and should be approved subject to changes in the underlying test year rate base as discussed later in this Final Argument.

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[32] Mr. Mace essentially admits that, in retrospect, a clearer explanation might have been a good idea to avoid misleading the customers: Tr.2:208.

2.5.2 In our submission, the Board should encourage the Applicant to have clear discussions with its customers about the changes in the Rate Minimization Model over time, why those changes have been necessary, and how customers have been affected.

3 OM&A EXPENSES

3.1 *Overview*

3.1.1 The Applicant is proposing an increase of 18.9% in its OM&A spending from 2013 Actual to 2017 Proposed[33]. This is a CAGR of 4.4% per year[34].

3.1.2 This is further complicated by the fact that, in its 2013 cost of service application, the Applicant was granted a substantial OM&A increase, but then actually spent 7.5% less in that year[35]. As a result, the Applicant collected $1,067,000 more in rates in 2013 than it actually spent on OM&A. This continued throughout the 2013-2016 period, i.e. rate recovery exceeding actual spending, so that by the end of that four years the excess amounts collected in rates for OM&A, relative to actual spending, were $2,020,934[36].

3.1.3 Now they propose to essentially do that again, with proposed test year OM&A $1.5 million, or 10.4%, above the most recent actuals, 2015.

3.1.4 SEC is aware that other intervenors, and OEB Staff, will be providing submissions on the details of the proposed OM&A budget. As with our comments on the capital spending plan, SEC will focus on a more top-down approach to that budget[37].

3.1.5 Based on our analysis, the OM&A included in revenue requirement should be reduced to $14,521,074, a reduction of $1,208.798. This is an increase of 9.73% from 2013, or a CAGR of 2.35% per year. It is higher than inflation because it reflects the OM&A cost of monthly billing, and the increase in the OEB assessment.

3.2 *History*

3.2.1 ***Past Over-collection***. In EB-2012-0167 the Applicant obtained approval for $14,300,000 of OM&A. In that year, the amount actually spent was about $1.1 million less. When the actual spending is compared to the amounts embedded in rates for each of the subsequent years, again the Applicant underspent. The total

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[33] 4.0-SEC-21.
[34] The Applicant denied that is true at Tr.2:163, and continued to want to push forward a lower number, 2.41%, that is not only calculated wrong (see Tr.3:87-8), but is based on the 2013 Board-approved budget, which was more than the Applicant needed, as it turned out.
[35] Appendix 2-JC.
[36] K2.4, p. 62.
[37] We acknowledge the attempts by the Applicant to explain the "special" cost pressures they face – see for example Tr.2:20-21 – but all of them appear to us to be ordinary course of business spending. In a competitive market, a company would not be in a position to raise their prices because of those types of spending. They would manage within their existing revenues, finding savings elsewhere to pay for those cost pressures.

underspend relative to amounts collected in rates, $2,020,934, was calculated by SEC[38] and put to the Applicant in the hearing. After some wrangling, it was accepted by the witnesses subject to check[39]. SEC has not been advised of any concerns about the calculations, so it is now, from an evidentiary point of view, an agreed number.

3.2.2 We note that the lower actuals were not the result of efficiencies. The 2013 budget was simply more than they actually needed.

3.2.3 ***Executive Increases.*** One thing that was higher in 2013 compared to budget was executive compensation. Executives received on average another $10,000 per year in compensation, over and above the amounts in the approved 2013 budget. This has continued to this time. The increase was 5.1%[40]. At the same time, average management and non-union compensation went down from budget, and average union compensation was roughly the same as budget.

3.2.4 When this increase was disclosed in the response to the interrogatory, it was described as an increase applicable to the company's VPs. It was not until cross-examination during the hearing that the CEO – who is presumably not a vice-president – was also included in the round of special executive compensation increases[41].

3.2.5 SEC is, of course, concerned that the current OM&A budget may also be a high-balled figure, and also concerned that ratepayers could once again be paying for phantom OM&A costs.

3.2.6 There is no evidence on the record that a repeat of the executive compensation bump is likely, but in our submission commentary from the Board on the appropriateness of such a pattern could at least be helpful.

3.3 *Empirical Evidence of Reasonable OM&A*

3.3.1 ***The Aiken Model.*** For years parties in Board proceedings have used an OM&A model originally developed by Randy Aiken, a consultant for LPMA, Energy Probe, and others. The model, an abridged version of which is included in K2.4, p. 62[42], projects a reasonable level of OM&A spending based on the factors known to influence that spending: inflation, productivity, customer growth, stretch, and unusual adjustments.

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[38] K2.4, p.62.
[39] Tr.3:95.
[40] 4.0-SEC-50.
[41] Tr.3:109.
[42] SEC attempted to put the Aiken Model, and its results, to the Applicant's witnesses, but they had decided not to review it despite having been provided it in advance. They were thus unable to consider it during cross-examination.

3.3.2 The Aiken Model escalates actual OM&A by the Board's inflation factor, plus a factor based on the Applicant's actual customer growth, less the Board's Applicant-specific stretch factor. Aside from the stretch factor, productivity is assumed to be zero.

3.3.3 The base year can be any year's actual spending, but clearly in an IRM period the appropriate base year is the earliest historical year available. However, it has to be adjusted for any material factors that make that year unrepresentative (just as in all IRM calculations). In this case, the model adjusts the 2016 and 2017 figures for the increase in the OEB annual assessment, and for the OM&A cost associated with monthly billing.

3.3.4 The end result is $14,182,074 million in 2017, which when adjusted for the $339,000 for monthly billing and OEB assessment, is $14,521,074. The CAGR is 2.35% per year, which is more than inflation plus growth because of the additional adjustment noted. This is the objectively-determined reasonable OM&A envelope for the Applicant for 2017.

3.3.5 ***The Board's IRM Model***. The Aiken Model is essentially an OM&A-specific version of the Board's IRM Model. Even if the Applicant seeks to attack the Aiken Model, the Board's Model itself makes clear that the amounts being sought by the Applicant in this proceeding are well above a reasonable level.

3.3.6 Under the Board's IRM model, inflation less stretch factor for the four years 2013 to 2017 is 6.24%, assuming zero productivity other than stretch. If that is applied to 2013 actual spending, the 2017 result is $14,058,616. There are no reasonable adjustments to that level for external cost pressures that could bring it up to the proposed budget, $15,729,872. Under the IRM model, the OM&A budget proposed is almost 12% too high.

3.4 ***SEC Recommendation***

3.4.1 SEC believes that the Aiken Model provides a strong empirical basis for establishing a reasonable OM&A level for the Applicant in 2017 on a top-down basis. The methodology is sound, and accounts for all of the material elements that affect OM&A levels.

3.4.2 SEC agrees that it is appropriate, once a proposed envelope is determined, to compare it to the proposed line item budget to see if there are any exceptional items that should be considered outside of the envelope. In this case, the only two that could be considered are the OEB Assessment and the OM&A impact of monthly billing, which together total $339,000 per year.

3.4.3 Subject to that adjustment, SEC believes that it is appropriate to cap the approved

OM&A at the objectively-determined level, which after adjustment would be $14,521,074. That is the amount that SEC submits the Board should approve.

4 CAPITAL SPENDING PLAN AND DSP

4.1 ***Background***

4.1.1 The Applicant has embarked, since at least 2008, on a strategy of increasing capital spending year over year, every chance they get. It is an intentional strategy[43], and it has resulted today in higher levels of capital spending than most other Ontario LDCs.

4.1.2 In the test year, the Applicant proposes to spend $12.525 million on capital, about 20.4% higher than the earlier comparable year, 2012[44]. This is a CAGR of 3.77% per year over that period. They claim that they still have a backlog[45], but in the Distribution System Plan they only propose inflationary increases in capital spending for the next five years (due in part to lower General Plant spending).

4.1.3 The proposed capital spending in the test year is still much lower, according to the Applicant, than the optimal level, recommended by Kinectrics, of about $15 million per year. The reason it is lower is in part that the Applicant would have some difficulty getting that much work done, and in part to limit any further rate increases for their customers[46].

4.1.4 SEC believes that the Board should hold the capital spending for System Renewal to the average of the last five years. This would result in a reduction in the capital budget of $1.7 million.

4.2 ***Empirical Tests of Capital Spending Levels***

4.2.1 There are many ways to test or benchmark the reasonableness of capital spending on a top-down basis.

4.2.2 The Applicant says they use the ratio of capital expenditures divided by net PP&E[47]. This is not actually a useful ratio, unless it is adjusted by the age of the Applicant's assets. This ratio would be higher when net PP&E is lower, which is when the assets are likely to be older. That is precisely the time that higher capital spending may be indicated. Thus, an LDC with a higher ratio could either be overspending on capital, or underspending relative to its aging assets. There is no way of knowing.

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[43] Tr.2:25.
[44] Derived from 2-AB updated.
[45] Tr.2:26.
[46] Tr.2:27.
[47] Tr.3:49.

4.2.3 A better ratio would be capital expenditures to Gross PP&E. That will still be affected by age, but much less so. Unfortunately, many Ontario LDCs have restated their Gross PP&E on conversion to MIFRS, so comparisons between LDCs are more difficult.

4.2.4 All we really know for this Applicant is that, given a proposed capital budget of $12.5 million (increasing in the future with inflation), and a Gross PP&E of about $200 million[48], the Applicant is proposing to keep spending at a rate that will replace all of its capital assets in about 16 years. Even though there are of course inflationary impacts on the cost of replacement assets, this replacement rate is still shockingly fast.

4.2.5 SEC generally uses the ratio of capital expenditures to depreciation, which is also the ratio that forms the basis of the Board's ICM formula. It can be shown mathematically that a utility with average growth can spend more than 130% of depreciation on new capital assets within the normal IRM formula. In fact, the average spend across Ontario LDCs in 2015, the latest year for which we have full data, was 165% of depreciation[49].

4.2.6 In 2015, the Applicant, on the other hand, spent 363% of depreciation on new capital spending, more than twice the provincial average. Only twelve LDCs had higher ratios, and in almost every case they were because of a one-time capital asset coming into rate base in 2015, like a new head office or a transformer station. The Applicant has no such excuse.

4.2.7 Further, the Applicant, unlike most of those other LDCs, is proposing to continue its high rate of capital spending into 2017 and beyond.

4.2.8 When we put the high ratio of capital spending relative to other LDCs to the Applicant's witnesses, they said they did not understand the value or importance of that ratio, or benchmarking based on it[50].

4.2.9 SEC believes that, when a utility is replacing assets at a fast rate, and has an unusually high ratio of capital spending to depreciation, at the very least it is incumbent on the utility to explain those anomalies to the Board. This is not about providing a list of capital assets being replaced. Rather, it should be about the attributes of the utility – in this case the Applicant – or its situation that make it unusual relative to other Ontario LDCs.

4.2.10 No such evidence has been provided in this proceeding. The only attempt in that

[48] Derived from the 2013 Gross PP&E, and the continuity tables since then.
[49] OEB Electricity Distributors Yearbook, 2015.
[50] Tr.3:48.

area, suggestions that the Applicant has low density, were ultimately shown to be factually incorrect.

4.3 ***Kinectrics Evidence***

4.3.1 At the last minute, perhaps fearing that its capital plan was weak, the Applicant offered the opinion evidence of Kinectrics[51] to support the DSP and the capital spending levels. This caused a delay in the proceeding, but ultimately a full report was provided by the expert on the direction of the Board.

4.3.2 It is important to note that the capital budget was decided prior to both the Kinectrics Report, and the customer engagement. While resisting, the Applicant essentially admitted to that, as follows[52]:

> *"MR. SHEPHERD: You said they came in and said we should spend $15 million and you said no, that's too much. But actually, you already had a number, right? In fact you had a number many months earlier, right?*
> *MR. MACE: We had a planned range. I don't think we had a number. We had a sort of target of activity which was -- I would characterize it as a working assumption. The ACA came back in with a much higher number, which we did not accept. So we stuck with our lower number."*

4.3.3 In the result, the opinion evidence of Kinectrics is being led by the Applicant to support higher levels - 20% higher levels[53] - of capital spending than the Applicant has proposed. Kinectrics, as they are known to do, can be relied on to recommend capital spending well above both current and proposed levels for LDCs. As we note below, this bias in favour of more capital spending makes the evidence of Kinectrics less valuable to the Board than a true independent expert analysis.

4.3.4 ***What Did Kinectrics Say, and On What Basis?*** What Kinectrics actually has said is that the DSP of the Applicant is below the levels of spending they believe are appropriate, but is reasonable given the condition of the Applicant's assets.

4.3.5 The basis of Kinectrics' expert opinion is the application of their proprietary model, which they have refused to share with the Board or the parties, even on a confidential basis, the "expert opinions"[54] of the staff of the Applicant as to the condition of the Applicant's assets, which Kinectrics has not verified, and no independent information gathered by Kinectrics on the health of the Applicant's assets. It is also based on a fundamental bias held by Kinectrics and the expert, Mr.

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[51] Discussed at length in Tr. Vol. 1.
[52] Tr.3:38.
[53] Tr.2:27.
[54] Tr.3:15.

Tsimberg, that Ontario LDCs should be investing more in the renewal of their systems.

4.3.6 We will deal with each of those components of our critique of the Kinectrics evidence in turn.

4.3.7 ***The Model.*** The Kinectrics model is proprietary in nature. While the higher level equations are available publicly, Mr. Tsimberg almost laughed at the notion that anyone could replicate what they have done in its application to the full population of assets of a utility[55]. It is non-trivial, as they say.

4.3.8 The Board has ruled that it does not need to see the model in order to consider the Asset Condition Assessment, or the Tsimberg opinion. SEC proposed otherwise, and we lost. End of story.

4.3.9 We do, however, believe that the Board should consider the fact that they have never been able to review this model when assessing the weight of the Tsimberg opinion. That is particularly so, in our view, where as we note below the model consistently delivers results that lead to increases in capital spending.

4.3.10 ***Reliance on the Applicant's Input.*** It is these days an old saw that "garbage in, garbage out", or GIGO as it was once acronymized. In this case, all of the data came from the utility, and was based on the judgment of the utility employees, which Kinectrics considered to be "expert opinions".

4.3.11 The nature of the reliance on the utility judgment is described in the following exchange[56]:

> *"MR. TSIMBERG: No, they tell me -- I walk by pole A for example, and I think pole A is a condition C. We accepted it as condition C. We didn't verify it as C or B or D. We assume that it's condition C.*
> *That's what I meant by validating. We didn't validate whether indeed it's C. We didn't send our guys out to look at the same pole and determine whether it's C or B or D, no. We accepted it as a C.*
> *MR. SHEPHERD: So that's the Thunder Bay Hydro employee's judgment --*
> *MR. TSIMBERG: Yes.*
> *MR. SHEPHERD: -- as to the what condition it is. You just accept it. You don't instruct them this is how you should make that judgment.*
> *MR. TSIMBERG: That is right.*
> *MR. SHEPHERD: You just say you make the judgment, you tell us what the number is, we will accept it.*

[55] Tr.3:33.
[56] Tr.3:11.

MR. TSIMBERG: Yes."

4.3.12 The impact of the judgment of the Applicant's personnel was not insignificant, as evidenced by the following exchange[57]:

"MR. SHEPHERD: This says with respect to the asset degradation curves: "The latter," that is the curves, "depends on the engineering judgment by the local LDC personnel."
MR. TSIMBERG: With -- in absence of removal statistics, yes.
MR. SHEPHERD: And they have no removal statistics.
MR. TSIMBERG: They had some we couldn't use.
MR. SHEPHERD: Okay. So basically, they decided what the curve should look like.
MR. TSIMBERG: Yes and no."

4.3.13 This is not to suggest that it is wrong for an expert to rely on the client to provide input data. That is a normal practice, and particularly reasonable when large quantities of data are needed. It is even reasonable where some or all of the data relies on professional judgment, although generally an expert doesn't treat the providers of client data as experts on whom they can rely.

4.3.14 What is unusual here is that the expert did no random sampling or testing of the key data that would control the output of the expert's model. The only actions they took to consider whether their inputs were reliable were to compare the resulting degradation curves with their experience in other LDCs.

4.3.15 That would actually be a reasonable approach to data verification, except for the fact that the experience Kinectrics is relying on is biased by their opinion that ALL electricity distributors need additional investment above their current levels.

4.3.16 ***History of Spending Bias.*** SEC put to Mr. Tsimberg the proposition that Kinectrics has never, in Ontario, recommended less capital spending by an electricity distributor[58]. What is interesting is that, in the entire discussion, Mr. Tsimberg never denied the truth of the proposition. He said it was irrelevant. He said he didn't know the basis of it. But he never said it is untrue.

4.3.17 There is a reason for that. It is true. Hiring Kinectrics to do an asset condition assessment is a reliable way for an Ontario utility to get evidence that they should be spending more money in the future than they are today.

4.3.18 SEC has in fact reviewed all of the Kinectrics capital analyses for Ontario electricity distributors that it has been able to find on the public record. That

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[57] Tr.3:14.
[58] See the discussion at Tr.3:27-33.

includes the following:

(a) EB-2009-0139, Ex. Q1/3/1 – Toronto Hydro.

(b) EB-2014-0002, Ex.2, App. 2-4, App. B – Horizon

(c) EB-2008-0227, Ex. 2/1/1, App. A – EnWin (not a full ACA)

(d) EB-2014-0113, DSP App. A – St. Thomas (Asset Management Plan)

(e) EB-2015-0108, Ex.2, Attach 2-1, Fig. 3-3 – Waterloo North (poles only)

(f) EB-2014-0116, Ex. 2B/D4/D/App. A - Toronto

(g) EB-2016-0091, DSP, App. I – London (Lightning protection only)

(h) EB-2015-0073, 2014 ACA - Guelph

(i) EB-2015-0004, Ex. B1, Attach D – Ottawa (opinion approving 20% capex increase)

(j) EB-2015-0083, Ex. 2/Attach 2.2.1.1/App.4 - Kingston

(k) EB-2014-0083, DSP App. B – Hydro One Bramption (2009 ACA, 2013 Asset Management Assessment)

(l) EB-2014-0096, DSP, App. E – Niagara Peninsula (2011 ACA and 2014 ACA)

(m) EB-2013-0174, Ex. 2/3/6, Attach 1 - Veridian

(n) EB-2012-0033 – Enersource (2011 ACA)

(o) EB-2017-0024, Attach. 50, p. 95 – Enersource/Alectra (2016 ACA)

4.3.19 None of those studies – not one – recommends asset replacement or renewal strategies that would result in reduced capital spending. Whatever the existing level of capital spending by the LDC, Kinectrics always concludes that, to respond to the health of the assets, more capital spending is necessary.

4.3.20 A good example of the Kinectrics approach, and results, is in this quote from the EB-2015-0073 Guelph application, as follows[59]:

*"**GHESI** engages Kinectrics Inc. ("**Kinectrics**") to perform Asset*

[59] EB-2015-0073, Ex. 2, App. 2-A, p. 37.

> *Condition Assessment ("**ACA**") on its key distribution system assets on an annual basis to identify assets that have reached, or will be reaching, end of life in the near term. The 2014 **ACA** recommended that the following assets be targeted for replacement:*
> *Pole mounted transformers;*
> *Pad mounted transformers;*
> *Wood poles; and*
> *Manholes and vaults.*
> ***GHESI's** decisions on asset replacement and refurbishment are based on asset conditions and corresponding probabilities of failure. Therefore, System Renewal investments proposed in this **DSP** include proactive replacements to address targeted assets identified in the **ACA**, and reactive investments allocated for replacements on failure.*
> *Based on outcomes for the **ACA** with respect to our system renewal requirements, it was determined that **GHESI** has previously been under spending. To address this gap, **GHESI** has been prudently ramping up its expenditures on system renewal efforts to ensure long-term system viability."*

4.3.21 Kinectrics does, relatively often, conclude that the emphasis in the customer's capital plan or asset management plan, should change. As in the case of Thunder Bay, where a shift from a 4kV focus to a 25kV focus is recommended, so too in a number of others a shift in focus is part of the Kinectrics expert analysis[60].

4.3.22 However, in every single case the sum total of the Kinectrics analysis is more overall capital spending by the utility, often to the point, as here, that the utility cannot do as much capital spending as Kinectrics thinks is needed.

4.3.23 The apparent reason for this was perhaps inadvertently disclosed by Mr. Tsimberg under cross-examination, as follows[61]:

> *"MR. SHEPHERD: And in fact, your overall recommendation was that they do more replacements and spend more money than they have in the past. Isn't that right? In fact, they said they didn't even do as much as you told them to.*
> *MR. TSIMBERG: Right, and that's based on what we know about the condition of their assets. **And actually, they are not in unique position. It's pretty well similar situations for many utilities across Ontario**."*
> *[emphasis added]*

4.3.24 When we went on to point out that this demonstrated the Kinectrics bias in favour

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[60] In fact, the EnWin report cited above is another in which a shift in focus from 4kV to 27.6kV is proposed.
[61] Tr.3:30.

of additional spending, he said "I don't know whether it's factual statement."[62]

4.3.25 SEC is not suggesting that there is anything nefarious about the Kinectrics bias in favour of greater spending. It is just a fact. We accept that Kinectrics and their professionals honestly believe that greater spending levels are appropriate for this Applicant, and essentially all LDCs. They are engineers, and it is not surprising or unreasonable that they would generally want greater investment in asset renewal.

4.3.26 However, the fact that they ALWAYS want greater investment should give the Board cause for concern. While this doesn't mean the evidence should be rejected, it does mean it should be treated with caution.

4.3.27 When the Board is considering ROE issues, for example, it knows that certain experts always propose higher ROE, or greater equity thickness. Conversely, certain experts always say that the current ROE, or equity thickness, is too generous, and should be scaled back. The Board considers the evidence of each of those groups of experts within the context of their known bias or predilection.

4.3.28 SEC believes that a similar contextual skepticism should be applied to the evidence of Kinectrics.

4.3.29 ***How Should the Board Treat this Evidence?*** There are three key factors suggesting that the ACA and the Tsimberg opinion be given little weight:

(a) The overall capital budget of the Applicant was not driven by the ACA, and Mr. Tsimberg's Report is even later still. Except for the shift in emphasis away from 4kV, neither document forms a foundation for the capital budget or the DSP.

(b) The ACA is not an independent assessment of the health of the Applicant's assets. It is an analysis of the health conclusions reached by the Applicant's own staff.

(c) The authors of both the ACA and the Tsimberg opinion have a demonstrated and consistent bias in favour of increased spending.

4.3.30 As SEC's counsel said in cross-examination of Mr. Tsimberg:

> *"MR. SHEPHERD: See, here is what I am trying to understand, Mr. Tsimberg, and I will cut to the chase here. You have this model that we can't see. You use utility data that you haven't verified. You plug it into the model and you produce a result that -- we don't know quite how, and you always, every time, recommend that they are not doing enough. And*

[62] Tr.3:31.

I am not sure I understand how that is helpful to the Board. Help me understand that."

4.3.31 The witness sought to answer those concerns, but in the end his answers did not deal with the central concerns raised. He didn't know if he always produced upward recommendations (he does), and he didn't think that failure to let the adjudicator and the parties see the model was a problem.

4.3.32 On the other side, it is clear that the staff of Kinectrics have a lot of experience in both asset management and asset health analysis. Once the Board adjusts for their embedded inclination to spend more, the details of the asset condition are useful, even if the overall result is not.

4.3.33 SEC therefore submits that the Board should give reasonable weight to the technical aspects of the ACA and the Tsimberg Report, but little weight to the overall conclusions and spending implications of either document.

4.4 ***Details of Capital Spending Proposed***

4.4.1 The Applicant took a bottom-up rather than a top-down approach to their capital budget. While this is certainly sensible for their internal purposes, in our view it lacks context if the budget is not set against an objective analysis of a reasonable level of spending.

4.4.2 SEC believes that the appropriate starting point for capital budgeting is to establish a reasonable envelope, which for most utilities should be similar to spending in prior years. This can be tested using various ratios, and can be benchmarked to other LDCs in Ontario. This generates a total capital budget.

4.4.3 A well-run LDC should be able to plan within such a budget, absent exceptional circumstances. In general, SEC does not believe that it is helpful for the Board to try to second-guess the details of the capital budget, as long as it is within the objectively-determined reasonable envelope, and it is broadly similar in composition to other LDCs. Electricity distributors do not, in our view, benefit from the Board telling them how many poles to replace, and indeed the forward test year concept runs counter to that level of regulatory direction[63].

4.4.4 We understand that some other parties will discuss the capital budget in detail on a bottom-up basis. We will leave that analysis to them. In our view, unless the Applicant can demonstrate that there is something exceptional about their situation that justifies a jump in spending, there is no reason for the Board to allow it.

[63] It is well settled that, once rates are set, the utility is free to manage the utility in whatever way they see fit, as long as they do so prudently.

4.5 SEC Recommendation

4.5.1 SEC believes that any objective analysis shows that the capital spending proposed by the Applicant is much too high. No evidence has been provided that this Applicant is materially different from other LDCs in the province, yet their capital spending is already higher than most other LDCs. They are planning to bump it higher still.

4.5.2 SEC believes that the increases in capital spending are not justified, particularly in the area of System Renewal. The Applicant should be limited to a System Renewal Budget that is the average of the last four years' actuals, i.e. $6,671, a reduction of $1,709 from the 2017 forecast[64]. The other components of the capital plan for 2017 appear to be close enough to reasonable levels to be allowed by the Board.

[64] All figures derived from Appendix 2-AB Updated.

5 COMMUNICATIONS TO CUSTOMERS

5.1 *What is the Issue?*

5.1.1 SEC does not believe it is part of the normal role of the Board to dictate how regulated entities communicate with their customers, subject to a few obvious exceptions.

5.1.2 On the other hand, where a utility tells the Board they talked to their customers, and got information on customer preferences, the Board should legitimately ask whether the communications with the customers were sufficiently clear and forthright that the stated preferences of the customers are useful information.

5.1.3 In this case, it appears clear from the record that the utility knew their customers would object to certain of their spending plans, and to their large rate increase. In order to avoid those objections, the Applicant appears to have packaged information provided to the customers in a manner that was misleading, The sole reason for doing so appears to be to sidestep customer criticism[65][66].

5.1.4 In addition to ensuring that the customer preferences communicated to the Board are based on the truth – and that is clearly the primary issue here -, the Board must also be concerned whenever a utility appears to be afraid to tell its customers the full truth about what it is doing. This is not a healthy situation, and will almost certainly lead to future problems.

5.2 *Misleading Statements or Omissions*

5.2.1 ***Rate Impacts.*** There are numerous examples of the Applicant describing the impact of this Application to customers as 1.57%[67], when the Applicant knew that was misleading.

5.2.2 Challenged on this, the Applicant's witnesses first claimed that other parts of the bill would be going down, offsetting some of their increase. They referred to that as "full disclosure". Then, when the known applications for increases in OPG rates, and

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[65] The Applicant appears to have, perhaps somewhat innocently, done a similar thing with this Board. In discussing whether the spending levels in the Application have been approved by the Applicant's board of directors, Mr. Mace insisted that they were, even after having been shown documentary evidence that the board of directors had only approved a lower budget (see Tr.2:174-6) and later fixed it retroactively. Seeking to pass that off as something administrative was not credible. Yes, it was an honest mistake. No, it was not a wording error. The wrong budget was approved, not by accident, but intentionally. It was not necessary, or useful to the Board, to try to argue otherwise, especially since it was plain on the face of the record that the explanation being proposed was not true.
[66] A similar problem may have arisen in their discussion of efficiencies. See Tr.3:84-6. This confusion and misleading information was later corrected. The proposition that the Applicant had $1.2 million of efficiencies built into rates appears to be wrong.
[67] See, e.g., K2.4, p. 7, Tr.2:181, K2.4, p. 11, and many other examples.

transmission rates, were put to them, they claimed that they didn't know anything about those applications[68]. A read through of the entire exchange shows that their rationalizations are simply not credible.

5.2.3 ***Rate Minimization Model.*** The biggest area of misleading statements is related to intentional changes to the Rate Minimization Model, discussed in more detail elsewhere in this Final Argument. Instead of saying that $1.1 million of the rate increase was due to an increase in the utility's profit level from 7.00% to 8.78% (it is actually $1.344 Million, as we discuss elsewhere), the Applicant pretended in their oral and written communications to customers that this was part of the $2.8 million needed to fund past and future capital spending.

5.2.4 This misleading approach is then amplified when, in response to letters of comments, the Applicant again refers to the Rate Minimization Model, as if it had not changed over the years.

5.2.5 ***Capital Spending***. In addition to the statements about capital spending that deliberately hide the change in approach to ROE, the capital spending explanations also imply that the rate increase is to fund future capital spending, whereas it is mostly to cover past capital spending[69]. As well, the explanations tie the spending to reliability, which is not in fact the primary driver for the capital plan[70]. Asset condition is the primary driver.

5.2.6 ***Executive Compensation Increases***. Another misleading element in customer communications is an omission. There is no mention of increases in executive compensation after the last cost of service proceeding, nor of the fact that executive compensation increases since 2013 have substantially exceeded compensation increases for other employees.

5.2.7 In our submission, if there was nothing untoward about these increases, it should have been part of the disclosure to the public of what the utility was doing. Of course, we know why that didn't happen: the executives knew they would be criticized by their customers, most of whom do not benefit from percentage increases like those of Thunder Bay Hydro executives.

5.2.8 ***Overall Result***. SEC believes that these examples demonstrate a pattern of customer communications in which the Applicant is not willing to share the hard truths with its customers. Where a fact might get criticism or disapproval from customers, the Applicant seeks to hide it, packaging it or simply burying it, so that customers will not see that fact, and thus will not be critical of the Applicant and how it is operating their utility.

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[68] Tr.2:188-190.
[69] See, e.g., Tr.2:190-191.
[70] Tr.2:192-3.

5.3 ***SEC Recommendation***

5.3.1 It is not surprising that a utility wants to paint the rosiest picture possible to its customers. Doing so is not evil. Heads do not need to roll.

5.3.2 Having said that, it is not a good outcome for customers if utility management seeks to sell them a bill of goods, instead of developing a budget and plan that will meet customer acceptance based on straightforward information on what the utility is planning. Here, it appears that management saw "getting the budget we think is appropriate" as a separate issue from "managing customer reaction".

5.3.3 This is not the way customers should be treated.

5.3.4 In this case, we believe this utility – given their past history and the engagement of their shareholder - will shift to a more forthright approach if they get some Board guidance.

5.3.5 To that end, SEC proposes that the Applicant be required, in their draft rate order, to provide drafts of communications to customers, and to local press, detailing, based on the Decision, the amount, real impact, and drivers of the rate increase. The Board should require that this communication be approved by the Board and delivered to customers only as approved.

5.3.6 SEC notes that it is not proposing that the Board make this a standard practice, whether for electricity distributors generally or for this particular utility. Rather, we are suggesting that the evidence in this case suggests utility messaging that has veered somewhat off course, and can be corrected by a one-time monitoring in controlled conditions.

6 OTHER MATTERS

6.1 *Costs*

6.1.1 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.

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Jay Shepherd
Counsel for the School Energy Coalition