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HydroOttawa

February 26, 2010

Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto, ON M4P 1E4

Attention: Kirsten Walli
Board Secretary

Re: 2010 Electricity Distribution Rates
EB-2009-0231

Pleased find enclosed two hard copies of Hydro Ottawa Limited's Reply Submission in the above noted proceeding. An electronic copy has been submitted using RESS.

If further information is required, please contact the undersigned at 613-738-5499 ext 7499 or janescott@hydroottawa.com.

Yours truly,

Original signed by

Jane Scott
Manager, Rates & Revenue
Hydro Ottawa Limited

cc. M. Buonaguro, VECC
R. Higgin, VECC

Reply Submission
Hydro Ottawa Limited
2010 Electricity Distribution Rate Application
EB-2009-0231

1. Introduction

On October 21, 2009 Hydro Ottawa Limited ("Hydro Ottawa") filed an application with the Ontario Energy Board (the "Board") under section 78 of the Ontario Energy Board Act, 1998, seeking approval for changes to the distribution rates that Hydro Ottawa charges for electricity distribution, to be effective May 1, 2010. The application is based on the 2010 3rd Generation Incentive Regulation Mechanism ("3GIRM"). Interrogatories were received from Board staff and one intervenor; the Vulnerable Energy Consumers Coalition ("VECC"). Board Staff submission was received on February 5, 2010; VECC did not make a submission. This is Hydro Ottawa's reply submission and addresses the five matters on which Board staff made submissions.

2. Tax Sharing Rate Rider – December 31, 2010 Sunset Date

Hydro Ottawa has no submission on Board staff's position on the tax sharing rate rider and understands that their position does not constitute acceptance of the notion of aligning the rate year with fiscal year.

3. Disposition of Deferral and Variance Accounts as per the EDDVAR Report

Hydro Ottawa has no submission on Board staff's position on the disposition of deferral and variance accounts.

4. Potential Lost Revenue Adjustment Mechanism ("LRAM") Rate Rider

Hydro Ottawa has no submission on Board staff's position on the recovery of the LRAM amount and understands that their position does not constitute acceptance of the notion of aligning the rate year with fiscal year.

5. Adjustments to the Retail Transmission Service Rates ("RTSR")

Hydro Ottawa concurs with Board staff's submission that the revisions to the RTSRs ought to reflect the changes from the current level to the January 1, 2010 level; that is an increase of about 15.6% to the RTSR Network Service rate, and an increase of about 5.2% to the RTSR Line and Transformation Connection Service Rate.

6. Accounting for the Implementation of the Harmonized Sales Tax ("HST")

Board staff submission states 'that the Board may wish to consider establishing a deferral account to record the amounts, after July 1, 2010 and until Hydro Ottawa's next cost-of-service rebasing application, that were formally incorporated as the 8% PST on capital expenditures and expenses incurred, but which will now be eligible for an HST Input Tax Credit ("ITC")'[1].

Hydro Ottawa submits that the Incentive Regulation Mechanism ("IRM") application process is intended to streamline the processing of a large volume of rate adjustment applications, and is therefore mechanistic in nature. Rates are determined by the combination of the productivity factor and the inflation factor and are necessarily delinked from the utility's specific costs. A cornerstone of maintaining the mechanistic nature of an IRM application is that there are no adjustments to rates for increases or decreases in distributors' costs, with two exceptions: Z factors and, under 3GIRM, legislative changes to corporate income taxes.

Under 3GIRM, Z factors are limited to situations which meet all three of the following criteria: materiality, prudence and causality. For Hydro Ottawa, the materiality level is 0.5% of distribution revenue requirement or approximately $750k. Hydro Ottawa submits that the introduction of the HST on July 1, 2010 does not qualify under the Z factor exception, as the amount that would be recorded in the deferral account is estimated to be less than the materiality limit. The majority of the PST which was

[1] Board Staff Submission on Hydro Ottawa Ltd. 2010 Electricity Distribution Rates Application, Board File Number EB-2009-0231, February 5, 2010, page 9

included in Hydro Ottawa's last cost-or-service application was on materials which would have been capitalized. As a result, the impact on the distribution revenue requirement and hence rates would have been limited to the return on capital, depreciation and PILs associated with the PST. Similarly if Hydro Ottawa receives a ITC after July 1, 2010 and it is related to a capital expenditure, the amount to be returned to the customer should only be the return of capital, depreciation and PILs associated with the ITC. Hydro Ottawa has estimated this amount to be below the materiality limit.

The second exception was covered in The Supplemental Report of the Board on 3rd Generation Incentive Regulation issued on September 17, 2008 which determined that a 50/50 sharing of the impact of currently known legislative tax changes was appropriate. The tax changes in this case involved reductions in the Federal corporate tax rate and the Ontario capital tax rate and it was a fairly simple process to calculate the difference in distribution revenue requirement using the new rates and compare it to the approved amount in order to determine how much should be returned to customers.

The HST is not an income tax but a sales or value added tax ("VAT") and as such does not warrant the same treatment as the current tax changes required as part of the 3GIRM. The difficulty of determining the impact of the change in a sales tax necessitates that it not be treated in the same manner as an income or corporate tax.

Also as Hydro Ottawa stated in its responses to Board Staff's Interrogatory #7; 'Under IRM, a distributor's rate base is fixed and therefore future capital expenditures that exceed annual depreciation are not funded through rates. Even if it could be determined that the HST resulted in a small decrease to annual capital expenditures, if those capital expenditures continue to exceed depreciation expense the distributor will still experience a shortfall in funding for its capital program and therefore there would be no "savings" to share.'[2]

[2] Hydro Ottawa Response to Board Staff Interrogatory #7, January 11, 2010

For the above reasons, Hydro Ottawa submits that it would be inappropriate for the Board to require a deferral account to be established to track amounts related to PST expenditures which are now eligible for ITCs.

If, despite presenting our best case, the Board does decide to implement a deferral account, Hydro Ottawa would argue that it is not just a simple case of depositing all ITCs received after July 1, 2010 into the deferral account for eventual return to the customer. The creation of a deferral account for ITCs in 2010 appears to be rooted in the simplified assumption that 2010 rates are based on an adjusted revenue requirement from 2008 which included PST as an expense (either operating or capital) and that as of July 1, 2010 this 'expense' will disappear as we will receive an offsetting credit in the form of the ITC. It is not as simple as this and the following points must be taken into consideration:

- There are a number of situations where the costs of the distributor will actually rise as a result of the implementation of the HST. For example, electricity sales did not get charged PST in the past and as of July 1, 2010 they will have HST applied, however the ITC is restricted so that only a portion is claimable. This increase in expenses should also be recorded in the deferral account.
- As explained above, for capital expenditures, the 'excess' amount in rates due to the PST being in the original rebasing capital is not the total PST but the return on the PST in rate base, the depreciation and related PILs. It is this amount that would have to be calculated and put into the deferral account.
- There will be an impact on cash flow for distributors resulting from the collecting and remitting of HST which would result in a higher working capital requirement. This increase in working capital would also be required to be entered in the deferral account, offsetting any saving resulting from the ITCs.
- Hydro Ottawa's financial staff believe that the tracking of HST amounts relating to items that formerly incorporated the 8% PST, and will now be eligible for an HST Input Tax Credit will be very onerous and add to the

complexities of transitioning to a new VAT system. The tracking of amounts is complicated by the fact that the taxable base for HST purposes is much broader than for PST purposes and will therefore require the segregation of HST amounts that qualify for this treatment and those that do not. This added level of complexity will increase the possibility of misstatements as well increase processing time and ultimately costs. Furthermore, there will be some mismatching of tax amounts and expenditures in a given reporting period, as tax amounts are recorded on a cash basis whereas the recognition of capital expenditures and expenses is on an accrual basis.

In summary, Hydro Ottawa submits that requiring distributors to record the ITC in a deferral account in order to refund it to the customer is wrong as it violates that basic principle of IRM that there should be no adjustment for increases or decreases in costs, except for material changes that qualify for a Z factor. Hydro Ottawa also submits that this issue would be better addressed under a generic hearing for both gas and electricity utilities and not in individual rate applications.

All of which is respectively submitted.

Ms. Jane Scott
Manager, Rates & Revenue
Hydro Ottawa Limited