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ONTARIO ENERGY BOARD

STAFF SUBMISSION
REDACTED – FOR THE PUBLIC RECORD

FIVE NATIONS ENERGY INC.

2010 TRANSMISSION REVENUE REQUIREMENT

EB-2009-0387

Five Nations Energy Inc. ("FNEI", the "Company") filed an application with the Ontario Energy Board (the "Board") dated February 26, 2010 under section 78 of the *Ontario Energy Board Act*, 1998, S.O. c.15, (Schedule B) (the "Act"). The Board has assigned the application file number EB-2009-0387.

FNEI is a non-profit, non-share capital, federally-incorporated corporation with its head office in Moose Factory, Ontario, and main operational office located in Timmins, Ontario. FNEI is a licensed transmitter of electricity in Ontario (ET-2003-0074), owning and operating transmission facilities along the western coast of James Bay. FNEI currently serves four customers, which include three local distribution companies and one commercial customer.

FNEI's rates were last reviewed by this Board in 2001 (RP-2001-0036). In this application FNEI is seeking Board approval for a forecasted revenue requirement of $6,466,100 for 2010. The application is based on a future test year cost of service methodology.

FNEI's revenue requirement represents a small portion of the total provincial transmission revenue requirement used to establish the uniform transmission rates (UTR). Therefore, the increase in revenue requirement sought in this application is not large enough to trigger a change to the current UTRs However, due to the change in revenue requirement, there is a slight increase in FNEI's revenue allocators.

FNEI submitted an application for 2010 Revenue requirement on February 26, 2007. Energy Probe and the IESO applied for intervenor status. Both parties were granted intervenor status, while only Energy Probe was eligible for an award of costs.

By Decision and Order dated April 27, 2010, the Board declared FNEI's current rates interim. In this Order the Board also set the dates for filing interrogatories and responses to interrogatories. Board staff and Energy Probe filed interrogatories. The Company's responses to interrogatories were filed on June 4, 2010.

In Procedural Order No. 3, the Board decided to proceed with a written hearing and set out the dates for arguments. On July 5, 2010, FNEI filed its Argument-in-Chief. Board staff and intervenor submissions are due by July 19, 2010. Final reply is due by July 29, 2010.

These submissions reflect observations and concerns which arise from Board staff's review of the evidence and are intended to assist the Board in evaluating FNEI's application and setting just and reasonable rates. The submissions also pose questions on certain issues that parties may wish to address in argument.

FNEI in its original filing requested Board approval for a revenue requirement of $6,474,700. In an updated application, filed on March 29, 2010, FNEI revised its revenue requirement to $6,466,100.

	2001 Board Approved ($ Millions)	**2010 Applied ($ Millions)**
Operations, Maintenance & Administration	1,898.5	3,386.1
Depreciation & Ammortization	1,100.6	1,187.4
Interest on Debt	922.2	762.3
Return on Equity	1,256.7	1,130.3
Revenue Requirement	**5,178.0**	**6,466.1**

This submission contains staff comments on the following topics/issues:

- Status of Board Directives
- Operating Revenue Forecast
- Operations, Maintenance and Administration
- Cost of Capital
- Charge Determinant Forecast
- Harmonized Sales Tax

STATUS OF BOARD DIRECTIVES

Background

In FNEI's last rate case (RP-2001-0036), the Board dealt with the issue of how FNEI's rates should be set, given that it was a non-profit, non share capital organization. In that case FNEI had requested Board approval for a return on equity per the Board guidelines. In approving FNEI's request for a return on equity, the Board referred to the Canada Revenue Agency (CRA) position that a non-profit organization may earn income in excess of its expenditures under specific circumstances, without jeopardizing its non-profit status.[1] The Board also noted that the reason for approving FNEI's request for a return on equity was to allow FNEI to build up three reserves: Insurance reserve, capital reserve and operating reserve.[2] Given the Board's concerns of allowing a return on equity for a non-share capital organization, the Board directed that the excess revenue over expenditures should be referred to as "Internally Generated Funds".[3] The Board also directed the Company to file a report that would discuss the design of reserves and a transition to an alternate approach to using return on equity. [4]

The Board also directed the Company to use the Times Interest Earned Ratio (TIER) mechanism to establish revenue requirement in its next rate case. The TIER mechanism is used to set rates for rural electric cooperatives in the United States and represents a ratio of net income over interest expense.

Submission

In this application, FNEI is again requesting Board approval for a return on equity and has used the standard costs of service approach to determine revenue requirement. Board staff has referred to FNEI request as the ROE approach.

In Staff's view, the issue is whether it is appropriate for FNEI to determine revenue requirement using the ROE approach? If the ROE approach is not an appropriate methodology, then how should FNEI's revenue requirement be determined?

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[1] Decision RP-2003-0036, paragraph 3.3.8
[2] Ibid, paragraph 3.3.2
[3] Ibid, paragraph 3.3.13
[4] Oral Hearing Transcript, RP-2001-0036, paragraph 251 - 253

In FNEI's last rate case, three approaches to calculate the revenue requirement were discussed: ROE approach, a Reserve approach and TIER mechanism. In that hearing the company's witness confirmed that as FNEI gains experience it will move to the Reserve approach.

> "MR. MORAN: I guess the question then becomes is there any real need to tie the concept of reserve funds to the concept of return on equity when the concept of reserve funds is really based on other needs, like the need to have some reserves for operational capital expenses and self-insurance?
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> MR. AIKEN: I think that need could be -- that link could be severed in subsequent years. <u>I believe in the first year of operation, a fair way to do [it] is to tie it to return on equity. But as the company gains experience in its operations and we're back before the Board in a year or two, or whatever the case may be, then it may be appropriate to propose a reserve approach rather than a return on equity approach, because by then the company will have a better idea of the need for those reserves</u>."[5] [Emphasis added]

The Reserve approach implies that the Company would not be allowed a return on equity and that its revenue requirement would be determined by taking into account all costs (OMA, Depreciation, Interest Expenses etc.) and funds needed to build reserves.

However, after gaining over eight years of operational experience, FNEI is proposing to continue the ROE approach. It is unclear to staff as to why FNEI has not proposed to move to a Reserve approach, as described by its witness in the last rate hearing. Further, the approval of a return on equity was a temporary measure employed by the Board to allow the Company to build up reserves.[6]

Board staff is also concerned that the continued approval of excess revenues over costs for a non-profit organization without share capital may affect FNEI's status as a non-profit organization. Board staff notes, that Canada Revenue Agency (CRA), Interpretation Bulletin IT-396R, states that in determining the non-taxable status of a non-profit organization, the CRA is focused on the needs of a non-profit organization and future anticipated expenditures to test the reasonableness of excess of the revenues over costs. Board staff is concerned that the Board's continued reliance on a return on

[5] RP-2001-0036 Oral Proceeding Transcripts, Volume 1, January 29, 2002, Cross-examination by Board Counsel , Paragraphs 243 to 246.
[6] EB-2001-0036, Paragraph 3.3.2

equity for a non-share capital organization may compromise FNEI's status as a non-profit organization.

The Board once again approved the ROE approach in Attawapiskat Power Corporation's 2005 rate case (APC), however similar to the FNEI case that preceded it, noted that "Once the appropriate limit of reserves is achieved, the methodology <u>must</u> be reconsidered". [7] [Emphasis added]

Therefore, in staff's view, the Board may wish to consider the appropriateness of FNEI's request for a return on equity. Board staff submits the appropriate method is the Reserve approach and is discussed further in this submission.

Is FNEI's design and current practice for reserves appropriate?

In FNEI's last rate case, the Board in approving FNEI's request for a return on equity of 9.88%, stated that it was doing so to allow FNEI to build up its reserves. In its current application, FNEI has requested a return on equity and is proposing to build up the capital reserve and an operating fund that it established after the RP-2001-0036 proceeding. Board staff submits that the design of the capital reserve and operating fund are not appropriate.

In FNEI's last rate case, the Board approved FNEI's request for an insurance reserve and directed FNEI to submit a design for a reserve fund. [8] In addition to the insurance reserve, two other reserves were discussed – capital reserve and operating reserve.

To date, only the insurance reserve is fully funded and has a $4 million balance. In FNEI's 2009 balance sheet, the insurance reserve is identified as a "Restricted Deposit". Board staff does not have any concerns with the design or the manner in which the insurance reserve is set up.

In addition to the Insurance reserve, FNEI's balance sheet shows three other accounts – Equity in Operating Fund, Equity in Capital Reserve and Equity in Capital Fund. [9] Equity

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[7] EB-2005-0233, page 9
[8] Decision EB-2001-0036, paragraph 3.3.11

in Capital Fund represents capital assets that are presently invested, and therefore it is not a reserve.

As noted earlier, the principle reason for the Board's approval of the requested return on equity was to allow FNEI to build reserves. FNEI indicated that the capital reserve is presently unfunded and the balance of the capital reserve is nil as at December 31, 2009. In staff's view a reserve is an amount that is an appropriated fund and set aside to stabilize a non-profit's finances by providing a cushion against unexpected or extra-ordinary events. The capital reserve as currently designed does not perform this function.

FNEI further stated that the capital reserve is presently unfunded because FNEI has made significant capital expenditures since its last rate proceeding[10]. Board staff is unclear why capital expenditures are funded by the capital reserve. In staff's view significant capital projects should be planned and budgeted as a part of FNEI's asset management plan and capital planning. Board staff submits that the funds for capital planning (i.e. funds budgeted for planned capital work) and capital reserve (i.e. funds restricted for out-of-the-ordinary capital expenses) serve different purposes.

FNEI's current practice is to appropriate current earnings in the first three quarters of any calendar year to the operating fund and at year-end, the funds are transferred to the capital reserve. FNEI is proposing to continue this approach going forward. Board staff submits that if the operating fund is intended to serve as a reserve, then linking the operating fund and capital reserve is not appropriate. FNEI also uses the term "operating reserve" in its evidence. However, there is no such account on FNEI's balance sheet. Board staff submits that the operating fund as designed is not a reserve.

Further, FNEI's proposal of appropriating funds from the operating fund to the capital reserve makes it impossible to build up the operating fund.

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[9] EB-2009-0387, FNEI application, Exhibit 1, Tab 1, Schedule 13, Page 3 & 4 of 12

[10] EB-2009-0387, FNEI application, Exhibit 1, Tab 1, Schedule 13, Page 4 of 12

In staff's view the design of the capital reserve and operating fund is not consistent with the ROE approach as intended by the Board.

What is an appropriate methodology for establishing revenue requirement for a non-profit, non-share capital utility?

As noted earlier, Board staff does not believe that the ROE approach is an appropriate method to establish FNEI's revenue requirement. In Board staff's view the appropriate methodology is the Reserve approach. Under the Reserve approach once the reserves are established, the amounts in the reserves are capped and the revenue requirement is determined based on the cost of service and funding needed to build up the reserves. In comparison, under the ROE approach, the excess revenues over costs are used to build up reserves. The underlying purpose of both approaches is the same – to build up reserves.

Under Board staff's proposed Reserve approach, the process would be the following:

1. FNEI should determine its cost of service including OM&A expenses, interest expense, working capital, and depreciation;
2. FNEI should establish an operating and a capital reserve. The levels of these reserves and the duration over which the reserves should be built up is approved by the Board;
3. FNEI should calculate the funding needed to build up the reserves in the test year and subsequent years.
4. FNEI should then add the required operating and capital reserve for the test year to its total cost of service to arrive at the revenue requirement.

Board staff also notes that in FNEI's last rate case, the company's witness confirmed that FNEI is prepared "to provide a report in its next rate case saying: Here is how we want to go about designing a reserve fund as an alternate approach to using ROE". [11]Accordingly the Board directed FNEI to file such a report. Board staff submits that the Board's decision is indicative of the Board's preference to transition to the ROE approach.

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[11] Oral Hearing Transcript, RP-2001-0036, paragraph 251 – 253

Board staff submits that establishing the revenue requirement based on the Reserve approach prevents overcharging/undercharging customers, ensures FNEI is able to maintain its non-profit and non-taxable status, and allows FNEI to build up adequate reserves in a predictable manner.

One of the other rate making mechanisms that was discussed in the last rate case was the TIER mechanism. FNEI does not support the use of the TIER mechanism. FNEI argues that the TEIR mechanism was established for non-profit rural electric cooperatives and local publicly owned systems in the United States that are distinguished from FNEI as they are (a) not regulated by FERC or State regulatory commissions; (b) obtain debt financing from the US Federal government; and (c) are much more heavily debt-financed than regulated for-profit utilities.[12] Board staff agrees with FNEI's position. Board staff also notes that FNEI's test year revenue requirement would result is in a TIER of 2.5 – The generally acceptable ratio is between 2.0 and 2.8.

If FNEI's revenue requirement is established using the Reserves approach, what reserves should FNEI establish?

FNEI proposed that the revenue requirement should be established using the ROE approach. And further to that approach, FNEI proposes to rely on past practice of using a capital reserve and an operating fund. Board staff has already noted its concerns with the ROE approach and the manner in which the capital reserve and operating fund are used.

Therefore if the Board is persuaded to establish FNEI's revenue requirement based on the Reserve approach, FNEI will have to establish a capital and operating reserve.

Board staff is concerned that without appropriate reserves FNEI may not be able to address future cash flow problems or may lead to a short-fall in equity when FNEI faces unexpected and unplanned events. The worst scenario, being that FNEI may not have the financial resources to continue delivering its services and achieving its corporate objectives. In fact, as per 2009 Audit Financial statements, FNEI was not in a good

[12] FNEI's Argument-in-Chief, EB-2009-0387, July 5, 2010, Pages 10-11, Paragraph 21-22.

liquidity position as FNEI was in a negative cash position and the equity in the operating fund was also in a deficit position.[13]

Board staff submits that the operating and capital reserves would serve as an effective tool and provide the ability and flexibility for the non-profit, non-share capital utility to manage operational and/or capital spending when faced with unplanned and unexpected circumstances. Furthermore, the build-up of the appropriate levels of reserves is necessary for FNEI to maintain reliability of service and operations for its customers.

How should the amounts in the reserves be determined and should these the reserves be capped?

Board staff recognizes that the Board's existing Filing Guidelines for distributors and transmitters do not specifically provide any guidance to non-profit, non-share capital utilities. However, Board staff is of a view that while there are general guidelines for setting reserve goals, most approaches are based on a formula to have enough cash to cover operating expenses for a number of months. A commonly used operating reserve target amount is three to six months' expenses.

Board staff notes that in its Decision EB-2005-0233, the Board approved APC's request for an operating reserve of approximately $350,000 based on the sum of: (a) the three months with the highest cost of power and transmission costs; plus (b) three months of average OM&A costs. Board staff proposes a similar method for determining the amounts in the operating reserve.

With respect to the capital reserve, Board staff submits that FNEI must establish an integrated asset management plan to include a distinct capital plan and appropriate capital reserve. However, Board staff submits that the long-term capital plan and capital reserve serve different purposes.

Need for "caps":

With respect to the issue of whether the reserves should be capped, FNEI argues that reserves should not be capped.

[13] FNEI's 2009 Audited Financial Statements

FNEI argues that "it is not always possible to predict the new customers given the region may see more development than it has historically."[14] In Board staff's view given the depth of experience FNEI has accumulated since its last rate case, FNEI should be in a position to reasonably determine its capital and operating requirements.

FNEI further stated that a "cap" on reserves implies that FNEI cannot use the funds in other ways that are consistent with its corporate objectives until such time as these "caps" have been reached. Board staff submits that the reserve is established to meet the unexpected and unplanned expenditures regardless of whether or not the caps are reached.

Lastly, in response to Board staff interrogatory no. 3, FNEI stated that "To FNEI's knowledge, other Ontario rate-regulated utilities do not have any capped capital reserve or operating reserve." [15] Board staff disagrees. Board staff notes that in the APC case the Board allowed APC to establish an operating reserve with a cap of $350,000. In fact in that same case, the Board denied APC's request for a capital reserve, stating that, "the Board finds that it is premature to establish the reserve until the limits and the uses are more clearly understood".[16]

Board staff submits that not having upper limits on the reserves implies that ratepayers must provide unlimited cash flow through rates so that FNEI can establish flexible reserves.

For the above reasons, Board staff submits that it is not appropriate to have uncapped reserves.

Reserve Policy:

The Board in FNEI's last rate case also directed FNEI to file a report that would outline the process of moving from the ROE approach to the Resreve approach. FNEI has not

[14] Response to the Board staff IR #3, Ref: Ex 1/T1/S13/p. 6 – Operating & Capital Reserves & Ex 1/T1/S15 – Financial Policies and Procedures, EB-2009-0387, Exhibit 10, Tab 1, Page 5 of 103

[15] Response to the Board staff IR #3, Ref: Ex 1/T1/S13/p. 6 – Operating & Capital Reserves & Ex 1/T1/S15 – Financial Policies and Procedures, EB-2009-0387, Exhibit 10, Tab 1, Page 5 of 103

[16] Decision, EB-2005-0233

filed such a report. Board staff therefore submits that the Board should direct FNEI to establish a reserves policy. Board staff submits that the policy should address at a minimum the following elements:

1. Identification and definitions for the types of operating and capital reserves.
2. The purpose, goals, and intended use of the capital and operating reserves.
3. Target amounts for the reserves and methodology used to derive the target amounts.
4. The mechanism and the process to use, build, and maintain reserves.
5. The responsibilities of FNEI's Board of Directors and management with regards to the reserve funds.
6. The authorization and approval process for access and use of reserves
7. Investment objectives and policies.
8. Requirements for reporting and monitoring.

Accounting Guidance:

If the Board is persuaded that FNEI should establish reserves as recommended by Board staff, the Board may wish to consider adopting the approach established in the APC case.

Board staff proposes that the reserves be recorded in USoA account 3047, Appropriations of Retained Earnings – Current Period. The following three sub-accounts then could be established for three appropriations to the retained earnings:

- Earnings Retained for Operating Reserve
- Retained Earnings Reserves for Capital Improvement
- Retained Earnings General Reserve

Board staff recommends that the Board establish the following procedure and regulatory accounting treatment in order to simultaneously build, record, and track, appropriate levels of operating and capital reserves and report accordingly to the Board:

1. At the end of each year before the net income or loss is closed to retained earnings, the amount of "net income" that first arises shall be appropriated to the

Retained Earning for Operating Reserve, until the cumulative balance has risen to the amount set by the Board for the test year.

2. The appropriate funds for the test year should be appropriated to Retained Earnings Reserved for Capital Improvement.
3. Excess amounts of "net income" over and above the amounts approved by the Board should be closed to the Retained Earnings General Reserve. This subaccount will serve as a placeholder where the balance should be refunded to the customers in the next rebasing application.
4. In the case that a loss arises in a year, the loss would draw down the retained earnings sub-accounts in the reserve priority to how they are built up, i.e., general first, capital second, and operating last.
5. Once the approval limits for both operating and capital reserves are reached, the excess revenues shall no longer be required and will cease by way of an application for new rates by FNEI. FNEI should be expected to promptly file such an application and include revisions to its reserves, if applicable.
6. FNEI should report to the Board the balances of the account 3047, Appropriations of Retained Earnings – Current Period, and its sub-accounts on a quarterly and annual basis.
7. The Board's Regulatory Audit group should monitor activities of account 3047 and its subaccounts to ensure FNEI is building the required reserves and report to the Board, if required.

Implementation Matters

Earlier in this submission, Board staff proposed that FNEI's 2010 revenue requirement should be based on the Reserve approach. In order for the Board to implement this approach, the amounts in the capital and operating reserves will first have to be established.

In Board staff interrogatory no. 7, Board staff asked FNEI to provide limits for the operating and capital reserves. FNEI did not provide the requested information, arguing that set limits were not appropriate.

Board staff submits that for the purposes of establishing FNEI's 2010 revenue requirement, the amount for the operating reserve can be determined in a manner similar to the approach approved by the Board in the APC case. However, with respect to the capital reserve, the Board had denied APC's request for a capital reserve. In the absence of any guidance on the determination of an amount for the capital reserve, Board staff submits that the Board may wish to consider determining the amount for the capital reserve based on FNEI's as-filed test year capital expenditure forecast. Given that only a portion of the reserve needs to be funded in a given year, FNEI's revenue requirement for 2010 could still be established.

Earlier in this submission, Board staff recommended that FNEI establish a reserves policy. It is likely it will take FNEI six months to a year to develop such a policy. If the reserves policy proposes significantly different levels for the operating and capital reserves than those determined in this proceeding, FNEI can file an application for a change in rates.

Alternately, the Board could approve FNEI's request and establish the revenue requirement for 2010 using the ROE approach on a transitional basis (example one year) and direct FNEI to file an application for new rates under the Reserve approach and accompanied by a reserves policy.

OPERATING REVENUE FORECAST

Background and Submission

FNEI is requesting Board approval for a test-year Operating Revenue forecast of $5,078 million. The Operating Revenue forecast comprises of Transmission Services Revenue and Other Revenue. FNEI's Operating Revenue forecast consists almost entirely of transmissions services revenue. FNEI's test year forecast of Transmission Services Revenue is $4,978 million and its forecast of Other Revenues is $0.1 million. This submission deals with Board staffs concern with the test year Transmission Services Revenue forecast.

Transmission Services Revenues

FNEI is forecasting no growth in transmission revenues from 2009 to test year 2010. FNEI is therefore proposing to use its estimate of 2009 revenues as the forecast for

2010. Board staff is concerned that FNEI may have under-estimated the level of 2010 transmission revenue.

The 2009 transmission revenue of $4,978 million that is used as the basis for the test year forecast is an estimate and does not represent actual 2009 revenues. The actual transmission revenue for 2009 is provided in FNEI's 2009 Audited Financial Statements which were filed after the FNEI application. As noted in the 2009 Audited Financial Statements, the actual revenue for 2009 was $5,023,982 or $45,982 higher than estimated. Board staff submits that if the Board were to accept FNEI's proposal of using 2009 revenues as the basis for 2010, the Board may wish to consider using the actual audited transmission revenue as opposed to the estimate proposed by FNEI.

The table below summarizes the historical transmission revenues for the period 2002-2009, based on information provided at Ex3/T1/S2.

Year	Actual Transmission Services Revenue
2002	$5,169.10
2003	$5,459.50
2004	$5,416.00
2005	$5,613.20
2006	$5,508.50
2007	$5,583.90
2008	$5,226.60
2009	$5,023.90
2010 Forecast	**$4,978.00**
Average - Full History (2002 - 2009)	$5,375.09
Average - Since DeBeers (2006-2009)	$5,335.73
Average - Last 3 Years(2007-2009)	$5,278.13
Linear Trend Method (2002-2009)	$5,279.58

Board staff also notes that the test-year transmission revenue forecast of $4,978 million is the lowest in FNEI's history and is significantly lower that historical averages. The historical average (2002 to 2009) of actual transmission revenues is $5,375 million, or $0.397 million (8%) higher that the test year estimate. DeBeers, a customer of FNEI's, started operation in 2006. The average revenues for the period 2006 to 2009, i.e. since De Beers started operations, are 7% higher than the proposed test year estimate.

Further, FNEI's test-year charge determinant forecast is derived by averaging load for the last three years (2007-2009). Using a similar period (2007-2009) as used to forecast load/charge determinants, the average revenue is $0.35 million (6%) higher than the proposed test year estimate.

To test the appropriateness of FNEI's test year transmission revenue forecast, staff also compared the proposed estimate to a forecast based on a linear trend method, using data from 2002 to 2009[17]. The revenue forecast based on the trend method is $5,280 million, which is higher than the proposed forecast and is similar to the average revenue of the last three years of $5,278 million.

Given that the proposed test-year transmission revenue forecast of $4,978 is lower than 2009 actual revenue and historical averages, the Board may wish to consider whether the transmission services revenue forecast should be increased to levels consistent with historical trend. In Board staffs view a test-year transmission revenue forecast of $5,280 million is a more reasonable level and is consistent with the average of the last three years and historic trend.

OPERATIONS, MAINTENANCE AND ADMINISTRATION

Overview

FNEI has proposed Operations, Maintenance and Administration ("OM&A") costs of $3,386,100 for 2010. This represents an increase of 78% over 2001 over the previously Board approved amount of $1,898,500 for 2001.[18] This is an average yearly increase of approximately 6.6% over that period. Preparation of the OM&A budget is the responsibility of FNEI's CEO, and is discussed at both the Finance Committee and the Board of Directors meetings of FNEI.

FNEI employs a 'bottom-up' approach to OM&A budgeting. FNEI indicates in evidence that it is often more cost-effective to hire certain operations and administration expertise on a part-time or contractual basis, rather than a full-time employee position. FNEI has only three employees, with one currently on long-term disability. FNEI's OM&A costs

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[17] Represented by the equation, $y=-21.213x+5470.5$

[18] Board-approved, RP-2001-0036.

have varied significantly from year to year, with a significant number of external consultants retained, rather than full-time staff.

Board staff submits that, in general, the level of OM&A expenditures is reasonable and it appears that FNEI does not foresee significant escalation of OM&A costs in future years. Board staff submits that it would expect FNEI's OM&A budget to be reasonably static or decreasing over the coming years due to the fact that the significant build-out of the system is now largely complete. These significant additions included: transmission lines including the De Beers system additions, the fibre-optic communications "sky wire" and connection of back-up transformers.

Board staff has specific submissions with respect to OM&A on the following: International Financial Reporting Standards ("IFRS") costs, Tendering and Service Agreements with Related Entities, Fibre Optic line operating and maintenance costs, charitable donations and sponsorship.

IFRS costs

FNEI has applied for total one-time IRFS costs of $100,000 to be amortized over 2010, 2011, and 2012. The Board's Report on IFRS stated that:

> Examples of utilities that *may* not be required to use IFRS are utilities owned by First Nations incorporated as not-for-profit organizations under the *Canada Corporations Act*...[19] [Emphasis in original]

FNEI submits that it operates in the commercial mainstream, so from an accounting perspective FNEI has followed GAAP and not the non-profit organization ("NPO") accounting rules. FNEI submits that its auditors have considered GAAP reporting to be more appropriate and useful since it provides financial statements more comparable to those of other rate regulated entities.

Board staff submits that the FNEI request appears reasonable. The request for FNEI to adopt IFRS standards and reporting will provide the Board with more meaningful information and reporting, on standard intervals, which translates to more informed

[19] *Report of the Board on Transition to International Financial Reporting Standards*, July 28, 2009, footnote at p.9

regulation. Ultimately, Board staff submits that a decision whether these costs should be granted lies with whether or not the Board believes it is prudent for FNEI to adopt IFRS.

Tendering and Service Agreements with Related Entities

FNEI filed a letter on May 17, 2010, which discussed at length the status of FNEI's relationship to its member distributors; that they are not affiliates within the framework described by the *Affiliate Relationships Code* (*ARC*). This correspondence was filed as part of the response to Board staff interrogatory #1(a) in this proceeding. Board staff responded[20] confirming that FNEI and its member distributors are not affiliates in conjunction within the definition of the *Ontario Business Corporations Act* as adopted by *ARC*. However, the correspondence brings to light possible tendering and contract concerns at FNEI.

The three First Nation communities of Attawapiskat, Fort Albany and Kashechewan are remote, and travel between them is via plane only. For practical purposes, FNEI has indicated that this remoteness limits the number of businesses that would likely submit competitive tender to provide services to FNEI. FNEI stated that the only practical parties to take on such work are the neighboring local distribution companies ("LDCs").

Due to this unique business circumstance, FNEI acknowledges that the Board may exercise its discretion to apply the same level of scrutiny to the transactions between FNEI and the LDCs as they would to affiliate transactions.

FNEI confirms in its May 17 letter that the Board has closely examined the commercial relationship between related entities and that the Board has on previous occasions imposed a methodology to govern pricing for goods and services between related entities.[21] FNEI conceded that the Board will likely look more closely at FNEI's dealings with its neighboring First Nations LDCs than FNEI's dealings with otherwise unrelated parties.

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[20] Letter from the Board, Re: Compliance with Electricity Reporting and Record Keeping Requirements ("RRR")

[21] See FNEI letter dated May 17, 2010 which refers to the transcript of EB-2005-0544, Enbridge Gas Distribution, p. 80-82, July 24, 2006.

FNEI indicates that there are chiefly two types of transactions with related entities: the purchase of electricity by FNEI from each of the LDCs, and the purchase of services from each of the LDCs.

FNEI notes that it utilizes power line maintainers of the LDCs when doing maintenance on the transmission line, and also uses LDC staff to perform routine maintenance checks. FNEI does not have any full time power line maintainers located in the three communities, and given the remote location and costly travel in the region, use of LDC staff is by far the most economical way for FNEI to have this work completed.

FNEI notes that at present the work by LDCs is done on an "as needed" basis. There is no formal contract between FNEI and any of the LDCs. FNEI has indicated that it is currently contemplating putting contracts in place to clearly delineate responsibility and liability for work carried out. Since January 1, 2006, the amount paid to the three LDCs for these services totals to approximately $480,000.[22]

FNEI indicates that it does not put out to tender the maintenance services provided by the LDCs claiming that there is no purpose in doing so.[23] FNEI submits that the maintenance work carried out by the LDCs for FNEI can be done far more economically by LDC lineworkers than anyone else.

Board staff submits that FNEI should have formal agreements with each of the LDCs in the presence of what appears to be frequent and ongoing work from LDCs that when taken in aggregate, totals over $480,000. Without agreements between FNEI and the LDCs, disputes could arise as to pricing, accusations of non-performance, liability, or other terms which could otherwise be more appropriately understood at the outset of any work via a service agreement.

Board staff further submits that the need for service agreements are made more necessary since FNEI does little in the way of competitive tendering to complete the necessary work. From the perspective of a potential competitor, it is difficult to determine whether or not to tender to provide services when there is no clarity with

[22] See FNEI letter dated May 17, 2010.

[23] Response to Board staff interrogatory #56(c)

respect to terms of agreement including the prevailing pricing of such services. Board staff submits that, in the absence of competitive tendering, FNEI should treat the necessity of service agreements between itself and related entities as a priority.

Fibre Optic line operating and maintenance costs

FNEI has constructed a Fibre Optic "skywire" from Moosonee to Attawapiskat which provides FNEI superior operational control, metering communication, and the ability to monitor stations for security and public safety. The old telephone system did not provide the timely functionality that the Fibre Optic system affords.

Board staff requested the total operating cost of the new fibre optic system per month, the budgeted cost of ongoing maintenance of the fibre optic system at interrogatory #33 parts (a) and (b). FNEI did not provide this information in its response stating that it was an "apples versus oranges comparison".

Board staff submits that whether or not FNEI can meaningfully compare the costs of the fibre optic system with those of the telephone system, that the Board would be better informed of FNEI's operating costs with respect to these assets if FNEI were to provide this information. FNEI further indicated that the fibre strands not being utilized by FNEI will be leased to the Western James Bay Telecom Network ("WJBTN"), a potential affiliate of FNEI. Board staff submits that any proceeds from WJBTN leases of FNEI's fibre should also be included in the analysis.

Charitable Donations and Sponsorship Amounts recorded in Account 5410

With respect to charitable donations, the Board clearly indicates in its filing requirements that:

> "The recovery of charitable donations will not be allowed for the purpose of setting rates, except for contributions to programs that provide assistance to the distributor's customers in paying their electricity bills and assistance to low income consumers. If the applicant wishes to recover such contributions, it must provide detailed information for such claims. <u>The applicant must review the amounts filed to ensure that all other non-recoverable contributions are identified disclosed and removed</u>." [24]
> (Emphasis added)

[24] Filing Requirements for Transmitters and Distributors, Section 2.5.2, p.14

FNEI stated at response to interrogatory #40 that amounts totaling $31,225 included in this account do not specifically provide the assistance in the manner and as outlined in the above paragraph. The $31,225 is made up of $10,000 for sponsorship of *Creefest*, $12,000 in scholarships for local students, and $9,224 for other sponsorship of educational events. FNEI stated that the remainder of the $86,000 recorded in this account contributes to providing assistance in the manner and as outlined in the paragraph above.

Board staff submits that the Board should deny the inclusion of $31,225 in this account related to sponsorship and events which do not further the purpose for which this account was established. FNEI indicated in the response that these amounts do not fit the description of amounts that should be recorded.

COST OF CAPITAL

Overview

FNEI proposes a capital structure of 60% debt and 40% equity, based on the Board's deemed structure. FNEI's current approved return on equity ("ROE") is 9.88%. FNEI has used the Board-approved ROE of 9.85% for its 2010 test year. FNEI's proposed overall cost of capital is $1,893,000 for the test year.

Staff's submissions on Cost of Capital are premised on the assumption that the ROE approach will be maintained for setting of 2010 rates. Board staff has discussed at length in previous sections that, for ratemaking purposes, it would be more appropriate for FNEI to move away from an ROE approach and instead use a Reserve approach for rate setting in subsequent years.

With respect to debt, FNEI has a Credit Agreement with Manulife and Pacific & Western Bank ("PWB") which provides FNEI with a term credit facility from Manulife and PWB up to $11 million (at 5.5%), and an operating facility from PWB of up to $500,000 (at prime plus 2.5%). FNEI also has a $500,000 operating line of credit with its bank, the Bank of Montreal ("BMO"). FNEI also has an interest-free loan from the Northern Ontario Heritage Fund Corporation ("NOHFC") which dates back to the initial development stage of the FNEI project. The NOHFC loan is interest-free until October 2010, at which point FNEI has indicated that interest at 4% will begin to accrue.

Board staff has specific submissions on the following: short term debt, Board deemed interest rates, other unfunded debt, and phase-in of debt-to-equity structure.

Short term debt

FNEI has an operating facility with the PWB in the amount of $500,000 at an interest rate described in evidence as "Prime + 250 bps". At interrogatory #59 FNEI indicated that the current prime rate was 2.25%. By simple calculation, this yields an interest rate of 4.75% on a short-term debt facility, well above the Board's current deemed rate for short term debt, 2.07%, based on January 2010 data. FNEI states in interrogatory responses[25] that the forecasted short term debt rate of 4.75% should be applied to all of the deemed short term debt capitalization of 4%. FNEI's proposal to use a 4.75% deemed short-term debt rate, instead of the deemed short-term debt rate, deviates from the guidelines in the Board's *Cost of Capital Report* [26], which adopts the deemed debt rate for electricity distributors and transmitters. FNEI has not provided reasons and support for deviating from the Board's guidelines.

FNEI provides a 2006 Credit Agreement covering the term facility and revolving short term debt facility with PWB. The PWB credit agreement indicates that the short term facility is at the "PW Interest Rate" which is defined as "equal to the Prime Rate <u>less</u> one quarter of one percent (0.25%)".[27] This appears to suggest that the "PW Interest Rate" effective at the time the interrogatory response was produced is 2.00%.

The interest rate stated in evidence for the PWB operating facility and the rate stated in the 2006 Credit Agreement differ significantly and are well in excess of the Board's deemed short term debt rate. Board staff invites FNEI to clarify the seemingly contradictory PW interest rates reported, and also why it is otherwise not possible for

[25] Response to Board staff interrogatories #60, #61, and #62

[26] *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities.* December 11, 2009, pages 56-58.

[27] Response to Board staff interrogatory #59 (a), attachment. Credit Agreement dated November 15, 2006, page 11

FNEI to secure short term debt financing at costs comparable to the Board's deemed rates.

Board deemed interest rates

FNEI believes the forecasted short term debt rate of 4.75% should be applied to all of the short term debt. FNEI stated that if the Board does apply the deemed rate to anything, it should be to the unfunded debt amount of $647,500.

FNEI provides a table at response to Board staff interrogatory #60 where a weighted indicated cost rate of 3.24% was used to determine the return component on the cost of debt. Staff had asked FNEI to provide a table using the Board's *Cost of Capital Report*[28] as a guide. The report stipulates that short term debt receives the deemed rate of 2.07% unless the utility can provide good reason why the rate for its short term debt should be otherwise. Board staff has reproduced the table at response to Board staff interrogatory #60 using the 2.07% for the indicated cost rate:

Table – Cost of debt and return component at Board's deemed rates

2010 - Deemed	Structure Principal ($000s)	Capital Component (%)	Indicated Cost Rate (%)	Return Component (%)	Return Component ($000s)
Short Term Debt	1,147.50	4.00%	2.07%		23.8
Long Term Debt	16,065.40	56.00%	4.41%	2.47	708.5
Common Equity	11,475.30	40.00%	9.85%	3.94	1,130.3
Total	28688.1	100.00%		6.41	**1,862.6**

Compared to the application, Board staff's scenario results in an approximate reduction of $30,800 to the return component for FNEI. Board staff notes that all other electricity transmitters and distributors are subject to the Board's deemed interest rates and FNEI has made no arguments which suggest that FNEI should receive a rate other than that deemed by the Board.

The effect of the use of the Board's deemed interest rates on FNEI's return is minor, but would treat FNEI consistently with other electricity transmitters and distributors for rate-making purposes.

[28] *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities*. December 11, 2009.

Other unfunded debt

FNEI indicates that it has unfunded debt in the amount of $647,500. This is comprised of two broad amounts: an operating facility from BMO to a maximum of $500,000[29], and $147,500 where Board staff has been unable to determine the debt facility or lending arrangement associated with the funds. FNEI was asked in interrogatory #59 to indicate if it had any other debt instruments and did not provide any information with respect to the applied for $147,500 tranche of unfunded debt.

Staff submits that no compelling reason has been provided by FNEI why this short-term unfunded debt should attract a rate higher than the Board's deemed rate of 2.07%. FNEI indicated that it forecasted the cost of short term debt as 4.75%, and that this was consistent with the process for natural gas distributors and is subject to review. FNEI did not address staff's preamble to interrogatory #59 which clearly stated:

> "With the development of a new <u>deemed short-term debt rate for use in the electricity transmission</u> and distribution sector, the Board notes that it and other participants may take into consideration the deemed short-term debt rate..." – *Cost of Capital Report* [30] (Emphasis added)

Staff submits that the Board clearly contemplated the specific case of electricity <u>transmission</u> and distribution utilities, and that utilities should apply the deemed short term debt rate to short-term debt capitalization, whether funded or unfunded. In light of the quote above, Board staff submits that FNEI's argument that it should receive treatment similar to natural gas distributors does not comply with the Cost of Capital Report, and FNEI has not supported its proposal for different treatment. Board staff reiterates that any unfunded short term debt should be set at the 2.07% as prescribed by the Board's *Cost of Capital Report*.

Transition to deemed 60/40 capital structure

Beginning in 2008, the Board adopted a deemed capital structure of 60% debt (56% long-term debt and 4% short-term debt) and 40% equity, with a transition over a number of years. Most electricity transmitters and distributers have transitioned to the 60/40

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[29] Exhibit 5, Tab 1, Schedule 1, page 2. FNEI indicated that the current average rate on amounts drawn down from the BMO facility were 5.5%

[30] *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities*. December 11, 2009, page 55-56.

deemed capital structure by 2010, but FNEI had not. In the 2009 Cost of Capital Report, the Board indicated that utilities that are still transitioning to the deemed capital structure, the matter would be dealt with in each such distributor's cost of service application.[31] FNEI has applied for a 60/40 debt-to-equity split in 2010, without transition.

At interrogatory #60, FNEI indicates that it has sufficient debt financing to pay operating costs under a 60/40 debt-to-equity split, and responded "no" when asked if FNEI has ever experienced a shortage in operating funds necessary for day-to-day activities.

Board staff submits that FNEI appears capable to make the transition directly to a 60/40 debt-to-equity split without undue hardship. Board staff submits that the proposed capital structure for rate-setting purposes should be granted as applied for.

CHARGE DETERMINANT FORECAST

Background and Submission

[redacted]

[redacted]

[31] Supra. page 61, section 5.1.1

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

HARMONIZED SALES TAX (HST)

Background and Submission

Pursuant to Bill 218 which received Royal Assent on December 15, 2009, the provincial sales tax ("PST") and goods and services tax ("GST") was harmonized effective July 1, 2010. Unlike the GST, the PST is typically included as an OM&A expense and is also included in capital expenditures. When the GST and PST are harmonized, corporations will realize a reduction in OM&A expenses and capital expenditures that have not been reflected in the current application for 2010 rates.

In response to Board staff interrogatory no. 10 and 27, FNEI confirmed that it had not made any adjustments to the capital expenditure forecast or OMA expenses to account for the elimination of the PST. While FNEI was able to provide PST paid on capital expenditures, it noted that it typically does not have any OMA expenses that are subject to PST, as a majority of these expenses (wages, travel etc.) are PST exempt. The PST amounts paid on capital expenditures were $17,814 in 2008 and $167,096 in 2009. While FNEI did not object to the establishment of a deferral account to record these savings, FNEI noted that it was not clear as to how amounts accrued in a variance account would be dealt with.

Board staff notes that the Board has consistently directed LDCs who filed a 2010 rate application to establish a deferral account for this purpose. Board staff submits that the

Board should adopt a similar approach in this case too. Accordingly, the Board may wish to consider establishing a deferral account to track any savings that may arise.

All of which is respectfully submitted.