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November 26, 2007

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

Attention: Kirsten Walli
Board Secretary

Re: Interrogatory Responses - Application for an Accounting Order to Establish a Variance Account
EB-2007-0770

Attached please find Hydro Ottawa's responses to the interrogatories sent by Board Staff and the Vulnerable Energy Consumers Coalition on November 13, 2007 for the above noted proceeding.

If further information is required, please contact the undersigned at 613-738-5499 ext 527 or lynneanderson@hydroottawa.com.

Yours truly,

Lynne Anderson
Chief Regulatory Affairs and Government Relations Officer
Hydro Ottawa

Question

2007 CAPITALIZED OVERHEAD VARIANCE ACCOUNT

Issue 1.1 Is the variance account request by Hydro Ottawa reasonable?

1.1 Ref: Exhibit(s) Letter September 14, 2007 – Application

Hydro Ottawa was to have implemented the new allocation procedure and updated capitalization policy on October 1, 2007.

a) Please confirm that Hydro Ottawa has implemented the new allocation procedure and updated capitalization policy on October 1, 2007. If Hydro Ottawa has not implemented these please explain why not.

b) Hydro Ottawa estimates in the application that the resultant impact will be approximately $1.5 to $2.0 million. Please advise if this estimate is an annualized amount or for the last calendar quarter of 2007. Please advise if Hydro Ottawa still believes that this will be the approximate amount. If the estimate has changed please provide the new estimate.

c) Please confirm if Hydro Ottawa has closed the company's financial records for the month ended October 2007. If Hydro Ottawa has closed the records please confirm if Hydro Ottawa has recorded the affected overhead costs using the new accounting procedure. In the alternative, please explain why it has not used the new procedure.

d) Please prepare a detailed step-by-step calculation, including details on assumptions made, of the amount Hydro Ottawa would propose to book to the requested variance for the month of October 2007. Include in the detail the accounting entries for the proposed transaction.

Response

a) Hydro Ottawa implemented the new allocation procedure and capitalization policy (together, the “new capitalization process”) on October 1, 2007.

b) The initial impact estimate of \$1.5 to \$2.0 million pertained only to the 4th quarter of 2007, not the entire year. This estimate was based on the annual impact and prorated for the 4th quarter. The amount of overhead costs that will not be capitalized as a result of this change is currently estimated at \$1 million for the 4th quarter.

c) The October fiscal period is closed and the new capitalization process for allocating overheads was used for the October close.

d) Hydro Ottawa reports financial data quarterly to its Board of Directors and certain external users. As Hydro Ottawa is not reporting financial data monthly for the final quarter of 2007, the calculation of the variance will be made only after the last quarter has been closed due to the time and complexity of running a parallel calculation. The calculation based on the former capitalization process cannot be performed in Hydro Ottawa’s “production database” as it would create actual transactions in the financial system. The database will have to be copied into another environment once the quarter is closed and then have the calculations performed. This information would be compared to the actual quarterly information produced from the new capitalization process, which would result in the amount to be recorded in the variance account. The amount would be recorded as follows:

DR Account 1508 Other Regulatory Assets - Capitalized Overhead	XXX
CR Account 4080 Distribution Services Revenue	XXX

Question

2007 CAPITALIZED OVERHEAD VARIANCE ACCOUNT

1.2 Ref: Exhibit(s) Letter September 14, 2007 – Application

Hydro Ottawa had its 2007 electricity distribution rates set in accordance with the 2nd Generation Incentive Regulation Mechanism "price cap" as documented with the Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation Mechanism for Ontario Electricity Distributors (the "Board Report"). Hydro Ottawa has applied for an accounting order establishing a variance account request to track incremental costs resulting from a change in allocation procedure for capital costs for the remainder of the calendar year.

In section 4.2.4 of the Board Report, the Board stated the following with respect to the need for and treatment of deferral and variance accounts under 2nd Generation IRM:

"Deferral and variance account balances will be dealt with in accordance with the provisions of the *Ontario Energy Board Act, 1998*.

Consistent with its proposal on Z-factors, the Board has determined that, to the extent possible, it will limit reliance on creation of new deferral accounts during the term of the scheme to well-defined and well-justified cases only. Z-factor rules should govern need for, and treatment of deferral accounts."

Under section 3.5 – Z-factors, the Board Report contains the following:

"For 2nd Generation IRM, the Board will limit reliance on Z-factors to well-defined and well-justified cases only – specifically, Z-factors will be limited to changes in tax rules and to natural disasters. The Board believes that for 2nd Generation IRM, Z-factors should be limited to events genuinely external to the regulatory regime and beyond the control of management and the Board – changes in Board policy should not be included. The Board can always assess the implications of such changes and make provision for them. Regardless, in order for amounts to be considered for recovery in a **Z-factor**, the **amounts must satisfy the eligibility criteria set out in Table 3**, below. The Board notes that changes in tax rules may result in positive or negative amounts.

Table 3: Z-Factor Amount Eligibility Criteria

Criteria	Description
Causation	Amounts should be directly related to the Z-factor event. The amount must be clearly outside of the base upon which rates were derived.
Materiality	The amounts must have a significant influence on the operation of the distributor; otherwise they should be expensed in the normal course and addressed through organizational productivity improvements.
Prudence	The amount must have been prudently incurred. This means that the distributor's decision to incur the amount must represent the most cost-effective option (not necessarily least initial cost) for ratepayers.

In addition, **the Board intends to maintain the materiality thresholds established in the 2006 EDR Handbook**: for expenses, the materiality threshold would be 0.2% of total distribution expenses before taxes; and for capital cost recovery, the materiality threshold would be 0.2% of net fixed assets. In both cases, the materiality threshold must be met on an individual event basis in order to be eligible for potential recovery."

The section concludes:

"Therefore, the Board will expect that any application for a Z-factor will be accompanied by a clear demonstration that the management of the distributor could not have been able to plan and budget for the event."

Please document how the request for the deferral account satisfies the conditions under sections 4.2.4 and 3.5 of the Board Report with respect to: causality, materiality, prudence, and exogeneity/inability of management to control.

Response

Hydro Ottawa is requesting approval of a variance account, rather than a deferral account, and so it is not clear whether section 4.2.4 is applicable. A deferral account is more akin to a Z-factor than a variance account in that a deferral account tracks an amount that cannot be forecast with any degree of reliability. Hydro Ottawa is nevertheless providing the following response.

Causality	The implementation of the accounting change on October 1, 2007 had a direct relationship to the increase in operating costs. It is this increase in operating costs, net of decreases in amortization and return on rate base, for which Hydro Ottawa is seeking a variance account.
Materiality	Based on Hydro Ottawa's Board approved distribution expenses, the materiality limit for Hydro Ottawa would be $88k not including amortization and $156k with amortization included. The estimated amount to be recorded in the variance account clearly exceeds these limits.
Prudence	Exhibit B1-3-1 in the EB-2007-0713 proceeding describes the process that resulted in Hydro Ottawa's new cost allocation procedure and the corresponding update of its capitalization policy. This exhibit, and the attachments to it, clearly demonstrate that Hydro Ottawa's management acted prudently throughout the process. While it is understood that there would be an impact on customers in 2008, making this change is clearly the most cost effective for customers in the long-run because, if the resultant costs had continued to be capitalized instead of expensed,

Hydro Ottawa would have a larger rate base and a larger return on rate base. This additional return would result in revenue requirements higher than the revenue requirements if the amounts were expensed. (See Exhibit B1-3-1, Attachment U, Page 5, paragraph 18).

Exogeneity Exhibit B1-3-1 in the EB-2007-0713 proceeding describes the process that resulted in Hydro Ottawa's new cost allocation procedure and the corresponding update of its capitalization policy. Hydro Ottawa acknowledges that the timing of that process was within its control. However, once that process was concluded, paragraphs 1000.20 and 1000.20(b) of the CICA Handbook required Hydro Ottawa to implement its new cost allocation procedure and the corresponding update of its capitalization policy on a timely basis; see Hydro Ottawa's response to Board Staff Interrogatory # 1.5 a) for the text of these paragraphs.

Question

2007 CAPITALIZED OVERHEAD VARIANCE ACCOUNT

1.3 Ref: Exhibit(s) Exhibit B1/Tab3/Sch1/Pg 1 Capitalization Policy and Allocation procedure

Hydro Ottawa stated the review of its capitalization policy and cost allocation procedure was triggered by the Rate-Regulated Operations Exposure Draft, which was released by the Canadian Institute of Chartered Accountants in March 2007.

a) The Canadian Accounting Standards Board issued its decision on this Exposure Draft on August 22, 2007. Please discuss how this decision is relevant and requires changes, if any, to Hydro Ottawa's capitalization policy and cost allocation procedure based on changes to current accounting standards.

b) Is the 2007 fiscal year impacted by any changes to current accounting standards arising from this decision?

Response

a) The initial exposure draft on Rate Regulated Operations was issued by the Accounting Standards Board (ASB) in March 2007 for comments. Amongst changes to various sections of the CICA Handbook was a reference to the removal of the temporary exemption in Section 1100 (Generally Accepted Accounting Principles) pertaining to the application of this section to the recognition and measurement of assets and liabilities arising from rate regulation. It was issuance of this exposure draft that motivated Hydro Ottawa to assess its accounting treatment with respect to the capitalization of overhead costs. For more details, please see Exhibit B1-3-1 in the EB-2007-0713 proceeding.

Hydro Ottawa commissioned Deloitte & Touche to undertake a review of accounting guidelines and industry practices as they relate to including overhead allocations in the costs capitalized to Property Plant and Equipment (report filed as Exhibit B1-3-1 Attachment S). The review was to provide insight into the “recognition and measurement” of capitalized costs should the exemption to Section 1100 be removed, and to help Hydro Ottawa gauge its existing practice.

Deloitte & Touche observed that there has been a shift towards more narrow definitions in terms of types of costs that can be capitalized. Canadian convergence with International Financial Reporting Standards and the Canadian exposure draft discussing the elimination of rate regulated accounting were also seen to be contributing factors to a narrowing definition. Hydro Ottawa also undertook its own informal review of this issue and concluded that a full review and update of its capitalization of overhead costs should be undertaken. KPMG was engaged to assist with the review based on their demonstrated experience in this area. A copy of KPMG’s report, dated August 16, 2007, was filed as Exhibit B1-3-1 Attachment T.

Rather than react to the removal of the exemption from Section 1100, Hydro Ottawa took a proactive approach to determine the impact of such an action by the ASB. The Canadian Accounting Standards Board did issue its decision on August 22, 2007 removing the temporary exemption from Section 1100 for rate regulated entities. This pronouncement clearly demonstrated that Hydro Ottawa Limited was correct in anticipating a changing accounting standards environment that would impact the measurement and recognition of regulated assets, specifically the capitalization of overhead costs. The KPMG review emphasized the need to determine the causal link between overhead costs and capital activity to ensure that only those costs directly attributable to capital work should be capitalized. KPMG concluded that the accounting change arising from Hydro Ottawa's review and determination of the causal link (cost drivers) is reasonable and in accordance with industry standards and practice related to overhead capitalization.

In summary, Hydro Ottawa would have had to react to the August 22, 2007 ASB decision in the same manner that it did on a proactive basis, to assess its practices for overhead capitalization. The ASB decision provides no choice in the matter and thereby removed any ambiguity that Hydro Ottawa needed to complete a capitalization review.

b) Changes arising from the ASB decision are applicable to fiscal years beginning on or after January 1, 2009. Early adoption of ASB decisions however is usually encouraged. There is also a professional consideration to be made by financial management in their representation that financial statements are relevant and reliable. The accounting change resulting from the review of overhead capitalization is material in nature and hence would have a material impact on Hydro Ottawa's financial statements. Consequently, the 2007 fiscal year has been impacted by the ASB decision. Although a compliance date beyond 2007 is mentioned in the ASB decision, it was regarded by Hydro Ottawa as an end date to allow for the substantial review and analysis that many companies may have to undertake to comply with the decision. Hydro Ottawa was proactive in this matter and consequently was able to implement its accounting change effective October 1, 2007.

Question

<u>2007 CAPITALIZED OVERHEAD VARIANCE ACCOUNT</u>

1.4 Ref: <u>Exhibit(s) Appendix U Report to Audit Committee August 21, 2007</u>

On page 2 paragraph 4 the report states *"It is management's opinion that the adjustment to overhead allocations is a change in accounting estimate only. As suggested by our external auditors, Ernst & Young, an independent professional accounting firm will be sought to provide an opinion on this accounting change in accordance with section 1506 – Accounting Changes, of the Canadian Institute of Chartered Accountant's (CICA) accounting handbook*."

a) Please confirm whether the opinion noted above has been completed by the independent professional accounting firm.

i If yes, please provide a copy of that opinion.

ii If no, please confirm expected date of completion and explanation for delay. If the declared opinion were to be anything other than a change in accounting estimate, how would Hydro Ottawa request for a variance account change?

Response

a)

i & ii) The opinion on the accounting change has not been completed and is expected by mid-December 2007. Although the initial assessment, which was discussed informally with various accounting professionals, suggested that the accounting change was a change in accounting estimate, this is being examined in more depth by Hydro Ottawa's past (Deloitte & Touche) and present (Ernst & Young) external auditors and

PriceWaterhouseCoopers, who were retained by Hydro Ottawa to render the opinion. The process is taking longer than expected due to additional analysis that was requested by PWC on the accounting change.

Prospective application of an accounting change would still prompt Hydro Ottawa to request a variance account for the additional operating costs not capitalized from October 1, 2007 and therefore not in Hydro Ottawa's approved rates.

Question

2007 CAPITALIZED OVERHEAD VARIANCE ACCOUNT

1.5 Ref: Exhibit(s) Appendix U Report to Audit Committee August 21, 2007

On page 5 paragraph 17 the report states "*Once a change in accounting estimate is considered and accepted it is a requirement of Generally Accepted Accounting Principles (GAAP) that it be implemented prospectively and in a timely manner. Consequently, implementation has been planned for October 1, 2007, as this is the most practical timeframe in which to incorporate the revised methodology into our existing accounting processes*."

a) Please provide reference and copy of the CICA handbook section that details the "requirement" to implement in a timely manner.

b) Please provide discussion by management on the subject of interpretation of the CICA handbook section detailing "requirement" to implement in a timely manner.

c) Has Hydro Ottawa received any documentation from the company's external auditor or other independent professional accounting firm that discusses the implementation timeframe for the change in accounting estimate and procedure? Please provide copy of all documentation.

d) Please discuss what the company's management believes the consequences would have been if the implementation of the change in accounting estimate were to have been January 1, 2008.

e) Does Hydro Ottawa's management believe that they had the ability to control the date of implementation? Please discuss.

f) Please provide a discussion by Hydro Ottawa's management on what reasons the company would have for not continuing with the current procedure?

g) Has Hydro Ottawa ever disclosed any other accounting changes in the company's annual audited financial statements? If yes, please provide a copy of the note(s) to the financial statements supporting the change and its date of implementation. Please explain the effective date for implementation of such change and in particular identify any which were mid-year changes.

Response

a) The reference is Section 1000, General Accounting, CICA Handbook paragraphs .20 and .20(b) which specifically state the following under "Relevance", which is one of the four principal qualitative characteristics underlying GAAP.

.20 - For the information provided in financial statements to be useful, it must be relevant to the decisions made by users. Information is relevant by its nature when it can influence the decisions of users by helping them evaluate the financial impact of past, present or future transactions and events or confirm, or correct, previous evaluations. Relevance is achieved through information that has predictive value or feedback value and by its timeliness.

.20 (b) -Timeliness

For information to be useful for decision making, it must be received by the decision maker before it loses its capacity to influence decisions. The usefulness of information for decision making declines as time elapses.

b) The magnitude of the dollar impact of the accounting change associated with the overhead capitalization, coupled with the company's requirement to comply with GAAP and to have senior financial staff sign-off on the financial statements in accordance with professional accounting standards, left little debate as to the necessity to implement the accounting change in a timely manner. Senior financial staff also make representations to the company's Board of Directors, the Audit Committee and the Board of Directors of the Shareholder that the financial statements are relevant and reliable; and therefore once it is determined that an accounting change is merited, it is incumbent on staff to make the change in a timely manner.

c) Hydro Ottawa has not received any specific documentation from its external auditor or other independent professional accounting firm that discusses the implementation timeframe for an accounting change. However, the documentation filed with the 2008 Electricity Distribution Rates Application includes management's memo to Hydro Ottawa's Audit Committee dated August 21, 2007 (Exhibit B1-3-1 Attachment U), which outlines the rationale for the proposed accounting treatment for the amount of overhead costs directly attributable to capital programs. It is noted on page 8, paragraph 22, that Hydro Ottawa's external auditors, who participate in meetings of the Audit Committee and review most agenda items in advance of an Audit Committee meeting, are in agreement with the updated cost allocation procedure and the corresponding update of the capitalization policy. Paragraph 17 on page 5 of the memo also states that the implementation date is planned for October 1, 2007. The implementation date has never been an issue with, or raised by, Ernst & Young as being incorrect.

d) The accounting change implemented as of January 1, 2008 would have been less problematic for Hydro Ottawa management. The additional administration related to implementing the change in the final quarter of 2007 would have been avoided. However, as in the response to part a), the requirements of GAAP and professional standards dictate timeliness and not convenience in the implementation of an accounting change.

e) Hydro Ottawa is compelled by professional standards to recognize a material accounting change in a timely manner. As discussed in the response to Board Staff Interrogatory #1.3, the removal of the temporary exemption for rate regulated utilities from section 1100 of the CICA Handbook would have forced Hydro Ottawa to assess its capitalization policy and implement the change by the January 1, 2009 sunset date outlined in the Accounting Standards Board's Decision Summary, dated August 22, 2007. However, in advance of the ASB's decision, Hydro Ottawa took a proactive role to assess its capitalization of overhead costs as outlined in Exhibit B1-3-1in the EB-2007-0713 proceeding. This review indicated that a material change in overhead capitalization should be made. Generally Accepted Accounting Principles and professional standards require that accounting changes be implemented in a timely manner to ensure financial statements are relevant to their users. It is incumbent upon Hydro Ottawa to make such a change on a timely basis.

In order to effect the required changes to Hydro Ottawa's enterprise business system and allocation models, and to inform and educate staff that rely on the burden rates to cost capital projects and work for others, it was determined that the change could be implemented on October 1, 2007. It would have been inappropriate for Hydro Ottawa to delay the implementation beyond that date.

f) There are no supportable reasons for continuing with the capitalization and cost allocation policies in effect prior to October 1, 2007. As described in the response to Board Staff Interrogatory #1.3, the work commissioned by Hydro Ottawa involving various professional accounting firms indicated a more conservative and causal linkage was required by Hydro Ottawa in the allocation of overhead costs to capital. The Accounting Standards Boards decision on the removal of the temporary exemption for rate regulated entities from section 1100 of the CICA Handbook and the eventual convergence of Canadian GAAP with International Financial Reporting Standards all signal a review and change in the capitalization of overhead costs was merited. GAAP requires that such a change be recognized in a timely manner.

g) Hydro Ottawa has reviewed its annual audited financial statements dating back to amalgamation in 2000 and was only able to identify the adoption of a new accounting treatment for spare transformers and meters, as prescribed by the Accounting Procedures Handbook (“APH”), as a change. Based on Section 1506 of the CICA Handbook, an accounting change arises when there is a change in an accounting policy, a change in an accounting estimate or a correction of a prior period error. The effective date for implementation of a change is assessed based on whether an error has occurred or it is due to a change in policy or estimate. An error requires a prior period adjustment, a change in accounting policy is applied retrospectively unless it is impractical to do so, and a change in accounting estimate is implemented prospectively. Section 1506.16 of the CICA Handbook further states that “The following are not changes in accounting policies: (b) the application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.” Since the adoption of the new accounting treatment for spare transformers and meters, as prescribed by the APH, can be considered an “application of a new accounting policy for transactions”, the change would not qualify as an accounting change under Section 1506. Therefore, Hydro Ottawa has never disclosed any other accounting changes in its annual audited financial statements.