**IN THE MATTER OF** the *Ontario Energy Board Act, 1998*, being Schedule B to the *Energy Competition Act, 1998* S.O. 1998, c.15;

**AND IN THE MATTER OF** an application by Norfolk Power Distribution Inc. to the Ontario Energy Board for an Order or Orders approving or fixing just and reasonable rates and other Service charges for the distribution of electricity as of May 1, 2011.

**Norfolk Power Distribution Inc. (NPDI)**
**Responses to Ontario Energy Board Staff**
**Interrogatories on the Preliminary Issue**

**<u>QUESTION 1</u>**

***It is stated with respect to NPDI's 2011 forecast:***

> ***"Based on current rates, the 2011 projected net income of $1,310,935 equates to a 5.61% return on 2011 deemed equity. This is 296 basis points below NPDI's Board approved 2008 deemed return on equity of 8.57% and 424 basis points below the 9.85% deemed return on equity approved by the Board for 2010 rebasing applications."***

**<u>QUESTION 1(a)</u>**

***Please provide a detailed derivation of the 2011 return on deemed equity of 5.61%.***

**<u>RESPONSE – QUESTION 1(a)</u>**

The 2011 return on deemed equity is based on the following forecasted amounts:

2011 Net Income $ 1,310,355

2011 Deemed Equity 23,357,103

ROE = 5.61%

NPDI has provided the following information to demonstrate the calculation of net income, deemed equity and return on equity.

**Calculation of Net Income:**

For consistency NPDI has provided the following Net Income calculation from Sheet 5 of Revenue Requirement Work Form submitted with its 2011 cost of service application.

| | 2011 TEST<br>At Current Approved Rates |
|---|---|
| Distribution Revenue | $10,906,382 |
| Other Operating Revenue Offsets - net | $467,122 |
| **Total Revenue** | $11,373,504 |
| Operating Expenses | $7,821,817 |
| Deemed Interest Expense | $1,907,541 |
| **Total Cost and Expenses** | $9,729,360 |
| **Utility Income Before Income Taxes** | $1,644,144 |
| Tax Adjustments to Accounting Income | ($446,090) |
| **Taxable Income** | $1,198,054 |
| Income Tax Rate | 27.86% |
| **Income Tax on Taxable Income** | $333,790 |
| **Income Tax Credits (Capital Tax)** | $ - |
| **Utility Net Income** | $1,310,355 |

**Calculation of 2011 Deemed Equity**

| | |
|---|---|
| 2011 Rate Base | $58,392,759 |
| Equity Portion | 40% |
| Deemed Equity | $23,357,103 |

**2011 Rate Base Calculation**

| | |
|---|---|
| Gross Fixed Assets (average) | $83,215,606 |
| Accumulated Depreciation (average) | ($30,432,619) |
| Net Fixed Assets (average) | $52,782,987 |
| Allowance for Working Capital | $5,609,772 |
| **Total Rate Base** | $58,392,759 |

**Allowance for Working Capital**

| | |
|---|---|
| Controllable Expenses | $4,964,625 |
| Cost of Power | $32,433,852 |
| Working Capital Base | $37,398,477 |
| Working Capital Rate % | 15.00% |
| Working Capital Allowance | $5,609,772 |

**QUESTION 1(b)**

***Please confirm that the forecast 5.61% return on equity for 2011 is inclusive of the proposal to include smart meters in rate base. If confirmed, please provide the calculations in sufficient detail so that all impacts of the smart meter proposal on this calculation are evident. Please also provide the 2011 deemed return on equity exclusive of the smart meter proposal. If not confirmed, please provide a detailed derivation of the 2011 return on deemed equity inclusive of this proposal.***

**RESPONSE – QUESTION 1(b)**

NPDI confirms that the forecast 5.61% return on equity for 2011 is inclusive of the proposal to include smart meters in rate base. The calculations below detail the impact of the smart meter proposal on the return on equity for 2011.

The following table illustrates the addition of $2,515,813 in smart meter assets to the 2011 opening balance of Fixed Assets, less accumulated depreciation of $296,600 for a total increase in net fixed assets of $2,219,213.

| 2011 Rate Base Calculation - Including Smart Meters | |
|---|---|
| Net Fixed Assets Opening Balance 2011 | 50,070,158 |
| Add: Smart Meters | 2,515,813 |
| Less: Accumulated Depreciation (Smart Meters) | (296,600) |
| Adjusted Fixed Assets Opening Balance 2011 | 52,289,371 |
| Fixed Assets Closing Balance 2011 | 53,276,603 |
| Average Fixed Asset Balance for 2011 | 52,782,987 |
| Working Capital Allowance | 5,609,772 |
| **Rate Base** | **58,392,759** |

In 2011 these smart meters will depreciate $184,307 for an ending balance of $1,922,613. The total impact to 2011 rate base can be calculated as the increase to average net fixed assets in 2011:

2011 Net Fixed Assets – Smart Meters, opening balance $2,219,213

2011 Net Fixed Assets – Smart Meters, closing balance $2,034,906

Average 2011 Net Fixed Assets $2,127,060.

For the purposes of the return on equity calculation 40% of this amount would be considered deemed equity, thereby increasing deemed equity by $850,824.

In addition, with the inclusion of smart meters in rate base, NPDI has also included expenses related to smart meters in the calculation of net income. These expenses, including operating expenses, depreciation and interest are shown below.

| **Impact of Smart Meter Expenses on 2011 Net Income** | |
|---|---|
| Operating Expense | |
| ODS (Operational Data Storage) | 72,300 |
| Sensus/TGB Monthly Tower Reads | 60,000 |
| | $ 132,300 |
| Amortization Expense: | |
| Smart Meter Amortization for 2011 | 158,871 |
| Smart Meter Software Amortization for 2011 | 25,436 |
| | $ 184,307 |
| Interest Expense* | $ 69,538 |
| Total Increase in Expenses | **$ 386,145** |
| Less Tax Impact (27.86%) | $ 107,580 |
| Total Decrease in Net Income<br>Due to Inclusion of Smart Meter Expenses | $ 278,565 |

* Smart Meter Value in rate base = $2,127,060
LTD of 56% at deemed rate of 5.69% = 69,538
STD of 4% at deemed rate of 2.07% = 1,761
Total Interest expense $72,039

Based on the calculations above Net Income excluding smart meters would be increased to $1,589,520.

| 2011 Net Income - Excluding Smart Meters | |
|---|---|
| Net Income with Smart Meters Included | 1,310,955 |
| Adjustments to exclude Smart Meters | 278,565 |
| Net Income excluding Smart Meters | $1,589,520 |

Rate Base and corresponding Deemed Equity would be reduced to $56,265,699 and $22,506,280 respectively.

| 2011 Rate Base Calculation - Excluding Smart Meters | |
|---|---|
| Net Fixed Assets Opening Balance 2011 | 50,070,158 |
| Net Fixed Assets Closing Balance 2011 | 51,241,697 |
| Average Net Fixed Assets | 50,655,927 |
| Add Working Capital Allowance | 5,609,772 |
| Rate Base | $56,265,699 |
| | |
| Deemed Equity (40%) | 22,506,280 |

This would provide a return on deemed equity of 7.07%.

| ROE - Excluding Smart Meters | |
|---|---|
| Net Income | 1,589,520 |
| Deemed Equity | 22,506,280 |
| ROE - Excluding Smart Meters | 7.06% |

**QUESTION 1(c)**

***Please provide detailed derivations of the return on equity calculations for 2008 actual, 2009 actual and the 2010 Bridge year with any adjustments specified. Please ensure that these calculations are directly comparable to the 2011 calculation referenced above, or if not, please explain why.***

**RESPONSE – QUESTION 1(c)**

NPDI has replicated Sheet 5 from the Revenue Requirement Work Form (RRWF) shown above in the response to 1(a) for the years 2008 Actual, 2009 Actual, and 2010 Bridge.

| | 2010 BRIDGE | 2009 [1] | | 2008 [2] | |
|---|---|---|---|---|---|
| | At Current Approved Rates | Adjusted for Regulatory Items | Per Audited Financial Stmts | Adjusted for Regulatory Items | Per Audited Financial Stmts |
| Distribution Revenue | $10,997,878 | $10,852,474 | $11,015,722 | $9,913,395 | $9,750,148 |
| Other Operating Revenue Offsets - net | $324,000 | $428,286 | $428,286 | $418,768 | $428,348 |
| **Total Revenue** | $11,321,878 | $11,280,760 | $11,444,008 | $10,332,163 | $10,178,496 |
| Operating Expenses | $7,670,453 | $6,994,440 | $7,088,863 | $7,584,840 | $7,648,038 |
| Deemed Interest Expense | $1,753,264 | $1,733,514 | $1,270,618 | $1,494,639 | $1,346,917 |
| **Total Cost and Expenses** | $9,423,717 | $8,727,954 | $8,359,480 | $9,079,479 | $8,994,955 |
| **Utility Income Before Income Taxes** | $1,898,161 | $2,552,807 | $3,084,528 | $1,252,684 | $1,183,541 |
| Tax Adjustments to Accounting Income for 2010 (Effective Rate Not Available) | ($265,684) | $ - | $ - | $ - | $ - |
| **Taxable Income** | $1,632,477 | $2,552,807 | $3,084,528 | $1,252,684 | $1,183,541 |
| Effective Income Tax Rate | 31.00% | 29.57% | 29.57% | 52.47% | 52.47% |
| **Income Tax on Taxable Income** | $506,068 | $754,786 | $912,000 | $657,293 | $621,013 |
| **Income Tax Credits (Capital Tax)** | $39,406 | $84,500 | $84,500 | $81,000 | $81,000 |
| **Utility Net Income** | $1,352,687 | $1,713,520 | $2,088,028 | $514,391 | $481,528 |
| **Utility Rate Base** | $52,540,668 | $48,124,042 | N/A | $46,911,245 | N/A |
| Deemed Equity Portion of Rate Base * | $21,016,267 | $20,837,710 | $26,490,169 | $21,907,551 | $24,702,141 |
| Income/Equity Rate Base (%) | 6.44% | 8.22% | 7.88% | 2.35% | 1.95% |
| Approved Return on Equity | 8.57% | 8.57% | N/A | 8.57% | N/A |
| Variance from Approved ROE | -2.13% | -0.35% | N/A | -6.22% | N/A |

**1 - 2009 Adjustments**
- 2009 Distribution Revenues for "Adjusted Regulatory Net Income" have been adjusted to remove the 2008 Lost Revenue Rate Rider revenues ($163,248)
- Interest Expense has been adjusted from ACTUAL interest expense to "deemed" interest expense
- Amortization Expense (included in Operating Expenses) has been adjusted for the 1/2 year rule as per OEB Filing Guidelines for Distribution Rate Applications
- Equity has been adjusted to the Deemed Level of Equity based on 43.3% of Rate Base

**2 - 2008 Adjustments**
- 2008 Distribution Revenues for "Adjusted Regulatory Net Income" have been adjusted to add the 2008 Lost Revenue Rate Rider revenues collected in 2009 ($163,248)
- Interest Expense has been adjusted from ACTUAL interest expense to "deemed" interest expense
- Amortization Expense (included in Operating Expenses) has been adjusted for the 1/2 year rule as per OEB Filing Guidelines for Distribution Rate Applications
- Equity has been adjusted to the Deemed Level of Equity based on 46.7% of Rate Base

* For 2009 Actual and 2008 Actual, the Equity figure is the Equity figure reported in the financial statements

## QUESTION 1(d)

***Please provide the achieved return on equity for 2010 to date based on the most recent months of available actuals.***

## RESPONSE – QUESTION 1(d)

As at September 30, 2010, NPDI’s achieved estimated annualized ROE for 2010 is 6.17%.

**QUESTION 1(e)**

***Please provide the most current forecast of the 2010 return on equity if different from that contained in the application.***

**RESPONSE – QUESTION 1(e)**

NPDI completed a forecast for 2010 in November of 2010, using financial statements as of September 30, 2010. This forecast provides for a Return on Equity of 6.73% (29 points higher than the 2010 Bridge Year ROE calculated in the application). Calculations of the updated forecast and the 2010 ROE calculation as submitted in the rate application and are provided in the following table.

| | 2010 BRIDGE | 2010 FORECAST |
|---|---|---|
| | At Current Approved Rates | At Current Approved Rates |
| Distribution Revenue | $10,997,878 | $10,996,300 |
| Other Operating Revenue Offsets - net | $324,000 | $390,000 |
| **Total Revenue** | $11,321,878 | $11,386,300 |
| Operating Expenses | $7,670,453 | $7,552,394 |
| Deemed Interest Expense | $1,753,264 | $1,753,264 |
| **Total Cost and Expenses** | $9,423,717 | $9,305,658 |
| **Utility Income Before Income Taxes** | $1,898,161 | $2,080,642 |
| Tax Adjustments to Accounting Income per 2009 PILs | ($265,684) | ($39,480) |
| **Taxable Income** | $1,632,477 | $2,041,162 |
| Income Tax Rate | 31.00% | 31.00% |
| **Income Tax on Taxable Income** | $506,068 | $632,760 |
| **Income Tax Credits (Capital Tax)** | $39,406 | $39,406 |
| **Utility Net Income** | $1,352,687 | $1,408,476 |
| **Utility Rate Base** | $52,540,668 | $52,309,155 |
| Deemed Equity Portion of Rate Base | $21,016,267 | $20,923,662 |
| Income/Equity Rate Base (%) | 6.44% | 6.73% |
| Target Return - Equity on Rate Base | 8.57% | 8.57% |
| Sufficiency/Deficiency in Return on Equity | -2.13% | -1.84% |

## QUESTION 2

*... With reference to the Board's findings documented on pages 9-11 of the Hydro Ottawa Decision (Board File No. EB-2010-0133), please identify how the criteria documented in E1/T2/S1 (and in any other areas of NPDI's application) justify an early rebasing.*

**RESPONSE – QUESTION 2**

On page 10 of its Decision on the preliminary issue of early rebasing in Hydro Ottawa's 2011 cost of service rate application (EB-2010-0133), the Board sets out the following eight reasons provided by Hydro Ottawa for an early cost of service application.

1. Implementing an Asset Management Plan
2. Implementation of a Workforce planning strategy
3. Addressing declining throughput as a result of conservation and demand management
4. Conclusion of the Smart Meter program
5. Inclusion of higher return on equity in rates
6. Change in start of the rate year
7. Implementation of the Green Energy Act Plan
8. Desire to clear deferral and variance account balances

The Board's finding was as follows:

> "The Board finds that although these are reasons why a distributor might want to come in early for rebasing, none of these, either singly or taken together justify why Hydro Ottawa could not stay on the IRM framework in setting rates for another year." (EB-2010-0133, October 27 2010, p10).

NPDI's reasons for filing this cost of service application are very different from those of Hydro Ottawa, and NPDI does not believe that the Hydro Ottawa decision is or should be applicable to the NPDI application. The rationale provided in the NPDI application under Exhibit 1, Tab 2, Schedule 1 can be summarized as follows:

1. Rate Stabilization
2. Prior Board Decision
3. Rate Application Efficiency
4. Financial Need

**Rate Stabilization**

With the completion of NPDI's transformer station in 2010 NPDI's transformation services charges have declined and this will result in a significant reduction in Retail Transmission Connection Rates charged to customers. In this cost of service Application, NPDI is attempting to implement those savings for its customers now, whereas in a simple mechanistic IRM application, adjustments to the Retail Transmission Service Rates would be based simply on Board-approved revisions to the Uniform Transmission Rates. Reduced load information resulting in reduced transmission service costs would not be updated. As a result of the current NPDI cost of service application, NPDI's customers will be benefiting from the completed station both through increased reliability and reduced transmission rates, while also paying reasonable and appropriate costs related to the new station through distribution rates commencing in 2011.

In addition, in its 2010 IRM application (EB-2009-0238) NPDI proposed to delay disposition of 75% of the relevant Group 1 account balances until 2011. As discussed under the following section 'Prior Board Decision' and in the response to Energy Probe Interrogatory #7b, the rationale behind this request (which was approved by the Board) was to avoid rate volatility due to decreased rates in 2010 from a full disposition of Group 1 accounts in that year, followed in 2011 by both the removal of the disposition rate rider, plus increased distribution rates from the planned cost of service application. Rate riders for May 1, 2011 have already been approved to disburse in excess of $1 million, or more than 9% of NDPI's distribution revenue (Decision and Order, EB-2009-0238, Tariff of Rates and Charges). If NPDI's cost of service application does not proceed until 2012, rate volatility will occur at that time, with the removal of the 2011 rate riders and an increase in distribution rates from the cost of service application, thereby nullifying the rationale for the Board-approved two-year disposition of Group 1 accounts.

**Prior Board Decision**

NPDI has proposed using the 2011 cost of service application to help mitigate rate volatility as a result of clearing its deferral and variance accounts during the 2010 IRM application. The Board accepted NPDI's rationale and delayed the payment of 75% of the variance account balances until 2011, and understood that NPDI intended to submit a cost of service application for 2011 rates. The full details relating to the proposal and the Board decision can be found under Energy Probe Interrogatory #7b. Specifically the Board stated in its Decision:

> Norfolk's requested the disposition of its Group 1 account balance over a four year period. Board staff submitted that a disposition period no longer than one year would be appropriate for all Group 1 account since these balances have been accumulating over the last four year period and to delay any immediate action would not be in the interest of all parties. In its reply submission, Norfolk stated that refunding the Group 1 account balance over one year would have a significant impact on its cash flow. Norfolk also expressed concerns about rate volatility. Norfolk stated that it intends to file a 2011 cost of service application and anticipates upward pressure on rates due to rate base increase and approval to recover stranded meter costs.

> Norfolk submitted that if the Board were to disapprove a four year disposition period, the Board may wish to consider approving a two year disposition plan where 25% of the Group 1 account balances would be refunded in 2010 and the remaining amount in 2011."The Board accepts in principle Board staff's rationale for a disposition period of one year and adopts it subject to any compelling evidence that the disposition period should be lengthened. The Board finds that Norfolk's rationale for proposing to extend the disposition period is reasonable but is of the view that a four year disposition period is too long. The Board will accept Norfolk's alternative proposal to dispose 25% of the Group 1 account balances in 2010 and the remaining 75% in 2011. The Board will reflect these findings in Norfolk's draft Rate Order." (Decision and Order, April 6 2010, EB-2009-0238 p14).

As part of the 2010 IRM Decision and Order the Board approved specific rate riders for both 2010 and for 2011 (effective May 1 2011 to April 30, 2012), to reflect this Decision. The specific rate riders for 2011 can be found on NPDI's Tariff's of Rates and Charges (EB-2009-0238) under each applicable customer class.

NPDI believes that this decision to set aside the accepted principle of a one year disposition period, due to rate fluctuations from the early 2011 cost of service application, represents that NPDI would be making the application. NPDI believes the 2011 rates were specifically set by the Board, as NPDI requested, to help mitigate the increase in rates coming from its intended cost of service application. Moreover given that the Board set aside its accepted principle, and adjusted the rates, based on NPDI's stated intention to file the COS application, NPDI believes it now has an obligation to file the application. Given that that the 2011 disposition rate riders are already approved, if NPDI were to wait until 2012 to file a cost of service application, it would again be faced with significant rate volatility from decreased rates in 2011 and increased rates in 2012, and this would appear inconsistent with the Board's rationale in approving the two-year disposition.

For this reason NPDI does not believe the Ottawa decision applies to its application. This is similar to the Board's Findings on the preliminary issue for Horizon in EB-2010-0131, where it stated:

> However, the Board finds that it was reasonable for Horizon to believe that the Board would accept a cost of service application from Horizon at this time. Therefore the Board finds that the considerations in the April 20th Letter and the Hydro Ottawa decision do not apply to this application (EB-2010-0131, December 15, 2010, p6).

## Rate Application Efficiency

NPDI has submitted it will be more efficient to proceed with a cost of service application at this time, followed by a simpler IRM application in 2012 rather than file an IRM in 2011, along with applications for LRAM, Retail Transmission Rates reflecting updated transmission connection costs, Smart Meters and an Incremental Capital Module; to be followed with a full cost of service application in 2012.

In its Application, NPDI stated:

> "NPDI recognizes that the IRM application contemplates the possibility of an incremental capital module to help address the increased capital spending. However the IRM application would have become complex. " (NPDI COS Application, October 28 2010, EB-2010-0139 E1,T2, S1 P.4)

The IRM application would have been complex due to the inclusion of each of the LRAM/SSM, Retail Transmission Rate, and Smart Meter applications and an Incremental Capital Module. The retail transmission rate application adds complexity due to its departure from the standard IRM application process in order to reflect the true cost of transmission connection from reduced load at transformer stations not owned by NPDI. The Incremental Capital Module adds complexity on its own as NPDI would anticipate filing an ICM application which would address capital needs in 2010 and 2011. NPDI notes that previous ICM applications have resulted in a oral hearings, and believes it is likely an oral hearing would be required if it filed an ICM application for 2011. This would be a complex and costly process, which would include intervenor participation and costs. In addition, each individual application itself may not be overly complex, but all of them combined increase the complexity of what is supposed to be a mechanistic IRM application. NPDI believes that it is more cost effective and efficient to account for all of these applications now within a cost of service application, followed by a simple IRM application in 2012, rather than to address these as part of an IRM application, or separate applications in addition to the IRM application, followed by a cost of service application in 2012.

## Financial Need

On May 31, 2010 NPDI submitted a letter to the Board confirming its intention to file a cost of service application for May 2011 rates. In that letter NPDI stated it expected to earn less than its approved ROE, by more than 300 bps for the year 2011. Between the time of the letter and the submission of the application, revisions to expected expenditures in 2011 reduced this amount to 296 basis points.

Other LDCs, including the comparator, have indicated the need to finance future capital spending requirements. NPDI also anticipates significant capital expenditures to replace aging assets. In addition, since the last cost of service application NPDI's rate base has increased 21% and this increase is not being recovered in current rates. While the dollar values may appear small compared to other LDCs, based on NPDI's size, the capital spending requirements are just as great.