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VIA E-MAIL & COURIER

February 12, 2008

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, Suite 2700
Toronto, Ontario
M4P 1E4

Dear Ms. Walli:

**Re: Hydro Ottawa Limited;
2008 Electricity Distribution Rates;
Board File No. EB-2007-0713**

I am writing on behalf of Hydro Ottawa to file the following with you:

- Reply Argument on Issue 3.4; and
- Reply Argument on Issues 4.2 and 8.4.

Yours very truly,

(signed) J. H. Farrell

JHF/ko
Encls.

cc: Ms. Lynne Anderson
Hydro Ottawa

All Intervenors

Ontario Energy Board
EB-2007-0713

Hydro Ottawa Limited
2008 Electricity Distribution Rates

Reply Argument
(Issue 3.4)

Introduction

1. Hydro Ottawa Limited ("Hydro Ottawa") filed the Settlement Proposal in this proceeding on January 23, 2008. The Settlement Proposal indicated that Hydro Ottawa and the other parties to it achieved a complete settlement of 28 issues, an incomplete settlement of one issue (4.2), a partial settlement of one issue (3.4), and no settlement of one issue (8.4).¹
2. Hydro Ottawa and the other parties agreed that Issue 3.4 – capitalization process – should be addressed in an oral hearing of Hydro Ottawa's evidence on this issue. Hydro Ottawa and the other parties also agreed that Issues 4.2 and 8.4 should be addressed by means of argument alone and, moreover, they advised the Board that they preferred written argument.
3. The Board conducted a settlement hearing on January 24, 2008 in which the Board accepted the Settlement Proposal subject to the following:
 - the clarification of paragraph (c) in the description of the complete settlement of Issue 4.1;² and
 - the correction of three clerical errors in the Settlement Proposal identified by counsel for Hydro Ottawa.³
4. Hydro Ottawa revised the Settlement Proposal accordingly and filed the revised version on January 25, 2008. Hydro Ottawa also filed another version that indicated each revision of the original Settlement Proposal.
5. The Board conducted its oral hearing of Hydro Ottawa's evidence on Issue 3.4 on February 4, 2008.⁴ Hydro Ottawa presented a panel of three witnesses. School Energy Coalition ("SEC") was the only intervenor whose counsel cross-examined them. The Board approved the use of written argument for Issue 3.4 and established the following filing schedule in this regard:

¹ The Board's Issues List set out 32 issues. The Board disposed of the 32nd issue – Issue 9.2 – in its Decision on Request for Interim Rates dated January 10, 2008: "[t]he Board denies Hydro Ottawa's request that its existing distribution rates be declared interim effective January 1, 2008" (p. 5).

² See the settlement hearing transcript at pp. 42 and 45.

³ *Id.* at pp. 3 and 45.

⁴ The Settlement Proposal was marked as Exh. N1-1 at the outset of the hearing.

- February 7, 2008 for SEC's written argument; and
 - February 12, 2008 – today – for Hydro Ottawa's reply argument.⁵
6. SEC filed its submissions on Issue 3.4 with the Board on February 7, 2008. Hydro Ottawa is responding to SEC's submissions in this Reply Argument. Hydro Ottawa does not intend to respond to each and every one of SEC's submission, however, and so the absence of a response should not be taken as acquiescence on Hydro Ottawa's part.
 7. The Board's technical staff ("Board Staff") filed its submission on Issue 3.4 today. Hydro Ottawa is not responding to Board Staff's submission because, in short, "Board Staff have no concerns with the proposed change in capitalization policy."⁶

Partial Settlement

8. There was a partial settlement of Issue 3.4 because SEC did not accept the settlement reached by Hydro Ottawa, on the one hand, and Consumers Council of Canada ("CCC"), Energy Probe Research Foundation ("EP"), and Vulnerable Energy Consumers Coalition ("VECC") on the other. The latter "have accepted Hydro Ottawa's new capitalization process in principle and, in addition, they have accepted the \$6.5M increase as appropriate in the context of the Settlement Proposal."⁷
9. It is noteworthy that three ratepayer organizations – CCC, EP, and VECC – accept Hydro Ottawa's new capitalization process. It is noteworthy as well that the bill impacts of the new capitalization process are greater for their constituents, as it were, than for SEC's constituents.⁸

SEC's Themes

10. There are two themes in SEC's written argument. One has to do with the impact of Hydro Ottawa's proposal, on ratepayers and on Hydro Ottawa, and the other has to do with the generic nature of the proposed changes in accounting policy.
11. Hydro Ottawa is responding to both themes in this Reply Argument. The following is a preview:
 - SEC overstates the impact on ratepayers, by implication from its submissions on bill impacts, and understates the impact on Hydro Ottawa; and
 - SEC's analysis of Hydro Ottawa's evidence on the changes in accounting policy, which would implement its new capitalization process, is mainly an exercise in sophistry.

⁵ See the transcript of the oral hearing at pp. 63-64 (i.e., 1 Tr. 63-64). The presiding member of the Board's panel advised Hydro Ottawa's counsel as follows: "[y]ou are not going to file argument-in-chief on this issue;" see 1 Tr. 63 (lines 22-23).

⁶ Board Staff's submission (last para.).

⁷ Settlement Proposal (Exh. N1-1) at p. 15.

⁸ See 1 Tr. 48-51 and Exh. K1.6 (filed at 1 Tr. 59).

Impact on Ratepayers

12. SEC states the obvious; namely, that the impact on the distribution portion of the bill is "actually much larger" than the total bill impact.⁹ SEC goes on to state that "the bill impact is not a trivial matter."¹⁰
13. Hydro Ottawa agrees that the bill impact is not a trivial matter. Hydro Ottawa notes, however, that bill impacts should be viewed in relative terms for SEC's constituents compared to other rate classes:

MR. VLAHOS: Sorry to interrupt, Ms. Helt. Where would the schools fit into those rate classifications?

MS. ANDERSON: Schools would be at the very large end of the general service less than 50 class, so that would be, we assumed, a customer around 12,000 kilowatt-hours, which was a minus 1.5 percent bill impact, and then perhaps in the general service greater than 50 class, we estimated the 200 kilowatt range minus 1.7 percent.

There could be some larger schools than that, but none of them fall into the two large classes.

So it is the two, the general service less than 50 class, the general service greater than 50.¹¹

Impact on Hydro Ottawa

14. As for the impact on Hydro Ottawa, the gist of SEC's submissions is that Hydro Ottawa would benefit, in effect, by borrowing \$6.5 million instead of proposing a new capitalization process. The loan would offset the corresponding revenue shortfall, or so SEC claims, were the Board to disallow the use of the new capitalization process, for rate-making purposes, during the 2008 rate year.¹²
15. This claim is ludicrous, of course, because no prudent utility (or any other enterprise) would borrow \$6.5 million annually to cover its OM&A expenses. The claim also indicates that SEC simply ignores the financial consequences that would arise if Hydro Ottawa's revenue requirement is not aligned with the increases in its OM&A expenses.
16. SEC's submissions, moreover, do not comport with the evidence in this regard:

MR. DeVELLIS: I guess my question is, though, if you didn't have the 6.5 million, you would go out and borrow 6.5 million and you would pay at a cost of whatever that cost is, but you are being compensated for that in your rate base with your weighted average return on capital?

⁹ SEC submissions at para 4 (p. 1).

¹⁰ *Id.* at para. 5 (p.1).

¹¹ 1 Tr. 49 (lines 13-24).

¹² SEC's submissions at para 6-7 (p. 2).

MS. ANDERSON: Yes, but our net income would decrease by in excess of 6 million, because we have to make this change. Therefore, our expenses will be increasing and there wouldn't be an associated revenue, because the revenue would be [set] as if it had been a capital expenditure, which would be a few hundred thousand.

MR. DeVELLIS: When you say net income, you mean your financial statement net income?

MS. ANDERSON: Correct.

MR. DeVELLIS: Okay.

MS. ANDERSON: The net income that our credit rating agencies would look at, for instance.¹³

17. The 2008 rates will be the base rates for the Board's upcoming 3rd Generation Incentive Regulation Mechanism ("3GIRM"). If the Board disallows the new capitalization process now, and if 3GIRM has a term of two years, the total amount at Hydro Ottawa's revenue shortfall would be almost \$20 million:

[T]he most important thing to us is the fact that we are moving into third-generation incentive rate mechanism or 3GIRM, as we call it, 3GIRM, in which Hydro Ottawa's rates will be set in 2009 and 2010. We absolutely have to implement this capitalization change no later than January 1st, 2009. Therefore, if we are setting the base now, if we don't get this change implemented '08, the implications on Hydro Ottawa's finances for 2009 and 2010 are certainly extreme. We would be incurring 6-1/2 million of operating costs for which there would be no revenue.¹⁴

Changes in Accounting Policy

18. SEC's second theme is that changes in accounting policy are a generic issue and, as a result, Hydro Ottawa's new capitalization process is premature. SEC goes through an elaborate, but pointless, analysis of Hydro Ottawa's evidence in this regard to reach the following conclusion:

In any event, SEC submits that changes to utility accounting practices that are driven by changes to changes [*sic*] in accounting policy should be considered by the Board on a generic basis and not be done on a piecemeal basis as Hydro Ottawa is proposing.¹⁵

¹³ 1 Tr. 25 (lines 17-20) and 26 (lines 1-6). Ms. Anderson recalls saying "set", rather than "associated," in line 26 on p. 25.

¹⁴ 1 Tr. 21 (lines 22-28) and 22 (lines 1-4). Ms. Anderson's reference to \$6.5 million is a reference to the annual amount; see para. 16 above.

¹⁵ SEC's submissions at para. 25 (p. 4).

19. SEC's analysis is an exercise in sophistry. SEC is clearly seeking to undermine the PwC Opinion by diverting the Board's attention from it to the KPMG Report and, to a lesser extent, the D&T Report.¹⁶ Mr. Shannon described the reason for an independent opinion, which the PwC Opinion is, and the purpose of the KPMG and the D&T reports.¹⁷
20. The PwC Opinion describes the following as "[t]he most significant changes arising from the updated policy and procedure:"
 - a) Estimation and allocation of indirect costs subject to capitalization...
 - b) Reduction in the number of "allocation rates" used to allocate the costs subject to capitalization to the individual assets constructed, as well as simplification of the method to apply the rates.¹⁸
21. The PwC Opinion states the following with respect to these changes: "[i]n our opinion the revised methodology with respect to capitalized overhead described above is in conformance with Canadian GAAP."¹⁹ The PwC Opinion goes on to state the following:

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 "casual 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 apply more conservative approaches to capitalization of overhead and similar indirect costs and its is in accordance with Canadian GAAP on

¹⁶ The PwC Opinion is Exh. K1.1 (see 1 Tr. 2). The KPMG Report and the D&T Report are, respectively, Attachment T and Attachment S to Exh. B1-3-1.

¹⁷ See 1 Tr. 14 (lines 20-28) and 15 (lines 1-14).

¹⁸ Exh. K1.1 at pp. 2-3.

¹⁹ Exh. K1.1 at p. 3 (last para.).

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.²⁰

22. The evidence is clear, then, that the changes in accounting policy that comprise Hydro Ottawa's new capitalization process must be made by January 1, 2009. The evidence is also clear that Hydro Ottawa will incur adverse and material cost consequences if the changes are not made effective January 1, 2008.²¹
23. SEC claims "Hydro Ottawa offered little in the way of concrete evidence to support this position;" that is, in SEC's words, "Hydro Ottawa is in a unique position because it had been capitalizing more of its indirect costs than other distributors."²² This claim is disingenuous, at best, in the light of Hydro Ottawa's efforts in this regard as Ms. Anderson described them.²³ Ms. Anderson explained, in particular, the reason why Hydro Ottawa filed evidence from the application of Enersource Hydro Mississauga Inc.:

In particular we filed, as we indicated, evidence from the Enersource proceeding where -- Enersource is an LDC that has been routinely used as a comparator with Hydro Ottawa there was a comparator and cohort study in which Enersource was compared also the PEG report I just mentioned also compared Hydro Ottawa to Enersource.²⁴

24. The final exchange between SEC's counsel and Ms. Anderson is also informative:

MR. DeVELLIS: Other than the Enersource example which you have provided, there is no direct evidence on your capitalization -- the amounts that Hydro Ottawa capitalized versus other utilities?

MS. ANDERSON: Well, certainly the KPMG, the two reports that we did mention with New Brunswick Power and Union Gas, certainly there are those two reports that we did look at that indicated they were capitalizing a percent of their overhead costs as a percent of their gross OM&A somewhere in the same order of magnitude as Hydro Ottawa's revised approach, or, actually, slightly less.²⁵

²⁰ Exh. K1.1 at p. 6.

²¹ See paras. 12-15 above.

²² SEC's submission at, respectively, para. 27 and para. 26 (p. 4).

²³ See 1 Tr. 15 (lines 21-28) to 19 (lines 1-10).

²⁴ See 1 Tr. 18 (lines 1-6). This evidence comprises Exhs. K1.2, K1.3, and K1.4 in this proceeding.

²⁵ 1 Tr. 47 (lines 24-28) and 48 (lines 1-6).

Conclusion

25. The Board should approve Hydro Ottawa's new capitalization process effective January 1, 2008. To do otherwise would be unfair to Hydro Ottawa in the context of the adverse and material financial consequences under a 3GIRM rate-making process.
26. This Reply Argument is respectfully made to the Board on February 12, 2008 by Fraser Milner Casgrain LLP, through Jerry H. Farrell, as counsel for Hydro Ottawa in this proceeding.

Ontario Energy Board
EB-2007-0713

Hydro Ottawa Limited
2008 Electricity Distribution Rates

Reply Argument
(Issues 4.2 and 8.4)

Introduction

1. Hydro Ottawa Limited ("Hydro Ottawa") is replying to the written argument on Issues 4.2 and 8.4 of the following intervenors (in alphabetical order): Consumers Council of Canada ("CCC"), Energy Probe Research Foundation ("EP"), School Energy Coalition ("SEC"), and Vulnerable Energy Consumers Coalition ("VECC"). Hydro Ottawa is also replying to the written submission on the two issues of the Board's technical staff ("Board Staff").
2. This Reply Argument should be read in conjunction with Hydro Ottawa's Argument-in-Chief dated February 5, 2008 and its Reply Submission on Interim Rates dated December 28, 2007 in this proceeding. Hydro Ottawa does not intend to respond to each and every submission of the intervenors and Board Staff; however, the absence of a response should not be taken as acquiescence on Hydro Ottawa's part.

Intervenors

3. CCC, EP, SEC, and VECC all argue that the Board has already disposed of Issue 8.4 in its Decision on Request for Interim Rates dated January 10, 2008. CCC states the following, for example, while EP, SEC, and VECC use different words to convey a similar meaning:

The Council submits that the Board's Decision on interim rates has effectively eliminated the need for a further decision on the remaining issues. The Board, in that Decision, did not approve Ottawa's request to recover what it viewed as a "revenue deficiency" for the period January 1, 2008. [*sic*]¹

4. Hydro Ottawa is surprised by their submissions and, presumably, so is the Board. The Board's decision did not dispose of Issue 8.4; rather it disposed of Issue 9.2 in these words: "[t]he Board denies Hydro Ottawa's request that its existing distribution rates be declared interim effective January 1, 2008."²
5. Hydro Ottawa stated the following in its Reply Submission on Interim Rates but, nevertheless, the Board's decision makes no mention of it:

¹ CCC's written argument at p. 2 (third complete para.).

² Decision at p. 5 (second-last para.).

Hydro Ottawa also requested, in the alternative, a deferral account for the revenue deficiency. The issue before the Board at this point is whether to make an account order to establish the deferral account effective January 1, 2008. The issue at this point, in other words, is not whether to allow Hydro Ottawa to recover the balance that would be recorded in the deferral account. A denial of Hydro Ottawa's request in the alternative now, before hearing its evidence, would likewise be unfair to Hydro Ottawa from both a procedural and a substantive perspective.³

6. The Board considered the provisions of the Settlement Proposal on Issues 4.2 and 8.4 at its settlement hearing on January 24, 2008. The Board approved the use of written argument for these two issues.⁴ Why? The answer must be, presumably, that there was still a need for an argument process because the Board had not previously disposed of Issue 8.4 in its decision on Issue 9.2 (i.e., interim rates).
7. A deferral (or a variance) account, by definition, would not guarantee Hydro Ottawa's recovery of its revenue deficiency. Such an account would only provide relief from the rule against retroactive rate-making.⁵ Hydro Ottawa must subsequently satisfy the Board, when seeking to clear the deferral (or the variance) account, that it should be allowed to recover the amount recorded in the deferral (or the variance) account.
8. The clearance of the deferral (or the variance) account, moreover, would not occur prior to the end of the 2007 rate year. If the Board were to allow Hydro Ottawa to recover the amount recorded in the deferral (or the variance) account, the recovery would occur on a prospective basis.
9. VECC also claims that there is, in fact, no revenue deficiency.⁶ Simple arithmetic proves otherwise, however, because the revenue collected by Hydro Ottawa during the first four months of 2008 using 2007 rates will be less than Hydro Ottawa's cost-based revenue requirement, as adjusted by Hydro Ottawa, during the same period.⁷

Board Staff

10. Board Staff concurs that Issues 4.2 and 8.4 are two parts of a single issue but, nevertheless, goes on to identify "two separate issues."⁸ Hydro Ottawa understands each issue but not, however, Board Staff's submissions on each issue.
11. Board Staff's first issue involves the revenue deficiency that arises from the mismatch between the Test Year and the rate year. "Board staff submits that the test to determine the first issue is whether a revenue deficiency will occur if 2008 rates are implemented on May 1, 2008 rather than January 1, 2008."⁹

³ Reply Submission on Interim Rates at p. 3 (first para.); the footnote is omitted.

⁴ See the settlement hearing transcript at pp. 43-45.

⁵ See the Reply Submission on Interim Rates for an explanation of this rule.

⁶ VECC's written argument at para. 5 (p.2).

⁷ See Exh. I-3-2 for an explanation of "as adjusted."

⁸ Board Staff's submission at, respectively, p. 1 (second-last para.) and p. 2 (first para.).

⁹ Board Staff's submission at p.2 (second-complete para.).

12. Board Staff then makes the following statements:

Hydro Ottawa submits that because the test year differs from the rate year, they will have a revenue deficiency. For that to occur, the 12 month forecast used to determine the revenue requirement would have to significantly differ from the actual demand experienced by the distributor.

Hydro Ottawa has not demonstrated that they will be suffering a revenue deficiency associated with their forecast differential in their requested 2008 revenue requirement.¹⁰

13. It would appear that Board Staff thinks that Hydro Ottawa's revenue deficiency results from an expected difference between (a) its load forecast for the first four months of 2008 and (b) its load expectations for the same period in 2009. There is a potential for a load differential, to be sure, although Hydro Ottawa would expect only a small one.
14. The cause of the revenue deficiency is not a load differential, though, but rather the difference between the revenue collected during the first four months of 2008 (2007 rates) and the cost-based revenue requirement, as adjusted, during the same period; see paragraph 9 above. The revenue deficiency is the result, in other words, of the mismatch between the Test Year and the rate year.

15. Board Staff goes on to postulate, notwithstanding the foregoing, the following situation:

Board staff notes that it is possible that Hydro Ottawa could collect revenues in excess of the requested revenue requirement if there is higher electricity consumption in January to April 2009 as compared to the forecast load, based on January to April of 2008, which is used to establish rate [*sic*] for the 2008 rate year.¹¹

16. Board Staff then jumps to the following conclusion:

Hydro Ottawa has not demonstrated how the revenue deficiency occurs in this situation. If no deficiency can be clearly demonstrated, there appears to be no reason to establish the requested mechanism or deferral account.¹²

17. Hydro Ottawa has two responses to this conclusion. One is that it is a little late, to say the least, to suggest that Hydro Ottawa should make such a demonstration. This matter is one for evidence rather than argument.
18. The other response to Board Staff's conclusion is that it completely overlooks the purpose of a deferral (or a variance) account in Hydro Ottawa's circumstances. The Board's decision on interim rates leaves Hydro Ottawa with no means, other than such an account, to recover the revenue deficiency by virtue of the rule against retroactive rate-

¹⁰ Board Staff's submission at p. 2 (fourth and third-last paras. on p. 2).

¹¹ Board Staff's submission at p. 2 (second-last para.).

¹² Board Staff's submission at p. 2 (last para.).

making. There is no guarantee, though, that Hydro Ottawa would recover the revenue deficiency even with such an account; see paragraphs 7 and 8 above.

19. Board Staff's second issue involves a so-called implied change in the rate year to match the Test Year. Hydro Ottawa is not asking for any change; rather, it is asking for a means to avoid the cost consequences of the mismatch.

20. Board Staff makes the following submission:

In addition, Hydro Ottawa has indicated that it is not aware of any regulatory precedent in support of this proposal. Hydro Ottawa is encouraged to address the impacts of this proposal on these Board processes and on other distributors.

21. Hydro Ottawa has two responses to this submission. One is found in part of its response to Board Staff Interrogatory #57 a):

Hydro Ottawa is not aware of any such regulatory precedent but, on the other hand, Hydro Ottawa is not aware of any economic regulator of electricity or natural gas utilities in Canada or the United States – except the Board – that fixes rates for one period (the rate year) based on a utility's cost of service for another period (the test year).¹³

22. Hydro Ottawa's other response is, once again, that Board Staff is a little late with its encouragement. It is clear that "the impacts of this proposal" is a matter for evidence rather than argument and, in any event, Hydro Ottawa is in no position to credibly assess the impacts "on those Board processes and on other distributors."
23. Board Staff concludes with the following statement: "Hydro Ottawa has failed to address why the Board's Decision dated January 10, 2008, denying interim rates, does not apply to the present request as the end result appears to be the same."¹⁴ The Board's decision did not address Issue 8.4 directly. Hydro Ottawa's response, in any event, is set out in paragraphs 4 to 6 above.

Conclusion

24. The revenue deficiency is real, not notional, and the Board should allow Hydro Ottawa to record it in a deferral (or a variance) account. Hydro Ottawa would otherwise be precluded from subsequently recovering the revenue deficiency – if it makes a persuasive case for recovery – by virtue of the rule against retroactive rate-making.
25. This Reply Argument is respectfully made to the Board on February 12, 2008 by Fraser Milner Casgrain LLP, through Jerry H. Farrell, as counsel for Hydro Ottawa in this proceeding.

¹³ This response was made with reference to regulators that use a forward test year rather than, for example, a base year with annualizing and normalizing adjustments.

¹⁴ Board Staff's submission at p. 3 (last para.).