	Report Title	Tillsonburg Hydro System Expansion Charges
	Report No.	CAO-19-03
	Author	David Calder
	Meeting Type	Council Meeting
	Council Date	April 23, 2019
	Attachments	Distribution System Code (DSC) Memorandum of Understanding and Direction (MOUD) Pre-Meeting Briefing Memo Tillsonburg Development Committee Letter Hayhoe Homes Letter Oxnard Developments Letter Tillsonburg and District Chamber of Commerce Communication. THI Board Decision Notice Memo Ontario Energy Board Staff Communications

RECOMMENDATION

THAT Council receive report CAO-19-03 Tillsonburg Hydro Inc – System Expansion Charges for information.

EXECUTIVE SUMMARY

On April 8, 2019, Town Council passed the following resolution:

Moved By: Councillor Gilvesy

Seconded By: Councillor Parker

THAT Council receives Report DCS 19-07 - Economic Development Advisory Committee Resolution Regarding THI's New Economic Evaluation Model as information;

AND THAT the CAO provide an update report for the Council meeting of April 23, 2019;

AND FURTHER THAT Council call a special meeting of the Shareholder of Tillsonburg Hydro Inc. and the Board of Directors of Tillsonburg Hydro Inc. be called on April 23, 2019, to discuss the Economic Evaluation Model recently approved by the Board.

Carried

It should also be noted that the CAO was requested to obtain information as it relates to hydro system expansion charges from other Local Distribution Companies (LDCs) in the vicinity of Tillsonburg. Information from other LDCs was somewhat problematic due to the fact that the request was going to private companies for the purposes of a public report. Staff did their best to obtain information from other LDCs and the obtained information is contained within this report.

In addition, this report outlines the key considerations and the chronological order of events leading up to the THI Board Resolution below, dated January 29, 2019:

AND THAT the Board confirm that THI use the EEM process capturing total capital costs (developer and THI) and ongoing costs defined as Operating, Maintenance, Administration, Depreciation and Interest costs as outlined in the Distribution System Code effective January 1, 2019;

AND THAT the expansion deposit collection be deferred until it is mandated by the regulator.

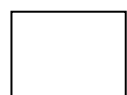
As a result of various decisions by the Tillsonburg Hydro Inc., Board of Directors, there is a feeling by the local development community that the development industry in Tillsonburg will not be competitive with other LDC territories due to higher costs to development in Tillsonburg thus impacting future development opportunities. It has been suggested that development will go to other communities due to lower cost impacts related to hydro infrastructure and different interpretations of “incremental costs” include in Economic Evaluation Models.

BACKGROUND

Tillsonburg Hydro Inc. is incorporated under the Ontario Business Corporation Act (OBCA) and operates as a monopoly and is regulated by the Ontario Energy Board (OEB). The OEB utilizes a multitude of Codes, Regulations, Decisions, Reports and Memos to provide direction to the various organizations regulated by the OEB, including Local Distribution Companies (LDCs), Retailers and Generators. The OEB also provides a license to THI to operate as a LDC.

In regulating the System Expansion Charges for THI and other provincial LDCs, the OEB has adopted the Distribution System Code (DSC) and associated Appendices. The most recent version of the DSC is dated December 18, 2018. The DSC is attached to this report for reference but I would refer readers to Section 3.2 of the DSC which addresses “Expansions” and the criteria LDCs such as THI must apply. Specifically, Appendix B to the DSC outlines the Methodology and Assumptions for an Economic Evaluation. It should be noted that Appendix B states “to achieve consistent business principles for the development of the elements of an economic evaluation model, the following parameters (contained in Appendix B) for the approach are to be followed by all distributors.” Therefore, the OEB dictates the principles used in an Economic Evaluation Model. It is the responsibility of THI to implement the principles.

In addition, the THI Board of Directors are governed by the Memorandum of Understanding and Direction (MOUD) which sets out the general expectations of the Town (as sole Shareholder) and THI. A copy of the MOUD is attached to this report. Section 2.0 Guiding Principles (Governance), is provided below as an excerpt from the MOUD relevant to this report.



2.0 GUIDING PRINCIPLES (GOVERNANCE):

The following guiding principles will direct the deliberations of the TOWN and THI in achieving that goal. It must be further understood that the TOWN is the Sole Shareholder of THI and that THI is a distinct and separate Corporation granted the benefits of operating under the regulations of the Ontario Business Corporations Act.

The Board Shall;

- a) Govern and provide stewardship of the business and affairs of THI. In so doing, shall adhere to all appropriate legislation and regulations that impact the electrical distribution industry in the Province of Ontario
- b) Provide that the focus of safe, reliable and financially responsible distribution is adhered to
- c) Address any conflict of interest, act honestly and in good faith with a view to the best interests of THI and shall exercise the same degree of care, diligence and skill that a reasonably prudent person would exercise in similar circumstances
- d) Promote operational and strategic improvement projects that will enhance the profile of THI and the TOWN

The TOWN Shall;

- a) Encourage and support the THI Board and staff in their endeavors
- b) Receive an annual return on its' investment in the form of a cash Dividend, subject to the conditions set out in Section 7.0-- Dividend Policy

It should be noted that the Town of Tillsonburg Council as sole shareholder and the THI Board of Directors entered into the most recent Memorandum of Understanding and Direction on June 26, 2018. It would appear that the THI Board of Directors, through their application of the DSC and its Appendix B was ensuring THI was "adhering to all appropriate legislation and regulations...." and "acting honestly and in good faith with a view to the best interests of THI....".

DEVELOPMENT INDUSTRY CONCERNS

There appear to be four areas of concern from the local development industry. One is the application of an Economic Evaluation Model when a subdivider is developing a new subdivision which includes new customers to be connected to the main distribution system. The second is the change in the capital contribution percentage split between the developer and THI. The third is the collection from the developer of an expansion deposit. The fourth is a concern regarding the communication to the local development industry by THI when a policy change was made to the components of incremental costs when applying the Economic Evaluation Model.

To assist Council, the following is the previous and current differences related to the Economic Evaluation Model used by THI.

Incremental Costs in Economic Evaluation Model

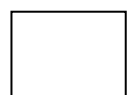
Incremental Cost included in previous Economic Evaluation Model – Operating and Maintenance (O&M).

Incremental Cost included in current Economic Evaluation Model – Operation, Maintenance, Administration, Depreciation and Interest (OMADI).

Capital Contribution Percentage Splits between the Developer and THI

Previous split was approximately developer 46%. THI 54%

Current split is approximately developer 90%. THI 10%



Expansion Deposit

Previously there was no expansion deposit collected.

Currently there is no expansion deposit being collected.

APPLICATION OF DISTRIBUTION SYSTEM CODE

First of all, it is important to understand terminology as contained in the Distribution System Code. An “expansion” as contemplated by the OEB and as contained in the Distribution System Code states in section 3.2.1 “If a distributor must construct new facilities to its main distribution system or increase the capacity of existing distribution system facilities in order to be able to connect a specific customer or group of customers, the distributor shall perform an initial economic evaluation based on estimated costs and forecasted revenues, as described in Appendix B, of the expansion project to determine if the future revenue from the customer(s) will pay for the capital cost and on-going maintenance costs of the expansion project.” The DSC goes on to say in section 3.2.6 “If a shortfall between the present value of the projected costs and revenues is calculated under section 3.2.1, the distributor may propose to collect all or a portion of that amount from the customer in the form of a capital contribution, in accordance with the distributor’s documented policy on capital contributions by customer class.” The objective of the capital contribution is to avoid any undue cross-subsidization of new customers by existing customers.

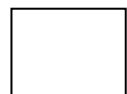
Section 3.2.20 of the DSC addresses expansion deposits as follows, “For expansions that require a capital contribution, a distributor shall require the customer to provide an expansion deposit for up to 100% of the present value of the forecasted revenues as described in Appendix B. For expansions that do not require a capital contribution, a distributor may require the customer to provide an expansion deposit for up to 100% of the present value of the projected capital costs and on-going maintenance costs of the expansion project.” In addition, section 3.2.21 goes on to state “the expansion deposit collected under section 3.2.20 shall cover both the forecast risk (the risk associated with whether the projected revenues for the expansion will materialize as forecasted) and the asset risk (the risk associated with ensuring that the expansion is constructed, that it is completed to proper design and technical standards and specifications, and that the facilities operate proper when energized) related to the expansion.”

INCREMENTAL COSTS

In order to prepare an Economic Evaluation Model as required for a system expansion (subdivision development), THI looks at the incremental costs associated with the hydro infrastructure expansion. As noted previously, the prior policy of the THI Board was to include the incremental costs of O&M in the Economic Evaluation Model. The new model approved by the THI Board now includes Operating, Maintenance, Administration, Depreciation and Interest (OMADI).

The following information is what staff could obtain regarding LDCs that are currently using OMADI in their incremental costs in Economic Evaluation Models:

Centre Wellington Hydro, EPCOR (Collingwood), innpower (Innisfil and South Barrie), Midland Power Utility Corporation, Wasaga Distribution Inc., Hydro One.



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Staff have been advised that the following LDCs are currently using OM&A in their incremental costs in Economic Evaluation Models:

Grimsby Power – currently using OM&A but looking at moving to OMADI in the future, Orangeville Hydro – using O&M and billing costs (not capturing remaining A or D & I). Entegrus (St. Thomas) uses OM&A costs directly and Depreciation and Interest as impacting income tax only, London Hydro – OM&A (they do not use 100% of all cost lines), ERTN – O&M plus \$360 per lot (works out to an approximate 60% developer/40% LDC split)

The risk of THI not using OMADI and reducing the incremental costs would be that a future rate application may be at risk in that costs could not be captured in a future rate application which may impacting share value.

It appears base on the information provided by other LDCs that there is a lack of consistency in the application of incremental costs by the various LDC when applying Economic Evaluation Models. Perhaps the OEB should be encouraged to standardize and create a consistent Economic Evaluation Model across the LDC sector in Ontario.

EXPANSION DEPOSIT

As noted, THI is not currently collecting an expansion deposit. It should be acknowledged, that not collecting an expansion deposit as decided by the THI Board of Directors, is a significant concession to the development industry. In the realm of town subdivision approvals, developers are required to provide securities (cash, letter of credit, bond) for large portions of the infrastructure being installed as well as directly paying for the subdivision infrastructure. Please see clause 3.3.20 – 3.3.21 of the Distribution System Code as attached which addresses expansion deposits. As previously noted in THI's resolution, the Board has decided to wait until mandated by the OEB to collect a mandatory expansion deposit. It appears there may be flexibility in terms of the actual percentage of the deposit (ie. 10%-100% deposit).

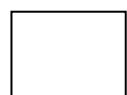
The risk to THI is that if a development got into financial trouble, THI does not have the securities on hand to complete the hydro infrastructure or to maintain what may already be in the ground.

OPTIONS FOR POSSIBLE CONSIDERATION

It would appear that the THI Board of Director's could consider options related to what might be included in incremental costs in order to develop the Economic Evaluation Model. For example the incremental costs could perhaps remain at O and M or just add A or have the Interest and Depreciation incremental costs apply only to the tax component. The unknown is whether the regulator would step in and suggest the THI Board is not applying the DSC properly in terms of incremental costs. Another avenue might be to request more direction from the OEB regarding the inputs into the Economic Evaluation Model to identify specifically what the definition is of "incremental costs".

In terms of the capital contribution percentage splits, perhaps this is a change by THI that could be phased in over time. THI could move from 50/50 to 75/25 to 90/10 over a 3 period. Conversely, the status quo could remain and THI could manage any associated risk accordingly.

As noted, an expansion deposit is not currently being collected. THI is of the understanding the OEB may be making the collection of an expansion deposit mandatory but the timing is unknown as are the



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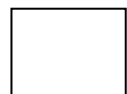
specifics around such a deposit (ie. 100% deposit or flexibility in % collected). The THI Board has already decided to wait until the Board takes any action towards a mandatory expansion deposit.

Based on the resolution passed by the THI Board of Directors, one would assume the Board did its due diligence before making a decision on the incremental costs to be included in the Economic Evaluation Model and weighed the pros and cons of their decisions. The THI Board of Directors is responsible to identify and manage risk and it appears they have been taking steps to minimize risk to THI. In addition to managing risk, THI is responsible for ensuring the LDC is compliant with the regulations as provided by the regulator and that the THI Board is not putting the LDC's operating license in jeopardy. The shareholder may wish to request the THI Board of Directors to reconsider the revised Economic Development Model or obtain direction from the OEB but it would seem, according to the MOUD, to be a THI Board of Directors decision.

COMMUNICATION

In terms of communication with the development industry regarding any THI policy changes, the following is a chronology of events related to the decision making process of the THI Board of Directors related to its review and application of the Economic Evaluation Model.

- 2017, THI joined an industry association of similar sized LDCs known as Cornerstone Hydro Electric Concepts (CHEC).
 - CHEC is comprised of 16 LDC including:
 - 1) Centre Wellington Hydro (Fergus & Elora)
 - 2) EPCOR (Collingwood)
 - 3) Grimsby Power
 - 4) innpower (Innisfil & South Barrie)
 - 5) Lakefront Utilities (Cobourg & Colbourne)
 - 6) Lakeland Power (Bracebridge, Huntsville, Burk's Falls, Sunridge, Magnetawan & Parry Sound)
 - 7) Midland Power Utility Corporation
 - 8) Niagara On-The-Lake Hydro
 - 9) Orangeville Hydro
 - 10) Orillia Power
 - 11) Ottawa River Power (Pembroke)
 - 12) Renfrew Hydro Inc
 - 13) Rideau St. Lawrence Distribution Inc (Cardinal, Iroquois, Morrisburg, Westport, Williamsburg & Prescott)
 - 14) Tillsonburg Hydro Inc.
 - 15) Wasaga Distribution Inc.
 - 16) Wellington North Power Inc. (Arthur, Holstein & Mount Forest)
 - CHEC works together to streamline various regulatory documents, concepts and concerns in an effort to minimize the regulatory burden of meeting OEB, and other regulators rules.
- June 2018



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- Town staff brought forward a report to the THI Board outlining changes to THI's System Expansion Charges to align with the CHEC process and industry standards (OEB Staff Communications and Hydro One).
 - Suggested changes included:
 - Developers responsible for contracting majority of work directly (previous THI would perform work or contract directly). End result of cost responsibility did not change with this recommendation.
 - A Discounted Cash Flow (DCF) model or Economic Evaluation Model (EEM) is applied using estimated costs to approximate any deposits (if required) and an initial cost splitting estimate.
 - A final EEM is run upon system energization utilizing actual costs and projected customer connections.
 - The revised EEM would also include Operations, Maintenance, Administration, Depreciation and Interest costs (OMADI), essentially all cost areas against future revenue streams from the development. Any extra revenue is then used to off-set capital costs of the development.
 - Historically THI was using Operations & Maintenance (O&M) costs for this analysis
 - A deposit, permissible but not mandated by the OEB, to protect against revenue exposure was also to be collected. This deposit is set at the Net Present Value (NPV) of the revenue streams.
- Resolution Passed
 - *AND THAT the Board approve that THI revise the EEM process to include capturing total capital costs (developer and THI) and ongoing costs defined as Operating, Maintenance, Administration, Depreciation and Interest costs as outlined in the Distribution System Code and authorize the collection of expansion deposits for exposure above \$20,000.*

Note: Between June 2018 and October 2018 there was no communication to the broader development industry of the THI Board resolution that was passed in June. It became evident that the Board was under the impression that action was being taken to meet and obtain input from the development industry. Upon a change in leadership related to the CEO of THI it became apparent no action had been taken by staff and the Board felt they had not been provided with complete information from previous leadership. As a result, the Board wanted to revisit the issue and the new leadership was requested to provide a second staff report.

- October 2018
 - A second Staff report was provided to the THI Board which revisited the decision from June 2018 and provided quantitative analysis of applying a revised Economic Evaluation Model and expansion deposit.
 - From this discussion, it became apparent that proper communication to the development community had not been organized and delivered.

- Staff were instructed to organize a communication memo (Pre-Meeting Briefing Memo, attached to this report) and a communication session for the development community.
- Resolution Passed:
 - *And the Board confirm that THI use the EEM process capturing total capital costs (developer and THI) and ongoing costs defined as Operating, Maintenance, Administration, Depreciation and Interest costs as outlined in the Distribution System Code and authorize the collection of expansion deposit for exposure above \$20,000 and effective January 1, 2019.*
 - Deferring implementation for 1 year (Jan 2018 to Jan 2019)
- December 2018
 - A communication meeting was scheduled and well attended on December 5, 2018.
 - At this meeting the development community was encouraged to provide letters of comment directly to the THI Board. A number of Board members were also in attendance. The following letters were received and discussed at the January 2019 THI Board meeting (attached to this report):
 - Development Committee
 - Hayhoe Homes
 - Oxnard Developments
 - Tillsonburg District Chamber of Commerce
 - As discussed at the Developer meeting, Town staff contacted OEB staff to confirm THI's understanding of the DSC guidelines relating to the EEM process. The email chain is provided in this report (OEB Staff Communications).
- January 2019
 - The letters received were reviewed, discussed and the following resolution passed by THI Board on January 29, 2019:
 - *AND THAT the Board confirm that THI use the EEM process capturing total capital costs (developer and THI) and ongoing costs defined as Operating, Maintenance, Administration, Depreciation and Interest costs as outlined in the Distribution System Code effective January 1, 2019;*
 - *AND THAT the expansion deposit collection be deferred until it is mandated by the regulator.*
 - Confirmed cost of EEM and implementation date, deferring deposit requirements.
 - A memo was provided to attendees from the Dec. 5, 2018 meeting providing the updated THI Board resolution (THI Board Decision Notice Memo, attached to this report).
- April 2019
 - Further letters provided through Town Council April 8th agenda.
 - As part of the discussion at Town Council, it was requested that staff obtain what neighbouring LDCs are utilizing for ongoing incremental costs.
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FINANCIAL IMPACT



To provide an example of the application of the previous and current Economic Evaluation Model as applied by THI, a sample subdivision has been created for demonstration purposes, utilizing the following assumptions:

- 100 Homes
- Electricity Infrastructure Capital = \$450,000
- 5-year connection horizon (as allowed by OEB regulation)
- Revenue derived using current known distribution rates with expected GDP inflation
- Incremental Expenses (2 scenarios)
 - Historical Process – O&M costs @ \$183 / customer / year
 - Current Policy – OMADI @ \$432 / customer / year
- Net Present Value (NPV) (EEM) Output
 - Historical
 - THI Capital = \$348,750 (77.5%)
 - Developer Capital = \$112,500 (22.5%)
 - Current
 - THI Capital = \$55,350 (12.3%)
 - Developer Capital = \$394,650 (87.7%)

At risk to THI is the recovery of the differential capital cost values (identified above at \$293,400 being the difference from the historical THI Capital contribution to the Current THI Capital contribution) through distribution rates (annual depreciation expense) and on-going profit margin on the assets. Calculation of annual risk provided below:

- Depreciation Expenses - \$293,400 (capital cost differential) / 50 (useful life) = \$6,000
- Profit Margin - \$293,400 X 40% (deemed equity %) X 8.98% (approved Return %) = \$10,500
- Total Annual Risk = \$16,500

The Annual Risk (\$16,500) potential arises from not meeting OEB expectations (as delivered from OEB staff through email communication) and codes (DSC). As a regulated monopoly, THI periodically applies for a resetting of distribution rates to move to current expense portfolio and asset base. Through this process the OEB looks at the reasonability of all costs supplied through the hearing. If the OEB deems that THI did not follow the DSC, certain costs can be excluded from recovery from customers (e.g. \$293,400), resulting in a downgrade of after tax net income, calculated above at \$16,500.

Note, this \$16,500 Annual Risk Potential is per development per year (50 year exposure). Each development would have a cumulative impact to THI's profitability (not discounted for time value of money) of \$550,000 (declining balance of net fixed assets changes return value annually). If THI was found to be non-compliant for 2 years with 2 developments per year, this potential profit impact grows to over \$2,200,000 over the 50 year life of the asset.

OEB COMPLAINT PROCESS

The regulatory process mandated by the OEB provides any customer of an LDC to submit an issue to the OEB through a complaint process. These complaints are handled by either OEB staff or by the OEB itself (depending on the severity and impact of the complaint). It is THI's obligation to communicate this process to customers and this was done verbally through the December 5, 2018 session. The ultimate

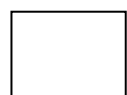


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decision on costs to be included in the Economic Evaluation Model belongs to the OEB and could be raised through the complaint process.

CONCLUSION

Staff has attempted to provide background material outlining the THI decision making process and the regulatory requirements the THI Board of Directors are required to follow. Staff has also provided some possible options for consideration but it is up to the Board of Directors to “govern and provide stewardship of the business affairs of THI”. In addition, the MOUD does provide the Town as shareholder and the Board of Directors of THI with the roles and responsibilities of each party to the agreement.



Report Approval Details

Document Title:	CAO 19-03 Tillsonburg Hydro System Expansion Charges.docx
Attachments:	- CAO 19-03 attachments.pdf
Final Approval Date:	Apr 17, 2019

This report and all of its attachments were approved and signed as outlined below:

**No Signature - Task assigned to David Calder was completed by workflow administrator
Donna Wilson**

David Calder - Apr 17, 2019 - 4:22 PM

