PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP/s.r.l./s.e.n.c.r.l.
1250, boulevard René-Lévesque Ouest
Bureau 2800
Montréal (Québec)
Canada H3B 2G4
Telephone +1 514 205-5000
Facsimile +1 514 205-5675

January 8, 2008

Mr. Wojciech Zielonka
Chief Financial Officer
Hydro Ottawa Limited
3025 Albion Road North
Ottawa, Ontario K1G 3S2

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

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.