



# **ONTARIO ENERGY BOARD**

## **STAFF SUBMISSION**

**2007 Electricity Distribution Rates  
Variance Account for Capitalized Overhead  
Hydro Ottawa Limited  
EB-2007-0770**

December 10, 2007

## INTRODUCTION

Hydro Ottawa Limited ("Hydro Ottawa") has made application requesting the Board to issue an accounting order that would authorize Hydro Ottawa to establish a variance account – to be called the 2007 Capitalized Overhead Variance Account – and to record in it the variance between: (a) one-quarter (1/4) the Board-approved amount of capitalized overhead in the 2007 service revenue requirement; and (b) the actual amount of capitalized overhead in the last quarter (October-December) of 2007. The variances arise from the following:

- an update of Hydro Ottawa's accounting estimates of the amount of overhead costs directly attributable to its capital programs; and
- a change in Hydro Ottawa's methodology for identifying and allocating directly attributable overhead costs.

Hydro Ottawa explains that the changes in the accounting estimates and the methodology for allocating overhead costs have been reflected in a new cost allocation procedure. Hydro Ottawa's capitalization policy has been updated to reflect the new allocation procedure. Hydro Ottawa implemented the new allocation procedure and updated capitalization policy on October 1, 2007.

Hydro Ottawa emphasize that timely implementation of the new allocation procedure and updated capitalization policy is a requirement under the CICA handbook. Hydro Ottawa estimates the impact of these changes for the last quarter of 2007 to be approximately \$1.0 million of overhead costs that will be charged to operating expenses instead of being capitalized.

Board staff submits that there are two questions that the Board should address in considering Hydro Ottawa's request.

1. Can Hydro Ottawa's change in capitalization policy be considered as an "off ramp" to the Incentive Regulation Mechanism (IRM) rate making process in 2007?
2. What level of review of Hydro Ottawa's new capitalization policy is required, from a prudency perspective, prior to the issuance of the requested variance account?

The following addresses each of these questions.

1. Can Hydro Ottawa's change in capitalization policy can be considered as an "off ramp" to the Incentive Regulation Mechanism (IRM) rate making process in 2007?

Board staff notes:

- The request for a deferral account covers the period between October 1, 2007 and December 31, 2007. This period falls under the auspices of the 2007 IRM

application process and covers a period for which rates are already approved by the Board.

- Included in the Board's issuance of its Report entitled "Cost of Capital (EB-2006-0088) and 2<sup>nd</sup> Generation Incentive Regulation Mechanism (EB-2006-0089)", dated December 20, 2006, (the Board's Report) were instructions for filing 2007 rate applications.
- In the 2007 IRM rate process, the Board established guidelines for a distributor to make an application to adjust its distribution rates using a formulaic mechanistic update of its 2006 rates except for two specific items identified as "Z-factor Adjustments"; namely, tax rule changes and natural disasters. In addition, the Board stated that accounting rule changes should not be a Z-factor for 2<sup>nd</sup> Generation IRM.
- The assessment of operating costs and capital asset inclusions in rate base require careful review, which was not part of the 2007 review process.
- The Board's Report included section 4.3 with respect to "Off-ramps", in which it states:
  - "The Board expects distributors to use the incentive mechanism to file a rate application as required over the three-year period to effect rate adjustments in 2007, 2008 and 2009. As noted previously, there are limited adjustments available to distributors. If these adjustments are insufficient for specific cost pressures (e.g. additional capital investment) or the distributor is in the tranche to be rebased, then the Board would expect these distributors to file a comprehensive cost of service application and not to rely on the simplified filing requirements for the incentive mechanism."

Board staff suggests that Hydro Ottawa may wish to clarify how it believes the request for a deferral account to record changes in asset values (due to a new capitalization policy) is congruent with the Board's Incentive Regulation Mechanism (IRM) rate making process used in setting the 2007 distribution rates.

2. What level of review of Hydro Ottawa's new capitalization policy is required, from a prudence perspective, prior to the issuance of the requested variance account?

Board staff notes:

- The change of the capitalization policy for capital assets changes the underlying values of the tangible capital assets and means that when the prudence of the capital costs is reviewed on clearing the account at a future date, the underlying base assets will already be in service in 2007. Accordingly, prudence will only be possible to assess in relation to the one component of capital cost – the changes (reduction) in overhead capitalized to the various projects involved.
- The Board's established regulatory practice for reviewing the level of rate base has been to review such costs only when a rebasing rate application has been

before the Board. In the regulation of the electricity sector, the Board has established 2001, 2006 and 2008 as rebasing years for rates.

- The four-part criteria for deferral/variance account are also outlined in the Board's Report. One criterion is that the precipitating event must be outside management's control.
- In response to Board Staff IR 1.2 on the subject of exogeneity (management's ability to control), Hydro Ottawa acknowledges that the timing of the process (i.e., the new cost allocation procedure and the corresponding update of its capitalization policy) was within its control. This suggests that the effective date of the capitalization policy implementation could have been January 1, 2008 to align with the start of its 2008 financial reporting year.
- While the CICA Handbook does require a change in accounting estimate be implemented prospectively and in a timely manner, the Handbook does not define the term "timely manner". This leaves the matter of "timely implementation" as matter of judgment in the circumstances as to when it is reasonable and practical to implement such a change, and thus within management's ability to control.
- Hydro Ottawa asserts that the accounting change was outside their control by virtue of it arising from changes in generally accepted accounting principles. Board staff is not aware of any change in accounting standards in the CICA Handbook that could have caused Hydro Ottawa's change to capitalization policy and cost allocation procedure. Any known changes to accounting standards will affect 2011, if the utility is considered to be subject to International Financial Accounting Standards (IFRS). The changes to Canadian accounting standards for rate-regulated operations that come into effect on January 1, 2009 affect the accounting for income taxes and do not affect capital asset costs. The application of Section 3061 of the CICA Handbook on property, plant and equipment, including capitalization of interest/allowance for funds used during construction, has not changed.

Board staff suggests that Hydro Ottawa may wish to clarify how it believes the request for a deferral account to record changes in asset values (due to a new capitalization policy) conforms to the Board's established regulatory practice for authorizing such accounts and of testing the prudence of capital additions only in a rebasing rate application.

All of which is respectfully submitted