

***STUDY OF AFFILIATE
SERVICE COSTS AND
COST ALLOCATION***

***In Respect of
Kingston Hydro***



November 22, 2010

BDR

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EXECUTIVE SUMMARY

Introduction and Scope

Kingston Hydro is a local electricity distribution company (“LDC”) licensed by the Ontario Energy Board (“OEB”) to provide electricity distribution service in central Kingston. As of March, 2010, Kingston Hydro served 27,003 electricity customers.

As is common among Ontario LDCs, Kingston Hydro shares goods and services with affiliates in order to benefit from economies of scale and thereby control the level of costs of providing services to customers.

The City of Kingston (“the City”) is the sole shareholder of Kingston Hydro, and through a holding company, also of Ontario Corporation #1425445, doing business as Utilities Kingston (“UK”). UK is an integrated service company that employs staff providing services to the City’s utility operations, which include gas distribution, water treatment and distribution, sewage collection and treatment, and fibre optics, as well as Kingston Hydro (electricity). The City provides certain services to UK on a shared basis with its own requirements, under a service agreement (the “City/UK Agreement”), and charges UK for the services on a cost recovery basis. UK provides engineering, operation, maintenance and administrative services to Kingston Hydro’s electricity distribution business under a services agreement (“the UK/KH Agreement”), and charges Kingston Hydro for these services, along with a portion of UK’s costs of services from the City, to Kingston Hydro, also on a cost recovery basis. The parties consult regularly to ensure that there is no duplication or omission of services that are provided.

Both the City/UK Agreement and the UK/KH Agreement first became effective in 2000. Kingston Hydro has therefore been managed and operated by UK since its initial creation as a business corporation in accordance with the provisions of the *Energy Competition Act, 1998*, and has never employed any employees or incurred any operating costs directly.

BDR NorthAmerica Inc. (“BDR”) was retained by Andrew Taylor Energy Law to review the approaches used by the City and UK in establishing transfer pricing for their services to Kingston Hydro, and has prepared this report. In making its assessment, BDR relied exclusively on data provided by management. The scope of the study specifically excludes:

- evaluation of the appropriateness of the services or the reasonableness of the costs, and
- independent audit of the accounting or analysis which underlie the costs or cost allocation.

The Affiliate Relationships Code for Electricity Transmitters and Distributors (“ARC”) provides that services defined as “shared corporate services” and services provided where no reasonably competitive market exists should be priced at fully-allocated costs, and all other services at no more than a market-based price. BDR has taken the provisions of the ARC into account in reviewing the transfer pricing methodology applied to each service.

Conclusions

Transfer Pricing from the City to UK

The stated policy of Kingston Hydro and its affiliates is that charges are for costs incurred without markup, and exclude any return on investment capital. The ARC allows recovery of a return on investment in assets used by an affiliate to serve the LDC, at the rate of return allowed by the OEB for investment in assets of the LDC. The City and UK might therefore wish to consider a change to their costing methodology to include a return on investment, if applicable.

In quantifying amounts to be allocated by the City to UK, BDR was advised that the first step was to eliminate from the total costs in each department any costs related to activities that do not benefit UK. BDR regards this as a necessary and appropriate part of the cost allocation process.

For City costs of legal and information systems services, the approach is that the total department costs are allocated based on an allocator (time spent for legal and number of desktop computers for information systems). This appropriately accounts for all costs in the departments, including salaries and wages, benefits, and other costs, net of the costs of any activities that do not benefit UK.

For finance, call centre, communications and human resources/payroll, the City charges UK based on employee time. The charge includes a 25% increment to wages and salaries to allow for employee benefits, and a 10% overhead charge. A review of the ratio of employee benefits to salaries and wages in the departments indicated that 25% is an appropriate amount. On questioning, it was explained that the 10% “overhead” charge is intended to recover costs within the functional departments, other than the costs of salaries and benefits.

BDR was provided with budget data for finance, call centre, communications, and human resources/payroll. In finance, communications and human resources/payroll, costs other than salaries and benefits exceed the level of 10% of salaries and benefits. For the call centre, these costs are less than 10%. In aggregate, costs other than salaries and benefits for the departments exceed 10% of salaries and benefits. Therefore the existing methodology is favourable to UK, and by extension, to Kingston Hydro.

An alternative method that uses employees' time as an allocator, and applies such allocator to the full cost of the department or function (as is already done in the legal and information systems departments) would, in BDR's view reflect the actual amount of non-salary costs for each department more accurately than the current method, and would not be difficult to implement. BDR therefore recommends that this change be applied in future allocations of finance, call centre, communications and human resources/payroll costs from the City to UK.

BDR also noted that not all costs incurred by the City to serve UK are being charged through to UK, and some of those instances are documented in this report. While the City is not to BDR's knowledge prohibited from charging UK less than fully allocated costs for its services, it is hoped that this report will be useful if the City chooses to reconsider its policy in the future.

BDR considers the selection of allocation bases used by the City in charging UK to be reasonable and appropriate based on the type of costs involved and the information available. The City has used time-based allocations in many instances, and where it has elected not to do so, BDR believes that the selected cost driver is valid on a forecast basis (as for test year purposes), and would have the benefit of producing a consistent relative allocation from year to year between the City and UK.

Transfer Pricing from UK to Kingston Hydro

The following table summarizes the services received by Kingston Hydro from UK, whether directly or through the City, the transfer pricing method presently used by UK, and BDR's comment or recommendation.

Nature of Service	Allocation by City to UK	Allocation by UK to Kingston Hydro	BDR Comment or Recommendation
System design and construction, operation and maintenance provided through third party contracts	N/A	Amounts directly assigned to each utility and passed through without markup	Accurately tracks cost causation. Since these costs are from arms length suppliers, the price is market-based.
System design and construction, operation and maintenance provided through UK labour force	N/A	Amounts tracked to specific utility projects through the job order system.	Accurately tracks cost causation. Since there is no third party provider in the Kingston area for the work done by the employees, there is considered to be no market.

Nature of Service	Allocation by City to UK	Allocation by UK to Kingston Hydro	BDR Comment or Recommendation
Billing and collection	N/A	Adjusted number of customers	Reasonable method. A refinement reflecting the relative complexity of each utility bill should be considered. Market price data should be collected if available.
Regulatory and financial functions provided by UK	N/A	Number of customers	Recommend time records as basis of allocation.
Procurement and warehouse overheads	N/A	Equally to four utilities (25% each)	Reasonable method given the type of cost and use of the resources.
Training, recruitment, labour relations and safety	N/A	Number of customers	Recommend direct assignment where available, otherwise number of employees.
Vehicles	By hourly use records	By hourly use records	Consistent with acceptable cost allocation.
Information Systems other than GIS	Number of desktop computers	Number of customers.	Recommend allocation from UK to Kingston Hydro based on the allocation of employees who use computers.
GIS Services	Management judgment	Management judgment	Reasonable method in view of the nature of the cost.
Client Services	Time, based on a call monitoring system	Non-weighted number of customers.	Reasonable method in the absence of data supporting a weighting factor.
Human Resources	Number of employees	Number of customers.	Recommend an FTE approach.
Communications	Staff time records	Number of customers	Reasonable method for communications activities that address all utility customers. Direct assignment of time and other costs is recommended where a

Nature of Service	Allocation by City to UK	Allocation by UK to Kingston Hydro	BDR Comment or Recommendation
			communication program is dedicated to a specific utility.
Financial services other than payment processing	Supervisor's estimate of time spent	Number of customers	Given that the services cannot be separately identified with each utility, BDR accepts the existing methodology as reasonable.
Back office payment processing	Number of payments	Number of customers	Reasonable and consistent with accepted cost allocation approaches.
Legal	Management analysis of activities and time spent	Number of customers.	Recommend management analysis of time spent.
Insurance	Proportion of time spent	Number of customers	Recommend estimate of proportion of time spent.
CAO Office	Estimate of time spent	No charge to Kingston Hydro	N/A
Mail room	Pieces of mail	Number of customers	In view of the small cost involved and the complexity of any in-depth analysis, BDR accepts the methodology as reasonable.
Occupancy costs	Square footage	Management judgment	Recommend office-based FTEs for office space, management judgment for warehouse space.

1 SCOPE OF STUDY

At the date of this report, Kingston Hydro has a cost of service and rate approval application before the OEB. Kingston Hydro proposes to include in its revenue requirement charges from its affiliate UK, including charges to UK for services from the City, forecast to be incurred in the management and operation of Kingston Hydro's electricity distribution business in the test year. Andrew Taylor Energy Law, on behalf of Kingston Hydro, requested BDR NorthAmerica Inc. ("BDR") to prepare this report as to the appropriateness of the affiliate transfer pricing mechanisms, and to suggest changes that will improve the fairness or accuracy of the transfer pricing.

As sources of information for this study, BDR received from the City and UK data as to affiliate relationships, the nature of affiliate services provided, pricing, and statistics used in the development of cost allocators. These were accepted by BDR as correct and complete, subject to a review as to reasonableness, but without independent verification.

Following an initial review, BDR met by conference call with management of the City and UK to confirm our understanding of the data provided, to discuss alternatives and consider possible methodology changes.

The focus of the study is entirely on the appropriateness of the transfer pricing arrangements and the costs charged by the City to UK and by UK to Kingston Hydro, and is not intended as a broader audit of compliance with any other aspect of the ARC.

2 NATURE OF AFFILIATE TRANSACTIONS

UK manages and operates Kingston Hydro's electricity distribution business under a services agreement ("the UK/KH Agreement"). Some services are provided to Kingston Hydro directly by UK. Other services are provided by the City to UK to support all of the utilities: gas, water, sewer, fibre optics, and Kingston Hydro. UK charges Kingston Hydro for these services on a cost recovery basis.

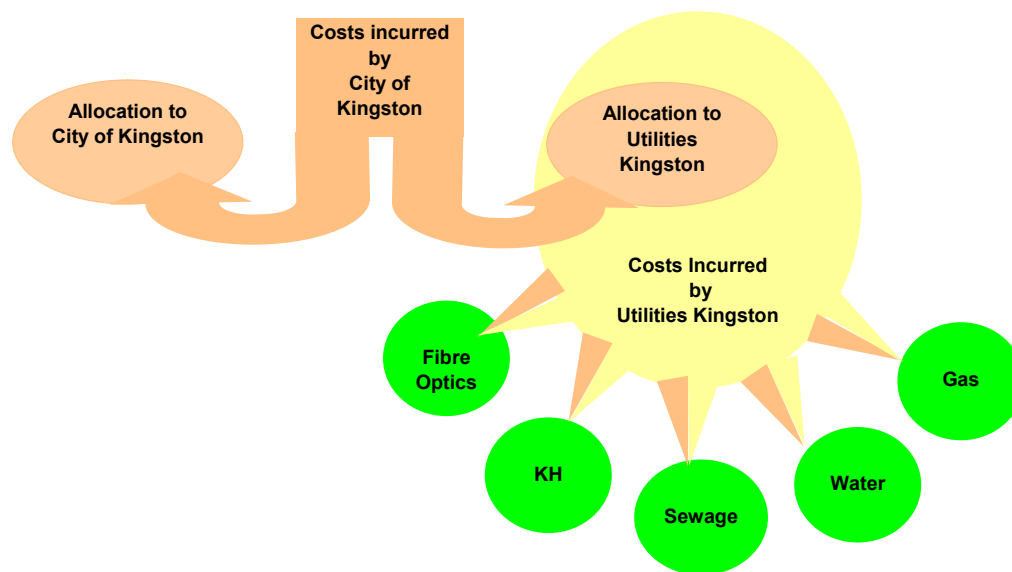
Both the City/UK Agreement and the UK/KH Agreement first became effective in 2000. Under the provisions of the Affiliate Relationships Code this agreement will expire in September of 2012.

Kingston Hydro has therefore been managed and operated by UK since its initial creation as a business corporation in accordance with the provisions of the *Energy Competition Act, 1998*, and has never employed any employees or incurred any operating costs directly. As a result, there were no considerations as to whether any

of the costs incurred are duplicative or redundant, except as between the services provided by the City, and those provided directly by UK.

There are two “tiers” of allocations to be considered in this study. The first is the allocation of costs from the City to UK; the second is the allocation of costs by UK to Kingston Hydro. Costs allocated by UK to Kingston Hydro include a portion of the costs allocated by the City to UK.

Kingston Hydro does not provide any products or services to its affiliates.



From documentation provided by the City, dated July, 2010, it was determined that the following services are provided to UK by the City, for which UK is charged an allocated cost:

- **Information services**, including Geographic Information Systems (GIS), systems development, administration and security, distributed computing and service desk, telephone network and computer connectivity;
- **Client services**, including call centre for service and bill-related communication with clients, and related management, training, and process improvement;
- **Human resources**, including payroll and benefits administration, compensation administration and administration of the human resources information system;
- **Communications**, including broadcast and print advertising, press releases and media advisory for such items as outage notifications;

- **Financial services**, including financial management services, accounting, year-end reporting and audit, accounts payable services, and payment processing;
- **Legal services**, including tenders, contracts and construction, environmental, real property, municipal and other regulatory, labour and employment, insurance, claims management and litigation, damage recoveries, collections and privacy.
- **Other services**, including, mailroom, and provision of office/service centre space in the building at 1211 John Counter Blvd, which is owned by the City and houses the UK operations.

The ARC, in providing direction as to inter-affiliate transfer pricing, provides the following important definition:

“shared corporate services” means business functions that provide shared strategic management and policy support to the corporate group of which the utility is a member, relating to legal, regulatory, procurement services, building or real estate support services, information management services, information technology services, corporate administration, finance, tax, treasury, pensions, risk management, audit services, corporate planning, human resources, health and safety, communications, investor relations, trustee, or public affairs”.¹

Section 2.3.5 of the ARC provides that fully allocated cost based pricing is the appropriate treatment for these costs.

The only services provided by the City which are not “shared corporate services” according to this definition are therefore Client Services and rental of space in the building at 1211 John Counter Blvd and Fleet services.

In addition to these services provided by the City, Kingston Hydro receives all services related to the design and construction, operation and maintenance and administration of its distribution system from UK. UK provides these services through a combination of its own labour and externally contracted services. UK provides billing services to Kingston Hydro, as well as to the City for water, sewage, and gas. UK also provides procurement services, specialized financial and regulatory services, training, recruitment, labour relations, health and safety services to the utilities, including Kingston Hydro; through discussions with UK management, BDR ascertained that none of these functions duplicate a service for which costs are allocated to UK by the City.

¹ ARC, Section 1.2.

3 TRANSFER PRICING

3.1 *Costs Incurred within UK*

3.1.1 Range of Services

The services provided by UK, rather than by the City, are of three broad types:

- Engineering, Planning, Operating and Maintenance
- Billing and Collecting
- Certain general and administrative services that are required and not provided by the City.

UK's policy is to directly assign costs that can be identified as incurred directly for one of the utility services (Kingston Hydro, gas, water, sewage or fibre optics). Costs that cannot be identified to a specific utility for direct assignment are allocated to those utilities that use the related service.

3.1.2 Engineering Planning, Operations and Maintenance

System design and construction, operation and maintenance services of UK are provided through a combination of its own labour and third party contracts.

For third party contracts, the amounts are tracked through UK's job order system and identified specifically with the "client" utility. These costs are passed through to each utility, including Kingston Hydro, as incurred without markup. For these contracts, procurement of materials is the vendor's responsibility, included in the contract price, and is therefore also directly assigned.

For direct labour a system is in place for employees to record their time to job orders which are associated directly with each utility. The costs for work by UK employees on behalf of Kingston Hydro can therefore be directly identified. All labour cost is charged per hour at the hourly wage rate of the employee, plus 25% benefits based on the average cost of benefits as a percentage of wages and salaries for all employees.

Direct assignment through detailed record-keeping is the most accurate method of computation of a cost-based transfer price. Therefore, BDR concludes that the direct assignment approach used for direct labour and third party contracts is reasonable and consistent with acceptable methods of cost allocation.

These services are not "shared corporate services" as defined by the ARC. However, UK management advised BDR that there is no local third party provider of the services in the Kingston area. BDR has therefore considered the services provided by UK labour as services for which no market exists.

3.1.3 Billing and Collection

Billing and collection activities are performed on behalf of all the utilities by UK. Customers receive a monthly bill that incorporates all services received by the customer. In postage alone, this results in significant savings over the alternative of sending separate bills.

Because all utility charges are made on one bill, no distinction can be made among collection and remittance processing activities associated with the individual utilities.

UK allocates the costs to each utility based on the number of customers. In the case of Kingston Hydro, the current number of customers is 24.5% of the total. The allocation factor being used is 23%. The purpose of the small reduction is to reflect variability in the proportion of water and sewer services without disadvantaging Kingston Hydro.

UK's approach to these services means that all of the resources are shared, and that the cost of providing service to one utility cannot be separately identified. UK's management believe, and BDR concurs, that the complexity of the Kingston Hydro bill would exceed that of the water and sewer bills; a methodology refinement reflecting the number of line items in the bill for the allocation of the billing (but not collection) cost component might therefore be supported. BDR did not quantify the potential impact of such a methodology refinement, but expects that the result would be a higher allocation of costs to Kingston Hydro and to gas, and a reduced allocation to water and sewer.

BDR therefore concludes that the existing simple allocation based on number of customers is reasonable and consistent with acceptable methods of cost allocation, and does not disadvantage Kingston Hydro. BDR recommends that for the billing component of costs, a weighting factor based on number of lines be considered for the future.

Billing services are potentially available from third party providers, and therefore can be considered a service for which a market exists. UK should attempt to establish a market price level. However, BDR notes that the single bill issued by UK for all utilities would result in extensive savings of the cost of bill printing, bill mailing, back office payment processing and collection activities as compared with these services provided separately for Kingston Hydro by any party.

3.1.4 Specialized Financial and Regulatory Functions

UK provides specialized financial and regulatory reporting functions, that are required in addition to the accounts payable and transaction accounting functions performed on behalf of UK by the City.

The services provided by UK include:

- Regulatory affairs and compliance administration;
- Maintenance of Kingston Hydro's chart of accounts and compliance with the OEB's Accounting Procedures Handbook;
- PILs and any other taxes that are not applicable to the City, and
- Procurement of utility-specific goods and services.

Costs other than Procurement and Warehousing

The costs of these services other than procurement and related warehousing are allocated among the utilities based on number of customers.

UK's management believe, and BDR concurs, that the level of effort provided to Kingston Hydro for these functions is greater on a per-customer basis than that provided to the utilities that are not subject to independent regulation. BDR concludes that the existing methodology results in a lower allocation of costs to Kingston Hydro than would a methodology that specifically tracked level of effort.

In BDR's view, number of customers is not a cost driver for the functions involved. BDR therefore recommends that all of the above functions be allocated to the utilities based on level of effort. On-going time records represent the best approach to this, but can be supplemented with estimations where an activity provides benefit to more than one utility.

Procurement and Warehousing

For work done by UK's work force, costs associated with warehouse space costs are part of the occupancy cost, which is addressed in Section 3.2.13.

Warehouse overheads and purchasing activities are divided equally among Kingston Hydro and the gas, water and sewer utilities, so that each receives an allocation of 25%.

BDR discussed this issue with UK management and was advised that a higher component of capital work is performed by internal labour resources than is the case for the gas, water and sewer utilities. In the case of materials for capital work performed by third parties under contract, UK's warehouse facilities are not used. The conclusion is that Kingston Hydro makes more use of UK's warehouse facilities than the other utilities.

BDR considered methodologies that would more closely relate to cost drivers for this function, and concluded that procurement and warehousing overheads are causally related to a mix of factors which include complexity of procurement requirements, inventory turnover rate, handling and storage requirements, number of items and

variety of items. Some or all of these factors might vary considerably on an item-by-item basis.

BDR has therefore concluded that an allocation based on the judgment of management is reasonable in the circumstances, and that the current allocation is favourable to Kingston Hydro.

3.1.5 Training, Recruitment, Labour Relations, Health and Safety

These Human Resources functions are provided within UK for the utility operations. The costs are currently allocated among the utilities by UK on the basis of number of customers.

In BDR's view, number of customers is not a cost driver for the functions involved. Where it is possible to specifically identify activities or programs as applicable to one utility, BDR recommends that a direct assignment approach be used. Where activities and programs are shared by all of the utilities, BDR considers that the number of employees is the allocation factor that best demonstrates a cost causation approach to allocation.

3.2 Costs Incurred by the City and Allocated to UK

This section addresses the costs for services provided by the City to UK.

Transfer pricing from the City to UK and from UK to the City is cost-based without markup. First, the City allocates costs between its own municipal functions and utility functions, and charges the costs allocated as utility functions to UK. UK then charges each of the utilities (gas, water, sewage, fibre optics and Kingston Hydro) an allocated share of these costs.

3.2.1 Use of Vehicles

Until the present, it has been the practice for vehicles used by UK to be owned by the City. Historic practice, ending this year, was that UK paid for use of the vehicles on an hourly basis, at a charge set to recover both operating costs and replacement capital over all the hours of use. From 2011 onwards, the hourly charge will be set to recover operating costs only, with the result that reserve funds for utility vehicles will be drawn down. When a replacement vehicle is required for use by Kingston Hydro, Kingston Hydro will purchase the vehicle directly, with the capital cost added to rate base. Therefore, there will be a period over which some vehicles used by Kingston Hydro are owned by Kingston Hydro, and some are owned by the City. At some point in the future, all vehicles for use by Kingston Hydro will be owned directly by Kingston Hydro and no cost allocation will be required in respect of vehicle costs.

In BDR's view, the method of determination of the hourly rate is reasonable and consistent with acceptable methods of cost allocation. Since the determination of hourly usage is on the basis of complete usage records, this method is also consistent with acceptable methods of cost allocation.

3.2.2 Information Services other than GIS

3.2.2.1 Allocation from the City to UK

The City provides a comprehensive array of information services to itself and UK. These include both hardware and software, and both services that are organization-wide in their application and services directly to system users. Some examples of organization-wide services include: disaster recovery; procurement of hardware and software, installation, and maintenance of corporate systems and services related to the network. Services directly to system users include help desk, technical services, maintaining desktop configurations, and procurement of desktop hardware.

Since ultimately all of these services support system users through their workstations, the City allocates the related costs in proportion to the number of desktop computers. 167, or 16% of the total desktop computers are used by the employees of UK. The cost allocation percentage is therefore 16%. No allocation is presently being made in respect of computers used by City employees whose time is allocated to UK.

The allocation factor of 16% applies to all department costs, and therefore includes both salary-related and non-salary-related costs.

BDR considers this approach reasonable and consistent with acceptable methods of cost allocation, as it applies to the employees of UK. BDR considers that it would be appropriate to also allocate a share of computer costs in respect of services of employees whose time is shared between the City and UK. An FTE approach to such allocation would, in BDR's view, be appropriate.

3.2.2.2 Allocation from UK to Kingston Hydro

UK allocates the cost of information services among the utilities on the basis of number of customers.

In BDR's view, number of customers is not a cost driver for this cost.

BDR recommends that number of employees who use computers be the basis of allocation from UK to Kingston Hydro. Where employees of UK who use computers share their time among the utilities or perform shared functions (such as customer billing), BDR recommends that the cost of information services be

allocated in proportion to the allocation of computer-using FTEs serving each utility.

3.2.3 GIS Services

3.2.3.1 Allocation from the City to UK

In 2010, work was done to transfer utility asset data into GIS. During 2011, work will be continued, including migration of UK's asset data management to the GIS and integration of the GIS with a new system.

As a result, management estimates that the level of effort associated with GIS services to UK will represent 25% of the total associated with GIS for the foreseeable future.

On review, BDR considers this treatment to be reflective of the present conditions of operation and expected conditions in the test year, and therefore consistent with acceptable methods of shared cost allocation.

3.2.3.2 Allocation from UK to Kingston Hydro

Costs of the GIS are relatively fixed with respect to level of activity, number of employees and number of customers.

UK therefore allocates each utility (gas, electricity, water and sewage) an equal share of the costs (25%).

In view of the nature of this cost, BDR considers this approach reasonable and consistent with acceptable methods of cost allocation.

3.2.4 Client Services

3.2.4.1 Allocation from the City to UK

This function is a call centre that responds to customer inbound calls, and takes the follow-up actions required by the call. It also coordinates with field staff who will be dispatched to customer appointments. A sample follow-up actions resulting from customer calls includes:

- processing applications for service;
- explaining and investigating billing inquiries;
- collecting and updating customer information;
- preparing and sending out history reports of consumption and payment.

Senior and management staff resolves complaints that are referred from more junior levels, provide training and coaching, supervise staff, prepare statistical reports and advise on process improvements to improve service and control costs.

Costs allocated to UK are based on the proportion of time that each staff position is working on UK-related inquiries. This includes telephone time and “off-line” work that arises from customer transactions. The call monitoring system allows staff to code their telephone time to UK or the City. Off-line time is tracked as much as possible using specific “off-line work codes” on the call monitoring system. This data is supplemented by an adjustment to reflect estimated off-line work completed between calls.

Once the amount of time spent has been developed for each staff member, the cost is determined as the salary for the staff position, plus 25% for benefits and 10% for overhead.

BDR considers this approach to be a detailed analysis of actual resources used to perform the functions for UK. It is therefore reasonable and consistent with acceptable methods of cost allocation. As to the amounts allocated, on the basis of detailed cost information provided by the City, BDR considers the amount of 25% for benefits to be an acceptable estimate. However, for this function, non-payroll costs are considerably below 10%. BDR recommends that an overhead estimate more closely related to actual costs be applied.

3.2.4.2 Allocation from UK to Kingston Hydro

The client services are shared by water, sewer, gas and Kingston Hydro. The fibre utility does not use these services. As UK does not have an identical service territory for each of the utility services, the number of customers receiving each of the services is different.

Client services costs are allocated by UK to each of its utilities by an allocator based on the number of customers. The percentage represented by electricity customers is currently 24.5%. In order to maintain consistency over time and ensure that there is no over-allocation of costs to Kingston Hydro, its allocation factor for number of customers has been set at 23%, slightly lower than the percentage of customers.

At present the call monitoring system is not capable of tracking the efforts of client service staff to each utility, and management in the function reports that in any case, identification of a call with an individual utility would not always be possible, since many calls address a combined issue or multiple issues involving more than one utility service. An alternative to the present system would be to use management judgment or monitoring of a sample of calls to derive a weighting factor to represent the level of effort in addressing utility client service calls. UK management believes that calls with respect to electricity service are more complex and time-consuming

than the calls for other utility services. If this is the case, (and BDR considers this judgment to be reasonable), the present use of a non-weighted number of customers as the allocation factor is resulting in an allocation to Kingston Hydro of less than its appropriate share of call centre costs.

In the absence of data to support a weighting factor to reflect length and complexity of calls, BDR considers that the methodology being used is reasonable.

3.2.5 Human Resources

3.2.5.1 Allocation from the City to UK

The Human Resources services provided by the City include payroll and benefits administration, compensation administration and administration of the human resources management system. For training, recruitment, labour relations, health and safety, please see section 3.1.5.

Since UK does not utilize all of the services of the City's Human Resources function, the costs of services not used by UK are excluded before an allocation is made to UK. UK is allocated a share of costs based on number of employees; UK's percentage of the number of employees is 16%. As a result of some costs being excluded from any allocation to UK, the allocation of costs to UK represents only 6.8% of the total of the City's Human Resource costs.

BDR considers that the use of number of employees to allocate this cost is reasonable and consistent with acceptable methods of cost allocation. BDR notes that the 16% factor includes only UK employees, and therefore includes no cost related to City employees whose activities are shared with UK. BDR considers it appropriate for UK to be allocated a share of such costs, and would recommend allocated FTEs as the basis of Human Resources cost allocation. BDR understands that there would be a further complexity in adopting this recommendation, since the scope of services provided to City employees is different from that provided to UK employees.

The amounts allocated to UK include a share of salaries, plus benefits at 25% of salaries, plus 10%. The additional 10% is intended to recover a contribution toward the costs of the Human Resource function other than salaries and benefits, which includes such costs as contracted services and office supplies, and also a proportion of department administration which is budgeted separately, but which supports the functions of payroll services, compensation administration and the HRMS which serve UK. BDR has reviewed a breakdown of budget information provided by the City, which indicates that such costs exceed 10% of the salary and benefit costs across the functions shared with UK.

BDR therefore concludes that the present method results in an allocation that is favourable to UK. However BDR recommends that in the future, the City reflect the actual percentage of costs other than salaries and benefits in quantifying the Human Resource costs allocated to UK.

3.2.5.2 Allocation from UK to Kingston Hydro

The costs are presently being allocated by UK to each utility based on number of customers.

In BDR's view, employees are the driver of the Human Resources function costs, and reflect the method by which the costs are incurred by UK from the City. Therefore in allocating costs to each utility, BDR recommends that UK adopt allocated FTEs as the basis of allocation of this cost.

In response to discussion with UK management of this recommendation, management has indicated on a preliminary, estimated basis that an FTE approach would result in an allocation of approximately 26% of these costs to Kingston Hydro. Since the customer approach results in an allocation of 23%, the impact of the methodology change is not significant.

3.2.6 Communications

3.2.6.1 Allocation from the City to UK

Communications services include including broadcast and print advertising, press releases and media advisory for such items as outage notifications.

Time worked for UK is recorded by staff and charged at an hourly rate which includes 25% for benefits and 10% overhead. The hourly rates are determined based on the average hourly salary of the staff involved including management

BDR considers the allocation approach to be a detailed analysis of actual resources used to perform the functions for UK. It is therefore reasonable and consistent with acceptable methods of cost allocation.

The 10% "overhead" charge is intended to recover a contribution toward the costs of the Human Resource function other than salaries and benefits, which includes such costs as contracted services, advertising, publications and office supplies. BDR has reviewed a breakdown of budget information provided by the City, which indicates that such costs exceed 10% of the salary and benefit costs.

BDR therefore concludes that the present method results in an allocation that is favourable to UK. However, BDR recommends that in the future, the City reflect

the actual percentage of costs other than salaries and benefits in quantifying the costs allocated to UK.

3.2.6.2 Allocation from UK to Kingston Hydro

Communication cost is currently allocated to the utilities by UK on the basis of number of customers.

Given that the communications are being directed to customers, it is BDR's view that number of customers is not an unreasonable allocator for communication cost, especially where the communication addresses all utility services; however, to the degree that the communications being produced can be identified with specific utility services, it would be preferred to allocate the costs accordingly. Given that the communications employees are already recording their time for allocation purposes, this more detailed approach may not prove onerous.

3.2.7 Financial Services

3.2.7.1 Allocation from the City to UK

The services involved include:

- Financial Management Services – municipal utilities
 - Investment management
 - Debt management
 - Capital funding management
- Accounting Services
 - Transaction accounting
 - Technical and system support
- Accounts payable services
- Cashier and payment processing services.

UK also has a finance group that provides services specific to utilities, and which are not provided by the City. These are detailed in Section 3.1.4.

For all services other than cashier and payment processing, staff time is allocated to UK based on the proportion of time that each staff position works on UK accounting related tasks. The time proportion is determined by a supervisor's estimate. Time is charged at the actual hourly salary rate of the position, plus 25% for benefits and 10% for overhead.

BDR considers the allocation approach to be a detailed analysis of actual resources used to perform the functions for UK. It is therefore reasonable and consistent with acceptable methods of cost allocation.

For cashier and payment services, the costs are separated into cost of processed “back room” (mail and bank) payments and customer front counter payments. The cost of back room payments is allocated based on the number of payments processed. No charge is made to UK for customer front counter payments, because the City has chosen to continue front counter services where UK would otherwise have eliminated them.

BDR considers that the number of payments processed is a reasonable cost driver for this function, and is therefore an acceptable allocation basis for the cost.

The 10% “overhead” charge is intended to recover a contribution toward the costs of the financial function other than salaries and benefits, which includes such costs as contracted services, training and office supplies. BDR has reviewed a breakdown of budget information provided by the City, which indicates that such costs exceed 10% of the salary and benefit costs.

BDR therefore concludes that the present method results in an allocation that is favourable to UK. However BDR recommends that in the future, the City reflect the actual percentage of costs other than salaries and benefits in quantifying the costs allocated to UK.

3.2.8 Allocation from UK to Kingston Hydro

At present, a customer-based allocation is being used.

For cashier and payment services, since all of the utilities share one bill provided by UK, it would not be possible to attribute specific customer transactions to a single utility service. ***It is therefore BDR’s view that an allocation based on number of customers is reasonably reflective of the causation of this cost.***

For other financial services, discussion with management has suggested that the level of integration of the services prevents the use of any methodology that relies on separate identification of staff time or work product. For example, accounts payable are usually in respect of the operation of more than one utility.

In the absence of any methodology that would more closely identify cost causation with individual utilities, BDR accepts the existing methodology as reasonable in the circumstances.

3.2.9 Legal Services

3.2.9.1 Allocation from the City to UK

Legal services include support with respect to tenders, contracts and construction, environmental compliance, real property, regulatory, labour and employment, insurance and claims management, litigation, damage recoveries, collections and privacy.

The charge-out rate is determined by dividing the total legal department expenditure budget, plus 10% for corporate overheads, by the standard hours available to be charged out (i.e. total working hours for the year, net of vacation, statutory holidays, sick time, etc.). Time charged is determined by a management analysis of activities and time spent.

BDR considers this approach to allocation to be analysis of actual resources used to perform the functions for UK. It is therefore reasonable and consistent with acceptable methods of cost allocation.

BDR considers it reasonable that costs in support of a specific function, including corporate management, be part of the costs allocated by the City to UK where applicable. BDR would recommend that any percentage be based on a review of supporting costs, and be applied consistently to the costs of activities as allocated to UK.

3.2.9.2 Allocation from UK to Kingston Hydro

This function is being allocated to utilities based on number of customers.

In BDR's view, number of customers is not reflective of causation of these legal costs, and suggests that a management analysis be used to determine time spent and allocate the costs.

3.2.10 Insurance Services

3.2.10.1 Allocation from the City to UK

Insurance services include the cost of support from an insurance specialist employee in resolving insurance related matters.

Costs are allocated to UK based on the proportion of time that the insurance specialist works on UK matters. The cost applied is the salary of the employee(s) plus 25% benefits and 10% overhead.

In BDR's view, the time allocation of the individual involved is a reasonable method of allocation, and consistent with accepted methods of cost allocation.

BDR has reviewed the overhead analysis for the insurance function. Once certain costs not relevant to UK have been excluded, costs other than salaries and benefits are approximately 11% of salaries and benefits.

BDR therefore regards the 10% overhead allocation as reasonable.

3.2.10.2 Allocation from UK to Kingston Hydro

The costs are presently being allocated based on number of customers. ***BDR recommends that the allocation be made based on a time allocation made by the individual, either through time records or an estimate.***

3.2.11 CAO Office

Since no component of this cost is allocated to Kingston Hydro, this cost was not analyzed.

3.2.12 Mail Room

3.2.12.1 Allocation from the City of UK

Costs include salary costs and expenses including postage meter. The mail room costs are for general mail, and not for bill mailing.

Allocation basis is the proportion of total UK main pieces to the total pieces of mail.

BDR considers that the number of pieces of mail is reasonable and consistent with accepted methods of allocation for this cost.

3.2.12.2 Allocation from UK to Kingston Hydro

This cost is now being allocated based on number of customers.

Analysis of pieces of mail, which would be the most accurate cost driver, would be onerous for the allocation of a cost of only approximately \$15,000, of which only about \$4,000 is being allocated to Kingston Hydro. ***BDR therefore accepts the existing methodology as being reasonable for this small cost.***

3.2.13 Building Occupancy

3.2.13.1 Allocation from the City of UK

UK's operations are housed in a building at 121 John Counter Blvd, which also houses the City's engineering, planning and building departments. UK leases the space from the City under a lease agreement for a term of ten years, ending December 31, 2013. As the lessor, the City covers the cost of utilities, light fixtures and replacement bulbs, heating and ventilation, hot and cold running water and fully equipped washroom facilities. UK's share of these costs is included in the rental charges.

The rental amount is computed as the square footage used by UK, multiplied by a charge computed as total operating cost divided by the total square footage in use by the City and UK. At two-year intervals, the square footage utilization is reviewed, and the rental charge per square foot is adjusted to reflect current operating cost information. UK's square footage is determined as the areas utilized directly by UK, plus 50% of common areas on the main floor and in the basement of the administration building. The second floor of the administration building and all of the service centre space are 100% dedicated to use by UK.

BDR has been advised that the rental charges recover operating costs and a contribution to capital reserves for upgrades as required, and that at the time of the original lease, market rates in Kingston were taken into account in establishing the rental rate.

In addition to the rent, UK pays 100% of the PILs or property taxes as applicable that are incurred as a result of its use of the space, and maintains public liability and property damage insurance at its own cost.

In the course of this study, BDR was provided with the analysis done for 2008 by a third party of the square footage utilization. The analysis also compared the rental rate currently in effect (\$13.58 per square foot) with market rates for comparable commercial office and service centre space in the City of Kingston. Such rates typically consist of a fixed component and a component for operating costs that is adjusted annually during the term of the lease. The third party determined that the market rate for commercial office space was \$10.00 plus \$8.92 in operating costs (total \$18.92) per square foot; and that the market rate for service centre space was \$5.00 plus \$8.92 in operating costs (total \$13.92) per square foot. The rate paid by UK, of which a component is allocated to Kingston Hydro, is therefore below the benchmark market rates.

BDR considers that the square footage approach to the allocation of the building costs is a reasonable and acceptable allocation basis. BDR notes that the costs

allocated are less than fully allocated costs, which would include an allowance for depreciation and the cost of invested capital. BDR also notes that the rate per square foot has been benchmarked against market rates, and does not exceed market rates. BDR also notes that no charge for the use of office space is being made in respect of City employees whose time is being allocated to UK.

3.2.13.2 Allocation from UK to Kingston Hydro

Building occupancy costs are being allocated by UK as 23% to each of Kingston Hydro, gas, water and sewer, and the remaining 8% to fibre. This allocation reflects management's judgment of the level of services provided to each of the utilities.

BDR recommends that management consider the feasibility of making the allocation of occupancy costs based on the allocation of office-based FTEs in the service of each utility (i.e. excluding field staff from the allocator).

The building includes warehouse space utilized by UK. BDR has considered and discussed with UK management alternative approaches to allocation of the warehouse. However, since warehousing costs are related to multiple factors that cannot easily be tracked, BDR has concluded that the allocation of the warehouse on a relatively equal basis to all the utilities (except fibre) is reasonable under the circumstances.