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January 29, 2008

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

Attention: Kirsten Walli
Board Secretary

Re: 2008 Electricity Distribution Rates (EDR), EB-2007-0713
Consolidated Document for Oral Hearing

Attached please find a consolidation of all documents that are relevant to Hydro Ottawa's oral hearing to be held February 4th, 2008, as required in the Regulatory Electronic Submission System (RESS) Document Guidelines, Page 20 of 42. The consolidated document includes the following, all of which are already on the record:

Exhibits A1-11-1 updated, A1-11-2 updated, A2-2-2, B1-3-1 and attachments, B3-2-2, D1-1-1, D1-1-4
Board Staff Interrogatories #28, 29
Schools Energy Coalition Interrogatories #17, 18, 32
Vulnerable Energy Customer Coalition Interrogatories #23-26, 28, 29, 38, 41, 42
PricewaterhouseCoopers LLP Opinion
Enersource (EB-2007-0706) Exhibits A-3-1, B-2-1 and Interrogatory Response #22 in Exhibit J-E

Two hard copies of the consolidated document have been couriered to the Ontario Energy Board offices. 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

LIST OF WITNESSES

Hydro Ottawa proposes the following Witness Panel for the oral hearing on Issue 3.4 as described in the Board's Procedural Order No. 2. The Curricula Vitae for these witnesses are presented in Exhibit A1-11-2.

Lynne Anderson, BSc., MBA
Michael Grue, CMA
Doug Shannon, CA

CURRICULUM VITAE OF
LYNNE M. ANDERSON, BSc. MBA

Experience:

Hydro Ottawa Limited

Chief Regulatory Affairs & Government Relations Officer - December 2006 to present
Director/Manager, Regulatory Services - November 2001 to December 2006
Manager, Records - November 2000 to November 2001

Nepean Hydro

Manager, Customer Service - February 1995 to November 2000

Ontario Hydro

Account Manager - May 1991 to February 1995

St. Lawrence College

Teaching Master - November 1987 to May 1991

General Motors

Plant Engineer - May 1984 to November 1987

Education:

- Bachelor of Applied Science (Electrical Engineering), Queen's University, 1984
- Master of Business Administration, Queen's University, 1994

Appearances:

Smart Meter Combined Proceeding, EB-2007-0063
Hydro Ottawa 2006 EDR, EB-2005-0381

CURRICULUM VITAE OF
MICHAEL GRUE, CMA

Experience:

Hydro Ottawa Limited

Treasurer - 2000 to present

In addition to treasury functions, responsibilities include corporate budgeting and financial forecasting, including the determination of internal allocations and the capitalization of overheads.

Ottawa Hydro

Special Projects - 1999 to 2000

The Regional Group

Controller - 1987 to 1998

Statesmen Management & Realty

Controller - 1985 to 1986

Duckworth, Price & Henderson

Chief Accountant - 1984

Coopers & Lybrand

Staff Accountant - 1981 to 1983

Education:

- Business Administration Accounting Major, Southern Alberta Institute of Technology, 1981
- Certified Management Accountant, 1983

Appearances:

Hydro Ottawa 2006 EDR, EB-2005-0381

CURRICULUM VITAE OF DOUG SHANNON, CA

Experience:

Hydro Ottawa Limited

Director, Finance – March 2006 to present

Responsible for overall financial planning and reporting for the company. Supply Chain and Facilities functions were added responsibilities as at March 30, 2007.

Hydro Ottawa Holding Inc.

Director Corporate Audits - November 2000 to March 2006

Responsible for the Internal audit function for the enterprise group of companies.

Regional Municipality of Ottawa Carleton - Environment and Transportation Dept.

Manager / Director, Finance and Operations Support - 1993 to November 2000

Professional Accreditations & Education:

- Chartered Accountant
- Certified Fraud Examiner
- Bachelor of Commerce (Hons.), Carleton University, 1975

Appearances:

Smart Meter Combined Proceeding EB-2007-0063

CHANGES IN METHODOLOGY

1.0 INTRODUCTION

There are two areas in which methodologies have been changed from 2006, the year of the last rate application, to 2008. Following is a description of these changes.

2.0 LOAD FORECAST

As described in Exhibit C1-2-1, Hydro Ottawa has revised its methodology for forecasting load and customer growth. In 2006, a competitive process was used to select a new statistical modelling software (*Metrix ND* by Itron). While the previous methodology had been quite effective, the decision to change the methodology was made to include more rigorous statistical analysis and weather correction.

3.0 CAPITALIZATION

Hydro Ottawa has completed a review of its Capitalization Policy and its Cost Allocation Rates Policy as filed with the Board in the 2006 EDR Application. The result of this review is two-fold: updated accounting estimates used to determine the appropriate capitalization of overhead costs and a simplified allocation methodology. Details are provided in B1-3-1 together with the Capitalization Policy that has been updated to reflect the new estimates and the new Cost Allocation Rates Procedure. The impact on capital expenditures is described in Exhibit B3-2-2 and the impact on Operations, Maintenance and Administration costs is described in Exhibits D1-1-1 and D1-1-4.

CAPITALIZATION POLICY AND ALLOCATION PROCEDURE

Hydro Ottawa's management undertook a review of its Capitalization Policy and its Cost Allocation Rates Policy in April 2007. The former became effective on July 26, 2005; a copy is attached (Attachment P). The latter became effective on January 1, 2004; a copy is also attached (Attachment Q).

The review was triggered by the Rate-Regulated Operations Exposure Draft, which the Canadian Institute of Chartered Accountants ("CICA") released in March 2007. This document proposed to remove from the CICA Handbook all paragraphs that provide recognition and measurement guidance to rate-regulated entities. Management was concerned that the removal of these paragraphs would also remove Hydro Ottawa's flexibility, as a rate-regulated entity, to capitalize indirect or overhead costs compared to other entities.

Management accordingly began to assess the impact that the Exposure Draft might have on its two policies. The policies had been in place for a number of years so the release of the Exposure Draft coincided with the appropriate timing for a review of these policies in any event. This review by Management indicated that these accounting estimates were outdated. Management questioned the capitalization of overhead costs that are "directly attributable" to the construction or development of property, plant and equipment; see paragraph 3061.20 of the CICA Handbook. There is no definition, however, of the term "directly attributable" in the CICA Handbook.

Deloitte and Touche ("D&T") was retained to assist management by researching how overhead costs are capitalized in other jurisdictions. Management submitted a report in this regard dated May 15, 2007 to Hydro Ottawa's Audit Committee; a copy is attached (Attachment R).

D&T's report dated June 8, 2007 ("D&T Report") concluded that, historically, capitalization of overhead by North American utilities has been aggressive. There has

been a shift, however, toward more conservative polices in the U.S. and, in Canada, "a shift towards more narrow definitions in terms of the types of costs which can be capitalized" (p.8); a copy of the D&T Report is attached (Attachment S).

Management then instructed Hydro Ottawa's staff to conduct an informal web-based review to determine how other utilities interpret "directly attributable" as the term applies to overhead costs. Staff considered two reports prepared by KPMG to be the most relevant and current.

Management accordingly retained KPMG to assist in a review to update Hydro Ottawa's accounting estimates of the amount of overhead costs directly attributable to its capital program. The review and update resulted in accounting estimates that are based on three allocation factors or "cost drivers". It also resulted in a simplified allocation methodology that does not affect the amounts of overheads costs that are capitalized; however, it does affect the classification of costs within the envelope of Operations, Maintenance & Administration ("OM&A") costs. The capitalization and allocation policies were reviewed and updated to reflect any necessary changes as a result of this process. This review indicated that the updated allocation policy was a procedure, rather than a policy, and it was renamed accordingly.

KPMG prepared a report dated August 16, 2007 ("KPMG Report"); a copy is attached (Attachment T). KPMG has concluded that Hydro Ottawa's updated accounting estimates adhere to the following principle: any assignment of indirect costs to a capital project should be done based upon some reasonable causal link or association with the capital activity. KPMG has also concluded that the allocation factors are based on a defensible cost causation linkage.

Management submitted another report to Hydro Ottawa's Audit Committee dated August 21, 2007 together with the updated Capitalization Policy and the updated but renamed Allocation Procedure; a copy of the report is attached (Attachment U). The Audit

Committee accepted both the policy and the procedure; a copy of each is attached (Attachments V and W respectively).

The changes in the accounting estimates and the methodology for allocating overhead costs have been reflected in the Cost Allocation Procedure. Hydro Ottawa's Capitalization Policy has been updated accordingly; the update is not a change in accounting policy.

The new Allocation Procedure – "Cost Allocation Rates" – replaces the previous Cost Allocation Rates Policy. This procedure reflects the simplified methodology using three Burden Rates to capitalize overhead costs.

The resultant level of capitalized overhead is significantly lower than it would have been under the prior accounting estimates: $10.6M compared to $4.1M, or a decrease of approximately $6.5M, for 2008. There is a corresponding increase in the OM&A costs for 2008.

This change has the effect of increasing Hydro Ottawa's service revenue requirement for 2008. This increase is estimated as follows:

Operating Costs	+$6.5M
Amortization Expense (assuming 25 year assets on average)	-0.1M
Return on rate base	-0.2M
Estimated Change in Service Revenue Requirement	+$6.2M

A $6.2M increase represents a 4% increase in the 2008 service revenue requirement.

Hydro Ottawa expects the annual amount of capitalized overhead will continue at approximately the 2008 level for the foreseeable future. So too then would the correspondingly effect on OM&A costs.

Hydro Ottawa plans to implement the updated Capitalization Policy and the updated but renamed Allocation Procedure on October 1, 2007 because timely implementation is a requirement under the CICA Handbook. The resultant effect in the last quarter of 2007 is that approximately $1.5M to $2.0M of overhead costs will be charged to operating expenses instead of being capitalized. Hydro Ottawa has accordingly applied to the Board for approval to establish the related variance account; see its letter application dated September 14, 2007.

Hydro Ottawa has compared its 2008 OM&A costs with the 2006 OM&A costs of the 10 largest LDCs in the province from the data published by the Board in the 2006 Yearbook for Electricity Distributors dated August 31, 2007. The results follow in Table 1. As can be seen, Hydro Ottawa's proposed OM&A cost per customer for 2008 is roughly equal to the 2006 average OM&A cost per customer for the 10 largest LDCs and well under the 2006 OM&A cost per customer when all LDCs are considered.

Table 1 – OM&A Costs per Customer Comparison

	Enersource Hydro Mississauga	Enwin Powerlines	Horizon Utilities	Hydro One Brampton	Hydro One Networks	Kitchener-Wilmot Hydro	PowerStream	Toronto Hydro Electric System	Veridian Connections	Hydro Ottawa 2006	Average 2006 Largest 10	Average 2006 All	Hydro Ottawa 2008 (excluding Smart Meters)
OM&A ($000)	$43,210	$21,730	$34,258	$16,090	$393,558	$11,994	$38,300	$159,542	$19,805	$45,703			$58,588
Number of Customers	182,596	84,701	231,499	120,364	1,163,961	80,940	228,471	678,106	107,231	282,393			293,220
OM&A per Customer	$237	$257	$148	$134	$338	$148	$168	$235	$185	$162	$201	$235	$200

Policy Number: FIN5-001.01	**Subject:** Capitalization
Effective Date: July 26, 2005	**Policy Owner:** VP Finance

Applicability
This policy applies to the capitalization of assets for Hydro Ottawa Limited.

Purpose
This policy describes the process and specific criteria used for determining if expenditures should be capitalized on the Balance Sheet or expensed to operations in the period incurred.

Expenditures are capitalized to ensure that there is an equitable allocation of costs among existing and future customers. Assets are expected to provide future economic benefits for more than one year. Any expenditure associated with the acquisition, construction, development or betterment of an asset should be capitalized and allocated over the useful life of the asset.

Guidelines
Tangible Assets
Property, plant and equipment are identified as tangible assets provided that they are held for use in the production or supply of goods and services, are intended for a continuing use, and are not intended for sale in the ordinary course of business.

Intangible Assets
An intangible asset is an asset that lacks physical substance.

Goodwill
When an asset is acquired for a cost over and above the net amount of the acquired assets and assumed liability, the excess cost is considered goodwill.

Capital Assets
Capital assets include tangible and intangible assets, exclusive of goodwill.

Betterment
A betterment is a cost which is incurred to enhance the service potential of a capital asset. Expenditures for betterments are capitalized. This enhancement in service potential can include an increase in the physical output or service capacity, decrease in associated operating costs, extension in the useful life of the asset, or improvement in the quality of the asset's output.

Repair
A repair is a cost which was incurred to maintain the service potential of a capital asset. Expenditures for repairs are expensed in the period in which they occurred.
Development
The development of an asset includes work to prepare an asset for further capital work and would typically include development of a piece of land for construction of a transformer station or other distribution plant.
Materiality
All additions to capital and betterments will be capitalized subject to materiality limits as set out in this policy. At times the administrative costs of capitalizing an asset may outweigh the intended benefits. While an expenditure may meet the definition to qualify as a capital asset, a level is set, which if an expenditure falls below, it is not capitalized. This level is known as a materiality limit.

Policy Number: FIN5-001.01	**Subject:** Capitalization
Effective Date: July 26, 2005	**Policy Owner:** VP Finance

Materiality Limit
For identifiable assets the materiality value for capitalization for new assets or addition to existing assets will be $500.00 for distribution plant and $200 for general plant.

For grouped assets the value for capitalization will be $1000.00 based on a single occurrence for distribution plant and $200.00 for general plant. Where programs are established for ongoing betterment work this minimum will not be applicable.

Readily Identifiable Assets (Discrete)
An identifiable capital asset has a unit cost sufficiently high, and is easily indentifiable, for the asset to be individually tracked and recorded.

Grouped Assets
For efficiency, capital assets may be grouped if, by their nature, it would be impractical to identify individual units. These grouped assets are managed as a pool for the purposes of amortization.

Cost
Cost is the amount of consideration given up to acquire, construct, develop or better a capital asset. Capital assets will be recorded at the fully allocated cost including AFUDC if applicable.

Fully Allocated Costs
Fully allocated costs include all expenditures necessary to put a capital asset in service including all overhead costs based on full absorption costing.

Capital Related Overhead Expenses
Per Allocation Policy
Allowance For Funds Used During Construction
For projects with a construction duration of greater than 2 months a financing charge will be applied against the project and capitalized. The financing charge will be at the rate deemed by the Ontario Energy Board (OEB) for rate-setting purposes.

Depreciation
Capital assets are generally depreciated based on a method and life set by the OEB which is considered a suitable indicator of estimated useful life for our industry. Large and unique capital expenditures will be reviewed on an individual basis to determine the expected life and appropriate method of depreciation.

Capital Spares
Spare transformers and meters will be accounted for as capital assets since they form an integral part of the reliability program for a distribution system. Spare transformers and meters are held for the purpose of backing up transformers and meters in service in the existing distribution system. Transformers and meters received for the purpose of expanding the distribution system will only be capitalized once they are put into service and will remain in inventory until that time.

Policy Number: FIN5-001.01	**Subject:** Capitalization
Effective Date: July 26, 2005	**Policy Owner:** VP Finance

Extraordinary Items
Extraordinary items will be identified separately provided that they exceed the materiality threshold set by the OEB. Recovery of extraordinary items through rates as a Z factor expense will follow OEB guidelines.

Other
Capital contributions paid to Hydro One for upgrades to the transmission system will be capitalized for inclusion in a future rate base, or recorded as directed by the OEB.

Approval Levels
As per Procurement Policy

Policy Compliance
All current practices will comply with the Accounting Procedures Handbook issued by the OEB and CICA handbook. There will be no exceptions to the requirements of this policy in the execution of day-to-day business. Employees must report incidents of non-compliance relating to this policy in a timely manner to the Policy Owner. Non-compliance issues of a serious nature will be immediately reported to the Chief Operating Officer. Determination of "non-compliance issues of a serious nature" will be the responsibility of the Policy Owner.



Acting Chief Operating Officer | Policy Owner | Vice President Finance

Hydro Ottawa Limited

POLICY AND PROCEDURE MANUAL

Policy Number:	Subject: **COST ALLOCATION RATES**
Effective Date: January 1, 2004	Policy Owner: Vice-President, Finance

Applicability

This policy applies to the costing of all Hydro Ottawa activities

Purpose

Hydro Ottawa's regulator, the Ontario Energy Board requires Local Distribution Companies to follow full absorption accounting practices. This requires indirect corporate overhead costs (HR, IT, and Facilities), and direct operating department overhead costs to be recovered over the three major work activities of the corporation, which are:

- Maintenance
- Capital
- Work for others

This will ensure that these three major work activities are fairly and fully costed and that the Balance Sheet and Profit and Loss Statements of the Corporation reflect appropriate values.

The allocation of these overhead costs will be accomplished by applying a series of burden or overhead rates to direct costs as detailed below.

Guidelines

Separate allocation rates will be determined for the following activities:

Direct Labour Rate

An hourly labour rate will be developed which recovers direct labour, benefits, non productive time costs, corporate overheads, and operations overheads. It will be applied to all direct labour hours charged to maintenance, capital, and work for others through timesheet reporting.

Engineering Rate

An Engineering burden rate will be developed which recovers the direct cost of the Engineering Department and its share of corporate overheads. It will be applied to Distribution Capital projects and Work For Others where applicable.

Vehicle and Equipment Rates

Vehicle and equipment burden rates will be developed to capture the full costs associated with usage (maintenance, fuel, license, insurance, corporate overheads, depreciation, fleet

overheads). Individual rates will be developed for major vehicle classifications based on expected utilization. Broad category rates will be developed for estimation purposes. Charges to the three major work activities will be accomplished through vehicle timesheet reporting.

Supply Chain Rate

A Supply Chain burden rate will be developed to charge all stock, non-stock, and outside services transactions to fully recover the costs charged to the Supply Chain area including its share of the corporate overheads.

General Plant Labour Rate

A General Plant burden rate will be developed for labour charged to general plant capital projects that will recover an appropriate share of corporate overheads.

Administrative Costs Rate

An Administrative Costs burden rate will be developed which charges all direct work (Maintenance, Distribution Capital, General Plant Capital, Work for Others) with their fair share of Finance and Corporate Costs (Communications, Corporate Costs, Holdco charges)

Customer Service and Marketing

These two areas will be directly charged for their share of all corporate overheads.

Procedures

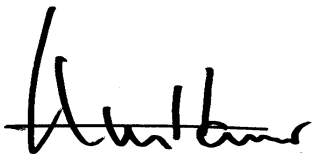
New Burden rates will be developed by the Finance Department each year in conjunction with the development of the following year's budget. They will be used to develop the budgets and applied in the JD Edwards accounting system commencing on January 1 of the budget year.

Recoveries against actual costs will be monitored during the year as part of the forecast management process.

True-ups will be completed on an annual basis at a minimum.

Policy Compliance

Any exceptions to the requirements of this policy must be approved by the Chief Operating Officer and disclosed as an addendum to the policy.



Anthony Haines – Chief Operating Officer

Stephen Thompson – VP Finance

HYDRO OTTAWA LIMITED
HYDRO OTTAWA LIMITÉE

REPORT
RAPPORT

May 15, 2007

TO/DEST. Chair and Members of the Audit Committee

Agenda Item 3 CAPITALIZATION POLICY AND COST ALLOCATION RATES POLICY

RECOMMENDATION

The Audit Committee receive this report for information.

SUMMARY

1) The purpose of this report is to provide the Audit Committee with an update on Hydro Ottawa Limited's (HOL) current accounting treatment of indirect (overhead) costs and their inclusion within the cost allocation rates policy and the capitalization policy. Pending changes in this area are also discussed.

BACKGROUND

2) HOL considers its capitalization of overheads in conformance with Generally Accepted Accounting Principles (GAAP). Canadian Institute of Chartered Accountants (CICA) Handbook section 3061.20 states that "The cost of an item of property, plant and equipment includes direct construction or development costs and overhead costs directly attributable to the construction or development." This principle is similarly applied in US Financial Accounting Standards (FAS). CICA Handbook section 1100 speaks to the use of accounting standards from other jurisdictions as further guidance to CICA primary sources of GAAP. Currently, rate regulated entities are provided with an exemption to the application of Section 1100, as CICA Handbook paragraph 1100.34 states that "...an entity is not required to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulations..."

3) HOL is a capital-intensive company with the majority of its expenditures being earmarked for capital projects and the subsequent ongoing maintenance of these assets. Historically it has always applied "burden" rates to its projects/programs as

do most entities in the utility sector. Each utility has its own policies in this regard and determines what costs qualify for capitalization.

4) HOL completed a project in 2003 to review its capitalization process and develop associated polices, which are applied in the formulation of its annual audited statements.

5) The development of the allocation model also considered Ontario Energy Board (OEB) prescribed accounting guidelines within its Accounting Procedures Handbook (APH), specifically articles 230 – Definitions & Instructions, Article 340 – Allocation of Costs & Transfer Pricing and Article 410 – Capital Assets. These guidelines are designed to satisfy regulatory reporting requirements and do not necessarily follow GAAP although the CICA Handbook is referred to as the underlying principle.

6) Deloitte & Touche reviewed the allocation model and related policies in July of 2004. They found the model was working as intended. The capitalization policy and allocation model have remained consistent to date.

INDUSTRY PRACTICE

7) Currently there are no "across the board standard industry practices" regarding the accounting for overheads within a capitalization policy. Depending on corporate structures, past practices, and provincial Regulator oversight, the inclusions/exclusions can vary from company to company. Most utilities do not publicly disclose in detail their process of capitalization. The OEB Accounting Procedures Handbook (APH) articles provide guidance but not definitive rules on the components of construction costs. In 2005 the CICA issued an Accounting Guideline on Disclosures by Entities subject to Rate Regulation (AcG-19) requiring note disclosure on the differences between GAAP and rate regulated accounting. In the area of overhead capitalization, Hydro Ottawa Limited, similar to other utilities felt they did not need to disclose overhead capitalization practices as they conformed to GAAP for entities subject to rate regulation.

NEW DEVELOPMENTS

8) EXPOSURE DRAFT

The CICA released a Rate Regulated Operations Exposure Draft in March 2007, which proposes to remove CICA Handbook paragraph 1100.34 and eliminate from all other Accounting Sections of the CICA Handbook any paragraphs that provide recognition and measurement guidance to rate regulated entities. It is felt that the Handbook wants to remain silent on rate-regulated entities as a result of the expected convergence with International Accounting Standards (IAS) by 2011. There is a perception that rate-regulated entities are afforded more leeway in the capitalization of indirect costs and that if CICA Handbook paragraph 1100.34 is

removed the increased flexibility to capitalize indirect costs is removed. AcG-19 will continue to provide disclosure guidance to rate regulated entities.

The Accounting Standards Board (AcSB) plans to finalize the proposals in this exposure draft by the end of 2007 and has indicated it expects implementation for fiscal years beginning on or after January 1, 2009.

In the interim before the move to International Accounting Standards, there is a suggestion that Canadian entities follow the US accounting standard on the Accounting for the Effects of Certain Types of Regulation (FAS 71). Depending on interpretation, this standard is perceived to be close to current Canadian GAAP.

9) 2008 ELECTRICAL DISTRIBUTION RATE APPLICATION

HOL is currently preparing a budget for 2008 –2010 to support its upcoming rate application. It is critical that this rate application appropriately reflect HOL's future policy on the allocation of overheads to capital, since it will be these costs that determine the utility's future revenue stream. This application is due by August 15, 2007.

FINANCIAL IMPLICATIONS

10) Now that the CICA has issued its Rate Regulated Operations Exposure Draft, HOL is assessing the potential impact it may have on its capitalization methodology and financial position. Currently, approximately 50% to 60% of HOL indirect costs are capitalized.

($ millions)

Indirect Costs (1)	**P&L Expense**	**Capital Allocation** (2)	**Total**
IT	1.4	1.6	3
HR	1.6	1.9	3.5
Finance	1.4	1.8	3.2
Holdco	0.9	1.0	1.9
Corporate	0.9	1.0	1.9
Facilities	1.8	2.2	4
Operational G&A	0.9	$1.1	2
Total	**$8.9M**	**$10.6M**	**$19.5M**

(1) Indirect Costs based on budget numbers for 2007.
(2) Used an average 55% capitalization rate in calculation.

If all the exposure draft proposals are implemented HOL will most likely have to conform to the more conservative capitalization policies of non-rate regulated entities.

At issue is the interpretation of "directly attributable" as it relates to indirect or overhead costs. HOL has strong arguments for a portion of Facility and

Operational general and administration (G&A) costs being directly attributable to capital projects. However it is more difficult to establish that IT, HR, Finance, Holdco and Corporate costs are directly attributable to capital projects. HOL plans to review capitalization practices of non-rate regulated entities to see how they interpret "directly attributable".

Preliminary analysis performed by HOL indicates that the percentage of indirect costs currently capitalized may decrease thereby increasing the amount of indirect costs expensed to the P&L. This would translate into increased rates for the ratepayer and increased cash flow for HOL, provided the OEB approves the capitalization policy amendments. Generally, a $4M increase in expenses translates to a 1% increase to the ratepayer's overall hydro bill.

NEXT STEPS

11) There appears to be a move towards more conservative accounting standards in Canada and in many other jurisdictions. Therefore, it is possible that some indirect costs, which are currently capitalized under GAAP by non-rate regulated entities, could also be disallowed in the future thereby compounding the impact on rate-regulated entities.

Presently, HOL is assessing the impact the exposure draft will have on its capitalization methodology and financial position. The assessment will include FAS and IAS guidance in this area. HOL has also commissioned Deloitte & Touche to research how indirect costs are capitalized in other jurisdictions.

Recommended by:

Wojciech (Wojo) Zielonka
Chief Financial Officer

Approved for submission to the Audit Committee:

Rosemarie T. Leclair
President and Chief Executive Officer

exposure draft

ACCOUNTING STANDARDS BOARD
PROPOSED ACCOUNTING STANDARDS

Rate-Regulated Operations

March 2007

COMMENTS MUST BE RECEIVED BY JUNE 30, 2007

This Exposure Draft of proposed accounting standards is issued by the Accounting Standards Board. The Board is composed of persons knowledgeable in the preparation and use of financial statements who are drawn from public practice, business and academe. All members serve as individuals and not as representatives of their employers or organizations.

Individuals and organizations are invited to send written comments on the Exposure Draft proposals. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.

Comments are most helpful if they are related to a specific paragraph or group of paragraphs, and, when expressing disagreement with the Exposure Draft, they clearly explain the problem, and include a suggested alternative supported by specific reasoning. All comments received will be available on a public file one month after the Accounting Standards Board has discussed the comment letters, unless confidentiality is requested.

To be considered, comments must be received by June 30, 2007, addressed to:

Peter Martin, CA
Director, Accounting Standards
Accounting Standards Board
277 Wellington Street West
Toronto, Ontario M5V 3H2

For ease of handling, we prefer comments to be sent by e-mail (in Word format) to:
ed.accounting@cica.ca

"Standards need not be applied to immaterial items. While materiality is a matter of professional judgment in the particular circumstances, the Board believes that, as a general rule, materiality should be judged in relation to the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is deemed to be material if it is probable that its omission or misstatement would influence or change a decision."

(Introduction to Accounting Standards — CICA Handbook – Accounting)

Highlights

The Accounting Standards Board (AcSB) proposes, subject to comments received following exposure, to remove from GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, the temporary exemption pertaining to the application of the Section to the recognition and measurement of assets and liabilities arising from rate regulation, and eliminate from other Sections of the CICA Handbook – Accounting all recognition and measurement guidance relating specifically to rate-regulated operations. ACCOUNTING GUIDELINE AcG-19, Disclosures by Entities Subject to Rate Regulation, would be amended as necessary as a result of this proposal, and retained.

Background

In March 2002, the AcSB approved a project examining the need to modify existing Canadian accounting standards to deal specifically with the unique characteristics of rate-regulated operations. The project was undertaken as a domestic project, not intended specifically as part of the AcSB's efforts (under its previous Strategic Plan) to support the international convergence of accounting standards while harmonizing with US GAAP.

The AcSB made continued progress on the project, deliberating the key issues and seeking stakeholder input as appropriate to better understand the nature of rate regulation in Canada and its economic effects on entities subject to rate regulation. In May 2005, the AcSB issued AcG-19 to improve disclosures by entities subject to rate regulation pending completion of the project.

Following the adoption of its Strategic Plan for the period 2006-2011, the AcSB considered the Plan's implications for the AcSB's current work program and concluded that the project, as it was originally envisaged, should be discontinued. The decision to discontinue the project required further decisions by the AcSB regarding the disposition of existing Handbook guidance relating specifically to rate-regulated operations. The proposals described in this Exposure Draft reflect the AcSB's decisions in this regard.

Proposals

The Exposure Draft proposes to:

(a) remove the temporary exemption in Section 1100 pertaining to the application of that Section to the recognition and measurement of assets and liabilities arising from rate regulation; and

(b) withdraw from the Handbook all other recognition and measurement guidance relating specifically to rate-regulated operations. Such guidance is found in CONSOLIDATED FINANCIAL STATEMENTS, Section 1600, PROPERTY, PLANT AND EQUIPMENT, Section 3061, INCOME TAXES, Section 3465, and DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475.[1]

The Exposure Draft also proposes that AcG-19 be retained after the consequential amendments indicated at the end of the document.

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[1] Other Sections that mention rate-regulated operations do not provide recognition and measurement guidance relating specifically to this sector, and are unaffected by this proposal.

These proposals should be read in conjunction with the accompanying Background Information and Basis for Conclusions document.

Plans for finalizing the proposals

The AcSB will redeliberate these proposals to take into account comments received on this Exposure Draft. The AcSB will provide updates about its redeliberations on its website at www.acsbcanada.org.

These proposals are expected to be finalized in the fourth quarter of 2007, to be applicable to interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009.

Comments requested

The AcSB welcomes comments on all aspects of the proposals. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, and, when expressing disagreement with the Exposure Draft, they clearly explain the problem, and include a suggested alternative supported by specific reasoning.

The AcSB particularly welcomes comments on the following questions concerning the proposals:

1. Do you agree with the proposed elimination from Canadian GAAP of all recognition and measurement guidance relating specifically to rate-regulated operations? If not, why not?

2. Do you agree that AcG-19 should be amended as proposed, and retained? If you do not agree that it should be retained, why not? If you do not agree with the proposed amendments, what changes would you suggest and why?

3. Do you agree with the effective date for the proposed amendments to Sections 1100, 1600, 3061, 3465 and 3475, and that the proposals should apply to both interim and annual financial statements for periods beginning on or after that date? If not, what alternative(s) do you propose and why?

4. Do you agree that the effect of any changes in accounting policy required as a result of the proposal to remove the temporary exemption in Section 1100 should apply prospectively, in accordance with paragraph 1100.33? If not, what alternative do you propose and why?

5. Do you agree that when initially applying Section 1100 to the recognition and measurement of assets and liabilities arising from rate regulation, and when this results in a change in the accounting for such assets and liabilities, entities should be required to repeat the disclosures made in the comparative period under paragraph 8 of AcG-19, in order to assist financial statements users in performing a comparative analysis? If not, why not?

Rate-Regulated Operations

PROPOSAL

The following Handbook material would be amended as indicated below. Additional text is denoted by underlining and deleted text by strikethrough. Paragraphs that do not contain changes have been omitted.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100

.32 This Section applies to fiscal years beginning on or after October 1, 2003, except as specified in paragraph 1100.32B ~~except in the circumstances described in paragraph 1100.34~~. Earlier adoption is encouraged.

.32B This Section applies to the recognition and measurement of assets and liabilities arising from rate regulation in interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009. Upon initial application of this Section to assets and liabilities arising from rate regulation, when such application results in a change in the accounting for such assets and liabilities, entities are required to repeat, in their current period financial statements, information disclosed in the comparative period under paragraph 8 of ACCOUNTING GUIDELINE AcG-19, Disclosures by Entities Subject to Rate Regulation.

~~.34 Pending completion of a separate project on rate-regulated operations, an entity is not required to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation. Entities are required to apply this Section to all other assets and liabilities for fiscal years beginning on or after October 1, 2003.~~

~~.35 An entity that chooses not to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation is required to comply with all disclosure requirements of GAAP, and to disclose the nature of the differences between its accounting policies for assets and liabilities arising from rate regulation and those required by the primary sources of GAAP.~~

~~.36 Rate regulation exists when all of the following criteria are present:~~

~~(a) The rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.~~

~~(b) The regulated rates are designed to recover the cost of providing the services or products.~~

~~(c) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition.~~

CONSOLIDATED FINANCIAL STATEMENTS, Section 1600

~~.29 Where a parent or subsidiary manufactures or constructs facilities for a regulated public utility in the consolidated group, any intercompany gain or loss is deemed to have been realized to the extent that the transfer price on such facilities is recognized for rate-making purposes by a government regulatory body.~~

PROPERTY, PLANT AND EQUIPMENT, Section 3061

~~.10 Rate-regulated property, plant and equipment are items of property, plant and equipment held for use in operations meeting all of the following criteria:~~

~~(a) The rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.~~

~~(b) The regulated rates are designed to recover the cost of providing the services or products.~~

~~(c) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for any capitalized costs.~~

.23 The cost of an item of property, plant and equipment that is acquired, constructed, or developed over time includes carrying costs directly attributable to the acquisition, construction, or development activity such as interest costs when the enterprise's accounting policy is to capitalize interest costs. ~~For an item of rate-regulated property, plant and equipment, the cost includes the directly attributable allowance for funds used during construction allowed by the regulator.~~

INCOME TAXES, Section 3465

.01 This Section establishes standards for the recognition, measurement, presentation and disclosure of income and refundable taxes in an enterprise's financial statements~~, except that certain rate-regulated enterprises may limit the application of this Section as set out in paragraphs 3465.102-.104~~. Special considerations related to the accounting for investment tax credits are dealt with in INVESTMENT TAX CREDITS, Section 3805.

.09 The following definitions have been adopted for purposes of this Section:

~~(k) A rate-regulated enterprise is an enterprise that meets all of the following criteria:~~

~~(i) the rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products;~~

~~(ii) the regulated rates are designed to recover the cost of providing the services or products; and~~

~~(iii) it is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct~~

and indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for amounts recorded as recoverable under the rate formula.

.102 ➤ *A rate-regulated enterprise need not recognize future income taxes in accordance with this Section to the extent that future income taxes are expected to be included in the approved rate charged to customers in the future and are expected to be recovered from future customers. If future income taxes are not recognized in accordance with this Section, the rate-regulated enterprise should disclose the following, in addition to the information to be disclosed in accordance with paragraphs 3465.91-.92:*

(a) the reason why future income tax liabilities and future income tax assets have not been recognized, and

(b) the amount of future income tax liabilities, future income tax assets and future income tax expense that have not been recognized.

.103 Pending further study of accounting for rate-regulated enterprises as a whole, rate-regulated enterprises are not required to record future income taxes for temporary differences that arise from assets and liabilities relating to their rate-regulated activities to the extent that these future income taxes will be included in the rates charged to customers in the future and will be recoverable at that time as set out in paragraph 3465.102.

.104 Future income taxes would be recognized in accordance with the remainder of this Section to the extent that future income taxes are not expected to be included in the rates charged to customers in the future. In addition, a rate-regulated enterprise that chooses to recognize future income taxes despite the expectation that they will be included in the rates charged to customers in the future would recognize all future income tax liabilities and future income tax assets in accordance with the requirements of this Section.

DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475

.03 The following terms are used in this Section with the meanings specified:

(d) Rate-regulated long-lived assets are long-lived assets held for use in operations meeting all of the following criteria:

(i) The rates for regulated services or products provided to customers are established by or subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.

(ii) The regulated rates are designed to recover the cost of providing the services or products.

(iii) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct or indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for any capitalized costs.

~~.26 For rate-regulated operations, the regulator may require the difference between net carrying amount and the proceeds on disposal of a long-lived asset to be considered in the determination of future rates charged to customers. In such circumstances, the difference is deferred, provided there is reasonable assurance that:~~

~~(a) any excess of net carrying amount over proceeds on disposal will be recovered through future rates; or~~

~~(b) any excess of proceeds on disposal over net carrying amount will serve to reduce future rates.~~

CONSEQUENTIAL AMENDMENTS

ACCOUNTING GUIDELINE AcG-19, Disclosures by Entities Subject to Rate Regulation

AcG-19 would be modified as follows to:

(a) remove references to Handbook guidance that the Exposure Draft proposes be eliminated;

(b) clarify that paragraph 1 of the Guideline is not to be interpreted as providing a definition of rate-regulated operations that may be used for recognition and measurement purposes once current Handbook definitions relating specifically to rate-regulated operations have been eliminated; and

(c) remove from the Illustrative Example the hypothetical description of an entity's accounting for income taxes, since this accounting would not likely be followed if the proposals are adopted.[2]

PURPOSE AND SCOPE

3 This Guideline does not address recognition and measurement issues associated with the accounting for rate-regulated operations, and applies regardless of the accounting policies selected by an entity for its rate-regulated operations. The description in paragraph 1 of entities to which this Guideline applies should be used only for purposes of complying with the disclosure requirements of this Guideline, and should not be interpreted as providing a definition of rate-regulated operations that may be used by analogy for recognition and measurement purposes. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, applies to the recognition and measurement of assets and liabilities arising from rate regulation. ~~GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, paragraph 1100.34, indicates that an entity is not required to apply that Section to the recognition and measurement of assets and liabilities arising from rate regulation, pending completion of a separate project on rate-regulated operations, which is currently underway.~~

DISCLOSURE

Additional information on the financial statement effects of rate regulation

7 ~~Rate regulation may cause an entity to account for a transaction or event differently than it would in the absence of rate regulation. Such differences in accounting may result from the application of GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, paragraph 1100.34, or other Sections that require or permit entities subject to rate regulation to recognize or measure an item differently from other entities (see CONSOLIDATED FINANCIAL STATEMENTS, Section 1600, PROPERTY, PLANT AND EQUIPMENT, Section 3061, INCOME TAXES, Section 3465, and DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475).~~

8 When rate regulation has caused an entity to account for a transaction or event differently than it would have in the absence of rate regulation, ~~affected the accounting for a transaction or event,~~ the entity should state this fact and

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[2] These modifications would, in turn, necessitate other amendments to the Guideline of an editorial or referencing nature. These are not identified below.

disclose additional information about the effect on its financial statements. This information should include, at a minimum, the following:

ILLUSTRATIVE EXAMPLE

Other items affected by rate regulation

~~As prescribed by a regulatory rate order, income tax expense is recovered through customer rates based on the taxes payable method. Therefore, rates do not include the recovery of future income taxes related to temporary differences between the tax basis of assets and liabilities and their carrying amounts for accounting purposes. RRO Inc. has not recognized future income taxes, as it is expected that when these amounts become payable, they will be recovered through future rate revenues. Generally accepted accounting principles require the recognition of future income tax liabilities and future tax assets in the absence of rate regulation.~~

Rate-Regulated Operations

AcSB
Exposure Draft

Background Information and Basis for Conclusions

FOREWORD

In March 2007, the Accounting Standards Board (AcSB) released an Exposure Draft, "Rate-Regulated Operations," proposing revisions to the CICA Handbook – Accounting. The AcSB also approved for publication the contents of this document setting out its rationale for the Exposure Draft proposals. The AcSB believes this Background Information and Basis for Conclusions document will assist readers of the Exposure Draft in understanding its proposals.

March 2007

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INTRODUCTION

1. This document summarizes considerations that were deemed significant by the members of the Accounting Standards Board (AcSB) in reaching the conclusions in the March 2007 Exposure Draft, "Rate-Regulated Operations." This Exposure Draft proposes to remove from GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100, the temporary exemption pertaining to the application of the Section to the recognition and measurement of assets and liabilities arising from rate regulation, and withdraw from the CICA Handbook – Accounting (Handbook) all other recognition and measurement guidance relating specifically to rate-regulated operations. ACCOUNTING GUIDELINE AcG-19, Disclosures by Entities Subject to Rate Regulation, would be retained after some consequential amendments. This document sets out the reasons the AcSB undertook a project on rate-regulated operations, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken and rejecting others. Individual AcSB members gave greater weight to some factors than to others.

2. Nothing in this document is to be taken as overriding the requirements of the Handbook or the proposals in the Exposure Draft. However, it may help readers understand how the AcSB reached its conclusions in developing the proposed Handbook revisions, and the AcSB's intent with respect to the interpretation of its proposals.

BACKGROUND

3. In March 2002, the AcSB approved a project examining the need for modifications to the Handbook to address rate-regulated operations more comprehensively. The project was undertaken for the following reasons:
   (a) Currently, the Handbook provides limited guidance dealing specifically with rate-regulated operations. Consequently, financial statement preparers have found it necessary to analogize to guidance on other topics, or have adopted industry practice or relied on US GAAP when dealing with areas in which Canadian GAAP is silent.
   (b) In the late 1990s, after becoming aware of certain accounting and financial reporting issues related to rate-regulated operations and in light of changes in the regulatory environment (for example, increased deregulation and the emergence of new forms of rate regulation), the AcSB and the Public Sector Accounting Board (PSAB) jointly commissioned a research study on the topic. In 2002, the CICA published a Research Report, "Financial Reporting by Rate-Regulated Enterprises." The report recommended that the AcSB issue a new Section on accounting for the effects of rate regulation and that the accounting requirements be substantially converged with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS 71), of the US Financial Accounting Standards Board (FASB), with the exception of accounting for income taxes.

4. The issuance of Section 1100 in July 2003 provided another reason for undertaking the project. Paragraph 1100.34 exempts entities subject to rate regulation from the requirement to apply the Section to the recognition and measurement of assets and liabilities arising from rate regulation pending completion of the project.

5. This project was undertaken as a "domestic" project, not intended specifically as part of the AcSB's efforts (under its previous Strategic Plan) to support the international convergence of accounting standards while harmonizing with US GAAP. Nonetheless, the AcSB recognized that the project could result in Canadian GAAP moving closer to either US GAAP or International Financial Reporting Standards (IFRSs) with respect to the treatment of rate-regulated operations. US GAAP includes guidance relating specifically to rate-regulated operations in SFAS 71 and other pronouncements or guidance issued subsequently by the FASB and its Emerging Issues Task Force (EITF). In contrast, IFRSs are silent on rate-regulated operations. Entities subject to rate regulation must comply with IFRSs with no exceptions or specific guidance for their circumstances.

6. The project, as originally planned, was intended to address the following key recognition and measurement issues:
   (a) Whether, and if so, under what circumstances, rate regulation may create assets and liabilities meeting the asset and liability definitions of FINANCIAL STATEMENT CONCEPTS, Section 1000.
   (b) If rate regulation creates assets and liabilities meeting the conceptual framework definitions, how these items should be measured.

7. Since rate regulation is an important consideration in evaluating the financial performance of entities with rate-regulated operations, the project was also intended to consider how best to meet user needs through disclosures in the general purpose financial statements of such entities.

8. Considerable progress was made towards the resolution of these issues. Most notably, the AcSB:
   (a) has gained a better appreciation for the nature of rate regulation in Canada, its economic effects on entities subject to rate regulation and the various accounting treatments that have been adopted;[1]
   (b) commenced deliberations on the issue set out in paragraph 6(a); and
   (c) issued AcG-19 in May 2005.

9. The AcSB recently reconsidered this project in light of the Strategic Plan it adopted in January 2006 and the impending move to IFRSs for publicly accountable enterprises. Since publicly accountable enterprises are currently expected to be following IFRSs in approximately four years' time, any new guidance resulting from the project would be short-lived and potentially require two accounting changes within a relatively short period. Therefore, the AcSB decided that the project, as it was originally envisaged, should be discontinued.

10. The decision to discontinue the project and the implications of the new Strategic Plan required further decisions by the AcSB regarding:
    (a) the temporary exemption described in paragraph 4;
    (b) Handbook guidance relating specifically to rate-regulated operations in Sections 1600, 3061, 3465 and 3475 (see paragraphs 12-15);

[1] This was achieved, in part, through stakeholder input obtained at roundtable discussions and from written submissions, including those provided in response to the AcSB's invitation to submit fact patterns.

(c) the appropriateness of entities subject to rate regulation relying on other sources of GAAP (including SFAS 71); and
(d) AcG-19.

The decisions taken, and their supporting rationale, are described in paragraphs 17-37.

HANDBOOK GUIDANCE ON RATE-REGULATED OPERATIONS

11. Certain Sections of the Handbook currently provide additional or different requirements that apply only in the specific circumstances of entities subject to rate regulation and permit or require these entities to account for transactions and events differently than they would in the absence of rate regulation. As noted above, Section 1100 is one such Section. Paragraphs 12-15 describe the guidance relating specifically to rate-regulated operations in each of the other such Sections and compare it to corresponding guidance under US GAAP. As noted in paragraph 5, there is no corresponding guidance in IFRSs.

12. CONSOLIDATED FINANCIAL STATEMENTS, Section 1600, currently requires the elimination of unrealized intercompany gains or losses arising subsequent to the date of an acquisition on assets remaining within the consolidated group, but provides an exception for entities subject to rate regulation. SFAS 71 provides a similar exception.

13. PROPERTY, PLANT AND EQUIPMENT, Section 3061, currently permits the capitalization of carrying costs directly attributable to the acquisition, construction or development of property, plant and equipment over time and specifies that, in the case of rate-regulated property, plant and equipment, these costs include the regulator-approved allowance for funds used during construction (AFUDC). Since AFUDC typically includes not only an interest component but also a cost-of-equity component, carrying costs capitalized by entities subject to rate regulation generally exceed those capitalized in similar circumstances by other entities. Similarly, SFAS 71 specifies that when a regulator requires an entity to capitalize the cost of financing, comprising both a computed interest cost and a designated cost of equity funds, the entity should capitalize the same amount for financial reporting purposes, rather than the amount of interest that would otherwise be capitalized under Statement of Financial Accounting Standards No. 34, "Capitalization of Interest Cost" (SFAS 34).

14. INCOME TAXES, Section 3465, currently requires the recognition of future income taxes, but provides an exception for entities subject to rate regulation to the extent that future income taxes are expected to be included in regulator-approved future rates and recovered from future customers. US GAAP in this area differs. While SFAS 71 originally mandated the approach to accounting for future income taxes found in Section 3465, the standard was subsequently amended by Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" (SFAS 109). US GAAP now requires entities subject to rate regulation to recognize future income tax liabilities and assets, as well as a separate regulatory asset (or liability) for the amount of future income taxes expected to be included in future rates and recovered from (or paid to) future customers.

15. DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475, currently requires the immediate recognition of gains or losses on the sale of a long-lived asset, except for rate-regulated operations, when the regulator requires such gains or losses to be included in the determination of future rates and there is reasonable assurance that the gain (or loss) will serve to reduce (or be recovered through) future rates. In such cases, the gain or loss is deferred for financial reporting purposes. Neither SFAS 71 nor Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS 144), specifically addresses the accounting for disposals of long-lived assets by entities subject to rate regulation. However, SFAS 71 includes general guidance on when the rate actions of a regulator justify the deferral and amortization of gains that would otherwise be included in net income of the current period, or the capitalization of costs that would otherwise be charged as a current period expense. Such guidance might reasonably be applied to disposals of long-lived assets when the qualifying criteria have been met.

16. IMPAIRMENT OF LONG-LIVED ASSETS, Section 3063, does not specifically address rate-regulated operations, but the accompanying Background Information and Basis for Conclusions states that the Basis for Conclusions for SFAS 144 might be helpful to Handbook users. Hence, it may be concluded that Canadian and US GAAP are consistent in this area. As explained in the Basis for Conclusions for SFAS 144, the impairment provisions of that standard are intended to apply differently to entities subject to rate regulation. Another US standard, Statement of Financial Accounting Standards No. 90, "Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs," provides guidance on impairments of a particular nature.

AcSB DECISIONS

Section 1100

17. The temporary exemption provided in Section 1100 and described in paragraph 4 was granted pending completion of the AcSB's project on rate-regulated operations, so that entities subject to rate regulation making changes as a result of the adoption of Section 1100 would not be required to make further (and possibly reversing) changes upon completion of the project. When Section 1100 was issued, the AcSB anticipated the timely completion of the project and that the exemption would be in place for a limited time. The Decision Summary for the December 1-2, 2004 meeting of the AcSB noted that it remained the Board's intention to eliminate the exemption within a reasonable period of time.

18. The AcSB has now decided that the Section 1100 exemption should be removed concurrently with any proposed amendments to Sections 1600, 3061, 3465 and 3475, for the following reasons:
    (a) Section 1100 makes it clear that accounting prescribed by regulatory authorities should not be considered in and of itself generally accepted for purposes of financial reporting. This includes financial reporting by entities subject to rate regulation.
    (b) The AcSB had previously concluded, and stakeholder input received throughout the project has consistently supported the view, that the GAAP conceptual framework and hierarchy should apply equally to all entities,

whether or not they are subject to rate regulation. Removing the Section 1100 exemption will ensure that this is the case.

(c) Revising Sections 1100, 1600, 3061, 3465 and 3475 concurrently as proposed would allow entities subject to rate regulation to make all necessary changes simultaneously, thus eliminating the need for the exemption.

The application of GAAP to rate-regulated operations

19. The AcSB notes that the Handbook, SFAS 71 and IFRSs are based on a common premise, namely, that entities subject to rate regulation should follow GAAP. However, they differ in terms of how this premise is expressed. While IFRSs are silent on rate regulated operations, SFAS 71 is explicit in its acknowledgment that the economic effects of rate regulation may affect the manner in which GAAP is applied. Although the Handbook does not have an equivalent to SFAS 71, the guidance it contains relating specifically to rate-regulated operations reflects the same concept.

20. The issue at hand is whether rate regulation introduces an economic dimension in some circumstances that should affect the application of generally accepted accounting principles to rate-regulated operations. The FASB concluded that it does, noting the cause-and-effect relationship of costs and revenues as a primary economic effect of regulation that affects the accounting for rate-regulated operations. The specific circumstances in which the FASB believes rate actions should affect the accounting for rate-regulated operations are described in SFAS 71.

21. SFAS 71 does not imply that GAAP does not apply to entities subject to rate regulation. Rather, it specifies how the different types of rate actions are reported in general purpose financial statements. The economic effect of regulatory decisions, not the mere existence of regulation, is the pervasive factor that determines the application of GAAP.

22. SFAS 71 requirements relating to future income taxes serve to illustrate this concept. As the FASB notes, rate actions of the regulator cannot eliminate obligations that were not imposed by the regulator. Thus, entities must recognize a future income tax liability when appropriate, and this liability is not affected by rate actions. At the same time, rate actions may create an asset related to but quite separate from the future income tax liability, to the extent that the future income taxes are expected to be included in future rates and recovered from future customers.

23. The AcSB's project, as originally envisaged, would have provided the opportunity to assess the appropriateness of using SFAS 71 as a model for the development of more comprehensive Handbook guidance on rate-regulated operations, considering such factors as the standard's age and changes in the North American regulatory environment since it was issued. However, this work has not been completed and, therefore, the AcSB has not formed an opinion on the extent to which SFAS 71 remains relevant in today's environment, and whether it incorporates the best measurement model.

24. Nonetheless, the AcSB is aware that the accounting for rate-regulated operations in both Canada and the US has largely evolved from the principles of SFAS 71, and that these principles were rigorously tested by the FASB

when developing the standard. The AcSB considers the FASB's analysis of, and conclusions on, the issue described in paragraph 20 to be reasonable. At the same time, the AcSB is also aware that certain differences exist between SFAS 71 and current practice in Canada.

Sections 1600, 3061, 3465 and 3475

25. The AcSB considered the extent to which existing Handbook guidance relating specifically to rate-regulated operations is consistent with SFAS 71, and whether any differences are justified. As noted in paragraphs 12, 13 and 15, the guidance contained in Sections 1600, 3061 and 3475 is consistent with SFAS 71. However, as also noted in paragraph 14, the guidance in Section 3465 differs from SFAS 71 as concerns the treatment of future income taxes.

26. During the development of Section 3465, Canadian entities subject to rate regulation were opposed to the proposed adoption of US requirements relating to income taxes. They argued that:
    (a) these requirements would result in an increase in large corporations taxes and capital taxes payable by entities subject to rate regulation, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allowed the increased cost to be included in the calculation of customer rates; and
    (b) the unique circumstances created by Canadian tax rules justified a different approach from the one taken in SFAS 71.

    After considering these concerns, the AcSB decided to include the exception found in paragraph 3465.102, "pending further study of accounting for rate-regulated enterprises as a whole."

27. The AcSB sees no theoretical justification for this exception. It notes that entities not operating in a rate-regulated environment must manage the pricing effects of recognizing future income taxes, and suggests that concerns about the tax effects of applying accounting standards are more appropriately brought to the attention of either the taxation authorities or the regulator, who may extend the period over which any associated increase in costs is recovered through rates. The AcSB further notes that in most Canadian tax jurisdictions, large corporations and capital taxes have either been eliminated or are being phased out. As a result of these considerations, the AcSB decided that leaving Section 3465 as is was not a feasible option.

28. The AcSB recognizes that one way of achieving consistency between those Sections with guidance relating specifically to rate-regulated operations and SFAS 71 would be to:
    (a) remove the exception in Section 3465 and further amend the Section to require the treatment of future income taxes specified in SFAS 71; and
    (b) leave Sections 1600, 3061 and 3475 intact.

    However, it could be argued that in order to make it more helpful, the Handbook should be further amended to incorporate all guidance provided in SFAS 71 and subsequent related US standards. For example, Appendix B to SFAS 71 provides guidance on the application of the standard to specific situations including intangible assets, early extinguishment of debt, and accounting for leases. The Handbook does not provide similar guidance. Anything less than this more comprehensive amendment would result in a continuation of the Handbook's current piecemeal approach to dealing with rate-regulated operations, a situation the project was intended to rectify.

29. The AcSB decided that, to the extent that it is possible for Canadian entities subject to rate regulation to account for their transactions and events in accordance with SFAS 71, this result would more appropriately be achieved through the removal of all Handbook recognition and measurement guidance relating specifically to rate-regulated operations. This conclusion rests on the view that, once such guidance has been removed, SFAS 71 is a possible "other source" of GAAP as described in Section 1100.

30. As noted in paragraph 18(b), the proposed removal of the Section 1100 exemption means that the Section's requirements regarding consistency with the conceptual framework and the application of the GAAP hierarchy would apply fully to entities subject to rate regulation. This includes the requirement, in paragraph 1100.04, that when the primary sources of GAAP do not adequately deal with an entity's circumstances, the entity adopt accounting policies and disclosures that are consistent with the primary sources of GAAP and developed through the exercise of professional judgment and the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section 1000. The AcSB notes that:
    (a) the FASB regards the principles of SFAS 71 as being consistent with FASB Concepts Statements (for example, the Basis for Conclusions for SFAS 71 speaks to the ability of a regulatory action to create a future economic benefit, the essence of an asset, and concludes that the qualifying criteria for an asset, found in FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, are met); and
    (b) the financial statement concepts described in Section 1000 are substantially converged with the FASB Concepts Statements.

31. Canadian entities subject to rate regulation intending to consult the pronouncements of accounting standard setters in other jurisdictions in the absence of Handbook guidance adequately dealing with their circumstances are reminded of paragraph 1100.26, which states that such other sources of GAAP should be evaluated in the context of the relative manner in which the foreign standard setter requires its pronouncements to be applied, as well as in the context of the related pronouncement.

32. The AcSB notes that the eligibility criteria of SFAS 71 appear more restrictive than the criteria included in the current Handbook definition of rate-regulated operations. Most notably, while the Handbook requires that rates be established by or subject to approval by "a regulator or a governing body empowered by statute or contract to establish rates," SFAS 71 further requires that the rate regulator be an "independent, third-party regulator." The AcSB further notes that this has implications, and could be a particular concern, for public sector entities that are required to comply with the Handbook and have a rate regulator deemed not to be independent.

33. The AcSB decided against introducing elsewhere in the Handbook a definition that differs from the one in SFAS 71 if, as proposed, all Handbook recognition and measurement guidance relating specifically to rate-regulated operations is withdrawn. The AcSB is aware that DIFFERENTIAL REPORTING, Section 1300, currently includes a definition of rate-regulated enterprises and that it differs from the SFAS 71 definition. However, the purpose of the Section 1300 definition was, and remains, only to determine the entities that qualify to use differential reporting, and not to otherwise provide recognition and measurement guidance. Therefore, the AcSB proposes that this definition be left as is.

34. Based on the foregoing, the AcSB proposes to eliminate all explicit references to rate-regulated operations in Sections 1600, 3061, 3465 and 3475.[2] This would:
    (a) open the door to the possibility of Canadian entities looking to SFAS 71 and other related US pronouncements as other sources of GAAP;
    (b) reduce the diversity of practice currently in evidence among Canadian entities subject to rate regulation; and
    (c) bring Canadian GAAP closer to IFRSs before publicly accountable enterprises are required to begin reporting using IFRSs. The AcSB observes that, at this stage in the movement towards a single set of globally accepted accounting standards, it is too early to tell whether IFRSs will be interpreted and applied in a manner that produces results consistent with those of SFAS 71. However, the AcSB's proposals create a level playing field between Canadian entities subject to rate regulation, once they are reporting using IFRSs, and others following IFRSs.

35. The AcSB observes that input received to date appears to support its choice. Stakeholders commenting on the appropriateness of SFAS 71 as a model for the development of more comprehensive Handbook guidance on rate-regulated operations strongly agree with the standard's underlying premise that the actions of a rate regulator can create an asset or liability.

AcG-19

36. AcG-19 has no equivalent in US GAAP or IFRSs. However, the AcSB believes that this Accounting Guideline is, and will remain, beneficial to the readers of the financial statements of entities subject to rate regulation. Therefore, the AcSB proposes that AcG-19 be amended as necessary as a result of the proposals in the Exposure Draft, and retained throughout the period leading up to the date on which publicly accountable enterprises are required to begin reporting using the new IFRS-based standards. The ultimate disposition of AcG-19, and other Handbook guidance with no equivalent in IFRSs, will be decided at a later date, in conjunction with the AcSB's detailed implementation plan for IFRS convergence.

37. Besides removing from AcG-19 references to Handbook material that will be withdrawn if the proposals in the Exposure Draft are adopted, the AcSB proposes the following:
    (a) The Guideline would be amended in the manner indicated so as to make clear that its broad scope is not to be used by analogy for recognition and measurement purposes once all Handbook recognition and measurement guidance relating specifically to rate-regulated operations has been withdrawn. More specifically, Handbook users cannot access SFAS 71 via AcG-19. Rather, they must look to SFAS 71 itself to determine whether they meet its qualifying criteria.
    (b) The reference, in the Guideline's Illustrative Example, to RRO Inc. accounting for income taxes using the taxes payable method would be

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[2] One Section other than Section 1300 makes mention of rate-regulated operations but is unaffected by the AcSB's proposals. INTEREST CAPITALIZED — DISCLOSURE CONSIDERATIONS, Section 3850, scopes out interest capitalized by rate-regulated enterprises as part of AFUDC when AFUDC in the period is disclosed. The AcSB decided that this scope exception should remain, since it affects the disclosure, rather than recognition and measurement, practices of entities subject to rate regulation.

eliminated, as this scenario is no longer relevant if the proposals are adopted.

EFFECTIVE DATE AND TRANSITION

38. The effective date selected for the Handbook revisions proposed in this Exposure Draft reflects the AcSB's practice of providing a reasonable period from the publication of Handbook revisions to their effective date.

39. The AcSB decided that the proposals should apply to interim, as well as annual, financial statements relating to fiscal years beginning on or after the effective date. The AcSB notes that in determining the effect of the proposals on interim financial statements in years following the one in which the proposals become effective, entities should refer to INTERIM FINANCIAL STATEMENTS, Section 1751.

40. The AcSB considered whether the effect of any change in accounting policy made as a result of now applying Section 1100 to the recognition and measurement of assets and liabilities arising from rate regulation should be applied retrospectively, as would normally be the case under ACCOUNTING CHANGES, Section 1506, or prospectively, as required by paragraph 1100.33. As noted in the Background Information and Basis for Conclusions for Section 1100, the AcSB's rationale for requiring prospective application of the effect of any change in accounting policy made on adopting the Section related primarily to the dramatic changes in reported equity that might otherwise result, and the recognition that public companies are sensitive to financial statement restatements. Prospective application was also viewed by the AcSB as making it easier to meet the Section's effective date. The AcSB decided that this rationale applies equally as well to entities subject to rate regulation and the proposals at hand, and, therefore, entities subject to rate regulation should be subject to the same requirement as all other entities.

41. The AcSB also considered whether additional guidance on the application of the transitional provisions in Section 1100 is required. In particular, it noted that paragraph 1100.33(b) does not permit an entity to recognize assets and liabilities that were not recognized previously but would have been recognized had these proposals been in place. The AcSB concluded that additional guidance is not required. However, it notes the important distinction between not now recognizing items that were not recognized previously, and presenting separately (gross) amounts that may have previously been offset. Taking income taxes as an example, entities subject to rate regulation have, in essence, already been recognizing future income tax assets and liabilities, as well as offsetting liabilities and assets for the rate actions of the regulator, and netting them for presentation purposes. Under the proposals, the amounts would be required to be presented gross.

42. In order to ensure that financial statement users have the information needed for comparative analyses, the AcSB decided that when initially applying Section 1100 to the recognition and measurement of assets and liabilities arising from rate regulation, and this results in a change in the accounting for such assets and liabilities, entities should be required to disclose the additional information specified in proposed paragraph 1100.32B.

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June 8, 2007

Mr. Wojciech Zielonka
Chief Financial Officer
Hydro Ottawa Holding Inc.
3025 Albion Road North
Ottawa, ON
K1G 3S4

Dear Mr. Zielonka:

We are pleased to present this report to you, outlining the key elements of and the key findings arising from our engagement to assist management in determining the accounting guidelines and industry practices as it relates to including overhead allocations in the costs capitalized to Property, Plant & Equipment.

Our role in this engagement is to report on research conducted. The selection of accounting policies is the responsibility of management and as such no opinion has been provided.

Scope of Engagement

According to management, Hydro Ottawa Holdings currently capitalizes between 50-60% of the "indirect costs" they incur. Our analysis included looking at accounting guidance in Canada, the United States, and International Accounting Standards. We also looked at the financial statements of some of the largest utilities in the United States, as well as some Canadian utilities, to identify the policies being used by other organizations in the industry. The Federal Energy Regulatory Commission (FERC) in the U.S. also provides guidelines which, although not mandatory, are used as guidance by many utilities in the U.S.

Canadian GAAP

CICA 3061 provides guidance on property, plant & equipment. Specifically, paragraph .05 provides a definition for cost:

> .05 Cost is the amount of consideration given up to acquire, construct, develop, or better an item of property, plant and equipment and includes all costs directly attributable to the acquisition, construction, development or betterment of the asset including installing it at the location and in the condition necessary for its intended use. Cost includes any asset retirement cost accounted for in accordance with ASSET RETIREMENT OBLIGATIONS, Section 3110.

Further guidance relating to acquisition, construction or development over time is as follows:

> .20 The cost of an item of property, plant and equipment includes direct construction or development costs (such as materials and labour), and overhead costs directly attributable to the construction or development activity. **[Development costs are further defined in CICA 3450]**
>
> .23 The cost of an item of property, plant and equipment that is acquired, constructed, or developed over time includes carrying costs directly attributable to the acquisition, construction, or development activity such as interest costs when the enterprise's accounting policy is to capitalize interest costs. For an item of rate-regulated property, plant and equipment, the cost includes the directly attributable allowance for funds used during construction allowed by the regulator.

Based on these paragraphs, an entity may only capitalize costs "directly attributable" to a capital asset. Determining what is "directly attributable" is a matter of judgment; a criterion commonly used is whether or not a cost would have been incurred if construction of a capital asset had never occurred. Such a criteria would preclude the capitalization of a portion of overhead costs such as portions of finance charges, executive costs, building leases, other administrative charges, etc.

CICA 1100 on GAAP transitional provisions states the following:

> .34 Pending completion of a separate project on rate-regulated operations, an entity is not required to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation. Entities are required to apply this Section to all other assets and liabilities for fiscal years beginning on or after October 1, 2003.
>
> .35 An entity that chooses not to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation is required to comply with all disclosure requirements of GAAP, and to disclose the nature of the differences between its accounting policies for assets and liabilities arising from rate regulation and those required by the primary sources of GAAP.

These two paragraphs essentially allow rate regulated entities to depart from GAAP as it relates to the measurement of assets and liabilities arising from rate regulation. Based on these paragraphs, an argument can be made that a portion of general and administrative costs should be capitalized in order to allow for a recovery of a cost of capital on these expenses, and not just in the year of incurrence. Note that AcG-19 requires disclosure in the notes to the financial statements of any deviations from the regular CICA handbook guidance as a result of section 1100 and rate regulated accounting.

We looked at the financial statements of several large utilities in Canada. Some of them disclosed capitalizing portions of overhead costs such as "indirect labour" and "proportional shares of administrative costs" while others did not specifically mention overhead. A summary of the practices of these Canadian utilities can be found in Appendix A. There are variations across Canada in terms of the capitalization policies of utilities; Hydro Ottawa does have policies which are similar to those of many other Canadian utilities.

There is also a publicly available report conducted by KPMG for NB Power relating to overhead capitalization. This report provides more detail on NB Power's accounting policies then would normally be found in a utilities' financial statements. NB Power only capitalizes overhead costs which are "incremental" in nature. Incremental costs are costs that would not exist if NB Power did not construct its own capital assets. Note that this definition is similar to the IFRS definition discussed below. NB Power uses a 3-5 year time frame when evaluating whether or not a cost is incremental ie: if NB Power discontinued capital asset construction, although there may not be an immediate reduction in administrative costs, to the extent such costs might decrease over a 3-5 year period, that portion of the cost would be incremental.

The recent release of a CICA Exposure Draft relating to Rate Regulated Operations is expected to be implemented in 2009 and removes all special provisions from the handbook related to rate regulated entities. In the absence of specific guidance for rate regulated entities, utilities may choose to follow US guidance is described below. Canadian standards are expected to converge with international standards by 2011, which is likely the reason for the exposure draft. International Accounting Standards do not allow for rate regulated accounting, and generally companies following international standards can not apply any special rate regulated accounting, even if they own utilities in the United States.

US GAAP

SFAS 71 in the U.S. allows regulated entities to depart from U.S. GAAP. The Statement sets forth three general standards for the effects of regulation, as defined:

1. Rate action of a regulator can provide reasonable assurance of the existence of an asset. Thus, before costs which would otherwise be expensed are capitalized or deferred, it must be probable that the regulator will allow their recovery in the future by the established rates.

2. A regulator can impose a liability on an enterprise. For example, it is not uncommon for a regulator to order a refund or revenues to customers or make provisions in rates for costs not

yet incurred. Revenue refunds are recorded in the fiscal year and interim period in which such refunds become probable.

3. Rate actions of a regulator can reduce or eliminate the value of an asset. If an asset is disallowed by the regulator as an allowable cost, the asset cannot be expected to produce revenue in the future through the rate-making process. Since the asset has been impaired, it must be written down.

As a result of SFAS 71, many utilities in the U.S aggressively capitalize overhead costs to fixed assets; however there are variations among the various utilities. Using a Fortune listing, we identified the 10 largest utilities in the U.S, and reviewed the accounting policies disclosed in their financial statements. The statements of 8 of these 10 companies made reference to the capitalization of overhead or indirect costs. This includes costs such as employee benefits, general and administrative costs, and finance charges. The financial statements do not provide details as to the methodology used to allocate these costs, or what portion of the total overhead costs are ultimately capitalized, however it does show that the majority of utilities in the U.S. do capitalize overhead or indirect costs.

In 2001, the AcSEC released a statement of position (SOP) on accounting for costs and activities relating to property, plant & equipment. The SOP goes into detail about capitalization of overhead costs, with the underlying theme being that in order to be capitalized, overhead costs must be "directly identifiable with the specific PP&E".

28. Costs incurred during the acquisition-or-construction stage should be charged to expense as incurred unless the costs are directly identifiable with the specific PP&E or the costs meet the requirements in paragraph 32 or 35. Subject to the provisions of paragraphs 29 and 30 of this SOP, directly identifiable costs include only:

   a. Incremental direct costs of acquiring, constructing, or installing the specific PP&E incurred in transactions with independent parties;
   b. Certain costs directly related to activities performed by the entity (or by parties not independent of the entity) for the acquisition, construction, or installation of the specific PP&E, and costs directly related to preproduction test runs of PP&E that are necessary to get the PP&E ready for its intended use. Those costs include only (1) payroll and payroll benefit-related costs of employees who devote time to a PP&E acquisition-or-construction stage activity, to the extent of time the employees spent directly on that activity and in proportion to the total hours employed, (2) depreciation of machinery and equipment used directly in the construction of installation of PP&E to the extent of time the machinery and equipment is used directly in that activity as a percentage of its expected useful life, and incremental costs (such as fuel for machinery) directly associated with the utilization of that machinery and equipment; and (3) the cost of inventory used directly in the construction or installation of PP&E

> 28A. Occupancy costs, including rent and depreciation of facilities and other costs associated with facilities are excluded from directly identifiable costs and should be charged to expense as incurred.
>
> 29. General and administrative costs incurred by the entity should be charged to expense as incurred. All costs (including payroll and payroll benefit-related costs) of executive management, corporate accounting, acquisitions, corporate legal, office management and administration, marketing, human resources, and similar costs or functions should be charged to expense as incurred.
>
> 30. The costs referred to in the previous paragraph should be charged to expense as incurred whether incurred internally by the entity or by another enterprise on behalf of the entity. For example, an entity could choose to establish its own internal human resources department or could outsource its human resources function. In either case, the costs should be charged to expense as incurred.

The SOP is fairly conservative as to what costs can be capitalized. It allows capitalizing certain directly related overheads, such as for purchasing, storeroom operations, plant accounting and engineering. However most other overhead costs would not meet the SOP criteria.

This SOP was never issued, but nevertheless, a number of utilities in the U.S amended their capitalization policies to remove some of the more "aggressive" overhead costs, such as a portion of executive costs. The belief among many in the US industry is that guidelines will eventually be issued which will be similar to this SOP, with a focus on applying a "directly attributable" criteria to overhead costs. Many American companies are adopting more conservative overhead capitalization policies as a result.

The Federal Energy Regulatory Commission (FERC) is an independent agency that regulates and oversees energy industries in the United States. They provide accounting guidance that is not mandatory, but is used as a guideline by most utilities in the United States. CFR 18 Part 101 provides the following guidance on components of construction cost:

> A. For Major utilities, the cost of construction properly includible in the electric plant accounts shall include, where applicable, the direct and overhead cost as listed and defined hereunder:
>
> (1) Contract work includes amounts paid for work performed under contract by other companies, firms, or individuals, costs incident to the award of such contracts, and the inspection of such work.
>
> (2) Labor includes the pay and expenses of employees of the utility engaged on construction work, and related workmen's compensation insurance, payroll taxes and similar items of expense. It does not include the pay and expenses of employees which are distributed to construction through clearing accounts nor the pay and expenses included in other items hereunder.

(3) Materials and supplies includes the purchase price at the point of free delivery plus customs duties, excise taxes, the cost of inspection, loading and transportation, the related stores expenses, and the cost of fabricated materials from the utility's shop. In determining the cost of materials and supplies used for construction, proper allowance shall be made for unused materials and supplies, for materials recovered from temporary structures used in performing the work involved, and for discounts allowed and realized in the purchase of materials and supplies.

These guidelines have a fairly narrow view of costs which meet capitalization criteria. The criteria is similar to the guidance in the SOP in that costs need to be "directly attributable" to the PP&E in order to be eligible for capitalization.

Recently, a forum on regulatory accounting was co-hosted by The American Gas Association and The Edison Electric Institute. Between them, these two associations represent the majority of all regulated gas and electric utilities in the U.S. We had a contact put forth the overhead capitalization question to a roundtable of representatives from the electricity industry. This is a fairly topical issue in the US as they are also concerned with the potential of US-IFRS harmonization and how this could impact regulatory accounting. There were 3 other questions put forward to the roundtable on the topic of overhead capitalization. Pertinent information from the forum on the overhead capitalization issue included:

- When asked whether G&A costs (or a portion thereof) are capitalized as part of the utility's capitalization policy, 17 respondents answered yes, and 5 responded no.
- 4 of the 17 who responded yes only capitalize based on direct charges to the project. For example, employees are either removed from their day to day job and assigned to the project or they complete timesheets to directly charge their time to a capital project.
- The other 13 apply a % to their G&A costs to represent direct capital work. The % applied is supported by performing full capitalization studies.
- 4 respondents include a % of executive costs as part of their capitalization policy, while 18 do not.
- When asked how often detailed capitalization studies are performed, 12 responded every 1-5 years, 8 responded every 6-10 years, and 2 responded greater then every 10 years.
- All respondents referenced FERC as the overriding source for them to use in determination of capitalization of overhead costs.

International Accounting Standards

International accounting standards differ significantly from Canadian & US standards in that they do not allow for special accounting for rate regulated entities. Therefore, utilities following international accounting standards can only look to the regular capitalization criteria found in IAS16 – Property Plant & Equipment. We also looked at the UK Standard FRS15 – Tangible Fixed Assets. The UK is moving towards international standards, and FRS 15 is very similar to IAS 16 however it provides some more detailed definitions as to what qualify as capital activities and tangible fixed assets.

FRS 15 defines capital activities as activities related to the initial construction, acquisition, or subsequent improvement of tangible fixed assets intended to be held long term in order to provide a service or other benefit to an entity and which are not held primarily for resale at a profit. The treatment of these activities as capital ceases when substantially all the activities that are necessary to get the tangible fixed asset ready for use are complete even if the asset has not yet been brought into use.

Tangible fixed assets are defined as assets that have physical substance and are held for use in the production or supply of goods and services or for administrative purposes on a continuing basis in the business. Held means that the entity has ownership of the assets through legal title or deemed ownership of an asset held under a finance lease. IAS 16 provides a similar definition.

FRS 15 & IAS 16 both also provide guidance on when activities associated with repairs and maintenance are treated as capital. There are three conditions which must be met:

1) where the activities provide an enhancement of the economic benefits of the tangible fixed asset in excess of previously assessed standard of performance.

2) where a component of the tangible fixed asset has been treated separately for depreciation purposes and depreciated over the useful life of the asset, is replaced and restored; and

3) where the activities relate to a major inspection or overhaul of a tangible fixed asset that restores the economic benefits of the asset that have been consumed by the entity and already have been reflected in depreciation.

FRS 15 states that fixed assets should initially be measured at cost. Only costs that are directly attributable to bringing the asset into working condition for its intended use should be included. Cost includes purchase price along with and costs directly attributable to bringing it into working condition for its intended use. Examples of directly attributable costs include the labor costs of employees arising directly from the construction, or acquisition, of the specific tangible fixed asset.

Per FRS 15, administration and other general overhead costs would be excluded from the cost of a tangible fixed asset. Employee costs not related to the specific asset (for example site selection activities) are not directly attributable costs.

Unlike direct costs, it is much more difficult and impractical to establish a direct relationship between indirect costs incurred, and capital activities. An indirect cost can be attributed to a specific capital project if the incremental costs to the entity would have been avoided only if the tangible fixed asset had not been constructed or acquired.

IAS 16 provides similar guidance, in that only directly attributable costs costs may be capitalized. In order for overhead costs to be capitalized under IAS 16, there must be proof that they are direct and incremental to the project. Directly attributable incremental costs under the IFRS definition are costs arising from the construction or acquisition of the specific asset and are incremental costs that would have been avoided only if the specific asset had not been constructed or acquired.

Examples of costs which can be capitalized under IAS 16 include

- Purchase price, including import duties and non-refundable purchase taxes;
- Site preparation;
- Delivery and handling;
- Installation and assembly, including employee benefits;
- Professional fees; and,
- Costs to add to, replace part of, and to service the asset.

Examples of costs which do not meet IAS 16 capitalization criteria include:

- Administration and other general overhead costs;
- Relocation and reorganization costs;
- Costs of day-to-day servicing;
- Costs of opening a new facility or introducing a new product; and,
- Abnormal amounts of wasted material, labor or other resources.

A study done by Deloitte for a UK utility revealed that the situation there is similar to that in North America in that there is no consistent capitalization pattern across the industry. For example, as it relates to capitalization of repair and maintenance charges, some utilities capitalized the entire cost of certain repair and maintenance projects if they met the criteria, whereas other utilities capitalized actual repair and maintenance expenditure based on budgeted capitalization rates (rather then basing it on the nature on an analysis of the actual activities).

The majority of costs capitalized in the UK relate to direct costs (85-95%), however in the area of indirect costs, there is significant differences in allocation and absorption bases among the various utilities.

Summary of Findings

There is significant variation among utilities across Canada and the United States as to capitalization policies, and specifically capitalization of overhead. Historically, capitalization of overhead by North American utilities has been fairly aggressive; however there has been a shift toward more conservative policies since the release of an SOP in the U.S. in 2001. In Canada there appears to be a shift towards more narrow definitions in terms of the types of costs which can be capitalized. This shift is the result of eventual convergence with International Standards which does not allow for rate regulated accounting, as well as a recent exposure draft discussing the elimination of rate regulated accounting in Canada, However, at this time it is still permissible to capitalize reasonable allocations of general and administrative costs as a result of rate regulated provisions.

Appendix A

Summary of Findings

	DM	DL	OH1	OH2	OH3	OH4
Hydro Ottawa	✓	✓	✓	✓	✓	✓
Accounting Standards						
CICA**	✓	✓	✓	✓	x	x
FERC**	✓	✓	✓	x	x	x
US GAAP**	✓	✓	✓	✓	x	x
IFRS	✓	✓	✓	x	x	x
Top 10 US Utilities						
Duke Energy	✓	✓	✓	✓	x[1]	x[1]
Dominion Resources Inc.	✓	✓	✓	✓[1]	✓[1]	*nc
Exelon	✓	✓	*nc	*nc	*nc	*nc
Southern Company	✓	✓	✓	✓	✓[1]	*nc
Public Service Enterprise	✓	✓	*nc	*nc	*nc	*nc
FirstEnergy Corp	✓	✓	✓	✓	✓[1]	*nc
Edson International	✓	✓	✓	✓	✓[1]	*nc
FPL Group	✓	✓	✓[1]	✓[1]	x	x
Sempra Energy	✓	✓	x[1]	x[1]	x	x
Con Edison Inc.	✓	✓	✓	✓	✓[1]	x
Sample of CDN Utilities						
Manitoba Hydro	✓	✓	✓	✓	✓[1]	*nc
Alberta Power	✓	✓	✓	✓	✓	✓[1]
BC Hydro	✓	✓	✓	✓	✓	✓[1]
Toronto Hydro	✓	✓	*nc	*nc	*nc	*nc
Newfoundland Hydro	✓	✓	*nc	*nc	*nc	*nc
Hydro Quebec	✓	✓	✓[1]	✓[1]	x[1]	x
NB Power	✓	✓	✓	*y	x	x

**in the absence of rate regulated accounting*

✓[1] = Financial Statement disclosure is not specific, it does appear as though these costs are capitalized by the utility
x[1] = Financial Statement disclosure is not specific, it does not appear that these costs are capitalized by the utility
*nc = Not clear from the financial statements whether or not such costs are capitalized
*y = Only to the extent that a procurement employee would not be necessary if a capital program did not exist.

Categories of Overhead
OH1 = directly attributable overhead, eg: staff taken out of regular role to work exclusively on project
OH2 = timesheet attributable overhead, eg: employees in procurement who charge their time to various projects
OH3 = not directly attributable, but based on reasonable percentage allocation eg: historically 20% of time spent by employees in finance relates to capital projects, therefore 20% of finance salaries are allocated.
OH4 = not directly attributable costs would likely be incurred regardless of capital projects eg: a percentage of executive costs

Hydro Ottawa Limited

Review and Update of Overhead Capitalization Estimates

August 16th, 2007

KPMG

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Executive Summary

KPMG was retained by Hydro Ottawa Limited ("Hydro Ottawa") to help review and update the company's estimates of the amount of overhead costs related to capital. These costs will be allocated to capital projects through burden rates applied to direct project costs. The study results will be reflected on a prospective basis, as the results are deemed by management to be a change in accounting estimate.

As noted in our report, no single regulatory guideline, statement, or source exists that is universally accepted by industries and regulators as the definitive statement, definition, or standard that prescribes what kinds of overhead costs should be considered for capitalization. However, this topic has been the subject of discussion and comment and a body of evidence exists on the topic. From this evidence, a common principle arises:

> *That any assignment of indirect costs to a capital project should be done based upon some reasonable causal link or association with the capital activity.*

The estimates outlined in this update adhere to this principle.

KPMG has reviewed Hydro Ottawa's documented policy and finds it reasonable and in accordance with industry standards and practice related to overhead capitalization. As part of this update, KPMG has also reviewed the cost drivers that have been used by Hydro Ottawa and validated the appropriateness of the overhead costs that are to be applied to capital projects. Accordingly, KPMG finds that the overhead capitalization results developed in this study and presented herein are fair and reasonable and meet the criteria that KPMG outlines in Chapter III for this review.

In the table below, we summarize this study's estimates of the amount of overhead costs related to capital.

Summary of Capitalized Overhead Costs – Draft 2008 Budget as at August 1st, 2008

	Total Gross OM&A	Total Capitalized Overhead	% of Total Gross OM&A Capitalized
Sub-total –Admin	26,398,993	5,923,819	22.4%
DAM & CAM[1]	52,467,305	7,087,088	13.5%
Customer Contact & Conservation	6,660,970	*Nil*	-
Metering & Electricity Revenue	16,654,415	*Nil*	-
Sub-total – Operations	75,782,690	7,087,088	9.4%
Total (Unadjusted)	102,181,683	13,010,907	12.7%
Less: Internal Maintenance Included In Total Above	(12,754,768)	*Nil*	-
Total OM&A Expenditures	89,426,915	13,010,907	14.5%

[1] *For DAM & CAM, there is $3,625,861 in costs capitalized through the Engineering Burden, and $3,461,227 in costs capitalized through the Supervision Burden. The Supervision Burden includes supervisory costs from the metering department within the Metering & Electricity Revenue division.*

I. Introduction

1. Objective of this Study

KPMG was retained by Hydro Ottawa Limited ("Hydro Ottawa") to help review and update the company's estimates of the amount of overhead costs related to capital. These costs will be allocated to capital projects through burden rates applied to direct project costs. The study results will be reflected on a prospective basis, as the results are deemed by management to be a change in accounting estimate.

2. Principal Findings and Recommendations

KPMG has reviewed Hydro Ottawa's documented policy and finds it reasonable and in accordance with industry standards and practice related to overhead capitalization. As part of this update, KPMG has reviewed the cost drivers that have been used by Hydro Ottawa and validated the appropriateness of the overhead costs that are to be applied to capital projects. Accordingly, KPMG finds that the overhead capitalization results developed in this study and presented herein are fair and reasonable and meet the criteria that KPMG outlines in Chapter III for this review.

3. Organizational Structure

Hydro Ottawa provides electricity distribution services in the Ottawa area. It is a subsidiary of Hydro Ottawa Holding Inc ("Holdco"). A telecommunications company and an electricity generating company are also subsidiaries of Holdco.

Table I-1 below summarizes the formal company names for each of the entities discussed in the report, matched to the abbreviations that have been used for brevity.

Table I - 1 – Glossary of Company Names

Name Used in this Report	Formal Company Name
Holdco	Hydro Ottawa Holding Inc.
Hydro Ottawa	Hydro Ottawa Limited

II. Study Approach

In this Chapter, we summarize the methodology and approach used to complete this study. Our work plan was developed in collaboration with Hydro Ottawa management, and was designed to provide a supportable basis for the company's estimates of the amount of overhead costs related to capital.

Our work plan incorporated the following steps:

- **Step 1: Interview company officials**. In this step, we interviewed senior representatives from each operating area to understand and identify those company departments that appear to support, either directly or indirectly, capital projects at Hydro Ottawa. The purpose of this step was to gain an understanding of the specific activities within Hydro Ottawa that may be eligible to have costs allocated to capitalized overhead. This step also provided us with a good understanding of Hydro Ottawa's organizational structure and its approach to the installation of capital assets.
- **Step 2: Document regulatory and accounting policy guidance**. In this step, we researched the guidance provided by various accounting and regulatory authorities on the topic of overhead capitalization. The objective of this step was to ensure that the approach adopted in this review was consistent with a cross-section of current industry standards and practices. The results of our research are summarized in the appendix.
- **Step 3: Develop criteria for an overhead capitalization approach.** Based on the initial steps above, and on our assessment of appropriate objectives, we developed a set of criteria to be used to evaluate our approach to estimating the amount of overhead costs associated with capital projects. The criteria are provided in Chapter III.
- **Step 4: Document Hydro Ottawa's capitalization approach.** In this step, we prepared a statement that summarizes Hydro Ottawa's guidelines for overhead capitalization. This statement appears in Section B of Chapter IV of this report. Additional guidance on the nature of eligible costs is provided in Section C of the same chapter. Together, these sections were used as an information guide for management when compiling information for this review and update. They provided:
  - Guidance on the types of activities and costs that may be eligible for overhead capitalization.
  - A framework for classifying these activities and costs.
  - The details of a "test" for identifying whether specific support costs should be included as capitalized overhead. The purpose of the test is to act as a materiality threshold and to thereby ensure that the overhead capitalization process does not become unduly complex or detailed as a result of trying to

capture all of the costs that may conceivably have a link to capital projects.[1] The test ensures that the process focuses only on costs with a significant or measurable link to capital.

- **Step 5: Assess reasonableness of Hydro Ottawa's approach.** In this step, we reviewed Hydro Ottawa's guidelines for overhead capitalization, as documented in the step above. We checked this approach against guidance from the Ontario Energy Board (OEB), the Canadian Institute of Chartered Accountants ("CICA"), from other accounting and regulatory agencies (e.g. the U.S. Federal Accounting Standards Board and the Federal Energy Regulatory Commission), and the practices of other North American utilities as observed through a review of regulatory filings in other jurisdictions. We also validated Hydro Ottawa's policies against the criteria that we developed in Step 3 and which are documented in Chapter III. KPMG then concluded that the Hydro Ottawa capitalization approach, as documented in Step 4 above, is reasonable and is an appropriate basis for overhead capitalization at the utility.
- **Step 6: Internal data collection.** In this step, KPMG and finance staff within Hydro Ottawa collected data from all relevant departments within each operating company. To support proposed allocations from any given department, company management prepared the following:
  - A written description of the specific activities within the department that support capital projects.
  - Estimates of the percentage of the cost of these activities that should be allocated to capitalized overhead, and
  - Supporting documentation with respect to the basis of the proposed cost allocation factors.

  This step was intended to provide an audit trail for the costs to be allocated to capitalized overhead.
- **Step 7: Review internal survey results.** In this step, KPMG reviewed the data assembled by company management in the step above. We checked that the information provided was consistent with Hydro Ottawa's internal policies for overhead capitalization as documented in Step 4 and with the information received from our initial interview process (Step 1). We also verified the accuracy of any supporting calculations and cross-checked the information provided with respect to the costs of activities and cost drivers used against budget data for Hydro Ottawa overall. Where required and appropriate, departments were asked to review and/or update the calculations provided in the previous step.

  Overall, this step was very important to the overall integrity of this study update process: KPMG personnel worked to ensure that the allocation process was reasonable and that it was applied consistently across the company.

[1] *As outlined in Chapter IV, the test states that a support function should not allocate costs if the workload for that function would not be reduced by at least ½ an FTE and any associated G&A costs in the absence of capital projects.*

- **Step 8: Prepare summary report.** In this step, we prepared this summary report to document and summarize the results of the update process.

III. Evaluation Criteria

Methodologies for overhead capitalization should address a set of formal, objective criteria that speak to company and policy objectives. The criteria that we used in this study to evaluate the proposed capitalization approach are as follows:

- **Defensible cost causation linkage.** To conform to accounting guidelines, the methodology should show a direct causal link between capitalized overhead costs and capital activity. This is a key test in ensuring that the methodology will be acceptable to regulators and under Canadian Generally Accepted Accounting Principles ("Canadian GAAP").
- **Freedom from Bias.** The allocation approaches should not tend to allocate an undue proportion of costs toward either operating or capital activities.
- **Transparency.** The methodology and calculations should be easy to follow and to understand by internal users and by external observers (i.e., regulators). This will facilitate acceptance of the methodology.
- **Accuracy of Underlying Data.** Any data used in the allocation process should be accurate and able to be relied upon. The data should provide an appropriate measure of the underlying volume of activity or output.
- **Flexibility/Adaptability.** The methodology should accommodate changes in organizational structure, business processes, and information systems with reasonable ease. Thus, the methodology should be dynamic: it should be relatively easy to update and keep current as the organization evolves. To the extent possible, it should automatically adjust for changes in circumstance.
- **Cost-Effectiveness.** In evaluating different accounting approaches, we need to ensure that they are cost-effective. Additional accuracy may require significant additional cost, and thus an appropriate balance is required between precision and cost. In evaluating cost-effectiveness, two different time perspectives are relevant:
  - **Low implementation cost.** All else being equal, the methodology should be capable of being implemented at a reasonable cost.
  - **Low on-going costs.** The approach should have relatively low costs of upkeep. Further, it should reduce the administrative, record-keeping and reporting burden imposed on operating staff. The methodology should also integrate easily with the process used to prepare company financial statements.
- **Stability.** The methodology should not result in disproportionately large variations in the amounts of capitalized overhead from year-to-year.

IV. Hydro Ottawa Capitalization Policies

In this Chapter, we review guidance from regulatory and accounting bodies on the capitalization of overhead costs. In this context, we then present the Hydro Ottawa policy for overhead capitalization and discuss its implications. This study confirmed the appropriateness of Hydro Ottawa's policy, and it was used as the basis of the current update.

A. External Guidance

In this section, we summarize guidance from the Ontario Energy Board (OEB) and the Canadian Institute of Chartered Accounts on the capitalization of overhead costs. We also note the potential for international harmonization of standards.

1. Ontario Energy Board

Article 410 of the Ontario Energy Board Accounting Procedures Handbook for electricity distribution utilities states:

> "Property, Plant and Equipment should be recorded at cost, which includes the purchase price and other acquisition costs such as: option costs when an option is exercised, brokers' commissions, installation costs including architectural, design and engineering fees, legal fees, survey costs, site preparation costs, freight charges, transportation insurance costs, duties, testing and preparation charges."[1]

Further guidance is provided by Article 230, Definitions and Instructions, No. 20. This document defines the components of construction cost as follows:

> "the cost of construction properly included in the electric plant accounts shall include where applicable, the cost of labour; materials and supplies; transportation; work done by others for the utility; injuries and damages incurred in construction work; privileges and permits; special machinery services; allowance for fund used during construction; and such portion of general engineering, administrative salaries and expenses, insurance, taxes, and other similar items as may be properly included in construction costs."[2]

[1] *Ontario Energy Board, Accounting Procedures Handbook, Article 410, p. 7.*
[2] *Ontario Energy Board, Accounting Procedures Handbook, Article 230, p. 5.*

2. The Canadian Institute of Chartered Accountants

The Canadian Institute of Chartered Accountants (CICA) provides guidance regarding the nature of costs that should be allocated to capitalized overhead within Handbook section CICA 3061.20 as follows:

> "The cost of an item of property, plant and equipment includes direct construction or development costs (such as materials and labour), and overhead costs *directly attributable* to the construction or development activity." [Emphasis ours]

The accounting standard does not go into further details on how the overhead costs should be identified or the actual determination of an overhead rate.

Additional sources of guidance from Canadian and U.S. bodies on the capitalization of overhead costs are summarized in the appendix.

3. International Financial Reporting Standards

As a result of recent initiatives by the Accounting Standards Board of Canada ("AcSB"), entities such as Hydro Ottawa may be required to report under International Financial Reporting Standards ("IFRS") by 2011. IFRS is more restrictive than current accounting standards for regulated utilities with respect to the capitalization of overhead costs.

At this point, there is still some uncertainty regarding the details of the application of IFRS to regulated Canadian utilities. IFRS and Canadian standards may evolve in the years leading up to 2011 and Canadian utility regulators have not yet addressed the issue of transition. The year 2011 is also beyond the horizon of this study's analysis. Accordingly, IFRS was not specifically considered in the development of this study's estimates of capitalized overhead costs for Hydro Ottawa.

B. Hydro Ottawa's Internal Guidelines

While the OEB and CICA, as noted above, provide general guidance with respect to capitalized overhead costs, Hydro Ottawa has prepared its own internal guidelines to provide more specific direction as to the nature, type, and quantum of costs that should be allocated to capitalized overhead. The definition of capitalized overhead costs that has been adopted for this study is as follows:

> "Overhead costs must be directly attributable to construction activity at the utility. This will be interpreted to mean that the overhead costs to be charged to capital are those that would not exist if Hydro Ottawa did not construct its own capital assets. Eligible costs may appear fixed in the short term but would be eliminated over time (in 3 to 5 years) if Hydro Ottawa did not have a capital

program. Overhead expenditures that are capitalized include such costs as salaries and benefits of construction and engineering personnel not directly chargeable to project costs and the cost of administrative and support services that are required as a result of construction activity."

This study has therefore adopted a time-based approach (i.e. the 3 to 5 year test) for identifying costs that are directly attributable to, or can be linked to, construction activity. This approach is useful because:

- It is easy to understand and to "operationalize" by personnel seeking to interpret the policy guidelines.
- It is conceptually attractive and captures the nature of costs that are typically considered for overhead capitalization.

Because Hydro Ottawa uses a 3-5 year time horizon, many of the overhead costs captured in the process will not vary directly with the level of capital spending in the short term. They could be eliminated in the absence of a capital program but, given that Hydro Ottawa does have a capital program, they are relatively fixed in nature and may not change materially with changes in capital spending from year to year.

1. Example Application of Costing Approach

The allocation approach adopted by Hydro Ottawa has implications for certain support costs. For example, in allocating the costs of the Human Resource department, Hydro Ottawa focuses only on those costs that will vary with the number of employees. To the extent that Hydro Ottawa would have fewer employees in the absence of a capital program, any Human Resources costs that would be eliminated as a result of the work-force reduction are eligible for inclusion in the overhead allocated to capital. For example, some portion of Human Resource costs (and staffing) may be associated with handling questions and benefits claims from employees. Such staffing should be reduced in proportion with a fall in the overall employee count. However, fixed costs associated with the Human Resource function, which would continue in the absence of a capital program, are not allocated proportionately between the operating and capital portions of Hydro Ottawa. They are instead charged to current operations.

2. Treatment of Non-Productive Time

For employees whose costs are captured through the overhead capitalization process, we have directed respondents to allocate a proportionate share of all costs associated with these employees to the capitalized overhead pool. Thus if an employee spends 50% of his/her productive time on activities related to capital, costs allocated to the overhead capitalization pool should be equal to 50% of the total salary and benefit costs associated with that employee. This approach means that capital projects are allocated an appropriate share of vacations, sick time, and other internal non-productive time.

The approach outlined above is consistent with the way that Hydro Ottawa allocates those costs associated with operating staff whose time is charged directly to projects. The labour rate used for directly-charged time includes an uplift to account for the portion of employees' paid time that is not charged. This can be referred to as non-productive time. Such paid time includes allowances for training, vacation, paid sick-leave, and any other paid time that is not directly associated with productive work. Some amount of non-productive time is inevitable, and it needs to be taken into account in the cost allocation process.

3. Change in Capitalization Thresholds

In parallel with this study, Hydro Ottawa has adjusted its capitalization threshold for General Plant. This threshold has been increased from $200 to $500. The change in threshold will decrease the number of General Plant items that are capitalized rather than expensed, although the dollar impact on amounts capitalized is not expected to be large.

C. The Nature of Capitalized Overhead Costs

Capitalized overhead costs can be distinguished from:

- **Costs charged directly to capital.** These are costs that are charged directly to capital projects and that therefore form part of the direct capital cost of the associated assets. Such costs include the costs of materials and construction labour, as well as any purchased services (e.g. outside contracting) that may be associated with installation of the asset. At Hydro Ottawa, direct costs also include fleet charges for the recovery of the costs of vehicles used by personnel performing capital work.
- **Costs charged directly to operating expenses.** These costs appear in the income statement for Hydro Ottawa in the period concerned. These costs include any costs that are not identified as being related to capital projects. They thus encompass a wide range of costs, including costs associated with customer billing and service, most general and administrative costs, and costs associated with maintenance activities.

Capitalized overhead, in contrast to the cost elements above, reflects those costs that relate to capital projects but that have not been specifically identified with any individual project. The nature of capitalized overhead costs is more fully outlined below.

Functions that have costs allocated to capitalized overhead generally fall into one of the three categories noted below. While the boundaries between these types of activities are not always clear, the categories do help to provide a conceptual framework to help identify and evaluate those costs eligible for capitalized overhead:

- **Non-Project-Specific Capital Support.** This category encompasses processes for formulating, evaluating, initiating, designing and implementing capital additions. This includes feasibility analyses, expenditures to obtain approval, and budgeting. It also includes in-house design work, software coding work, and economic assessments. Activities in this category are specifically focused on capital but cannot be charged to specific projects, either:
  - Because it is impractical or costly to do so, or
  - Because the function is related to capital projects generally rather than to specific or identified projects.
- **Administration and Oversight of Activities Directly Related to Capital Projects.** This category encompasses processes for the supervision and administration, cost control, and reporting of those activities and/or costs that are in direct support of capital projects. Activities in support of projects can either be directly charged to those projects or they can be associated with non-project specific capital support (the first category of capitalized overhead costs noted in the bullet above). Activities in this support category thus include the administration and supervision of construction departments.
- **Support Functions and Infrastructure.** This category covers the support functions and infrastructure networks that enable the departments that are directly involved in the installation of capital projects to do their work. Relevant support functions include Human Resources and Facilities.

Because the last category of cost has the least direct relationship to capital projects, Hydro Ottawa implemented a "test" to ensure that any cost centre or activity that allocates costs to capitalized overhead has some causal linkage with capital spending. This test applies only to Support Functions and Infrastructure, and is as follows:

> *Would the workload of this function be materially reduced if the company ceased to undertake all capital projects?*

As a materiality threshold, the workload for that function would need to be reduced by the equivalent of at least ½ of a Full-Time Employee (or "FTE") under the scenario in which all capital projects at Hydro Ottawa cease.

If the function would not have its workload reduced by at least ½ an FTE under a scenario in which capital projects cease, then none of the costs of that function should be allocated to capitalized overhead.

D. Impacts on Operations

Within Hydro Ottawa, the core processes associated with operation of the distribution network and the addition of new network assets occur within the divisions titled

Distribution Asset Management ("DAM") and Construction And Maintenance ("CAM"). Accordingly, CAM and DAM are the locus of most capital projects within the company and were a major focus of our review. These divisions operate under the direction of the Chief Operating Officer (COO) of Hydro Ottawa.

Management within CAM and DAM did a detailed analysis of the workloads of various groups and individuals within these divisions to determine the staffing that is in support of capital projects. In total, management determined that the work effort equivalent to approximately 190 FTEs within CAM and DAM is related to capital projects. Key elements of this staffing estimate are:

- About 70 FTEs, representing approximately 2/3 of the workload of trades-people within CAM. These are personnel who directly perform maintenance or capital work in the field or in company shops and who install projects in the field. Associated with these trades-people are, in addition, over 20 support personnel, including managers and supervisors, co-ordinators, and administrative assistants.)
- About 2/3 of the work-force associated with transformer stations, encompassing about 20 FTEs.
- Over 40 FTEs associated with design work, service layouts, and manning of the service desk.
- A substantial share of the workforce in the GIS/Records departments.
- Most of the engineering personnel in DAM.

It should be noted that some of the labour costs associated with the personnel outlined above are charged directly to projects. This is generally the case for the trades personnel who work in the field and at Hydro Ottawa transformer stations (comprising about 90 FTEs of the labour effort noted above).

As outlined elsewhere, the hourly labour charged includes an allowance for the non-productive time of the employees. The actual allocation of direct labour costs will adjust between capital and maintenance projects based on the mix of projects undertaken and, hence, timesheet entries by personnel in the field.

Beyond those FTEs that are charged directly to projects, it follows from the discussion above that there are about 100 FTEs of capital support within CAM and DAM whose costs remain within gross OM&A. The costs of these FTEs must be captured in the overhead capitalization process. This recovery is provided for in the allocation percentages outlined later in the chapter.

Some activities within DAM are not in support of capital projects and, hence, have no costs allocated to capitalized overhead. These groups include, for example, the Systems Operations Group. This group mans the control room at Hydro Ottawa, and thus directs the real-time operation of the network.

E. Use of FTE Estimates

The estimates of staffing within CAM and DAM that are in support of capital are a key starting point for our overall estimates of the overhead costs associated with capital projects at Hydro Ottawa. Staffing levels associated with capital are the basis of allocations from, in particular, the HR and Facilities departments. Demand for these support functions is largely determined by overall staffing levels. Allocations of costs from these support functions must therefore take into account the total amount of company labour that supports capital projects, and the associated impact on company costs for support and infrastructure. For the purpose of determining support allocations, the labour effort associated with capital projects includes both labour charged directly to capital projects and engineering and other overhead and administrative labour whose costs are recovered through the overhead capitalization process.

When the labour effort associated with all company support functions is taken into account, the total number of FTE's associated with capital projects is estimated at approximately 230. This represents approximately 40 percent of projected total staffing at Hydro Ottawa in 2008. Accordingly, capital projects represent a significant proportion of the workloads of Hydro Ottawa staff.

F. Allocation of Costs from Holdco

Holdco provides a variety of administrative and support services to the operating companies. These services include finance and treasury functions, regulatory affairs, and legal support.

To identify an appropriate allocation of costs, KPMG personnel and staff from the Finance group interviewed managers in the relevant functional departments. Based on the application of our guidelines in Section B, we determined that only two groups within Holdco should have costs allocated to capital projects at Hydro Ottawa. These groups are as follows:

- General Counsel.
- Regulatory Affairs.

Managers for these groups estimated the proportion of costs within these functions associated with capital projects. The basis of the estimates are as outlined in Table IV-1.

Table IV-1
Allocations by Departments from Holdco

Department	Allocation to Capital
Chief Executive Officer	*Nil*
Chief Financial Officer	*Nil*
Internal Audit	*Nil*
General Counsel	Allocation of 35.5% is based on the estimated time that is associated with the review of contracts for construction work and the administration and control of easements for the construction of capital assets.
Chief Regulatory Officer	Allocation of 10% of costs of Chief Regulatory officer, based on estimated time that is associated with regulatory work pertaining to capital assets.
General Office	*Nil*

G. Costs Allocated by Department

In Table IV-2 we provide an overall summary of the costs allocated to capitalized overhead from each of various departments and from Holdco. These costs are grouped by the burden rate through which they are recovered. (Burden rates are more fully explained in Section H of this Chapter.)

In Table IV-2, the first column lists the total gross OM&A associated with each department. In this context, "gross" means before deductions for overhead that is charged to capital. In the second column in the table, labeled "Total Gross OM&A Considered for Capitalization", the figures have been adjusted by removing certain overhead costs that are directly charged to operating expenses and that therefore are not considered eligible for overhead capitalization. These non-eligible costs include items such as OEB membership dues, facility costs for stations, and environmental costs. For costs associated with administration, the second column therefore represents those costs remaining, which were then examined for potential allocation to the pool of capitalized overhead costs.

Table IV-2
Summary of Capitalized Overhead Costs – Draft 2008 Budget as at August 1st, 2008

	Total Gross OM&A	Total Gross OM&A Considered for Capitalization	Total Capitalized Overhead	% of Total Gross OM&A Capitalized
Holdco	1,858,742	1,858,742	185,874	10.0%
Corporate Costs	1,995,871	1,868,867	373,773	18.7%
COO's Office	1,007,602	1,007,602	151,140	15.0%
Finance	3,275,140	3,275,140	605,901	18.5%
Regulatory	1,752,755	812,505	81,251	4.6%
Supply Chain	2,718,636	2,692,636	2,288,741	84.2%
Facilities	4,462,311	3,625,046	953,387	21.4%
HR & Safety	5,703,494	3,583,980	1,182,713	20.7%
IT	3,624,443	3,367,941	101,038	2.8%
Sub-total –Admin	26,398,993	22,092,459	5,923,819	22.4%
DAM & CAM[1]	52,467,305		7,087,088	13.5%
Customer Contact & Conservation	6,660,970		*Nil*	-
Metering & Electricity Revenue	16,654,415		*Nil*	-
Sub-total – Operations	75,782,690		7,087,088	9.4%
Total (Unadjusted)	102,181,683		13,010,907	12.7%
Less: Internal Maintenance Included In Total Above	(12,754,768)		*Nil*	
Total OM&A Expenditures	89,426,915		13,010,907	14.5%

[1] *For DAM & CAM, there is $3,625,861 in costs capitalized through the Engineering Burden, and $3,461,227 in costs capitalized through the Supervision Burden. The Supervision Burden includes supervisory costs from the metering department within the Metering & Electricity Revenue division.*

Table IV-3 provides a summary description of the basis of allocations, and a short description of the costs recovered.

Table IV-3
Basis of Overhead Allocations

	% Related to Capital	Basis of Allocation
Holdco	10.0	See Table IV-1
Corporate Costs	18.7	These costs represent allocations of future employee benefits and property insurance.
COO's Office	15.0	These costs represent about 40% of the labour and G&A expense associated with personnel providing performance indicators and efficiency improvements.
Finance	18.5	Based on elimination of one A/P associate, one financial analyst, one billing analyst, one management accountant and one supervisor because of reduction in supplier invoices, variance analysis, and billing for capital projects. Figure includes proportionate share of departmental G&A expenses.
Regulatory	4.6	Represents estimated share of Regulatory department's workload associated with seeking approvals for capital projects and modeling and approvals with respect to customer contributions. License fees and association dues are excluded from the allocation.
Supply Chain	84.2	Allocated based on dollar value of materials and outside services associated with capital projects (out of total).
Facilities	21.4	Pro-rata allocation of space costs.
Human Resources & Safety	20.7	Based on estimate of staffing reduction in HR function with no capital projects and, hence, fewer line and support staff elsewhere in the company.
IT	2.8	Reflects reduction in head-count of 1 person due to lower call volumes for help desk support.
Operations (Engineering)	10.5	Identified specific staff in engineering design, record keeping and asset management who would not be required in the absence of capital projects.
Supervision	61.4	Ratio based on estimated proportion of dollars associated with capital projects versus maintenance and work for others. Based on management salaries and one-half of G&A in Operations and Meter Installation areas.

A detailed discussion of some of specific issues associated with a number of the departments is provided below.

Information Technology (IT)

The information technology department allocates a relatively small proportion of its operating budget to capital. This reflects a number of circumstances that mean that its costs would generally not be reduced with a reduction in overall organizational staffing levels and in the level of capital activity:

- The cost of new computer equipment, which is generally purchased rather than leased, typically exceeds Hydro Ottawa's capitalization thresholds, and thus these costs do not appear within OM&A budgets. Accordingly, reductions in the number of personal computers as a result of reduced staffing levels would not appear in IT department's operating budget.
- Monthly fees associated with mobile phones and other telecommunications devices are included in the budgets for individual departments. Reductions in these costs that may be associated with lower staffing levels under a scenario of no capital projects are thus captured elsewhere as reductions in the general and administrative expenses of the functional departments, rather than as a saving by the IT department.
- Much of the cost of the IT department relates to supporting the breadth of software applications used at Hydro Ottawa, rather than the number of users associated with each. These types of costs would not be significantly reduced even in the absence of capital projects.

As a result of the above factors, the major source of savings in the IT department as a result of the elimination of capital projects are associated with one fewer staff person in the Help Desk to provide support to operating staff.

The IT budget does not include expenditures associated with the Customer Information System (CIS). These costs are included in the Customer Care division.

Facilities

Reductions in staffing under the scenario in which no capital projects occur would result in a reduction in space required at three Hydro Ottawa facilities: Albion Road, Merivale, and Bank Street. In total, about 390 inside staff are housed at the 3 facilities.

As a starting point to estimating costs for the overhead capitalization process, the operating budget associated with these facilities was converted to an amount per inside employee that works at these facilities. This amount per employee was multiplied by the expected reduction in the number of inside workers under a scenario in which there are no capital projects.

The costing approach outlined above has the following implications:

- The figures use an average figure per employee for the three facilities together, rather than identifying the specific space that would be reduced. This avoided difficulties that may arise from differences across facilities in the cost of space per unit area or uncertainties in the specific space that would be retained (versus sold or sub-leased.)

- We assumed that space is a variable cost over the 3-5 year horizon used for analyzing cost behaviour. We thus assumed that excess space could either be sold or sub-leased, to capture space savings from employee reductions.

Regulatory

The functions of the regulatory group are split between Hydro Ottawa and Holdco. The Chief Regulatory Officer sits within Holdco, and costs associated with her involvement in Hydro Ottawa capital projects are included in the allocation of Holdco costs. Within Hydro Ottawa, there are 5 staff working on regulatory and rates issues associated with the utility. Within this group, the effort of ½ of an FTE was determined to be directly related to capital projects. The focus of this work is on planning and approvals for capital projects, and work to calculate costs that should be recovered through customer contributions or connection fees.

The costs of this department include OEB license fees and association dues. These external costs are excluded from the allocation to capital projects. This results in a lower allocation of total department costs to capital projects than would be suggested by the ½ FTE workload share noted above.

Fleet Costs

The cost of vehicles is recovered through an hourly vehicle rate (or burden) that is charged to all applicable projects, whether they are related to capital, maintenance, or work for others. The hourly rate is designed to capture all costs associated with the fleet department. These rates are not included in the overhead capitalization amounts that are the subject of this report. Fleet charges, however, are included in the base that is used to allocate Engineering Burdens.

H. The Structure of Burdens

Hydro Ottawa applies overhead costs to capital through three separate burden rates. The use of multiple burden rates allows overhead costs to be applied more precisely to the particular projects that are associated with the various types of overhead costs. The three different burden rates are as follows:

- **Engineering Burden.** This burden is designed to recover those costs of the engineering department that are associated with capital projects.
- **Supervision Burden.** This burden is designed to recover the costs of management salaries and general and administrative costs in the operations and metering divisions (which includes CAM and DAM).
- **General and Administrative Burden.** This burden is designed to recover the costs of various administrative and support services associated with capital projects.

In applying burdens, the approach distinguishes between two types of capital assets:

- **Distribution Plant**, which represents projects associated with Hydro Ottawa's outside distribution network, and
- **General Plant**, which covers all other capital projects. Major elements of General Plant include computer and software projects, vehicles, and buildings and equipment.

The Engineering and Supervision Burdens are applied only to Distribution Plant, since it was determined that General Plant projects do not generally consume (or draw on) the overhead resources associated with engineering and supervision activities. The Administration Burden is applied to both General Plant and Distribution Plant.

The Supervision Burden differs from the others in that it is applied to all three of the major work activities performed by Hydro Ottawa: capital, maintenance, and work for others. ("Work for others" covers projects or work undertaken on behalf of customers or other parties.) The basis for allocating the Supervision Burden is the direct project costs associated with Hydro Ottawa field labour and with outside services (e.g. contracting fees). This reflects the fact that Hydro Ottawa needs to supervise and inspect both the work done by its own field staff and the work done by others.

In Table IV-2, presented earlier in this chapter, the amount of dollars allocated to capital through the Supervision Burden is calculated based on the budgeted proportion of capital work versus maintenance projects and work for others. The actual amount allocated to capital will vary during the course of the year based on the actual levels of work activity. This is due to the fact that the percentage burden developed to recover these costs is fixed. The actual recoveries are monitored on an ongoing basis and are compared to the actual costs considered for capitalization. Any adjustments that may be required are made through a true-up process as per the allocation procedures.

The key attributes of the burden structure at Hydro Ottawa are summarized in Table IV-4 below.

Exhibit IV-4
Burden Structure

Burden	Nature of Costs Recovered	Basis of Allocation	Types of Projects
Engineering	Engineering	Sum of: - Direct Labour - Materials - Fleet Charges - Outside Services	Distribution Plant Only
Supervision	Management salaries and general and administrative costs in the Construction & Maintenance (CAM) and Distribution Asset Management (DAM) departments	Sum of - Direct Labour - Outside Services	Distribution Plant Only *Note: Applied as well to distribution maintenance and work-for others*
Administration	Various administrative and support costs including: - Supply Chain - Facilities - Human Resources and Safety - IT - Finance - Corporate costs - Holdco - Regulatory	Sum of - Direct Labour - Materials - Fleet Charges - Outside Services	Distribution Plant and General Plant

V. Rationale for Capitalization Estimates

In this Chapter, we summarize the rationale for the capitalization estimates prepared, and link it to the criteria noted in Chapter III.

To ensure that our estimates are consistent with regulatory and industry precedent, we undertook a review of some relevant regulatory and accounting guidance, and have summarized the results of our review in the appendix. As noted in this appendix, no single regulatory guideline, statement, or source exists that is universally accepted by industries and regulators as the definitive statement, definition, or standard that prescribes what kinds of overhead costs should be considered for capitalization. However, this topic has been the subject of discussion and comment among regulators and professional accounting bodies and a body of evidence exists on the topic. From this evidence, a common principle arises:

> *That any assignment of indirect costs to a capital project should be done based upon some reasonable causal link or association with the capital activity.*

Any estimates that Hydro Ottawa prepares should apply this basic principle. It speaks to the first criterion listed in Chapter III, which is that the methodology should have a **defensible cost causation linkage**. The estimates outlined in this update adhere to this principle. For all departments that allocate costs to capitalized overhead, company officials were asked to identify the activities concerned and to provide a rationale for the proposed cost allocation approach. Proposed cost allocations were expected to have a reasonable and defensible basis.

Other elements of the capitalization approach are discussed below.

A. Allocation Factors

In this update, careful consideration was given to the allocation factors used to identify capitalized overhead costs. We ensured that allocation factors were based on a **defensible cost causation linkage**.

As noted in Chapter II, officials within each department were asked to provide the details of their proposed approach to allocating costs to capitalized overhead for those activities that support Hydro Ottawa's capital projects.

The following methods were used to allocate costs in this update:

- **Time estimation.** In this method, the allocation factors (or "cost drivers") for a particular department or function were based on estimates of the proportion of time spent by employees within the department on activities in support of capital. These estimates were typically made by managers within the department who had a good knowledge and understanding of the workloads of associated employees. For the operations area, the time of managers and support staff was

allocated based on the time allocation of front-line employees (or, in other words, of those employees directly involved in carrying out department functions).

- **Volume drivers.** In this method, allocations were based on measures of throughput for a particular department. For example, vehicle insurance costs are allocated based on the underlying share of Fleet department costs that are charged to capital versus maintenance and work for others.
- **Value Measures.** Where appropriate volume measures were not available, dollar values were used. Thus, for example, costs for the Supply Chain department were allocated based on the relative value of purchases for capital versus operating activities. This allocation was based on activity levels over the last few years.

In addition to identifying appropriate cost drivers for activities allocated to capital, it was important to have a clear philosophy or rationale for the costs to be capitalized. This study focused on those costs or activities that would be eliminated in the absence of capital projects. This clear definition helped to ensure that our estimates exhibit a **freedom from bias.** The materiality threshold also helped to achieve this objective.

B. Documentation

The approach implemented for this update relies on formal documentation at each step of the process. It thus addresses the need for **transparency.** Elements of this approach are as follows:

- The Hydro Ottawa capitalization policy was documented in a formal statement. This statement provided additional guidance, relative to earlier implementation efforts, regarding the types of activities that are considered to have a causal link to capital projects.
- Finance staff, working with managers from each operating area, were required to justify the allocation factors used and to provide associated back-up (whether based on outputs from the financial reporting system or a time estimation process). Responses received represent an in-house record of the bases of cost allocation factors.
- Under the direction of KPMG, finance staff reviewed all departmental input regarding cost allocation factors, requested additional support or clarification as required, and then put together an integrated Excel spreadsheet to calculate overall overhead capitalization factors for Hydro Ottawa. This spreadsheet framework will facilitate updates, and should thus help to support the criteria of **flexibility/adaptability** and **low on-going costs**.

VI. Implementation

In this Chapter, we discuss recommendations for updating the capitalization process on an on-going basis.

A. The Use of Annual Updates

Our review suggests that most of the costs included in the overhead capitalization process are likely to be relatively fixed in nature from year to year, either in their dollar value or in their percentage of the total OM&A budget. This reflects the fact that costs allocated to the overhead capitalization process are generally related to overhead functions that are relatively stable in nature and that do not vary directly with the dollar value of capital expenditures in any particular period.

Accordingly, we recommend that burden rates used to recover capitalized overhead costs rates be recalculated annually to take into account changes in capital expenditures from year to year. An annual updating of the rate will better reflect the nature of overhead costs associated with capital projects. It will ensure that the process compensates appropriately for changes in the size of the capital budget.

The base amount of overhead costs allocated to capital will also need to be reviewed annually for reasonableness, and should be adjusted by management to account for changes in overall budgets or in the nature or breakdown of activities in the organization.

B. Comprehensive Updates

Hydro Ottawa should undertake a formal, comprehensive review of its overhead capitalization process on a periodic basis. The appropriate frequency for such updates will vary depending on the amount of change that occurs within the company over intervening periods. As a general rule, however, a comprehensive review should be carried out no less frequently than every 4 to 5 years. Specific triggers that could suggest an earlier review include the following:

- There are material changes in the costs or structure of the support functions that are associated with capital projects. Thus, changes in the organization of engineering, procurement, or stores functions, for example, could suggest an earlier update.
- There are changes in the types or nature of costs that are directly allocated to capital projects. This update, for example, has suggested that the costs of direct labour be adjusted to include an allowance for non-productive time. Such a change would require an update to the allocations within this study.

- There are changes in the definition of capital versus operating projects. This could be manifested, for example, as a change in capitalization thresholds. Any significant change in threshold may require a review of the overhead allocations, since the threshold affects the balance of work related to capital versus operating projects.
- There are significant changes in the balance of work that is done using in-house staff versus outside suppliers. Such changes may require changes in the overhead costs related to supervision and control.
- There are large changes in the size of capital budgets. Such changes could be a signal that overhead costs associated with capital projects have changed materially.
- There are changes in accounting or regulatory guidance.

KPMG

Appendix

Accounting and Regulatory Guidance

August 16th, 2007

Appendix - Accounting and Regulatory Guidance

In this Appendix, we provide references to a variety of Canadian and US sources of guidance on the capitalization of overhead costs. This listing is not comprehensive, but does capture the key sources that are likely to be of interest or relevance to Hydro Ottawa.

A. Canadian Guidance

1. Ontario Energy Board's Accounting Procedures Handbook for Electric Distribution Utilities

Article 410 of the Ontario Energy Board Accounting Procedures Handbook states:

> "Property, Plant and Equipment should be recorded at cost, which includes the purchase price and other acquisition costs such as: option costs when an option is exercised, brokers' commissions, installation costs including architectural, design and engineering fees, legal fees, survey costs, site preparation costs, freight charges, transportation insurance costs, duties, testing and preparation charges."[1]

Further guidance is provided by Article 230, Definitions and Instructions, No. 20. This document defines the components of construction cost as follows:

> "the cost of construction properly included in the electric plant accounts shall include where applicable, the cost of labour; materials and supplies; transportation; work done by others for the utility; injuries and damages incurred in construction work; privileges and permits; special machinery services; allowance for fund used during construction; and such portion of general engineering, administrative salaries and expenses, insurance, taxes, and other similar items as may be properly included in construction costs."[2]

2. Ontario Energy Board's Uniform System of Accounts for Class A Gas Utilities

According to the Ontario Energy Board's Uniform System of Accounts for Class "A" Gas Utilities, Appendix A, Plant Accounting Instructions:

> "Overhead Charged to Construction: includes engineering, supervision, administrative salaries and expenses, construction engineering and supervision, legal expenses, taxes and other similar items. The assignment of overhead costs to particular jobs or units shall be on the basis of a reasonable allocation of actual costs. The records supporting the entries for overhead charged to construction

[1] *Ontario Energy Board, Accounting Procedures Handbook, Article 410, p. 7.*
[2] *Ontario Energy Board, Accounting Procedures Handbook, Article 230, p. 5.*

costs shall be maintained so as to show the total amount for each element of overhead for the year and the basis of allocation."

3. CICA Handbook Section 3061 Property, Plant and Equipment ("PP&E")

This Section of the Handbook of the Canadian Institute of Chartered Accountants ("CICA") discusses measurement of PP&E. Section 3061.16 indicates that PP&E should be recorded at cost. Cost is defined in Section 3061.05 as "the amount of consideration given up to acquire, construct, develop or better an item of PP&E and includes all costs directly attributable to the acquisition, construction, development or betterment of the asset".

When an asset is constructed or developed over time, Section 3061.20 indicates that cost includes the direct construction or development costs as well as the overhead costs *directly attributable [our emphasis]* to the construction or development activity.

The Handbook does not define the term "directly attributable"; however, this term is used throughout the handbook in various sections with reference to cost allocations.

4. CICA Handbook Accounting guideline AcG-16 Oil and Gas Accounting – Full Cost

This accounting guideline applies to the application of the full cost method of accounting for oil and gas exploration, development and production activities. While this guideline is not specifically relevant to the capitalization of costs to PP&E, it does discuss the concept of overhead allocation and the capitalization of such costs. The guideline does not recommend or discourage the use of the full cost method of accounting.

Paragraph 7 of the guideline indicates that internal costs capitalized should be limited to those costs that can be "directly identified with the acquisition, exploration and development activities undertaken by the enterprise for its own account, and should not include any costs related to production (lifting costs), general corporate overhead, or similar activities". The guideline further states that capitalized costs include the "portion of overhead or general and administrative costs that can be directly related to, and is necessary to, the exploration and development activity".

5. CICA Handbook Section 3450 Research and Development Costs

This section discusses the costs that can be capitalized as research and development costs. Paragraph 3450.08 indicates that R&D costs include a reasonable allocation of overhead with the allocation being made on bases similar to those used in allocating overhead to inventory. It further states that current accounting practice does not allocate general and administrative costs that are not clearly related to a particular activity or function. These are treated as period costs.

6. CICA Handbook section 3031 Inventories

Paragraph 3031.10 states that the "cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition".

Paragraph 3031.12 states that the costs of conversion include "a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods". It then states: "Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour."

Paragraph 3031.13 states that "the allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities". Normal capacity is "the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance". Paragraph 13 goes on to state that the "amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred."

7. REALpac Accounting Practices Handbook

The Real Property Association of Canada ("REALpac") has published a manual to provide practical and professional interpretations of accounting principles as they relate to Canadian real estate investment and development companies.

REALpac recommends that general and administrative costs directly attributable to construction of a property should be capitalized as a cost of the project. The section describes general and administrative costs to include the following:

- Salaries and benefits of officers of company;
- Travel and automotive costs;
- Audit and legal fees;
- Occupancy costs;
- Stationery;
- Office expenses,;
- Directors' fees;
- Insurance;
- Computer facility costs;
- Subscriptions;

- Capital and business taxes and;
- Donations.

General and administrative costs that cannot be identified with a specific project or projects should not be allocated as a capitalized cost. REALpac gives the example of corporate stewardship costs as a cost that would not be capitalized.

If general and administrative costs (that qualify for capitalization) relate to a number of construction projects, then REALpac recommends that they be allocated to the projects using judgment and well supported methodology. REALpac advises that a time basis would be the most appropriate basis for allocation in most cases. The allocation method should be used on a consistent basis.

B. US Guidance

1. FAS 67 – Accounting for Costs and Initial Rental Operations of Real Estate Projects

The guidance under FAS 67 from the Financial Accounting Standards Board (FASB) states that:

> "Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate. Indirect costs that do not clearly relate to projects under development or construction, including general and administrative expenses, shall be charged to expense as incurred." (FAS 67 para 7.)

2. Uniform System of Accounts – Federal Energy Regulatory Commission

Under the Uniform System of Accounts prescribed for public utilities and licensees subject to provisions of the Federal Power Act, capital overhead is defined as:

"Overhead Construction Costs"

A. All overhead construction costs, such as engineering, supervision, general office salaries and expenses, construction engineering and supervision by others than the accounting utility, law expenses, insurance, injuries and damages, relief and pensions, taxes and interest, shall be charged to particular jobs or units on the basis of the amounts of such overheads reasonably applicable thereto, to the end that each job or unit shall bear its equitable proportion of such costs and that the entire cost of the unit, both direct and overhead, shall be deducted from the plant accounts at the time the property is retired.

B. As far as practicable, the determination of payroll charges included in construction overheads shall be based on time card distributions thereof. Where this procedure is impractical, special studies shall be made periodically of the time of supervisory employees devoted to construction activities to the end that only such overhead costs as have a definite relation to construction shall be capitalized. The addition to direct construction costs of arbitrary percentages or amounts to cover assumed overhead costs is not permitted.

c. For Major utilities, the records supporting the entries for overhead construction costs shall be so kept as to show the total amount of each overhead for each year, the nature and amount of overhead expenditure charged to each construction work order and to each electric plant account, and the bases of distribution of such costs.

C. Summary

All of this guidance has a common theme. Overhead that can be directly attributed to the construction project should be capitalized as part of the cost of the project. Limited guidance is given to determine which items of overhead would be considered to be "directly attributed" to a project. It seems clear that each entity must review its overhead expenses by type and determine if the cost is necessary to perform the construction project and if so, a portion of the cost should be capitalized. A reasonable basis of allocation must be determined. No guidance is given on allocation methods.

No single regulatory guideline, statement, or source exists that is universally accepted by industries and regulators as the definitive statement, definition, or standard that prescribes what kinds of overhead costs should be considered for capitalization. However, this topic has been the subject of discussion and comment among regulators and a body of evidence exists on the topic and a number endorse a common principle: that any assignment of indirect costs to a capital project should be done based upon some reasonable causal link or association with the capital activity. Any definition or standard that Hydro Ottawa adopts should apply this basic principle.

HYDRO OTTAWA LIMITED
HYDRO OTTAWA LIMITÉE

REPORT
RAPPORT

August 21, 2007

TO/DEST. Chair and Members of the Audit Committee

Agenda Item 3 REVISIONS TO CAPITALIZATION POLICY AND ALLOCATION PROCEDURE BASED ON UPDATED ESTIMATES

RECOMMENDATION

That the Audit Committee receives this report for information and discussion.

SUMMARY

1) It is a best and common practice that all organizations review on a periodic basis their financial and operational policies and procedures for appropriateness. External influences such as, significant changes to legislation, generally accepted and/or regulatory accounting principles and internal changes such, as organizational redesign and modifications to business practices or business lines, usually cause the re-examination of corporate polices for their appropriateness. In the absence of the above, the passage of time, usually 3-5 years, also triggers a review of all major corporate policies and financial estimates contained there in.

2) Recent pronouncements by professional accounting bodies affecting rate regulated entities, the filing of the 2008 rate application and the passage of time has prompted Hydro Ottawa Limited to review its Capitalization Policy and Allocation Procedure. Although Hydro Ottawa Limited's Capitalization Policy is still considered appropriate (Annex A), estimates associated with the capitalization of indirect or overhead costs need to be updated. In addition, the existing methodology for allocating overheads is complicated and needs to be simplified to allow for financial planning and budgeting in a more timely manner.

3) Proposals outlined in this accounting memo, have been benchmarked and are in line with other similar Ontario distributors of electricity as noted in the table below. However, should the Ontario Energy Board (OEB) not accept the proposed changes in estimates and allocations, there would be a material impact on the financial performance of Hydro Ottawa Limited, as distribution rates would be insufficient to cover the increased operating costs resulting from the change in capitalization estimates and allocation.

Hydro Ottawa Limited's most immediate concern, as a regulated company, is that its approved distribution rates include the change in estimated overhead included in this memo. An additional downstream financial pressure associated with increased operating costs is the requirement for larger productivity savings if the present OEB emphasis on just operating costs, (as opposed to operating and capital costs) is maintained.

4) The application of a change in accounting practice 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, whereas a change in estimate is implemented prospectively. It is management's opinion that the proposed adjustment to overhead allocations is a change in 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.

BACKGROUND

5) Upon the amalgamation of the 5 predecessor utilities on November 1, 2000, Hydro Ottawa Limited adopted the capitalization policy and allocation procedure of one its predecessors, Ottawa Hydro, until it conducted its own review in 2003. Hydro Ottawa Limited's existing policy and procedure were developed as a result of a 2003 review, the results of which were applied in the preparation of the audited 2003-year end financial statements.

6) Deloitte & Touche reviewed the policy and procedure and the related indirect cost allocation model in July of 2004. They found the model was working as intended. It was their opinion that "administrative overhead costs may be allocated to the capital projects if they are qualifying capital costs under OEB rules and if this is consistent with industry practice." The capitalization policy, and the allocation procedure and model have remained consistent to date.

7) On May 15, 2007 the Audit Committee received a report outlining Hydro Ottawa Limited's current accounting treatment of indirect (overhead) costs and their inclusion within the Capitalization Policy and the Cost Allocation Procedure. The report discussed new accounting developments, industry practices and financial implications (Annex C). The May 15, 2007 report makes reference to the CICA's handbook, section 3061.20 that states that "The cost of an item of property plant and equipment include direct construction and development costs and *overhead costs directly attributable* to the construction or development". *Directly attributable* is a concept that is not defined in the CICA handbook. *Directly attributable* is a matter of judgment and as pointed out in the D&T and KPMG reports (available upon request) can vary among and within industries and professional accounting bodies.

8) Since the May 15, 2007, report Hydro Ottawa Limited has completed a review of its Capitalization Policy and its Cost Allocation Procedure. The review included a re-

evaluation of Hydro Ottawa Limited's accounting estimates related to those indirect or overhead costs *directly attributable* to its capital program and its model for allocating overheads. Fleet and Supply Chain costs were also examined but were found to be reasonably estimated and fairly allocated to capital and hence have not been commented upon in the balance of this memo.

ANALYSIS

9) Hydro Ottawa Limited engaged Deloitte & Touche (D&T) to research accounting guidelines and industry practice as they relate to including overhead allocations in the costs capitalized to Property, Plant & Equipment. D&T 's report concluded that there is a significant variation amongst utilities across Canada and the United States as to capitalization policies and specifically the capitalization of overhead. They noted that there has been a shift from aggressive to more conservative capitalization policies. Eventual convergence with International Financial Standards and the recent exposure draft discussing the elimination of rate regulated accounting in Canada would also be contributing factors towards a more conservative approach.

10) Hydro Ottawa Limited staff also conducted an informal web based review to determine how other companies interpret *directly attributable* overhead costs. Two reports issued by KPMG were considered by staff to be the most relevant and current. They are, a study undertaken on behalf of NB Power Group of Companies and another on behalf of Union Gas Limited. In both studies KPMG was retained to conduct an independent study of the companies' process for capitalizing overhead costs and in the case of NB Power, this included the allocation of corporate service costs from their Holdco.

11) Hydro Ottawa Limited engaged the same KPMG Managing Director who participated in the NB Power and Union Gas reviews to assist in a review to update Hydro Ottawa Limited's estimate of the amount of overhead costs related to capital work and ensure its capitalization and allocation policies reflect any change in the methodology to identify and allocate overhead costs to be capitalized. The common principle that KPMG has deduced from its review of accounting and regulatory guidance and industry practice is "That any assignment of indirect costs to a capital project should be done based on some reasonable causal link or association with the capital activity." It is this principle that Hydro Ottawa Limited incorporated into its current review of indirect or overhead costs attributable to its capital program. The resulting estimate, discussed below, is reflective of a less inclusive overhead capitalization approach being taken by Hydro Ottawa Limited than in the past. The allocation of overhead costs to capital in the past was not a miscalculation but rather a different estimate of *directly attributable* costs based on circumstances relevant at the time. The costs were reflected as such in past annual audited financial statements. The current methodology as outlined in the KPMG report is seen to be more reflective of industry practice and a trend towards less capitalization of overheads by professional accounting bodies.

12) The allocation model has been simplified to eliminate a complex process of assigning overhead costs amongst support activities i.e. Finance, Human Resources etc.

and then reassigning a portion of the support activity costs estimated to be directly attributable to capital work. The new model determines a percentage of indirect cost for each overhead activity, which is applied to each supporting activity's operating costs to determine a burden rate. The burden rate is then applied to a cost driver i.e. direct labour or material resulting in the capitalization of a directly attributable overhead cost. Only three burden rates, Engineering, Supervision and Administration have been established in the current model. These will be applied to the appropriate cost drivers independently to simplify the allocation process. This also allows overhead costs to be applied more precisely to particular projects that are associated with the various types of overhead costs. Cost comparability to previous years will be difficult or impracticable once the change is implemented.

13) In summary, KPMG reviewed Hydro Ottawa Limited's policy on capitalization and and found it to be reasonable and in accordance with industry standards and practice related to overhead capitalization. KPMG also reviewed the cost drivers (for overhead allocation) and validated the appropriateness of the overhead costs that are to be allocated to capital projects. KPMG finds the proposed overhead capitalization results developed in the study and presented in their report to be fair and reasonable.

FINANCIAL IMPLICATIONS

14) Hydro Ottawa Limited's reassessment of estimated overhead or indirect costs that are directly attributable to capital work has resulted in approximately $6.5M of overhead costs now identified in the 2008 budget as OM&A costs. Previously these costs would have been capitalized and amortized over 4 to 50 years depending on the asset type to which they were assigned. The table below provides a relative comparison of the impact of the change in estimates from 2007 to 2008.

($ millions)

		2007 Approved Budget			**2008 Proposed Budget (as of August 1/07**	
Indirect Costs (1)	**Total (3)**	**Capital Allocation (1)**	**P&L Expense**	**Total (3)**	**Capital Allocation**	**P&L Expense**
IT	3.0	1.6	1.4	3.3	.1	3.2
HR	3.5	1.9	1.6	3.5	1.2	2.3
Finance	3.2	1.8	1.4	3.3	.6	2.7
Holdco	1.9	1.0	0.9	1.9	.2	1.7
Corporate	1.9	1.0	0.9	1.9	.4	1.5
Facilities	4.0	2.2	1.8	3.6	1.0	2.6
Other (2)	2.0	$1.1	0.9	2.2	.6	1.6
Total	**$19.5M**	**$10.6M**	**$8.9M**	**$19.7M**	**$4.1M**	**$15.6M**

(1) Used an average 55% capitalization rate in the 2007 calculation.
(2) Other includes some costs from the COO's office, and some general and administrative costs from Operations, which are not included in supervisory or engineering burdens.

(3) Total Indirect Costs – some gross OM&A costs have been excluded from the pool of costs considered for capitalization because they are not directly attributable to the capital program.

15) The reallocation of $6.5M from Capital expenditure to an Operating expense in the 2008 budget introduces a financial risk to Hydro Ottawa Limited. OEB acceptance of the reallocated expenses will be required to ensure Hydro Ottawa Limited's revenue requirement, which reflects the reallocated expenses to be included in the 2008 rate application, is approved. Customer rate impact will be a consideration. An increase of $6.5M would have an approximate 1. 4% increase on the average residential consumer's total monthly electricity charges or a 5% increase to their distribution rate. Overall customer rate impact however, could be reduced or increased due to other factors affecting the 2008 rate application. This report does not address the overall customer rate impact of the 2008 rate application.

16) The reallocation of expenditures from capital to operating has financial implications for Hydro Ottawa Limited. The increased operating expenses, if approved by the OEB, would be included in rates as a 2008 cost and generate an immediate cash flow of approximately $6.5M per annum. This is unlike costs that are capitalized and cash flow is generated based on the amortization of expenditures over a 4-50 year horizon depending on the nature of the asset to which they are assigned.

In addition, operating expenses do not generate a Return on Equity (ROE) and therefore Hydro Ottawa Limited would forego approximately $230,000 of ROE in 2008. Over a 3-year period assuming approximately the same level of assignment of costs to operating expense ($6.5M) and the same ROE the cumulative after tax impact to net income would be an approximate $850,000 reduction. It should also be noted that the reduction in net income from the lost return on capital is also an amount that customers will not have to pay for through rates. This is discussed more fully later in this section.

17) 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. It is estimated that approximately $1.5M - $2.0M of expenditures in Q4 of 2007 will be charged to operating expense as opposed to being capitalized. The after tax effect is estimated to be an approximate $1.0M - $1.3M reduction to 2007 net income.

18) The financial impact to our customers was also considered in terms of the aggregate revenue requirement that they would fund depending on whether the $6.5M is treated as a capital expenditure or operating expense. Simply stated, our customers will pay less over the long term if the $6.5M is treated as an operating expense as opposed to being capitalized, but they will also experience a rate impact in 2008. This conclusion is outlined in the following paragraph.

An average asset life of 25 years was used for the calculation. Without considering the time value of money, and assuming full OEB approval, Hydro Ottawa would increase

its revenue requirement by $6.5M for the increase in operating expenses. Alternatively, if the $6.5M is capitalized the customers will pay $11.8M over the life (25years) of the capital asset. The additional $5.3M is due to the additional return on equity and cost of debt earned each year on the unamortized asset value over its 25-year life. If the calculation is adjusted to reflect the time value of money (assume an inflation rate of 2% per annum over the 25 years) the present value of the $11.8M would be reduced to $9.5M. This is still $3.0M in excess of the $6.5M operating expense. Although the initial impact of decreasing the amount of overhead capitalized is an increase in revenue requirement and therefore an increase in rates to the consumer, it can be seen that the decrease in overhead allocated to capital is more beneficial to the customer over the long term.

BENCHMARKING

19) Local Distribution companies are benchmarked based on various metrics by the OEB. OM&A per customer is one such metric. To assess the appropriateness of a change in OM&A based upon a $6.5M reallocation of expenditures from capital to OM&A the '2005 Yearbook of Electricity Distributors', published March 29, 2007 was utilized.

The following table outlines OM&A per customer using 2005 data and the approximate impact that an additional $6.5M of OM&A would have on Hydro Ottawa Limited's metric. Although, there is a significant increase to Hydro Ottawa Limited's metric the revised metric is less than the average of 22 of the larger utilities in Ontario using 2005 data. It is expected that once 2008 data is available that Hydro Ottawa Limited's OM&A per customer metric will be more towards the middle of the large LDC pack. Based on the proposed 2008 Budget, Hydro Ottawa Limited's OM&A per customer would be $202.50 (excluding Smart Meters), which is expected to be still in line with its peers.

2005 Data

LDC	OM&A per customer
Enwin Powerlines	$250.67
Toronto Hydro	223.76
Enersource Hydro	229.60
Powerstream Inc.	187.46
Average of 22 Larger Utilities	**184.00**
Horizon Utilities	165.34
Hydro Ottawa	156.39
Hydro Ottawa (+$6.5M of OM&A)	**179.73**

Furthermore, the OEB engaged the services of a consultant to calculate the productivity of all LDCs. The report produced by the consultant measured the productivity of LDCs only through OM&A, not considering capital programs. If the OEB adopts the productivity calculation proposed by the consultant, Hydro Ottawa's productivity would decrease relative to other LDCs as a result of these proposed changes in capital

allocations. This could have an impact on productivity factor targets set for Hydro Ottawa as part of incentive regulation.

The following table summarizes the productivity from the OEB consultant's report.

Large City Southern LDCs as defined by OEB Consultant	**Productivity (High value suggests good cost management)**	**Excess Cost (Negative value) is costs lower than benchmark per Year ($000's)**
	2005	2002 to 2005
Hydro One Brampton	1.82	(4,917)
Hydro Ottawa	1.71	(6,319)
PowerStream	1.31	(3,114)
London Hydro	1.31	91
Horizon Utilities	1.27	(2,724)
Veridian Connections	1.21	4,136
Toronto Hydro	1.19	15,556
Enersource Hydro Mississauga	1.16	2,270
Enwin	0.97	6,540
Group Average	1.33	

As can be seen, Hydro Ottawa compared very favourably based on 2005 costs. The calculation of productivity indicated that Hydro Ottawa's costs were $6.3 million lower than the benchmark when averaged over the years 2002 to 2005. The $6.5M change in allocated overhead is approximately equal to the negative excess costs of ($6.3M) calculated above by the OEB's consultant.

REGULATORY RESEARCH

20) Hydro Ottawa Limited also asked Fraser Milner Casgrain LLP (FMC), the counsel retained for the 2008 rate application, to conduct research for regulatory decisions on the issue of capitalization versus expensing expenditures. FMC's work to date covers decisions made in the last five years by the following regulators: the Ontario Energy Board (OEB), the Alberta Energy and Utilities Board (AEUB), the British Columbia Utilities Board and the National Energy Board. To date their research suggests there is no hard and fast rule, in short, when one is deciding whether to capitalize or expense an expenditure. To the contrary, well-accepted business principles are applied on a case by case basis, having regard to the facts of each case.

These regulators in general, and the OEB in particular, require an applicant to provide sufficient evidence and rationale to change its capitalization policy or cost drivers, or both, because such changes affect the basis for calculating revenue requirement. The OEB denied an application by Union Gas (RP-2003-0063), for example, on the ground that the applicant did not provide comprehensive and clear evidence, including full details on the impact on the revenue requirement that would result from the proposed changes in cost drivers. Consequently, Hydro Ottawa Limited intends to file this memo and annexes, and the accounting opinion to be obtained, with its 2008 rate application and present the necessary expert witnesses to substantiate the basis and impact of its change in estimated overhead allocation to capital work.

REVISED POLICY & PROCEDURE

21) Attached are the recommended Capitalization Policy (Annex A) and Allocation Procedure (Annex B) which effect the change in estimated indirect costs directly attributable to capital work and simplify the cost allocation model used to assign indirect costs to capital work.

22) Our external auditors are in agreement with the updated capitalization policy, resulting estimates and the revised allocation procedure.

CONCLUSION

23) It is management's opinion based on the studies and rationale provided within this report that Hydro Ottawa Limited's capitalization policy and allocation procedure should be updated to better reflect a more current estimate of overhead costs directly attributable to its capital work.

Recommended by:

Wojciech (Wojo) Zielonka
Chief Financial Officer

Approved for submission to the Audit Committee:

Rosemarie T. Leclair
President and Chief Executive Officer

Policy Number: FIN5-001-02	Subject: Capitalization
Effective Date: October 1, 2007	Policy Owner: Chief Financial Officer

Applicability
This policy applies to the capitalization of assets for Hydro Ottawa Limited.

Purpose
This policy describes the process and specific criteria used for determining if expenditures should be capitalized on the Balance Sheet or expensed to operations in the period incurred. Expenditures are capitalized if they meet generally accepted accounting principles. Capital assets are expected to provide future economic benefits for more than one year. Any expenditure that can be identified as directly attributable with the acquisition, construction, development or betterment of an asset should be capitalized and amortized over the useful life of the asset.

Guidelines
Tangible Assets
Property, plant and equipment are identified as tangible assets provided that they are held for use in the production or supply of goods and services, are intended for a continuing use, and are not intended for sale in the ordinary course of business.

Intangible Assets
An intangible asset is a right or non-physical resource, which provides a benefit or advantage to the company.

Goodwill
When an asset is acquired for a cost over and above the net amount of the acquired assets and assumed liability, the excess cost is considered goodwill.

Capital Assets
Capital assets include tangible and intangible assets, exclusive of goodwill.

Betterment
Betterment is a cost that is incurred to enhance the service potential of a capital asset. Expenditures for betterments are capitalized. This enhancement in service potential can include an increase in the physical output or service capacity, decrease in associated operating costs, extension in the useful life of the asset, or improvement in the quality of the asset's output.

Repair
A repair is a cost which is incurred to maintain the existing service potential of a capital asset. Expenditures for repairs are expensed in the period in which they occurred.

Policy Number: FIN5-001-02	Subject: Capitalization
Effective Date: October 1, 2007	Policy Owner: Chief Financial Officer

Development
The development of an asset includes work to prepare an asset for further capital work and would typically include development of a piece of land for construction of a transformer station or other distribution plant. If the associated project is not completed with an asset put into service, these costs would be expensed.

Materiality
All expenditures for capital assets and betterments will be capitalized subject to materiality limits as set out in this policy. At times the administrative costs of capitalizing an asset may outweigh the intended benefits. While an expenditure may meet the definition to qualify as a capital asset, a dollar level is set, and if an expenditure falls below, it is not capitalized. This level is known as a materiality limit.

Materiality Limit
For identifiable assets the materiality value for capitalization for new assets or addition to existing assets will be $500.00 for both distribution plant and general plant.
For grouped assets the value for capitalization will be $1000.00 based on a single occurrence for distribution plant and $500.00 for general plant. Where programs are established for ongoing betterment work this minimum will not be applicable.

Readily Identifiable Assets (Discrete)
A capital asset that has a cost over $500.00 and is easily identifiable, so the asset can be individually tracked and recorded.

Grouped Assets
For efficiency, capital assets may be grouped if, by their nature, it would be impractical to identify individual units. These grouped assets are managed as a pool for the purposes of amortization.

Capitalized Cost
Cost is the amount of consideration given up to acquire, construct, develop or better a capital asset. Costs include all expenditures necessary to put a capital asset into service including all overhead costs that are eligible under this policy and an Allowance for Funds Used During Construction (AFUDC) if applicable.
Overhead costs must be directly attributable to construction activity at the utility. This will be interpreted to mean that the overhead costs to be charged to capital are those that would not exist if Hydro Ottawa did not construct its own capital assets. Eligible costs may appear fixed in the short term but would be eliminated over time (in 3 to 5 years) if Hydro Ottawa did not have a capital program. Overhead costs that are capitalized include such costs as salaries and benefits of construction and engineering personnel not directly chargeable to project costs and

the cost of administrative and support services that are required as a result of construction activity.

Capital Related Overhead Expenses
Per Allocation Procedures.

Allowance For Funds Used During Construction
For projects with a construction duration of greater than 2 months a financing charge will be applied against the project and capitalized. The financing charge will be at the rate deemed by the Ontario Energy Board (OEB) for rate-setting purposes.

Amortization
Capital assets are generally amortized based on a method and life set by the OEB, which is considered a suitable indicator of estimated useful life for our industry. Large and unique capital expenditures will be reviewed on an individual basis to determine the expected life and appropriate method of amortization.

Capital Spares
Spare transformers and meters will be accounted for as capital assets since they form an integral part of the reliability program for a distribution system. Spare transformers and meters are held for the purpose of backing up transformers and meters in service in the existing distribution system. Transformers and meters received for the purpose of expanding the distribution system will only be capitalized once they are put into service and will remain in inventory until that time.

Policy Compliance

All current practices will comply with the Accounting Procedures Handbook issued by the OEB and the CICA handbook. There will be no exceptions to the requirements of this policy in the execution of day-to-day business. Employees must report incidents of non-compliance relating to this policy in a timely manner to the Policy Owner. Non-compliance issues of a serious nature will be immediately reported to the Chief Operating Officer. Determination of "non-compliance issues of a serious nature" will be the responsibility of the Policy Owner.

Chief Operating Officer	Policy Owner	Director, Finance

Policy Number: FIN5-001	Subject: CAPITALIZATION
Procedure Number: 001-02	Subject: **COST ALLOCATION RATES**
Effective Date: October 1, 2007	Document Owner: Chief Financial Officer

Applicability

This procedure applies to the costing of Hydro Ottawa activities pertaining to Capital, Maintenance, and Work for Others.

Hydro Ottawa has developed cost allocation rates to distribute directly attributable costs to its three major work activities of Maintenance, Capital and Work for Others. These rates are based on management's best estimates of the applicable cost allocation determinants.

Guidelines

Separate allocation rates are determined for the following activities:

Direct Labour Rate

The hourly labour rate recovers direct labour, benefits, and non-productive time costs. It will be applied to all direct labour hours charged to Maintenance, Distribution Capital, and Work for Others through timesheet reporting.

General Plant Labour Rate

The general plant labour rate recovers the direct labour, benefits, and non-productive time associated with these projects.

Supervision Rate

The supervision burden rate charges all applicable Capital, Maintenance, and Work for Others activities. This rate allocates the costs associated with the supervision of internal labour and outside services.

Engineering Rate

The engineering burden rate recovers the direct cost of the Engineering Department. It will be applied to Distribution Capital projects and Work For Others where applicable.

Policy Number: FIN5-001	Subject: CAPITALIZATION
Procedure Number: 001-02	Subject: **COST ALLOCATION RATES**
Effective Date: October 1, 2007	Document Owner: Chief Financial Officer

Vehicle and Equipment Rates

Vehicle and equipment burden rates capture the full costs associated with fleet usage (maintenance, fuel, license, insurance, amortization, fleet overheads). Individual rates will be developed for major vehicle classifications based on expected utilization. Charges to the three major work activities will be accomplished through vehicle timesheet reporting.

Administrative Costs Rate

An Administrative Costs burden rate charges all capital work with its share of overheads that have been determined to be directly attributable to capital programs. Overheads include the identified costs of departments that do not charge time directly to capital projects by timesheets. These departments include Procurement, Facilities, Human Resources/Safety & Training, Information Technology, Finance, Regulatory Services, and Corporate costs.

Procedures

Burden rates will be developed by the Finance Department each year, as applicable, in conjunction with the development of the annual budget.
Recoveries against actual costs will be monitored during the year as part of the forecast management process and adjusted if over or under recovered through a true-up process. True-ups will be completed as required based on materiality limits of the organization.

Compliance

Any exceptions to the requirements of this procedure must be approved by the Chief Operating Officer and disclosed as an addendum to the procedure.

Chief Operating Officer | Document Owner | Director, Finance

COMPARISON OF CAPITAL SPENDING 2008 VERSUS 2007

1.0 INTRODUCTION

Table 1 provides details of capital expenditures for the bridge year and test year:

Table 1 – 2008 versus 2007 Capital Expenditures

Capital Expenditures	2007 Estimate $000	2008 Forecast $000	Variance $000
Land and Buildings	$2,681	$3,504	$823
TS Primary Above 50	9,791	13,479	3,688
DS	2,972	4,422	1,450
Poles, Wires	27,054	24,264	(2,790)
Line Transformers	9,049	6,807	(2,242)
Services and Meters	26,000	18,066	(7,934)
General Plant	2,506	2,103	(403)
Equipment	4,399	3,002	(1,397)
IT Assets	9,063	5,060	(4,003)
Other Distribution Assets	1,053	1,089	36
TOTAL	$94,568	$81,796	($12,772)

As explained in Exhibit B1-3-1, for 2008, Hydro Ottawa has revised the estimate for Administration costs allocated to capital work. The impact of this change is an approximate $6.5M reduction in capital expenditures in 2008 from 2007. The remaining $6.3M variance is explained below in terms of programs/projects, as this is how Hydro Ottawa plans and budgets work. The Board's Filing Requirements, issued November 14, 2006, states that a written explanation is required for rate base related information when there is a variance greater than a materiality of 1% of total net fixed assets. In 2006, Hydro Ottawa's total net fixed assets were $448M, resulting in a materiality threshold of $4.48M. Hydro Ottawa has chosen to use materiality thresholds of $500k for Distribution Capital programs/projects and $100k for General Plant programs/projects in order to provide a more detailed explanation of variances.

Table 2 - Distribution Capital Program Expenditures, Sustainment

	Budget Program	2007 Estimate $000	2008 Forecast $000	Variance $000
2.1	Stations New Capacity	$4,190	$9,277	$5,087
2.2	Major and Minor Line Extensions	721	3,444	2,723
2.3	System Voltage Conversion	2,659	122	(2,537)
2.4	Distribution Enhancements	2,698	609	(2,089)
2.5	Stations Relay Replacement	1,581	0	(1,581)
2.6	Stations Switchgear Replacement	4,603	5,610	1007
2.7	Plant Failure Capital	2,094	1,171	(923)
2.8	Facility Programs - Stations	2,679	3,504	825
2.9	Distribution Transformer Replacement	2,506	1,708	(798)
2.10	Pole Replacement	3,980	3,409	(571)

Table 3 – Distribution Capital Program Expenditures, Demand

	Budget Program	2007 Estimate $000	2008 Forecast $000	Variance $000
3.1	Smart Meters	$16,920	$9,684	($7,236)
3.2	Residential Subdivision	7,418	8,350	932
3.3	Plant Relocation and Upgrades	4,882	4,182	(700)

Table 4 – General Plant Capital Expenditures

	Budget Program	2007 Estimate $000	2008 Forecast $000	Variance $000
4.1	GIS Budget Program	$6,513	$0	($6,513)
4.2	CIS Enhancements	1,020	2,722	1,702
4.3	Fleet Replacement	2,996	1,693	(1,303)
4.4	GRM System Enhancements	0	547	547
4.5	New PC and Peripherals	759	370	(389)
4.6	Website Enhancements	36	392	356
4.7	Buildings - Facilities	2,451	2,103	(348)
4.8	Information Services and Technology	827	719	(108)

Table 5 – Capital Programs with Immaterial Variances

	Budget Program	2007 Estimate $000	2008 Forecast $000	Variance $000
5.0	Projects with Variances less than Materiality	$22,890	$22,180	($710)

Table 6 – Total

	Budget Program	2007 Estimate $000	2008 Forecast $000	Variance $000
	TOTAL	$94,568	$81,796	($12,772)

Table 7 - Contributed Capital

		2007 Estimate $000	2008 Forecast $000	Variance $000
6.0	Contributed Capital	($15,022)	($15,345)	($323)

2.0 DISTRIBUTION CAPITAL PROGRAM EXPENDITURES, SUSTAINMENT

2.1 Stations New Capacity

Stations New Capacity increases in 2008 with the inclusion of two new substation capacity projects as described in Exhibit B3-4-1. A second transformer will be added to the existing Uplands substation and an additional new substation will be constructed adjacent to the existing Albion Substation.

2.2 Major and Minor Line Extensions

A number of line extensions were identified for the 2008 year, resulting in an increase from 2007. Ongoing residential development in the Stittsville area, the new Rockcliffe Airbase redevelopment and the construction of a second overhead crossing that will connect Nepean and Gloucester have all contributed to the increased requirements for line extensions in 2008. Additional information on these projects is found in Exhibit B3-4-1.

2.3 System Voltage Conversion

The Sunnyside System Voltage Conversion project began in 2006 with equipment ordering, and will be substantially concluded in 2007. The remaining expenditures in 2008 are for project wrap-up, such as civil landscaping re-instatement.

2.4 Distribution Enhancements

Distribution Enhancement projects are identified through the planning process. A pool of projects is evaluated yearly to determine priority and coordinate construction with other programs, such as City of Ottawa Works. Distribution Enhancement expenditures are reduced in 2008 as the program has been balanced with the required expenditures in the Station Capacity, as explained in B4-2-1.

2.5 Stations Relay Replacement

The stations switchgear and stations relay programs are combined in 2008 to realize efficiencies. The scope of work in 2008 is to replace equipment in three substations, Beechwood, Eastview and Kilborn. Each substation has different requirements that impact the expenditures for the equipment replacements, such as voltage of the switchgear, capacity of the station and number of relays. The forecast to complete the scope of work in 2008 is less than the estimate in 2007 to replace equipment in the Bayswater and Marchwood stations.

2.6 Stations Switchgear Replacement

Refer to Section 2.5.

2.7 Plant Failure Capital

The plant failure capital program is a reactionary program. Expenditures increased in 2006 based on the rate of equipment failure. One of the inputs into the development of Hydro Ottawa's sustainment programs is the location and nature of plant failures. The continuing implementation of sustainment, maintenance and inspection programs is expected to result in decreases in this category as the projects mature. Therefore the forecast for 2008 has been decreased.

2.8 Facilities Programs – Stations

In 2007, the Facilities Station program consists of the construction of the facilities for the new Substation located in the east end of the city, the new Cyrville Substation. The 2008 program consists of the construction of the facilities for two substations located on existing Hydro Ottawa lands; Albion Substation and Uplands Substation, as described in Schedule B3-4-1. For this reason additional expenditures are forecast for 2008.

2.9 Distribution Transformer Replacement

The distribution transformer replacement program scope in 2007 included the replacement of 350 transformers. In 2008 the remaining 126 units identified by the transformer survey program will be replaced.

Since the program related to transformers containing insulating oil with PCB concentrations greater than 50 ppm will be completed in 2008, the distribution transformer replacement program will return to replacement levels based on the asset management strategy, resulting in a much less intensive program.

2.10 Pole Replacement

Pole replacement continues in 2008 at significant levels. The expenditures are lower than 2007 as the Distribution Asset capital program has been balanced with the required expenditures in the Station Capacity capital program, as explained in B4-2-1.

3.0 DISTRIBUTION CAPITAL PROGRAM EXPENDITURES, DEMAND

3.1 Smart Meters

Smart Meters are discussed in Exhibit D3-1-1.

3.2 Residential Subdivision

Residential Subdivision expenditures are increased in 2008 to reflect the increased demand Hydro Ottawa expects as a result of the growth in population and desire for single-family homes.

3.3 Plant Relocation and Upgrades

Discussions with the City of Ottawa indicate that infrastructure work by the City of Ottawa will continue in 2008. The forecast is reduced due to an expected decrease of the impact of these projects on Hydro Ottawa plant in 2008.

4.0 GENERAL PLANT CAPITAL EXPENDITURES

4.1 GIS Budget Program

There will be no further GIS expenditures once the project is completed in 2007.

4.2 CIS Enhancements

In 2008, Hydro Ottawa will start a full version upgrade of PeopleSoft Customer Information System. Refer to Exhibit B1-2-6 for more details.

4.3 Fleet Replacement

Fleet replacement expenditures have been increases in recent years to rejuvenate the aged fleet. The Fleet Replacement forecast is reduced in 2008 as Hydro Ottawa reduces its investment towards normal lifecycle replacement levels.

4.4 GRM System Enhancements

Geographical Resource Management ("GRM") is a new general plant program in 2008. The program involves integration of geographic tools into systems and departments to gain efficiencies. One example of projects in this category is the OMS integration into IVR and internet site for customer outage information. Refer to Exhibit B3-4-2 for additional details.

4.5 New PC and Peripherals

The inclusion of the expenditures in 2007 for the implementation of a new Finance Budgeting and Allocation Tool has lead to this variance. The bulk of the project will be completed in 2007, and as a result, the expenditures for the budget program in 2008 will decrease. The details of this project are described in Exhibit B3-4-2.

4.6 Website Enhancements

The increase of capital expenditure on Website Enhancements is due to the planned implementation of Smart Meter/Time of Use website. Refer to Exhibit B3-4-2 for additional details.

4.7 Buildings – Facilities

Previous year expenditures included an increase in life cycle capital spending, such as roof replacement at the Albion facility and installation of security cameras at the Carling storage area, to maintain the buildings to a safe standard. The return of the Building Facilities expenditures towards normal yearly lifecycle capital spending resulted in the decreased forecast for 2008.

4.8 Information Services and Technology

In 2007 Hydro Ottawa undertook a review of software licence compliance and implemented the necessary changes. This program was completed in 2007, leading to a relative decrease in the 2008 forecast.

5.0 PROJECTS WITH VARIANCES LESS THAN MATERIALITY

The capital budget consists of the aforementioned programs with material variances between the 2008 forecast and the 2007 estimate, as well as a number of programs with variances below the materiality threshold. The projects with a material expenditure for 2008, which did not have a material variance from 2007, are described in Exhibit B3-4-1 for Distribution Plant and B3-4-2 for General Plant.

The following is a list of the 2008 capital projects with variances below the materiality threshold between the 2008 forecast and the 2007 estimate expenditures.

- Cable Replacement
- Civil Rehabilitation Program
- Damage to Plant
- Distribution Automation
- Elbow and Insert Replacement
- Embedded Generation Projects
- Furniture and Equipment
- Infill Services
- Insulator Replacement
- New Commercial Development
- O/H Equipment New and Rehab
- Outbound Calling Auto-Dialer
- PC/Peripheral Replacement Program
- PILC Risers & Pothead Replace
- Remote Disconnected Smart Meter
- System Operations Automation
- Splice Replacement Program
- Stations Automation
- Stations Battery Replacement
- Stations Enhancements

- Stations Minor Enhancements
- Stations Plant Failure Capital
- Stations Transformer Replacement
- Switchgear New and Rehab
- System Expansion
- System Reliability
- Tools Replacement
- Vault Rehab or Removal
- Vault Space Capital Leasing
- Wholesale Meter Upgrade

6.0 CONTRIBUTED CAPITAL

Although total capital expenditures for 2008 are forecasted at $12.8M less than 2007, contributed capital remains at $15M. This is due to the capital spending on demand projects remaining relatively the same. It is the assets included in demand projects, such as poles, services, etc., for which contributed capital is received.

OPERATIONS, MAINTENANCE AND ADMINISTRATION COSTS

1.0 INTRODUCTION

There are a number of factors, both external and internal, that affect Operations, Maintenance and Administration ("OM&A") Costs in the period 2006 to 2008.

1.1 Growth

The City continues to grow and Hydro Ottawa added approximately 3,800 new customers to the distribution system in 2006 and higher growth is forecast for 2007 and 2008. Hydro Ottawa's customer count is forecast to be 293,220 by year-end 2008 up 10,827 (3.8%) from the 2006 year-end number of 282,393.

1.2 Compensation

In March 2007, a new collective agreement was signed with the International Brotherhood of Electrical Workers, increasing the annual wages by 3% in 2007 and 3.25% for each of 2008 and 2009. Management staff compensation has been forecasted to increase by 3%.

At the end of 2006, the Hydro Ottawa Group of Companies underwent a reorganization. As a result of this, the vice-president layer of Hydro Ottawa's management was eliminated (four vice-presidents), two director positions were created and one eliminated and one existing director was transferred to the Holding Company.

Hydro Ottawa is nearing completion of an integrated Geographical Information System ("GIS") and Outage Management System ("OMS"). Once implemented, the system will enable Hydro Ottawa to diagnose and respond more quickly to problems in the distribution system and reduce outage times for customers. An important impact of the conclusion of this project is that the team members whose salaries have been fully capitalized during the project will now be focused on operational work. Only a portion of

these salaries will now be related to capital projects and the other part will be in Operating and Maintenance ("O&M") expenses. Further details on compensation are provided in Exhibit D1-5-1.

1.3 Workforce planning

In 2005, Hydro Ottawa launched its apprenticeship program to meet the challenges that the company is facing with an aging workforce. The apprenticeship program continued to grow through 2006 and 2007. It now includes four distinct groups of skilled trades including power line maintainers, cable jointers, stations electricians, and system operators. The total number of apprentices as of June 2007 is 29, and 20 more are planned for 2008. These apprentices are anticipated to be fully qualified within five years of their hire. Further details of this apprenticeship program are included in Exhibit D1-5-2. In addition to the apprentices discussed previously, Hydro Ottawa has a development program for distribution system designers to ensure that qualified staff are available as the current staff retire.

1.4 Asset Management Strategy

While Hydro Ottawa's asset management strategy is predominately related to the capital assets, some evaluation has been applied to OM&A activities. In particular the asset management strategy included the appropriate cycles for vegetation management. Details of this program are provided in Exhibit D1-4-2.

1.5 Environmental Requirements

Hydro Ottawa maintains its ISO 140001 certification for environmental stewardship, and continues to maintain a high standard on environment issues.

On November 4, 2006 Environment Canada published an updated draft of its Regulations on PCBs. Hydro Ottawa has been in the process of and continues to undertake a comprehensive transformer survey and replacement program to ensure

PCBs in concentrations greater than 50 ppm are removed from its equipment, in anticipation of the enactment of this regulation. While the replacement of transformers is a capital project, the testing of PCBs has been part of O&M costs.

Another significant factor for OM&A costs relates to City of Ottawa bylaw (Sewer Use By-Law No. 2003-514) that requires all water pumped out of manholes to be tested for contaminants before going into the sewer system. Hydro Ottawa has approximately 4,000 manholes (underground chambers) throughout the City to provide access to the underground distribution system for maintenance and construction. These manholes cannot be sealed for reasons of public safety; therefore, run-off water from city streets can enter the manholes. If the water has any contaminants, they existed prior to entering Hydro Ottawa's chambers. The logistics around testing are such that the only practical approach to allow work on the distribution plant to proceed would be to treat all water pumped out of manholes, at a considerable expense. This would require special contractors to pump the water and transport it to a waste treatment facility.

If all water in manholes must be pumped and treated, the additional annual costs to Hydro Ottawa is estimated at $1.3M. However, Hydro Ottawa is working with the City of Ottawa to determine the full extent of the requirements. Given some level of uncertainty as to the extent of the work required, Hydro Ottawa proposes that instead of including the $1.3M in the 2008 forecast for O&M costs, a deferral account will be sought for tracking the actual costs. This deferral account is discussed further in Exhibit A1-5-1.

1.6 Review of Overhead Allocation and Capitalization

As discussed in Exhibit B1-3-1, Hydro Ottawa is changing the accounting estimates used to allocate overhead costs to capital programs, and how it allocates overhead costs to O&M. This has two impacts on the OM&A costs. First, with fewer overhead costs allocated to capital programs, the total OM&A costs increase. Furthermore, to develop a simpler approach for accounting, overhead administration costs will no longer be allocated out to maintenance programs. This means that these corporate overheads will remain part of the Administration grouping of OM&A instead of being part of O&M.

2.0 OM&A COSTS

Table 1 shows the OM&A by year for the same OM&A groupings used as part of the 2006 EDR Application. These numbers are shown net of allocations out to capital. The changes being implemented to the allocation of overhead costs has a significant impact on the net OM&A but does not impact the gross OM&A. Therefore the allocations to capital and gross OM&A are shown as separate rows to illustrate the change.

Table 1 - OM&A by Groupings

Operations, Maintenance and Administration (OM&A)	2006 Approved Rate Application	2006 Actual	2007 Estimate	2008 Forecast
Operations	$17,646,027	$14,217,031	15,179,697	$14,562,448
Maintenance	4,459,435	5,547,781	5,217,978	5,111,153
Billing and Collection	9,197,432	8,446,010	9,392,339	9,716,811
Community Relations	3,455,624	3,512,896	4,419,933	4,515,270
Administrative and General[1] Expenses	5,125,241	6,904,950	7,571,263	20,313,829
Insurance Expense	210,000	296,852	289,565	325,692
Bad Debt Expense	900,000	2,992,045	2,002,739	2,000,008
Advertising Expenses	62,000	7,403		0
Allowable Charitable donations[2]		40,000	40,000	40,000
Other Distribution Expenses	2,931,751	1,859,728	1,991,516	2,002,832
Net OM&A without Smart Meters	**43,987,510**	**43,824,696**	**46,105,030**	**58,588,043**
Allocations to capital	not available	($33,414,021)	($36,681,333)	($28,866,253)
Gross OM&A without Smart Meters		**77,347,304**	**82,786,363**	**87,454,296**
Smart Meter Expenses[3]	$0	$0	$1,034,835	$740,018
Net OM&A with Smart Meters	**$43,987,510**	**$43,824,696**	**$47,139,865**	**$59,328,061**

[1] Administration costs do not include the costs for Low Voltages charges from Hydro One. These costs were recorded in USoA Account 5665 for 2006 but subsequent guidance from the OEB have these costs recorded in Account 4750, therefore not part of OM&A.

[2] Actual charitable donations were higher. This reflects the charitable donations related to helping customers pay their electricity bills.

[3] The Smart Meter expenses are discussed in Section 12.0. For 2007, the expenses shown relate to the calendar year including a portion from the 2006 rate year (January 1, 2007 to April 30, 2007) and a portion from the 2007 rate year (May 1, 2007 to December 31, 2007). For the calendar year 2008, the expenses are forecast at a total of $1,723,018. But this is comprised of $983,000 from the 2007 rate year (January 1, 2008 to April 30, 2008) and $740,018 from the 2008 rate year (May 1, 2008 to December 31, 2008).

3.0 OPERATIONS AND MAINTENANCE

Operation is defined as work that encompasses actions of a detective, preventative, and/or monitoring nature. Maintenance is defined as the routine activity to ensure the equipment or device operates correctly (generally work performed in a reactionary manner based on the results of an Operation activity).

With Hydro Ottawa's corporate structure, numerous different divisions and/or departments within the company can carry out operations and maintenance functions. For instance, the Construction and Maintenance division ("CAM") certainly has responsibilities for maintenance functions, but also has operations responsibility. The Distribution Asset Management division ("DAM") has responsibility for the system control room but also has responsibility for maintenance of stations. The Metering and Electricity Revenue ("MER") division has both operating and maintenance functions for metering. Reasonable effort has been taken to provide the appropriate split between operations and maintenance, but as a result of changes in corporate structures there are some inconsistencies year over year. Therefore, for the purposes of doing comparisons between years, operations and maintenance expenses should be considered in their totality.

The following is a description of typical operation activities and maintenance programs.

3.1 Control Room

Hydro Ottawa's control room is the "control authority" for the service area. The control room is operational 24 hours per day, 7 days per week ("24/7") to review and authorize system device operations and to provide key support for emergency response requirements.

3.2 General Switching

Hydro Ottawa has remotely operable switches; however, the vast majority of switches in the distribution system require manual operation. Qualified staff is required to travel to these devices in order to perform general system reconfigurations.

3.3 Distribution Transformer Oil Testing

A transformer survey program was undertaken, largely due to the GIS project and pending legislative changes concerning equipment containing insulating oil with PCB concentrations greater than 50ppm. Exhibit B2-3-2 contains information on the survey program. Testing the oil for PCB content is an O&M expense.

3.4 Station Transformer Oil Analysis

Chemical properties of the oil in stations' transformers can provide a general indication of the condition of the transformer. Oil tests are performed periodically to monitor transformer condition.

3.5 Asbestos Removal and Arc-Proofing of Cables

Cables in manholes and vaults are wrapped with an arc-proof tape. For health and safety reasons, workers cannot work freely in a manhole or vault with older, asbestos containing tape. Therefore, this program involves removing asbestos tape and replacing it with a new model of arc-proof tape that is asbestos free.

3.6 Supervisory Control and Data Acquisition ("SCADA") Maintenance

SCADA equipment is installed throughout the distribution system. Many remote devices are battery powered and the batteries require periodic replacement. The communications devices such as antennas and radios require repairs, as do other components, from time to time.

3.7 Thermographic Scan

Hydro Ottawa uses infrared scanning, a heat detection technology, as an early detection and preventative maintenance method to find possible plant failure. The program results in an increase in system reliability and safety and extends the useful life of the assets in the distribution system.

3.8 CO_2 Wash

The CO_2 wash program for pad-mounted switchgear is based on the results of the Thermographic Scan program. The CO_2 method has allowed switchgear to be maintained in an efficient and cost effective manner. The process involves cleaning energized switchgear using dry ice. Compared to washing with water, this affords flexibility to schedule switchgear maintenance throughout the year while decreasing maintenance costs, eliminating interruptions, avoiding switching thereby removing the associated safety concerns and freeing up manpower.

3.9 Insulator Washing

The insulators in the Hydro Ottawa system become contaminated by road salt, vehicle exhaust, and other airborne contaminants. The City of Ottawa uses more salt during the winter than many other Ontario municipalities. In damp weather, these insulators can flashover, cause pole fires, and jeopardize the system's reliability. To avoid this, Hydro Ottawa has adopted an extensive insulator-washing program along the major roadways where contamination builds normally. Full washing of these critical, 44 kV, 27.6 kV and 13.2 kV circuits is done around mid-February, and selective washing in the fall (around mid-October) each year. The program also involves washing all under-build (lower voltage lines on the same pole line as higher voltage lines) of 8 kV or more.

3.10 Graffiti Abatement

The purpose of the graffiti abatement is to remove and/or prevent inappropriate messages and statements, graphical or text, on Hydro Ottawa's assets (e.g., buildings, pad-mounted transformers or switchgear), from general public visibility. The requirement for this service is established under Hydro Ottawa's commitment to the City of Ottawa Utility Coordinating Committee. Assets to be addressed are identified by the City of Ottawa by-law enforcers, the police and the public at large.

The program typically involves provision of standard or anti-graffiti coating on Hydro Ottawa's pad-mounted equipment. The standard paint coating is a quick-dry gloss enamel type, while the anti-graffiti is an epoxy base or aliphatic clear finish. Normally, Hydro Ottawa's field representative assesses the type of coating needed. The program also includes the re-instatement of the area around the equipment, and re-labelling of the equipment using the approved materials and label placement specifications.

3.11 Tree Trimming / Vegetation Management

Information on Hydro Ottawa's vegetation management program is contained in Exhibit D1-4-2.

3.12 Manhole Inspection and Cleaning

Manholes are the access point to Hydro Ottawa's underground distribution system. There are approximately 4,000 manholes in Hydro Ottawa's distribution system. The majority are located along road right of ways, either in the road or within the sidewalk area. Regular access is required to plan projects to connect new customers, replace aged cables, troubleshoot outages or accommodate road construction.

The primary reason for manhole inspections is to maintain the integrity of the civil structures and below grade electrical system.

Items checked during a manhole inspection include:

- condition and height of the cover, the part that closes the manhole to the public and is therefore the utmost importance for public safety,
- condition of cable splices and cable racks,
- integrity of the concrete,
- existence of rust on steel components, and
- cleanliness of the manhole.

There is also a need to identify which manholes contain cables that have been treated with arc-proof tape containing asbestos. Work may still be performed within a manhole with tape containing asbestos; however, the presence must be identified for worker safety.

Many of the manholes are connected to the City storm/sewer system that may backup into the manholes. The lids of the manholes are not sealed and do allow water and dirt to enter the manhole over time. To ensure the contaminants do not degrade the equipment in the manhole and to allow for a safe working environment, the manholes are often cleaned prior to planned work. As discussed in Section 1.5, a City of Ottawa bylaw requires the potential treatment of water pumped from manholes.

3.13 Underground Locates

Information on Hydro Ottawa's Locates activities is contained in Exhibit D1-4-3.

4.0 BILLING AND COLLECTING

The Billing and Collecting function provides a variety of services that directly service the needs of electricity customers within Hydro Ottawa's service area. This function is responsible for customer billing, collections of electricity accounts and metering reading. Meter reading functions have been out sourced to a contractor for many years. This

contractor can also disconnect and reconnect meters. Internal field staff address more complex transactions and commercial/industrial accounts. Collection of accounts is an internally resourced function until the point at which avenues for collecting closed accounts have been exhausted. At this point the arrears are transferred to an external collection agency that is paid a percentage of the amount that is collected.

Meter data services is also a part of this grouping with responsibilities for reading all interval meters, determining the net system load shape for billing customers and wholesale settlement functions including the validation of electricity bills received from the Independent Electricity System Operator ("IESO") and Hydro One Networks Inc.

The other function within the Billing and Collecting group is Customer Information System ("CIS") Support. This function has responsibility for all support functions for Hydro Ottawa's CIS including the day-to-day support and oversight of any changes to the system or the reports that are produced from it. This function is separate but closely related to the information technology functions in the company that are part of the Administration grouping.

5.0 COMMUNITY RELATIONS

Costs included in the Community Relations group include the Customer Contact team; Hydro Ottawa's customer facing organization. The Customer Contact team is organized to serve a diverse customer base of approximately 250,000 residential and small commercial customers.

This group is responsible for all customer account and relationship activities including the handling of customer telephone calls, correspondence and move requests. The Customer Contact team routinely handles 350,000 customer generated account maintenance and outage reporting calls, 34,000 pieces of written correspondence and 60,000 customer initiated move requests per year. Over 72% of customer calls are answered within 30 seconds (exceeding the Board requirement of 65%), and 99% of

written correspondence is answered within 10 business days (exceeding the OEB requirement of 90%).

A call centre that operates between 8:00 am and 8:00 pm on business days handles customer telephone inquiries. The call centre handles higher volume and lower complexity "First Level" calls. This function has been outsourced to IBM for six years ending December 31, 2010. After 15 months into the agreement, it was recognized that call volumes were actually 20% higher than originally contracted, and an adjustment was made to the agreement to recognize this fact. Costs paid are based on a formula related to the size of Hydro Ottawa's customer base, not on the number of calls handled. Scripting, training and oversight are all managed strictly by Hydro Ottawa. Performance standards are monitored on a regular basis between Hydro Ottawa and IBM management.

Customer requests that are lower in volume but higher in complexity are directed from the call centre to a Hydro Ottawa customer contact support team, which provides "Second Level" support. This group also handles paper based move requests, miscellaneous correspondence, return mail, lawyer's letters, Auto Pay and Budget Billing requests, escalations and reporting.

In 2007 and 2008, the Customer Contact team is focusing on a number of customer service improvement initiatives including First Call Resolution, improved handling of customer service requests, improved meter reading processes, and timeliness of credit refunds to name but a few. Ongoing work in these areas and a continued focus on managing workflow, processes and the implementation of technology where applicable will help to continually improve the service that we offer our customers.

6.0 ADMINISTRATIVE AND GENERAL EXPENSES

Included with the Administrative and General Expenses grouping are all corporate service functions for Hydro Ottawa. Each of the following functions is lead by a member of the senior management team. For simplicity, this grouping of accounts will be called Administration expenses in subsequent sections.

6.1 Human Resources

The Human Resources Department is responsible for all payroll issues, labour relations, compensation reviews, internal communications, employee events and the development and oversight of human resources polices.

The Human Resources department also has oversight for safety, training and environmental programs. These functions together comprise the company's occupational health, safety and environment ("OHS&E") function. The costs of safety and training are considered an Administration cost; however, environment program costs are grouped with O&M expenses because they are primarily related to this function. An overview of Hydro Ottawa's approach to OHS&E is included in Exhibit D1-4-1.

6.2 Finance

Included within the Finance group are separate functions for general accounting, accounts receivable, accounts payable, payment processing (including electricity bill payments), retail settlements, budgeting/business planning, financial forecasting, taxes and banking.

Responsibility for the maintenance and upkeep of Hydro Ottawa's facilities are also a key function for the Finance department. This includes the corporate head office, three additional operations centre across the city, a separate fleet/training facility and approximately 70 distribution stations. Costs for maintaining the general plant (i.e. office

buildings) are part of Administration expenses whereas maintenance for facilities at transformer stations is part of O&M costs.

Another major responsibility for the Finance group is procurement /supply chain management. This group sets and oversees procurement policies and procures all products and services for the company. Details of Hydro Ottawa's Procurement Strategy are provided in Exhibit D1-3-1.

6.3 Information Technology ("IT")

The IT department has responsibility for all core IT infrastructure, corporate applications, voice services and data services. Business specific systems (SCADA, OMS, GIS and CIS) are currently administered or operated by the operational department that is the predominant user of that system. The IT department oversees coordination between systems through various working groups and steering committees.

For 2008, a particular priority for the IT department is enhancing the security of the infrastructure while supporting the company's move to a more mobile workforce enabled by the new GIS.

6.4 Communications

The communications team is responsible for the delivery of customer communication and community initiatives that promote customer and public awareness of business and industry activities. This function also maintains Hydro Ottawa's website, develops customer brochures, organizes community information sessions, interfaces with the media and local government representatives and manages the on-call and outage support procedures, schedules and training.

6.5 Regulatory Affairs

Regulatory Affairs is responsible for all filings with the Board and the IESO including comments on consultations, rate and other applications, compliance reporting, licence applications and renewals and reporting and record-keeping requirements. Regulatory accounting is also part of this group working closely with the finance staff. A major expense for the Regulatory Affairs department is the OEB Cost Assessment, Cost Awards paid to intervenors and annual fees to the Electrical Safety Authority.

6.6 Corporate Costs / Chief Operating Officer ("COO")

The COO has oversight responsibility for all of Hydro Ottawa's activities including the functions described in Sections 3, 4, 5 and 6. A major initiative for 2008 is the review of internal processes to ensure that all activities are aligned to common goals and are being performed in the most efficient manner.

The Uniform System of Accounts ("UsoA") requires all executive salaries to be recorded in Account 5605. While Hydro Ottawa's internal accounting normally records these salaries as part of the operational department costs, to be consistent with the USoA, the costs have been considered a corporate cost within the Administration grouping. Therefore all salaries and associated departmental expenses for the senior management team (COO and Directors) are included as corporate costs and therefore are part of Administration expenses. In addition, corporate costs would include bank charges, prudential requirements to the IESO, association fees (Canadian Electricity Association, Ontario Energy Association, Electricity Distributors Association), allocations from the Holding Company, audit fees and employee future benefits.

7.0 INSURANCE EXPENSE

While insurance expense is normally part of corporate costs, the amount was separated out for the 2006 EDR Application. Therefore, for consistency the insurance expense is

shown separately again. It should be noted that this includes only property and fleet insurance.

8.0 BAD DEBT EXPENSE

Bad debt expense is the difference between the allowance for doubtful accounts recorded or forecast between one year and the next. The allowance for doubtful accounts is set based on a percentage of the aged arrears. Therefore, the allowance associated with arrears from a customer that are 60 days old is less than the allowance for arrears that are a year old. This provides a weighting related to risk that the amount will not be collected.

There are two categories of bad debt expense. One is related to electricity billing and one is related to billing for other services. These other services could be pole attachments, damages to plant, temporary services, service isolation and re-energization to permit maintenance and upgrades, etc.

As part of the 2006 EDR Application, Hydro Ottawa only provided a forecast for the first category of bad debt expenses but experienced a significant impact from the second category as well. Therefore both categories are included in the forecast for 2008.

9.0 ADVERTISING EXPENSE

Included with Advertising Expense are Accounts 5515 and 5660. For Account 5515 the advertising would be *"designed to promote or retain the use of utility service".* For Account 5660 the advertising would be *"primarily designed to improve the image of the utility or the industry*". Hydro Ottawa has not identified any advertising for 2007 that would fit these descriptions, except for the advertising related to Conservation and Demand Management ("CDM") that is separate from this application. Therefore no amounts are estimated for 2007 or forecasted for 2008 for Advertising Expenses.

10.0 ALLOWABLE CHARITABLE DONATIONS

Hydro Ottawa is a founding sponsor of the Ottawa Safe Communities Program and is an active participant in the local United Way campaign. Consistent with the 2006 EDR Application, Hydro Ottawa has not included the costs for these charitable donations in its revenue requirement.

However, Hydro Ottawa is also a sponsor for the Winter Warmth Program. This is a charity to which a customer can apply for assistance in paying their electricity bill. These types of charitable donations were eligible for recovery in the 2006 EDR Application; therefore the costs have been included in this application.

11.0 OTHER DISTRIBUTION EXPENSES

Included within the Other Distribution Expenses grouping are two unrelated accounts. The first is for Account 6105, taxes other than income taxes. Included in this account are both provincial capital taxes and property taxes. Since the large corporation taxes are dealt with through the allowance for PILs, the only amount included in Other Distribution Expenses is for property taxes.

The other two accounts in Other Distribution Expenses are Account 5510 Supervision for sales activities and 5515 Demonstrating and Selling Expenses. Hydro Ottawa has recorded the expenses related to providing service to large customers referred to as “key accounts” in these accounts. These customers are the highest consumers of electricity within Hydro Ottawa’s service area and require ongoing and more complex service support.

For the 2006 EDR Application, Hydro Ottawa had also included in these accounts certain marketing functions that were recorded in the 2006 actuals, 2007 estimate and 2008 forecast as an Administration Expense.

12.0 SMART METER EXPENSES

Smart Meter expenses have been shown as a separate item because the presence of the variance account for 2007 means that the expenses are dealt with on a rate year basis (May 1, 2008 to April 30, 2009). The numbers shown are for the portion of the 2008 rate year that occur in the 2008 calendar year (May1, 2008 to December 31, 2008) of $740,018. In addition, not shown is $983,000 in costs that represents the portion for the 2007 rate year that occurs in the 2008 calendar year (January 1, 2008 to April 30, 2008). The 2007 rate year portion is higher because it includes a number of one-time costs in preparation for the implementation of time-of-use billing. The one-time costs include change management initiatives and incremental call centre costs.

Only the 2008 rate year portion of $740,018 was included for the purposes of determining the revenue requirement.

Details of Hydro Ottawa's current Smart Meter Investment Plan are described in Exhibit D3-1-1.

OPERATIONS, MAINTENANCE AND ADMINISTRATION
2008 FORECAST VERSUS 2007 ESTIMATE

1.0 INTRODUCTION

Table 1 summarizes the differences between the 2008 Forecast and the 2007 Estimate. Explanations for these differences are then provided for each category of expense. The USoA account grouping for Operations and Maintenance ("O&M") and Administration are shown net of the allocations to capital programs. There are no capital allocations in the other expense account groupings.

Table 1 - OM&A 2008 Forecast Versus 2007 Estimate[1]

OM&A	2007 Estimate	2008 Forecast
O&M	$20,397,675	$19,673,601
Billing and Collections	9,392,339	9,716,811
Community Relations	4,419,933	4,515,270
Administration	7,571,263	20,313,829
Insurance Expense	289,565	325,692
Bad Debt Expense	2,002,739	2,000,008
Advertising Expenses	-	-
Allowable Charitable Donations	40,000	40,000
Other Distribution Expenses	1,991,516	2,002,832
Total Net OM&A	**$46,105,030**	**$58,588,043**
Capital Allocations	(36,681,333)	(28,866,253)
Total Gross OM&A	**$82,786,363**	**$87,454,296**

The Board's Filing Requirements state that: "A written explanation is required for operating cost related information when there is a variance greater than or equal to of 1% of total distribution expenses before PILs, whichever is larger."[2] For Hydro Ottawa

[1] Table 1 does not include OM&A costs for the Smart Meter program that are discussed in Exhibit D3-1-1.
[2] Page 18 of the Board's Filing Requirements.

this requirement would set the materiality limit at $440k based on 2006 distribution expenses. Hydro Ottawa has generally provided more detailed explanations.

2.0 OPERATIONS AND MAINTENANCE

O&M includes all activities that are related to USoA Accounts 5005 through 5195 relating to the operating and maintenance of Hydro Ottawa's distribution plant. Variances are discussed in the total compensation, O&M programs and allocated costs. Overall O&M costs are forecast to decrease by $700k.

2.1 Compensation

Compensation expense has increased $2.3 million due mainly to the addition of 20 apprentices, two system designers, one stations electrician and one supervisor related to workforce planning, as discussed at Exhibit D1-5-2. The remainder of the increase can be attributed to regular compensation increases, 3.25% for unionized personnel and 3% for management as well as normal step increases set out in the collective agreement.

2.2 Programs

O&M programs include all of the costs in addition to compensation. Excluding compensation, the costs for planned maintenance programs are forecast to stay approximately the same as in 2007 with increases in some programs offset by decreases in others.

The following programs are forecast to have increased costs in 2008 over the 2007 level.

- Vegetation Management – This program is described in Exhibit D1-4-2. In addition to the cycle tree trimming, it includes emergency clean up. Hydro Ottawa has been working under the terms of a three-year contract that ends in

2007. A tender is being issued in third quarter of 2007 and costs are expected to increase.

- Stations facilities contracts – These involve general maintenance at Hydro Ottawa's 70 distribution systems throughout the city, including the new stations planned at Cyrville, Uplands and Albion. Maintenance includes cleaning, snow removal, landscaping, utilities and a requirement for increased security.
- General Maintenance Programs – These are described in Exhibit D1-1-1 and include switch maintenance, graffiti abatement program and manhole inspections. Hydro Ottawa addresses graffiti in accordance with City of Ottawa requirements. Manhole inspections were curtailed in 2007 because of work on the City's Light Rail Transit project but are now planned to return to normal levels for 2008.
- Other minimal cost increases relate to improving the management of the mobile workforce, including wireless units for use with Hydro Ottawa's GIS.

However, these increased costs are almost completely offset by small reductions to the following work:

- Oil testing of vault transformers – This work was largely completed in 2007,
- Maintenance of fleet – Costs are forecast to decrease in 2008 because the average age of the fleet has improved with the fleet replacement program undertaken over the past three years, and
- The 2008 forecast for asbestos removal and cable locates are down only slightly from the 2007 level.

In addition to these maintenance programs, Hydro Ottawa is forecasting a decrease of $600k from 2007 related to environmental work for spills and contaminated water in manholes. As discussed in Exhibit D1-1-1, a City of Ottawa by-law related to the testing and treatment of water from Hydro Ottawa's manholes could impact Hydro Ottawa's operations. Since it remains unclear on the extent to which Hydro Ottawa will incur costs related to this by-law, Hydro Ottawa is seeking a deferral account to record these costs

should they occur. The discussion of the deferral account is included in Exhibit A1-5-1. Therefore, program costs for 2008, excluding compensation, are decreasing approximately $600k from the 2007 level.

2.3 Capital Allocations

Prior to 2008, Hydro Ottawa allocated certain Administration costs to O&M. The Administration costs were allocated to either maintenance, i.e. expensed, or capital programs, i.e. capitalized. As discussed in Exhibit B1-3-1, Hydro Ottawa changed its accounting estimates for the overhead costs directly attributable to capital programs and thereby decreased the capitalized amount for 2008 by $6.5M compared to what it would have otherwise been. This change has resulted in a comparable increase in the Administration costs.

Furthermore, to simplify the allocation methodology, Administration costs will also no longer be allocated to O&M for maintenance programs. This change does not impact the overall OM&A, but has the affect of leaving costs in Administration that in prior years would have been allocated to O&M.

The process of preparing this exhibit in future years will be more efficient and simpler to manage as a result of this change. Another result is the more effective and thus meaningful comparisons of Hydro Ottawa's O&M costs and Administration costs with those of other LDCs.

The final material impact to the O&M relates to the number of hours of labour that were attributed to capital programs versus maintenance programs between 2007 and 2008. For 2008, less labour will be capitalized resulting in approximately $1.3M of costs remaining in net O&M. This is the result of a number of factors. The GIS program will be completed in 2007; as a result, a portion of the labour related to this project will be expensed in 2008. Furthermore, capital labour was higher in 2007 related to the Sunnyside voltage conversion project and work on refurbishing station circuit breakers

as part of Stations Enhancements. For both of these projects, the equipment was ordered in 2006 but the installation labour occurred in 2007. These projects are discussed in Exhibit B3-3-1.

2.4 O&M Summary

In summary, the O&M costs are forecast to decrease $700k from the 2007 estimated amounts. This is made up of a $2.3M increase in compensation plus an additional $1.3M related to labour not capitalized less a $0.6M reduction in maintenance programs and a $3.7M reduction in administrative costs allocated to maintenance programs, which therefore remains in the Administration grouping.

3.0 BILLING AND COLLECTIONS

Billings and collections expenses are forecast to increase by approximately $300k in 2008. Increases in compensation related to regular salary increases and the addition of a MDS Senior Analyst position, as described at Exhibit D1-5-1, accounts for approximately $250k of this increase. The remaining increase relates mainly to the requirement to provide support for the Customer Information System ("CIS"). Support for the current version ends in 2007 and the new version upgrade will not be completed until 2009. Therefore, Hydro Ottawa has to arrange for its own support. This additional support plus small increases for Oracle maintenance contracts and licenses will increase costs by approximately $250k.

These increases are offset by a drop in meter reading expense of approximately $200k as a result of implementing Smart Meters.

4.0 COMMUNITY RELATIONS

Community Relations expenses are forecast to increase by $100k in 2008. Regular salary increases amount to approximately $150k. There are no new staff being added. In addition, Hydro Ottawa plans to implement call recording for its call centre in 2008. This, plus normal increases in the IBM Call Centre contract, are forecasted to increase costs by $150k in 2008.

These increases were offset by a $200k reduction in consulting contracts from the 2007 level. A number of initiatives occurring in 2007 are not planned for 2008.

5.0 ADMINISTRATION

Administration costs are forecast to increase $12.7M in 2008. The main reason for this is $10.2M relates to changes in allocations of administration costs to capital and O&M as discussed in Section 5.3. Actual costs are increasing by $2.5M.

5.1 Compensation

Administration compensation has increased by $1M in 2008. As discussed at Exhibit D1-5-1, in addition to general salary increases, four new positions are forecast for 2008 including two IT analysts, a Security Specialist and a Database administrator to manage new services and growth, a management accountant to support the finance function and a human resources advisor to assist with the development and delivery of human resources programs.

5.2 Administrative Costs

In addition to the compensation increase, other administration costs are forecast to increase $1.5M in 2008. These costs can be attributed to increases for the following.

- New Programs – In 2008, Hydro Ottawa plans to embark on a program to review its internal processes to develop improved measurement tools, improve the timeliness of reporting and recommend process changes for greater efficiency. In addition, management development programs will be created to ensure succession plans are in place, to provide management skills development and review management benefits. In total, these programs are forecast to cost $500k in 2008.
- Regulatory expenses – Costs for the regulatory function are expected to increase by $200k in 2008. This is related to normal cost increases expected for OEB Cost Assessments and ESA membership dues, intervenor costs awards and legal fees related to the 2008 Rate Application and increased travel to Toronto for hearings and other proceedings.
- Customer communications – An increase of approximately $100k is forecast for 2008 related to growing customer base, communications for the e-billing service format for e-billing, and other additional promotional expenses.
- Hydro Ottawa Board and Holding Company allocations – An increase of $200k is forecast for 2008 for these costs. Having an independent Board of Directors for Hydro Ottawa is a new requirement of the Affiliate Relationships Code for Electricity Transmitters and Distributors. In 2007, the Holding Company paid for all of the costs of the Hydro Ottawa's Board of Directors, including administrative support. These costs will now be paid for directly by Hydro Ottawa. Additional administrative support will be required by Hydro Ottawa to support the Board's work. Furthermore, the Holding Company is undertaking a number of new initiatives as discussed in Exhibit D1-2-1 including business continuity planning and enhanced internal auditing and Hydro Ottawa will be allocated a portion of these new costs.
- A remaining increase of $500k relates to a 2% increase in other miscellaneous costs across all administrative departments.

5.3 Capital Allocations

As discussed in Section 2.3, Administration costs will no longer be allocated to O&M in 2008. As a result of this, $6.5M related to allocations to capital and $3.7M related to allocations to O&M (maintenance) will now remain in the Administration grouping of accounts. Therefore, Administration will increase by $10.2M as a result of this change. With the increase in compensation of $1M, the increase in Administration costs of $1.5M and not allocating Administration costs to O&M of $10.2M, the total increase in the Administration grouping is $12.7M.

6.0 INSURANCE EXPENSE

Insurance expense includes property and fleet insurance. Increases in 2008 are forecast to correspond with increases in property value, including increase in fleet value due to replacement of the aging fleet at the end of 2007.

7.0 BAD DEBT EXPENSE

Bad debts related to electricity accounts are forecast to be consistent with 2006 and 2007 at approximately $1.6 million. The bad debts incurred from other services, including pole attachments, street lighting contacts and work for others is anticipated to level off at approximately $400k for 2008. Therefore the bad debt expense forecast for 2008 is approximately the same as the estimate for 2007.

8.0 ADVERTISING EXPENSE

As described at Exhibit D1-1-1, no advertising expenses related to USoA Accounts 5515 and 5660 are estimated for 2007 or forecast for 2008.

9.0 ALLOWABLE CHARITABLE DONATIONS

There is no anticipated increase in the cost of the Winter Warmth Program, to be undertaken in 2007 and 2008.

10.0 OTHER DISTRIBUTION EXPENSES

Expenses for sales, marketing and key accounts and for property taxes are forecast to be in line with amounts expended in 2007. Reductions in managing key accounts are offset by property tax increases for the new Cyrville transformer station.

Interrogatory

Operation, Maintenance and Administration

General

28. Ref: Exhibit D1/ Tab 1/ Schedule 3

On page 4 of 18 "2.3 Allocations" and Exhibit D1 Tab 1 Schedule 3 Page 7 of 18 "5.3 Capital Allocations", Hydro Ottawa has estimated that capitalized O&M will increase by $2.0 M and $1.1 M. Hydro Ottawa has filed an application with the Board for an accounting order to establish a deferral account for a change in capitalization policy (EB-2007-0770). Please discuss how Hydro Ottawa has affected this estimate for the proposed accounting order.

Response

The $3.1M capital allocations referred to is the incremental increase in capital allocations for 2007 over 2006 before the change in the capitalization process was implemented.

The deferral account requested for the change in capitalization for Q4 of 2007 would reduce the 2007 capital allocations. The amount estimated for the change in the 2007 capitalization of overhead costs, and for which Hydro Ottawa is seeking an accounting order to establish a variance account, has been revised to $1M.

Interrogatory

Operation, Maintenance and Administration

General

29. Ref: Exhibit D1/Tab 1/ Schedule 4

On page 1 of 9 Table 1, Administration changes from $7.6M in the 2007 Estimate to $20.3M in the 2008 Forecast. Exhibit D1 Tab 1 Schedule 4 Page 4 of 9, 2.3 Capital Allocations and Exhibit D1 Tab 1 Schedule 4 Page 8 of 9, 5.3 Capital Allocations discuss how the change in allocations affect the values.

a) Please recast Table 1 inserting a column showing 2008 as it would have been had the capitalization policy change not taken effect, a new column showing the effects of the capitalization policy change which finalizes the 2008 Forecast as presented.

b) Please discuss the drivers that contribute to the $6.5M that would normally have been allocated to capital, and the $3.7M that would have normally have been allocated to O&M.

Response

a) The table has been recast to reflect the effect of the comments in Sections 2.3 and 5.3 of Exhibit D1-1-4. As noted in the response to SEC Interrogatory # 32 i), this is an approximation because 2008 burden rates were not determined using the 2008 costs and mix of labour hours.

Table 1 - OM&A 2008 Forecast Versus 2007 Estimate[1]

OM&A	2007 Estimate	2008 Forecast Approximation using old capitalization methodology	2008 Allocation Change	Final 2008 Forecast
O&M	$20,397,675	$23,373,601	($3,700,000)	$19,673,601
Billing and Collections	9,392,339	9,716,811		9,716,811
Community Relations	4,419,933	4,515,270		4,515,270
Administration	7,571,263	10,113,829	$10,200,000	20,313,829
Insurance Expense	289,565	325,692		325,692
Bad Debt Expense	2,002,739	2,000,008		2,000,008
Advertising Expenses	-	-		-
Allowable Charitable Donations	40,000	40,000		40,000
Other Distribution Expenses	1,991,516	2,002,832		2,002,832
Total Net OM&A	**$46,105,030**	**$52,088,043**	**-**	**$58,588,043**
Capital Allocations	(36,681,333)	(35,366,253)	$6,500,000	(28,866,253)
Total Gross OM&A	**$82,786,363**	**$87,454,296**	**$6,500,000**	**$87,454,296**

[1] Table 1 does not include OM&A costs for the Smart Meter program that are discussed in Exhibit D3-1-1.

b) The drivers that contribute to the changes are noted in the following table:

($ millions)

		2007 Approved Budget			2008 Proposed Budget	
Indirect Costs[2]	**Total**	**Capital Allocation (1)**	**P&L Expense**	**Total**	**Capital Allocation**	**P&L Expense**
IT	3.0	1.6	1.4	3.3	.1	3.2
HR	3.5	1.9	1.6	3.5	1.2	2.3
Finance	3.2	1.8	1.4	3.3	.6	2.7
Holdco	1.9	1.0	0.9	1.9	.2	1.7
Corporate	1.9	1.0	0.9	1.9	.4	1.5
Facilities	4.0	2.2	1.8	3.6	1.0	2.6
Operational G&A	2.0	$1.1	0.9	2.0	.6	1.4
Total	**$19.5M**	**$10.6M**	**$8.9M**	**$19.5M**	**$4.1M**	**$15.4M**

The $6.5M in capitalization allocation change is the 2007 amount of $10.6M less the 2008 amount of $4.1M. The $3.7M is driven by the same indirect costs but forms part of the residual Profit & Lost (P&L) expense in the table above. As noted in Section 5.3 of Exhibit D1-1-4, the costs for the overall O&M remain the same, but the $3.7M has been reclassified from O&M to Administration, as overhead administrative costs will no longer be allocated to O&M. The new basis of allocation for identifying capitalized costs is shown in Table IV-3, at page 15, in Appendix T (KPMG report) of Exhibit B1-3-1. A copy of the table follows:

[2] Used an average 55% capitalization rate in the 2007 calculation.

Table IV-3
Basis of Overhead Allocations

	% Related to Capital	Basis of Allocation
Holdco	10.0	See Table IV-1
Corporate Costs	20.0	These costs represent allocations of future employee benefits, property insurance, and fleet insurance.
COO	15.0	These costs represent about 40% of the labour and G&A expense associated with personnel providing performance indicators and efficiency improvements.
Finance	18.5	Based on elimination of one A/P associate, one financial analyst, one billing analyst, one management accountant and one supervisor because of reduction in supplier invoices, variance analysis, and billing for capital projects. Figure includes proportionate share of departmental G&A expenses.
Regulatory	10.0	Represents estimated share of Regulatory department's workload associated with seeking approvals for capital projects and modeling and approvals with respect to customer contributions.
Supply Chain	85.0	Allocated based on dollar value of materials and outside services associated with capital projects (out of total).
Facilities	26.3	Pro-rata allocation of space costs.
Human Resources & Safety	33.0	Based on estimate of staffing reduction in HR function with no capital projects and, hence, fewer line and support staff elsewhere in the company.
IT	3.0	Reflects reduction in head-count of 1 person due to lower call volumes for help desk support.
Operations (Engineering)	10.5	Identified specific staff in engineering design, record keeping and asset management who would not be required in the absence of capital projects.
Supervision	61.4	Ratio based on estimated proportion of dollars associated with capital projects versus maintenance and work for others. Based on management salaries and one-half of G&A in Operations and Meter Installation areas.

Interrogatory

Capitalization Policy and Allocation Procedure Based On Updated Estimates

17. Ref B1/T3/S1

On page 3 of B1/T3/S1, HOL states that its new Cost Allocation methodology is based on the changes in accounting estimates and the methodology for allocating overhead costs reflects the simplified methodology using 3 burden rates to capitalize overhead costs.

a. Please provide details of the 3 burden rates.

Response

a) Details of the three burden rates utilized to capitalize overheads are shown in Exhibit B1-3-1, Appendix T, page 19, Exhibit IV-4 – Burden Structure and are reproduced below:

Exhibit IV-4

Burden Structure

Burden	Nature of Costs Recovered	Basis of Allocation	Types of Projects
Engineering	Engineering	Sum of: - Direct Labour - Materials - Fleet Charges - Outside Services	Distribution Plant Only
Supervision	Management salaries and general and administrative costs in the Construction & Maintenance (CAM) and Distribution Asset Management (DAM) departments	Sum of - Direct Labour - Outside Services	Distribution Plant Only *Note: Applied as well to distribution maintenance and work-for others*
Administration	Various administrative and support costs including: - Supply Chain - Facilities - Human Resources and Safety - IT - Finance - Corporate costs - Holdco - Regulatory	Sum of - Direct Labour - Materials - Fleet Charges - Outside Services	Distribution Plant and General Plant

Interrogatory

Capitalization Policy and Allocation Procedure Based On Updated Estimates

18. Ref: B1-3-1, Appendix U, Hydro Ottawa Limited "Revisions to Capitalization Policy and Allocation Procedure Based on Updated Estimates"

The following table is adapted from the table on pg. 4 of Appendix "U":

		2	3	4	5	6	7	8	9	10	11	12	13	14
							2008 Proposed Budget @ New Capitalization Rate					**2008 Budet @ Former Capitalization Rate**		
		2007 Approved Budget												
		Total	**Capital**	**Op. Exp**	**Cap%**		**Total (D)**	**Capital (A)**	**Op. Exp**	**Cap %**		**Capital**	**Operating**	**A-B**
	Indirect Costs		**$'M**		**C**			**$'M**				**B=D*C**	**D-B**	
1	IT	3	1.6	1.4	53%		3.3	0.1	3.2	3%		1.8	1.5	-1.7
2	HR	3.5	1.9	1.6	54%		3.5	1.2	2.3	34%		1.9	1.6	-0.7
3	Finance	3.2	1.8	1.4	56%		3.3	0.6	2.7	18%		1.9	1.4	-1.3
4	Holdco	1.9	1	0.9	53%		1.9	0.2	1.7	11%		1.0	0.9	-0.8
5	Corporate	1.9	1	0.9	53%		1.9	0.4	1.5	21%		1.0	0.9	-0.6
6	Facilities	4	2.2	1.8	55%		3.6	1	2.6	28%		2.0	1.6	-1.0
7	Other	2	1.1	0.9	55%		2.2	0.6	1.6	27%		1.2	1.0	-0.6
8	**Total**	**19.5**	**10.6**	**8.9**	54%		**19.7**	**4.1**	**15.6**	**21%**		**10.7**	**9.0**	**-6.6**

Calculated at the new capitalization rate, $4.1 million of HOL's 2008 indirect cost will be allocated to capital, and the remaining $15.6M will be expensed. Calculated at the former capitalization rate, $10.7M will be allocated to capital, and the remaining $9M will be expensed.

a. Please confirm that the above calculations are correct.

b. Please calculate the 2008 service revenue requirement under both the 2007 and proposed 2008 capitalization rates and show detailed revenue requirement components.

Response

a) The calculations appear to be correct taking into account rounding. The 6.6 clearly agrees with the $6.5M as noted in Exhibit B1-3-1 Attachment U, page 4.

b) Hydro Ottawa did not determine what the burden rates would have been for 2008 based on the 2008 forecasts and the previous capitalization process. The 2007 burden rates would no longer have been valid because they were based on the 2007 costs, and the 2007 mix of labour hours for maintenance, capital and work for others. The calculation to determine these burden rates is complex, iterative and time-consuming. (Reducing this complexity is a secondary benefit resulting from the revised methodology.)

However, based on the $6.5M impact to distribution expenses, and assuming an average 25-year amortization, the impact to the total revenue requirement without the change in the capitalization process can be estimated as shown in the following table.

Rate Base	**%**	**2008 Service Revenue Requirement Per Exhibit A2-1-2, Table 1, Page 1 ($ millions)**	**Estimated 2008 Service Revenue Requirement without capitalization change ($ millions)**
Rate Base		$581.8	$584.9
Cost of Capital	6.67		
Return on Rate Base		38.8	39.0
Distribution Expenses		59.3	52.8
Amortization		43.7	43.9
Payments in Lieu of Taxes		13.7	$13.8
Service Revenue Requirement		$155.5	$149.5

Interrogatory

O&M and Administration Costs

32. Ref: D1/1/Schedules 2,3,4- Variance Analysis

The data as presented does not allow for an apples to apples comparison of expenditures year over year due to the fact that the "capital allocations" figure is only presented in aggregate form. For example, the 2006 Administration expenditure of $6.9 million is not comparable to the 2007 estimated expenditures of $7.571 million. Also the data for O&M is not broken down by the various programs (control room, general switching, etc.) described in paras. 3.1 to 3.13 in Exhibit D/Tab 1/Schedule 1). Therefore:

(i) Please provide a table showing OM&A expenditures for 2006 Board approved, 2006 actual, 2007, and 2008 normalized to take into account different capitalization rates in each year.

(ii) Under the "O&M" line please provide a breakdown of expenditures by subprogram (control room, general switching, etc.)

Response

(i) As discussed in the response to SEC Interrogatory #18 b), Hydro Ottawa did not determine burdens rates for 2008 based on the prior capitalization process[1]. A precise restatement of 2008 as it would have looked using the prior capitalization process cannot be provided. Based on the estimated year over year change of

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms "accounting change" and "change in capitalization process" interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy.

\$6.5M, and estimated change in reallocations between O&M and Administration, an approximation can be provided for what 2008 would have looked like using the prior capitalization process.

Operations, Maintenance and Administration (OM&A)	2006 Approved Rate Application	2006 Actual	2007 Estimate	2008 Forecast Approximation using old capitalization methodology	2008 Forecast
Operations & Maintenance	\$22,105,462	\$19,764,812	20,397,675	\$23,373,601	\$19,673,601
Billing and Collection	9,197,432	8,446,010	9,392,339	9,716,811	9,716,811
Community Relations	3,455,624	3,512,896	4,419,933	4,515,270	4,515,270
Administrative and General[2] Expenses	5,125,241	6,904,950	7,571,263	10,113,829	20,313,829
Insurance Expense	210,000	296,852	289,565	325,692	325,692
Bad Debt Expense	900,000	2,992,045	2,002,739	2,000,008	2,000,008
Advertising Expenses	62,000	7,403		0	0
Allowable Charitable donations[3]		40,000	40,000	40,000	40,000
Other Distribution Expenses	2,931,751	1,859,728	1,991,516	2,002,832	2,002,832
Net OM&A without Smart Meters	**43,987,510**	**43,824,696**	**46,105,030**	**52,088,043**	**58,588,043**
Allocations to capital	not available	(\$33,414,021)	(\$36,681,333)	(\$35,366,253)	(\$28,866,253)
Gross OM&A without Smart Meters		**77,347,304**	**82,786,363**	**87,454,296**	**87,454,296**
Smart Meter Expenses[4]	\$0	\$0	\$1,034,835	\$740,018	\$740,018
Net OM&A with Smart Meters	**\$43,987,510**	**\$43,824,696**	**\$47,139,865**	**\$52,828,061**	**\$59,328,061**

[2] Administration costs do not include the costs for Low Voltages charges from Hydro One. These costs were recorded in USoA Account 5665 for 2006 but subsequent guidance from the OEB have these costs recorded in Account 4750, therefore not part of OM&A.

[3] Actual charitable donations were higher. This reflects the charitable donations related to helping customers pay their electricity bills.

[4] The Smart Meter expenses are discussed in Section 12.0. For 2007, the expenses shown relate to the calendar year including a portion from the 2006 rate year (January 1, 2007 to April 30, 2007) and a portion from the 2007 rate year (May 1, 2007 to December 31, 2007). For the calendar year 2008, the expenses are forecast at a total of \$1,723,018. But this is comprised of \$983,000 from the 2007 rate year (January 1, 2008 to April 30, 2008) and \$740,018 from the 2008 rate year (May 1, 2008 to December 31, 2008).

ii) Please see the response to VECC Interrogatory #42.

Interrogatory

Question #23

Reference: Exhibit B1, Tab 3, Schedule 1, page 1, lines 8-14

a) What is the current status of the CICA's exposure draft?

Response

a) The CICA's Accounting Standards Board ("ASB") released a Decision Summary dated August 22, 2007 removing the temporary exemption from Section 1100 for rate regulated entities. This Section 1100 pertained to the recognition and measurement of assets and liabilities arising from rate regulation. 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.

Interrogatory

Question #24

Reference: Exhibit B1, Tab 3, Schedule 1, page 3, lines 4-7

a) Has this change in Cost Allocation procedure also been reflected in other areas that involve the allocation of overheads (e.g., costing of services done for affiliates, determination of activity rates for fleet services, etc.)? If yes, please discuss where and what the impact has been.

b) Has this narrower approach to cost responsibility been applied in the determination of the total Holdco costs that are allocated to Hydro Ottawa? If yes, what is the effect for 2008? If not, why not?

c) Has Hydro Ottawa adjusted its system expansion test at all for the October 2007 to May 2008 period to reflect the fact that there is a disconnect between the way capital work is costed and the costs incorporated into rates?

Response

a) No, the new Cost Allocation Procedure[1] does not affect the costing of services done for affiliates.

b) The cost allocation methodology used to allocate the Holding Company's charges to its subsidiaries has not been changed; however, the amount of these overheads that Hydro Ottawa capitalizes is determined by the new

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms "accounting change" and "change in capitalization process" interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy. The cost allocation procedure is therefore a subset of the accounting change or change in capitalization process.

capitalization process. The amount of the Holding Company's allocations that Hydro Ottawa capitalized in 2007 was approximately $1M. Using the revised methodology, approximately $0.2M of the Holding Company's total allocations are capitalized. All of the Holding Company's allocations that Hydro Ottawa does not capitalize become part of its OM&A expenses.

c) Hydro Ottawa assumes that the term "system expansion test" refers to the "Economic Valuation Model" for distribution system expansion. Hydro Ottawa uses approved distribution rates in its model in determining the amount of future revenue that will be received from a new development. The model will not be updated until the new rates for 2008 are approved. Costing of new projects will be based on the new burden rates that were developed as a result of the new capitalization process.

Interrogatory

Question #25

Reference: Exhibit B1, Tab 3, Schedule 1, page 4, lines 9-14

a) Please confirm that Hydro Ottawa is a member of the Coalition of Large Distributors (CLD).

b) Does Hydro Ottawa agree with the comments of the CLD submitted during the recent Board consultation regarding Comparison of Distributors' Costs (EB-2006-0268)? If not, in what areas does Hydro Ottawa disagree?

c) If Hydro Ottawa generally agrees with the CLD's comments, what weight does Hydro Ottawa believe should be attached to a comparison of its OM&A costs/customer for 2006 with those of other distributors in assessing the reasonableness of Hydro Ottawa's 2008 OM&A costs?

Response

a) Hydro Ottawa is a member of the Coalition Large Distributors ("CLD"); however, it should be noted that the CLD is an informal association of distributors with no legal status. The CLD participates in Board-related activities, such as consultatives, and Board proceedings on an issue-by-issue basis in accordance with agreements among its members.

b) Hydro Ottawa participated in the drafting of the comments submitted by the CLD regarding the comparison of distributors' costs and therefore agrees with these comments.

c) OM&A costs/customer is an appropriate measure to be used in comparing distributors' costs. The point of the CLD's comments was that OM&A costs/customer should not be the only basis of comparison, as proposed by Pacific Energy Group ("PEG"). As stated in the CLD comments paper, "capital costs, capital vintage, and substitution between capital and other inputs are very important factors in explaining and comparing LDC costs."

The PEG report had assessed Hydro Ottawa as among the most productive LDCs (20th out of 85). Hydro Ottawa agrees with the CLD's comments that capital costs should be included in the measure of productivity, despite the expectation that Hydro Ottawa's favourable productivity comparison, based on its old capitalization policy, would be affected. It is Hydro Ottawa's view that because it was generally capitalizing more overhead costs than other LDCs, the resultant productivity measure was misleading. This ability to compare costs with other LDCs was another reason why it was important for Hydro Ottawa to modify its capitalization process. Differences in capitalization processes between LDCs should not result in different assessments of productivity.

As noted in Attachment U, at page 7, to Exhibit B1-3-1, Hydro Ottawa had considered the productivity results from the PEG report. The PEG report had assessed negative "excess costs" for Hydro Ottawa of $6.3M based on the analysis of OM&A. Hydro Ottawa's change in capitalization process[1] is estimated to increase Hydro Ottawa's OM&A costs by $6.5M in 2008. There is a correlation between these two results.

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms "accounting change" and "change in capitalization process" interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy.

Interrogatory

Question #26

Reference: Exhibit B1, Tab 3, Schedule 1, Appendix T, page 15

a) Please indicate the previous "basis of allocation" for each of the areas set out in Table IV-3.

Response

a) Table IV-3 lists 11 types of costs that relate to overheads and a brief description on their basis of allocation effective October 1, 2007. The table on the next page recreates Table IV-3 to show the previous method of allocation for each item:

1 Table IV-3
2 Basis of Overhead Allocations

	% Related to Capital	Previous Basis of Allocation
Holdco	Variable	Costs were part of the total overhead pool and allocated to capital through a cascading calculation with the amount being capitalized based on the proportionate capital activity compared to maintenance and work for others.
Corporate Costs	Variable	As per Holdco allocation basis above
COO's Office	Variable	As per Holdco allocation basis above
Finance	Variable	As per Holdco allocation basis above
Regulatory	N/A	Regulatory costs where not included in the previous overhead pool.
Supply Chain	Variable	Allocated based on dollar value of materials and outside services associated with capital projects, maintenance and work for others.
Facilities	Variable	As per Holdco allocation basis above
Human Resources & Safety	Variable	As per Holdco allocation basis above
IT	Variable	As per Holdco allocation basis above
Operations (Engineering)	Fixed	Identified specific staff in engineering design, record keeping and asset management and their related expenses and allocated to distribution capital based on project costs.
Supervision	Variable	Ratio based on estimated proportion of dollars associated with capital projects versus maintenance and work for others. Based on management salaries and one-half of general administrative costs in Operations and Meter Installation areas.

3

Interrogatory

Question #28

Reference: Exhibit B3, Tab 2, Schedule 1

a) Do the capital expenditure forecasts set out in Table 1 reflect the change in Capitalization Policy implemented October 1, 2007. If yes, what is the impact on each of the line items in Table 1 for 2007?

b) Page 12 suggests that the reduction in capital contributions for 2007 (versus 2006 actual) is due to the reduction in Demand Capital Programs. However, based on the variances set out in Tables 3 and 8, the reduction in Capital Contributions appears to be significantly larger than the reduction in Demand Capital spending. Please reconcile.

Response

a) The capital expenditure forecasts set out in Table 1 do not reflect the change in capitalization process[1] implemented on October 1, 2007.

b) Table 1 below provides a comparison of demand capital expenditure and capital contributions for 2006 and 2007. It is true that there is a larger reduction in capital contributions than the reduction in demand work.

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms “accounting change” and “change in capitalization process” interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy.

Table 1: Demand Capital Expenses and Contributions

	2006 Actual ($000)	2007 Estimate ($000)	Variance ($000)
Demand Capital Expenses	43,668	41,007	(2,661)
Capital Contributions	20,029	15,022	(5,007)

Different types of demand work fall under different funding formulas; for example, relocations done for road widening are subject to funding under the *Public Service Works on Highways Act*, whereas plant extensions performed for customer connections are subject to the economic evaluation model. The mix of Hydro Ottawa expenses to capital contributions for a given year is dependent on the particulars of the work being done.

Another reason that the reduction in Capital Contributions appears to be significantly larger than the reduction in Demand Capital spending is that contributions have been assigned at the completion of the projects. Projects that occur over two years have not been assigned contributions until the end of the project, (i.e., in the second year). Therefore, there is not a direct relationship between the amount of Demand Capital in a year and the amount of Capital Contributions in a year.

Interrogatory

Question #29

Reference: Exhibit B3, Tab 2, Schedule 2, page 1, lines 9-19 and Table 1

a) Does the $6.5 M difference take into account the fact that the Capitalization Policy was changed October 1, 2007 and, therefore, also impacts on 2007 spending levels? If yes, how?

b) Does the change in Capitalization Policy have roughly the same proportional impact on all 2008 capital spending? If not, why not?

c) Which of the program areas discussed in this schedule account for the $3.7 M increase for TS Primary Above 50 and the $1.5 M increase in DS capital spending?

Response

a) The $6.5M difference is for the full fiscal year 2008. The $6.5M is based on the estimated amount of overheads that would have been charged to capital using the former capitalization process[1] versus the new one. It is independent of the change taking effect October 1, 2007; therefore, it does not take this implementation date into account.

b) The changes that are reflected in the new Cost Allocation Procedure mostly concern the administrative overheads and would impact all types

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms “accounting change” and “change in capitalization process” interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy.

of capital proportionately as these costs are charged to all capital programs.

c) The $3.7M increase for TS Primary Above 50 is due to the increased spending on Stations New Capacity, as shown in Table 2, page 2 of Exhibit B3-2-2. Hydro Ottawa has identified areas at or near their planning criteria capacity. Three Stations Capacity projects are planned to occur in 2008 to address areas of capacity concern; construction of the new Cyrville Station, installation of an additional transformer at the Uplands Station and a new station at Albion Station; please see Exhibits B2-3-1 and B3-4-1 for project descriptions.

The $1.5M increase in DS capital spending is due to the combination of the impact of:

i) increases in the Stations Capacity program as explained above,
ii) increases in the Stations Switchgear replacement program to address the aged switchgear,
iii) decreases in the Stations Relay Replacement program which has been coordinated with the Stations Switchgear replacement program to realize efficiencies, and
iv) changes not discussed for other stations programs below the materiality limit; that is, where the capital budget is less than $500k.

Interrogatory

Question #38

Reference: Exhibit C2, Tab 1, Schedule 5, page 6

a) Did the 2007 change in Capitalization policy impact at all on the costing of services to affiliates (i.e., less overhead cost capitalized leads to more overheads to be allocated to "operating activities")? If not, why not? If yes, what SLAs were affected?

Response

a) The 2007 change in capitalization process[1] does not impact the costing of services because they are two separate processes. The capitalization process is used to determine the overhead costs that are directly attributable to capital programs and, therefore, that are capitalized. The process of costing services to affiliates is based on either market prices or cost-based pricing; neither are capitalized.

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms "accounting change" and "change in capitalization process" interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy.

Interrogatory

Question #41

Reference: Exhibit D1, Tab 1, Schedule 1, page 4, Table 1

a) Does the 2007 "allocation to capital" reflect the fact that the Overhead Capitalization policy was implemented in October 2007?

b) Please indicate the dollars allocated to capital by cost category (i.e., line item) for 2006 Approved, 2006 Actual, 2007 Estimate and 2008 Forecast.

Response

a) The 2007 allocation to capital does not reflect the fact that a new capitalization process[1] was implemented on October 1, 2007.

b) The chart below provides the capital allocation by USoA line item. Please note that a different value for the 2006 Actual capital allocation amount was inadvertently used in Exhibit D1-1-1. The amount in the chart below balances to the correct value from Exhibit D1-1-2.

[1] In the Responses to Interrogatories, Hydro Ottawa has used the terms "accounting change" and "change in capitalization process" interchangeably to mean the implementation of both the new cost allocation procedure and capitalization policy.

1

USoA	2006 Approved Rate Application	2006 Actual	2007 Estimate	2008 Forecast
5415 - Energy Conservation	Not available	(3,775)	NA	NA
5085 - Miscellaneous Distribution Expense	Not available	(26,338,114)	(28,356,817)	(22,942,861)
5625 - Administrative Expense Transfer	Not available	(7,180,719)	(8,324,516)	(5,923,392)
Total Capital Allocation	Not available	(33,522,608)	(36,681,333)	(28,866,253)

2

Interrogatory

Question #42

Reference: Exhibit D1, Tab 1, Schedule 1, page 4, Table 1 and page 5, lines 17-19

a) Please provide a schedule that sets out the 2006 Actual, 2007 Estimate and 2008 Forecast for each of the O&M programs discussed on pages 5 through 9.

Response

a) The USoA is not structured in such a way as to provide total costs for each O&M program described. Hydro Ottawa has tried to structure its own System of Accounts ("SOA") in a similar way for O&M programs to allow for the required mapping to the USoA. Therefore, the total costs for a specific O&M program are found in more than one USoA Account (and SOA account), because labour and operating expenses are reported in different accounts.

To provide year over year comparisons for O&M, the table on the next page provides the total costs for the USoA Accounts in which the O&M programs are recorded. As can be seen, there can be different O&M programs in a particular USoA account. Furthermore, Hydro Ottawa has provided a second column for each year showing the amounts paid for the outside services (contracts) portion of the O&M programs, if applicable.

1 **O&M Programs by USoA Account ($000)**

USofA Account	US of A Description	Listed Programs included in USofA	2006 Actual	Outside Services 2006	2007 Estimate	Outside Services 2007	2008 Forecast	Outside Services 2008
5010	Load Dispatching	Control Room;General Switching	3,482	0	3,262	0	3,511	0
5014	Trans. Station Equip. - Operating Labour	Station Transformer Oil Analysis	69	0	60	0	117	0
5015	Trans. Station Equip. - Operating Expenses	Station Transformer Oil Analysis	30	17	50	5	27	20
5016	Dist. Station Equip. - Operating Labour	Station Transformer Oil Analysis	329	0	304	0	243	0
5017	Dist. Station Equip. - Operating Expenses	Station Transformer Oil Analysis	111	48	165	25	70	48
5020	Overhead Dist. Lines & Feeders - Operating Labour	Thermographic Scan; Tree Trimming	805	0	929	0	777	0
5025	Overhead Dist. Lines & Feeders - Operating Expenses	Thermographic Scan; Tree Trimming	2,101	26 1,934	2,524	13 2,308	2,621	13 2,461
5035	Overhead Dist. Transformers - Operation	Distribution Transformer Oil Testing	1,265	312	1,587	22	1,072	0
5040	Underground Dist. Lines & Feeders - Operation Labour	Thermographic Scan; Manhole inspection; Underground locates	762	0	742	0	356	0
5045	Underground Dist. Lines & Feeders - Operation Expenses	Thermographic Scan; Manhole Inspection; Underground Locates	1,094	140 110 701	1,435	110 100 900	1,281	110 100 900
5055	Underground Dist. Transformers - Operation	Distribution Transformer Oil Testing	36	0	341	240	48	19
5125	Maintenance of Overhead Conductors & Devices	Insulator Washing	1,023	125	912	83	862	75
5145	Maintenance of Underground Conduit	Manhole Cleaning	34	18	78	2	114	25
5150	Maintenance of Underground Conductors & Devices	Asbestos Removal & Arc-proofing of cables; CO2 Wash	1,098	90 32	1,446	226 100	1,263	250 100
5160	Maintenance of Line Transformers	Graffiti Abatement	534	100	508	150	467	120

2

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January 8, 2008

Mr. Wojciech Zielonka
Chief Financial Officer
Hydro Ottawa Limited
3025 Albion Road North
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Accounting Opinion on Change in Overhead Capitalization Policy

To Hydro Ottawa Limited:

We have been engaged to report on the appropriate application of Canadian generally accepted accounting principles ("Canadian GAAP") to the specific transaction described below. This report is being issued to Hydro Ottawa Limited for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with Canadian generally accepted standards for such engagements.

The facts, circumstances and assumptions relevant to the specific transaction as provided to us by the management of Hydro Ottawa Limited ("Hydro Ottawa") are as follows:

In the normal course of business, Hydro Ottawa capitalizes costs incurred to construct items of property, plant and equipment. Hydro Ottawa includes in the amount capitalized for such assets some "overhead" costs attributable to the capital work.

Hydro Ottawa's policy and methodology to capitalize overhead costs were described and documented in the following documents:

- Capitalization Policy FIN5-001.01 effective July 26, 2005
- Cost Allocation Rates effective January 1, 2004

Accounting Opinion on Change in Overhead Capitalization Policy

January 8, 2008

Effective January 1st, 2008, Hydro Ottawa has updated its policies and procedures with respect to capitalization of overhead costs in the following documents:

- Capitalization Policy FIN5-001.02 effective January 1, 2008
- Cost Allocation Rates Procedure 001-02 associated with the Capitalization Policy above effective January 1, 2008

The context and the rationale for this update is further described in the Hydro Ottawa Memo "Change in Overhead Capitalization – Accounting Treatment" dated December 19, 2007 (the "Memo") reproduced in Appendix A, and in particular in paragraphs 2 to 21 of said memo.

As described in paragraphs 17 to 21 of the memo, the updated methodology derives principally from a review that was performed by KPMG LLP and management of Hydro Ottawa and summarised in a report by KPMG dated August 16, 2007.

The most significant changes arising from the updated policy and procedure relate to the two following items:

a) Estimation and allocation of the indirect costs subject to capitalization

The pool of overhead costs described in the July 26, 2005 and January 1, 2008 versions of the Capitalization Policy remained materially the same, but the estimation of those costs directly attributable to capital projects was revised.

The attribution of indirect costs to capital under the previous estimation approach ascribed a larger proportional share of indirect costs to direct capital expenditures than direct operating expenditures. Hydro Ottawa has an ongoing and intensive capital program. Consequently, the relative weighting of capital spending as compared to operational spending resulted in a higher proportion of indirect costs attributed to the capital program following this approach. Under the revised policy, the indirect costs subject to capitalization are those that are determined through a "causal linkage". Guidance for the "causal linkage" is determined to be "costs that would be eliminated over time (in 3 to 5 years) if Hydro Ottawa did not have a capital program." Our understanding of the "3 to 5 years" notion is that in the event of a gradual or temporary reduction in the capital program, some staff in particular would be retained even if underutilized as it may be difficult to rehire and retrain new staff if and when the program were to increase again.

However, in the event of a drastic and expected to be long lasting decline in activity, the costs could be eliminated in a matter of weeks or months.

b) Reduction in the number of "allocation rates" used to allocate the costs subject to capitalization to the individual assets constructed, as well as a simplification of the method to apply the rates.

The previous procedure included seven allocation rates to recover direct and indirect costs, which were allocated based on activity or cumulative cost drivers. However, the procedure involved a "cascading" approach whereby these allocation rates included allocations from the indirect cost pools, as well as their own direct costs. The application method applied the allocation rates in a manner that layered them, requiring successive calculations such that certain rates became dependant on others.

The revised procedure was simplified to have four direct inputs with no indirect costs built in and three allocation rates to apply the indirect costs identified to be attributable to capital projects. The application is a "single step" approach based on the four direct inputs with no cascading or layering of rates requiring multiple calculations.

The previous policy and procedure was considered to result in the capitalization of amounts in excess of amounts "directly attributable" under paragraph 5 of Section 3061 *Property, Plant and Equipment* of the Accounting Handbook of the Canadian Institute of Chartered Accountants (the "CICA Handbook"). However, as described in paragraphs 6 and 9 of the Memo, this policy and procedure was accepted as part of the regulatory regime of Hydro Ottawa and therefore was considered to be in accordance with GAAP based on the exception provided by paragraph 34 of Section 1100 *Generally Accepted Accounting Principles* of the CICA Handbook.

The management of Hydro Ottawa has included the new capitalization policy as part of the 2008 rate application recently submitted to its regulator for approval.

In our opinion the revised methodology with respect to capitalized overhead described above is in conformance with Canadian GAAP.

The appropriate accounting principles to be applied to the accounting change described above are as follows:

> The change in the capitalization policy implemented on January 1, 2008, should be accounted for as a change in accounting policy on a prospective basis by Hydro Ottawa. Accordingly, the disclosure requirements of paragraph 29 of Section 1506 *Accounting Changes* of the CICA Handbook should be considered.

Our report is based on the following authoritative support and other supporting rationale:

> The relevant guidance with respect to changes in accounting policies, changes in estimates and corrections of errors is found in Section 1506. Paragraph 5 provides the following definitions:
>
> (a) **Accounting policies** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
>
> (b) A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.
>
> (c) **Prior period errors** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
>
> (i) was available when financial statements for those periods were completed; and
>
> (ii) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.
>
> Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

The issue is therefore to determine which of the three categories is applicable for the change in the overhead capitalization methodology implemented on January 1, 2008.

It is clear that from a basic policy point of view, Hydro Ottawa was capitalizing some overhead costs under the previous policy and procedure and will continue to capitalize some overhead costs under the new policy and procedure.

The change in methodology can be summarised as being one that moved from identifying "directly attributable" overhead costs subject to allocation to capital projects based on a "fully allocated cost" approach to a methodology that is more based on a "causal linkage" approach. Influencing factors for this change were:

- the new information provided by Deloitte & Touche, in their June 8, 2007, report on accounting guidelines and industry practices as they relate to including overhead allocations in the costs capitalized to Property Plant and Equipment;

- the completion in August 2007 of the exhaustive review by the management of Hydro Ottawa under the supervision of KPMG;

- the amendments to Section 1100 that would no longer permit a "fully allocated cost" approach by January 1, 2009.

In order to conclude, it is therefore required to determine if the predominant characteristic of changing how overheads are allocated falls within the concept of "principles, bases, conventions, rules and practices" as described in (a) above or within the concept of "estimate" as described in (b) above.

Determining what costs are "directly attributable" under paragraph 5 of Section 3061 remains an estimation process. Like other estimates, this estimation process is performed by establishing a systematic methodology that falls clearly within the notion of "principles, bases, conventions, rules and practices" of (a) above.

It is clear that Hydro Ottawa had one such methodology before and has a new one after. The methodology is simply trying to determine whether a specific cost should be part of the cost basis of an asset or be expensed as incurred and in what manner it is to be applied to a specific item of property, plant and equipment.

On the other hand, the definition of "change in accounting estimate" under Section 1506 is intended to apply to "adjustments of the carrying amount of any asset or liability" or to the "amount of the periodic consumption of an asset". What this implies is that sooner or later, new information will allow the estimate to be "proven right or wrong", such as the final recoverable amount of an account receivable, the settlement of a contingent

liability or the estimated life of an item of property, plant and equipment. In the case of the capitalization of overhead, there is no such notion as the future will never tell whether the amount capitalized was "right or wrong" and therefore the change in methodology would not constitute a change in estimate.

The information obtained indicates that the effects of the change in methodology will be significant on an annual basis from a quantitative point of view. However, regardless of the magnitude of the amounts, none of the information obtained points to any of the indicators of an "error" described in Section 1506, paragraph 5 c) reproduced earlier in this report. The magnitude of the effects of the change is due in part to the change from a "fully allocated" to a "causal linkage" cost approach and in part due to a more strict application of "directly attributable" as contemplated by paragraph 5 of Section 1506 to eliminate the need to rely on the "rate regulated" exception afforded by paragraph 34 of Section 1100. Accordingly, this is not considered to be a "prior period error".

Consequently, we consider that this new approach constitutes a change in accounting policy.

Under 1506.14 (b), as this change in policy is made on a voluntary basis, it is required that the change in policy can be applied in a reliable manner and provides more relevant information. On the basis that the revised policy is relatively simpler to apply than the previous one, there is no indication that Hydro Ottawa will not be able to apply it in a reliable manner. From a relevance point of view, as described in paragraph 27 of the Memo, the revised methodology is more in line with the observed trend of applying more conservative approaches to capitalization of overhead and similar indirect costs and it is in accordance with Canadian GAAP on a stand alone basis, i.e. without the need to rely on an exception afforded to rate regulated activities. Accordingly, this change should allow Hydro Ottawa to report its performance in a more relevant manner. Furthermore, as previously mentioned, such a change would have been required in any event by January 1, 2009, in order for Hydro Ottawa to be in compliance with Section 1100 of the CICA Handbook.

Finally, under paragraphs 19 to 27 and 50 to 53 of Section 1506, the change in policy would by default be applied on a retroactive basis under paragraph 19(b). However, the following arguments were considered to determine that it would be neither be practicable to apply such a change retroactively nor would it be appropriate in any case.

a) As described in paragraph 26 of the Memo, management of Hydro Ottawa has determined that retroactive application would not be practicable as it would require

making retroactive judgements on the cost structure that existed at the time to determine what costs, if any, would not have been capitalized, rebuilding the burden rates and applying these new burden rates based on cost drivers that may not have been captured in the past, all this for the thousands of individual line items carried in the property, plant and equipment subledger, and then recomputing depreciation;

b) Amending the accounting records retroactively would lead to a situation where Hydro Ottawa would unilaterally override the effects of rate decisions that were imposed onto it by the regulator in the past and were to be applied in the future, and thus giving a result that is inconsistent with the basic principles of accounting in a rate regulated situation;

c) The recent amendments to Section 1100, in particular the new paragraph 32B, the deletion of paragraphs 34 and 35 and the existing transitional provisions in paragraph 33 provide that any changes in measurement arising from the elimination of the "rate regulated" exception is to be applied prospectively.

The ultimate responsibility for the decision on the appropriate application of Canadian generally accepted accounting principles for the specific transaction described above rests with Hydro Ottawa management as preparers of the financial statements, who should consult with its auditors. Our judgment on the appropriate application of Canadian generally accepted accounting principles for the specific transaction described above is based on the facts, circumstances and assumptions provided to us. Should the facts, circumstances or assumptions differ, our conclusion may change.

This report is intended solely for the information and use of Hydro Ottawa Limited and may be used in the context of Hydro Ottawa Limited's rate application with the Ontario Energy Board and is not intended to be and should not be used by anyone other than these specified parties or for any other purpose.

PricewaterhouseCoopers LLP

Chartered Accountants

HYDRO OTTAWA LIMITED

MEMO

FINAL

December 19, 2007

To: Memo to File

From: Director of Finance and Chief Financial Officer

CHANGE IN OVERHEAD CAPITALIZATION – ACCOUNTING TREATMENT

1) The intent of this memo is to determine the appropriate accounting treatment for Hydro Ottawa Limited's (HOL) change to its allocation of indirect costs (overhead) to capital projects. Under Section 1506 of the Canadian Institute of Chartered Accountants' (CICA) Handbook, the application of a change in accounting practice 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 to be applied retrospectively or prospectively depending on considerations around reasons for the change and practicality of application, whereas a change in estimate is implemented prospectively.

BACKGROUND

2) Upon the amalgamation of the five predecessor utilities on November 1, 2000, HOL adopted the capitalization policy and allocation procedure of one its predecessors, Ottawa Hydro, until it conducted its own review in 2003. An HOL policy and procedure was updated as a result of the 2003 review, the results of which were applied in the preparation of the audited 2003-year end financial statements.

3) As an infrastructure-based business, HOL's operations are capital-intensive with the majority of its expenditures being earmarked for capital projects and the subsequent ongoing maintenance of these assets. Historically it has always used "burden" rates to apply overhead to its projects/programs, as do most entities in the utility sector. Each utility has its own policies in this regard to determine what costs qualify for capitalization and what methodology is to be used to apply this overhead to individual assets. HOL's practice has been to fully allocate its overhead costs to capital projects using budgeted burden rates and to perform a true up at year-end based on its actual costs.

4) As part of their audit of the financial statements for the year ended December 31, 2003, Deloitte & Touche (D&T), HOL's former auditors, analyzed the policy, procedure and related indirect cost allocation model. They were satisfied that the model was working as intended. D&T indicated at the time that "administrative overhead costs may be allocated to the capital projects if they are qualifying capital costs under the Ontario Energy Board (OEB) rules and if this is consistent with industry practice." The

capitalization policy and related procedure and model used previously has been applied consistently to date.

5) During the last seven years HOL's strategic direction has gradually shifted from a not-for-profit municipally owned utility to a commercially run, profit oriented business. In 2003 HOL hired a new Chief Operating Officer, who began transforming the Company to a commercially run business. As a result of this development the focus of the Company turned from maintaining infrastructure to building and replacing infrastructure, which dictated how HOL prioritized its workload and how it deployed its workforce. This affected more than just the frontline groups, but also the way the support groups such as Finance, Human Resources, Information Technology and others viewed their responsibilities and the association of their departmental costs with the capital program. This change in the Company's philosophy along with the introduction of an asset management plan further emphasized the Company's focus on capital. The 2003 capitalization review reflected this increased focus on capital while respecting both OEB and GAAP guidelines on capitalization and industry practice.

6) HOL's previous capitalization and overhead policy were submitted to the OEB as part of its 2006 Electricity Distribution Rate Application. The Application was approved in early 2006 and since that time the OEB has not questioned the methodology. Consequently, the overhead amount is considered to be an approved cost which is part and parcel of the capital assets and is recovered through the rate approval process via its inclusion in the amortization of capital assets.

7) It is a best and common practice that all organizations review on a periodic basis their financial and operational policies and procedures for appropriateness. External influences such as significant changes to legislation, generally accepted and/or regulatory accounting principles and internal changes such as organizational redesign and modifications to business practices or business lines, usually cause the re-examination of corporate polices for their appropriateness. In the absence of the above, the passage of time, usually 3-5 years, also triggers a review of all major corporate policies and financial estimates contained there in.

8) Recent pronouncements by professional accounting bodies affecting rate regulated entities such as the amendments to Section 1100 of the CICA Handbook that would eliminate exceptions for rate regulated starting January 1, 2009 and the proposed adoption of IFRS in Canada in 2011 (2010 for comparatives), the filing of the 2008 rate application and the passage of time has prompted HOL to review its capitalization policy and allocation procedure. In addition, the methodology for allocating overheads was considered to be unnecessarily complicated and could be simplified to allow for financial planning and budgeting in a timelier manner without unduly sacrificing the precision of the measurements.

9) Paragraph 3061.20 of the CICA Handbook states that (**emphasis added**) "The cost of an item of property, plant and equipment includes direct construction or development costs and overhead costs **directly attributable** to the construction or development." The notion of "directly attributable" is not further defined in the CICA Handbook and remains largely a matter subject to professional judgment. Rate regulated entities are

provided with an exemption to the application of Section 1100, as CICA Handbook paragraph 1100.34 states that "...an entity is not required to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulations..." Consequently the determination of those overhead costs to be capitalized by HOL could vary from those of a non-regulated industry. HOL's capitalization of overheads however would still be in conformance with Generally Accepted Accounting Principles (GAAP), as a rate-regulated entity until December 31, 2008 when the exemption for rate-regulated entities is removed from Section 1100 of the CICA Handbook.

10) The development of the past and present cost allocation models also considered OEB prescribed accounting guidelines within its Accounting Procedures Handbook (APH), specifically articles 230 – Definitions & Instructions, Article 340 – Allocation of Costs & Transfer Pricing and Article 410 – Capital Assets. These guidelines provide guidance in those particular areas where the CICA Handbook allows for differences in accounting treatment for rate-regulated enterprises. In the case of overhead capitalization the APH does not provide any further guidance.

11) Currently, there are no "across the board standard industry practices" regarding the accounting for overheads within a capitalization policy. Depending on corporate structures, past practices and regulatory oversight, the inclusions/exclusions and allocation methodology can vary from entity to entity. Most utilities do not publicly disclose in detail their process of capitalization. The OEB Accounting Procedures Handbook articles provide guidance but no definitive rules on the components of construction costs. In 2005 the CICA issued an Accounting Guideline on Disclosures by Entities subject to Rate Regulation (AcG-19) requiring note disclosure on the differences between normal GAAP and GAAP allowed for rate regulated entities. In the area of overhead capitalization, HOL, similar to other utilities in Canada, did not disclose specific differences on the topic of overhead capitalization practices. This was based on HOL's management conclusion that any difference could not be quantified without the incurrence of significant efforts and may not be accurately quantified. The inability to quantify the difference resulted in a reporting deficiency in HOL's financial statements for the years ended December 31, 2005 and 2006 however as the deficiency did not give rise to a material misstatement of the financial statements the external auditors were still able to provide an unqualified opinion.

12) The CICA released a Rate Regulated Operations Exposure Draft in March 2007, which proposed to remove CICA Handbook paragraph 1100.34 and eliminate from all other Accounting Sections of the CICA Handbook any paragraphs that provide recognition and measurement guidance to rate regulated entities. In the absence of specific Canadian GAAP for regulated entities those, entities that would desire to continue to apply "rate-regulated-type accounting" would likely have to adopt policies consistent with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS 71), of the US Financial Accounting Standards Board (FASB). There is a perception that rate-regulated entities are afforded more leeway in the capitalization of indirect costs and that if CICA Handbook paragraph 1100.34 is removed the increased flexibility to capitalize indirect costs is removed. AcG-19 would continue to provide disclosure guidance to rate regulated entities.

13) The Accounting Standards Board (AcSB) has decided to proceed with its proposal to remove the temporary exemption in Section 1100 for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009. The amendment to Section 1100 will apply prospectively. One of the CICA's published reasons[1] for the elimination of the Section 1100.34 exemption is to align recognition and measurement for rate-regulated and non-rate-regulated entities prior to the adoption of International Financial Reporting Standards by 2010 for comparative purposes.

14) As mentioned above, in the absence of specific guidance for rate-regulated entities within the CICA Handbook, utilities may choose at that time to follow US guidance. FAS 71, paragraph 9 states the following: Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

a) It is probable (*probable* is used in this Statement with its usual general meaning, rather than in a specific technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.

b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

FAS 71 does not specifically address what construction or development costs, other than interest, may be capitalized. In the absence of specific guidance, HOL's current interpretation is that the guidance in CICA Handbook section 3061.20 on "directly attributable" costs would apply. It would therefore appear that with the removal as of January 1, 2009 of the 1100.34 exemption for rate-regulated entities, a capitalization model that would capitalize costs other than those that are considered "directly attributable" may not be GAAP.

CURRENT DEVELOPMENTS

15) In view of the changing accounting environment with respect to rate-regulated entities, HOL engaged D&T during the spring of 2007 to research accounting guidelines and industry practice as they relate to including overhead allocations in the costs capitalized to Property, Plant & Equipment. D&T's report [2]concluded that there is a significant variation amongst utilities across Canada and the United States as to capitalization policies and specifically the capitalization of overhead. The report noted that there has been a tendency to move from more aggressive to more conservative capitalization policies. Eventual convergence with International Financial Standards and the exposure

[1] Accounting Standards Board Decision Summary – August 22, 2007
[2] Deloitte & Touche Report - June 8, 2007

draft discussing the elimination of rate regulated accounting in Canada would also be contributing factors towards a more conservative approach.

16) HOL also engaged Fraser Milner Casgrain LLP (FMC), the counsel retained for the 2008 rate application, to conduct research for regulatory decisions on the issue of capitalization versus expensing expenditures. FMC's work to date covers decisions made in the last five years by the following regulators: the OEB, the Alberta Energy and Utilities Board, the British Columbia Utilities Board and the National Energy Board. In short, their research suggests there is no hard and fast rule when one is deciding whether to capitalize or expense an overhead cost. To the contrary, well-accepted business principles are applied on a case-by-case basis, having regard to the facts of each case.

17) HOL staff also conducted an informal web based review to determine how other entities interpret *directly attributable* overhead costs. Two reports issued by KPMG were considered by staff to be the most relevant and current. They are, a study undertaken on behalf of NB Power Group of Companies and another on behalf of Union Gas Limited. In both studies KPMG was retained to conduct an independent study of the companies' process for capitalizing overhead costs and in the case of NB Power, this study addressed the allocation of corporate service costs from their holding company.

18) HOL engaged the same KPMG Managing Director who participated in the NB Power and Union Gas reviews to assist in a review to update HOL's estimate of the amount of overhead costs related to capital work and ensure its capitalization and allocation policies reflect any change in the methodology to identify and allocate overhead costs to be capitalized. The common principle that KPMG has deduced from its review of accounting and regulatory guidance and industry practice is "That any assignment of indirect costs to a capital project should be done based on some reasonable causal link or association with the capital activity."

19) This principle of "causal link and association" has been incorporated by HOL into the current review of overhead costs attributable to the capital program. The resulting methodology and related estimates, discussed below, resulted in the reduction of overheads costs that qualified for capitalization as compared with the past practice of fully allocating overhead costs. The current methodology as outlined in the KPMG report[3] is seen to be more reflective of current industry practice and is consistent with a trend towards less capitalization of overheads by professional accounting bodies.

20) As was mentioned earlier, the allocation model has also been simplified to eliminate a complex multiple step process of assigning overhead costs amongst support activities i.e. Finance, Human Resources etc. and then reassigning a portion of the support activity costs estimated to be *directly attributable* to capital work and then to specific capital projects. Only three burden rates, Engineering, Supervision and Administration have been established in the current model. These burdens are applied independently to the appropriate cost drivers of each individual project to simplify the allocation process.

[3] KPMG Report – Review and Update of Overhead Capitalization Estimates - Aug 15, 2007

This also allows overhead costs to be applied more precisely to particular projects that share causal links with the various types of overhead costs

21) In summary, KPMG reviewed HOL's updated policy on capitalization and found it to be reasonable and in accordance with industry standards and practice related to overhead capitalization. KPMG also reviewed the cost drivers (for overhead allocation) and validated the appropriateness of the overhead costs that are to be allocated to capital projects. KPMG found the proposed overhead capitalization results developed in the study and presented in their report to be fair and reasonable.

ACCOUNTING TREATMENT ANALYSIS

22) At issue is the interpretation of "*directly attributable*" contained in CICA 3061.20 as it relates to HOL's indirect or overhead costs. HOL has strong arguments to consider that a portion of Facility and Operational general and administration (G&A) costs are *directly attributable* to capital projects. However it is more difficult to demonstrate what IT, HR, Finance, Holdco and Corporate costs are *directly attributable* to capital projects. As mentioned earlier, there appears to be a move towards more conservative accounting standards in Canada and in many other jurisdictions, in particular under IAS 16. Therefore, it is possible that some indirect costs, which are currently capitalized under GAAP by non-rate regulated entities, could cease to be eligible for capitalization in the future thereby compounding the impact on rate-regulated entities.

23) HOL's reassessment of estimated overhead or indirect costs that are *directly attributable* to capital work has resulted in approximately $6.5M[4] of overhead costs that would previously have been capitalized that are now identified in the 2008 budget as OM&A costs. Although the magnitude of this change is large, it has evolved over a 4-year period. Previously these costs would have been capitalized and amortized over 4 to 50 years depending on the asset type to which they were assigned.

24) Accounting changes can be considered a change in an accounting policy. Under Section 1506, an accounting policy is defined as specific principles, bases, conventions, rules and practices an entity applies when preparing and presenting its financial statements. The CICA Handbook section 1506.35 states "A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate." Initial discussions by Hydro Ottawa with various accounting professionals suggested that the change in indirect costs being allocated to capital was a change in accounting estimate. Hydro Ottawa engaged PricewaterhouseCoopers (PwC) to render an opinion on whether its Capitalization policy is in accordance with GAAP and to confirm that the accounting change, resulting from the change in indirect costs being allocated to capital, is a change in estimate to be applied prospectively. In the conduct of PwC's work which involved consulting HOL's current and past external auditors the consensus of professional opinion suggests a change in accounting policy is more

[4] Audit Committee Memo – Revision of Capitalization Policy and Allocation Procedure Based on Updated Estimates – Aug 21, 2007

appropriate than a change in estimate. This consensus derives from the magnitude of the OM&A impact ($6.5M[4]) coupled with gradual change in circumstances in HOL's business. Furthermore, the change in methodology does not meet the definition of a change in estimate contained in Section 1506.05 (b), i.e. it is not an "an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities". An estimate is usually associated with a currently uncertain amount that will eventually become exact as new information becomes available or new developments occur such as a valuation allowance on an account receivable or the useful life of a capital asset. In the case of overhead capitalization, the amount considered to be *directly attributable* will never become exact and therefore proven right or wrong. Finally, a change in methodology such as the one instituted by HOL is consistent with the notion of a change in "principles, bases, conventions, rules and practices" as contained in the definition of Accounting policies in CICA 1506.05 (a).

25) The CICA Handbook section 1506.48 (Accounting Changes) states, "Corrections of errors are distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision, as additional information becomes known." As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information. The amount of overheads allocated to capital is inherently an estimate; there is no right or wrong amount. These decisions ultimately rely on professional judgment and as long as HOL's allocations are reasonable in comparison to the others in the industry as outlined in the D&T report[5], there is no evidence to indicate that the change in methodology is due to the existence of an error in the past.

26) Once the accounting change is determined to be as a result of a policy change, retrospective application is the default treatment. There are however qualifications on retrospective application per CICA Handbook Section 1506.23 "When retrospective application is required by paragraph 1506.19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change." Section 1506.50 goes on to say, "In some circumstances, it is impractical to adjust comparative information for one or more prior periods to achieve comparability with the current period." In management's opinion the retrospective application of this policy change would be extremely difficult and complex due to the thousands of line items on work orders being transferred to the fixed asset sub ledger on an annual basis, the need to reprogram the JD Edwards enterprise business system to reverse and rerun the depreciation calculations and the problem with translating historical business unit costs into the structure needed to apply the new allocation model. Management also feels that this change would not enhance the utility of the financial statements to the user, nor the comparability of financial results, as any restated Company's costs would be incongruent with its approved OEB revenue requirements.

[5] Deloitte & Touche Report - June 8, 2007

CONCLUSION

27) Based on the information gathered, it is management's opinion that HOL's change to better reflect a more current approximation of overhead costs *directly attributable* to its capital work be considered a change in an accounting policy. The CICA Handbook Section 1506.14 permits changes in accounting policies if the change "(a) is required by a primary source of GAAP or (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows". Since this change in accounting policy cannot be considered a change required by a primary source of GAAP currently, the change must result in reliable and more relevant financial information. CICA Handbook Section 1506.15 states "Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows". Management believes the new policy is more reflective of industry practice and is inline with the trend towards more conservative policies for the capitalization of costs. The complexity of implementing this accounting change retroactively, as well as the disjoint that would occur between the approved regulated revenue based on the previous capitalization policy would not result in reliable and more relevant financial information to users of the financial statements. Although the removal of the exemption from section 1100 is not mandatory until January 1, 2009 and is to be applied prospectively, Hydro Ottawa Limited will adopt the change commencing January 1, 2008. It is Hydro Ottawa Limited's belief that this change in accounting policy should be applied prospectively beginning January 1, 2008 in order to align it with its 2008 rate application, which is designed to recover costs based on the 2008 fiscal year. Prospective application of the policy commencing January 1, 2009 would result in a misalignment between costs and its approved 2008 rates which would carry forward to its next rebasing which is anticipated to be in 2011.

Summary of the Application

Enersource proposes distribution rates and other regulated rates and charges for the 2008 Test Year based on:

- Proposed rate base: $505.4 million
  - Proposed PPE: $408.9 million
  - Proposed Working Capital Allowance: $96.5 million
- Proposed costs of the period of $89.8 million
  - Depreciation: $34.4 million
  - OM&A: $42.1 million
  - PILs: $13.3million
- Overall cost of capital of 7.464% based on
  - A deemed 60/40 debt/equity capital structure
  - Enersource's actual cost of long term debt
  - Return on equity of 9%
- Recovery of the costs of the following initiatives:
  - The ongoing investment in Smart Meters;
  - The investment in the Customer Information System;
- Rate riders that return $5.1 million to rate payers based on:
  - the net return of $8.552 million related to the clearing of several variance accounts and regulatory asset balances as of December 31, 2006;
  - recovery of the Lost Revenue Adjustment Mechanism claim of $0.370 million and Shared Savings Mechanism claim of $1.280 million for Enersource's Conservation and Demand Management activities undertaken in 2006;
  - recovery of $0.023 million of Ontario price Credit Administrative Costs;
  - return of $0.031 million due to the past over-recovery of the Large Corporation Tax;
  - recovery of $0.253 million of Low Voltage charges levied by Hydro One; and

- recovery of $1.537 million of interest on regulatory assets

- Special Service Charges at the levels previously authorized for the 2007 Bridge Year;
- Standby rates that are currently interim made final for the 2006 and 2007 rate period and final standby rates for 2008;
- Administrative fixed charge for standby customers as follows:
  - For uncomplicated metering arrangements : $200/month
  - For complicated metering arrangement: $500/month;
- Adjusted loss factors;
- 2006 EDR revenue requirement responsibility methodology to support the determination of rates for all customer classes

The application, if approved, will authorize distribution rates and other charges to recover a revenue requirement of $124.3 million and will result in a monthly bill decrease of 1.33% or $1.55 per residential customer consuming 1000 kWh per month.

Forecast Charge Parameters

Number of Customers

Enersource's forecast of the number of customers by customer class for the 2008 Test Year is set out in the table below.

Average Number of Customers (Connections)

RATE CLASS	2006	2007	2008
Residential	159,692	161,217	166,825
Less than 50 kW	15,764	15,946	16,081
Small Commercial	3,245	3,265	3,288
GS 50-499 kW	3,920	3,960	3,986
GS 500-4999 kW	461	466	470
Large User	9	9	9
Street Lighting	47,588	47,981	48,255
TOTAL	230,679	232,844	238,914

Enersource's forecasting methodology is summarized below. A detailed description of the forecasting methodology is found at ExB/Sched3/Tab2 and ExB/Sched3/Tab3.

Enersource relied on past experience of customer additions to forecast customer additions in the 2008 Test Year. Upon initial occupation, premises in Enersource's service area tend to be continually occupied. As a result, Enersource typically does not lose end users at specific sites. This number of connected premises is referred to as the number of customers.

Enersource uses the number of customers as of the end of the previous period as a proxy for the number of customers at the beginning of the next period. For the purposes of forecasting the number of customers in the 2008 Test Year, Enersource adopted the number of customers at the end of the 2007 Bridge Year as the opening number of customers in the Test Year. Consistent

with the City of Mississauga's economic planning forecasts and with past experience, Enersource assumed a 1% average growth rate in the number of customers.

A specific adjustment has been made to the number of residential customers to take into account the number of new customers residing in condominium units who will take delivery service during the 2008 Test Year. Enersource has projected serving an additional 3,315 residential customers residing in condominium units. This adjustment did not require a compensating adjustment to any other customer class.

Interrogatory

Question #22 Reference: i) Exhibit D/Schedule 2/Tab 1

a) Was any OM&A expense capitalized as overheads in 2006, 2007 or 2008? If not, why not?

b) If the response to (a) is yes, please indicate the OM&A amounts that were capitalized as overheads in 2006, 2007 and 2008 and provide schedules setting out how the amounts for each were determined.

Response

a. OM&A expenses in 2006, 2007 and 2008 were or will be capitalized and allocated to customer projects. Exhibit D, Schedule 1/Tab 11,

b. The amount capitalized and allocated to customer projects for each year is listed below.

Description	2006	2007	2008
Recoveries	- 8,140	- 8,174	- 7,485