

**Ontario Energy
Board**
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto ON M4P 1E4
Telephone: 416- 481-1967
Facsimile: 416- 440-7656
Toll free: 1-888-632-6273

**Commission de l'énergie
de l'Ontario**
C.P. 2319
27^e étage
2300, rue Yonge
Toronto ON M4P 1E4
Téléphone: 416- 481-1967
Télécopieur: 416- 440-7656
Numéro sans frais: 1-888-632-6273



BY EMAIL

November 18, 2011

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, Suite 2700
Toronto ON M4P 1E4

Dear Ms. Walli:

**Re: Hydro Ottawa Limited
Application for Rates
Board File Number EB-2011-0054**

Pursuant to the Board's direction at the oral hearing on November 10, 2011, please find attached the Board Staff submission on the cost of service rate application filed by Hydro Ottawa Limited on June 17, 2011

Please forward the attached to Hydro Ottawa Limited and parties to this proceeding.

Yours truly,

Original signed by

Violet Binette
Project Advisor, Applications & Regulatory Audit

2012 ELECTRICITY DISTRIBUTION RATES

Hydro Ottawa Limited

EB-2011-0054

STAFF SUBMISSION

November 18, 2011

INTRODUCTION

On June 17, 2011, Hydro Ottawa Limited (“Hydro Ottawa” or the “Applicant”) filed an application (the “Application”) requesting an order or orders of the Board approving distribution rates and other charges effective January 1, 2012. The Application was updated on September 14, 2011 (the “Updated Application”), principally to reflect a delay in the implementation of the new Customer Information System (“CIS”) project and removal of the cost from the 2012 rate base.

The Consumers Council of Canada (“CCC”), Energy Probe Research Foundation (“Energy Probe”), School Energy Coalition (“SEC”), Vulnerable Energy Consumers Coalition (“VECC”), Ecology Ottawa, Enersource Hydro Mississauga Inc. and EnviroCentre were granted intervenor status in this proceeding.

Pursuant to Procedural Order No. 1, a Settlement Conference was convened on October 13 and 14, 2011. CCC, Energy Probe, SEC and VECC (the “participating intervenors”) participated in the Settlement Conference. A Proposed Settlement Agreement, which incorporated settlement of many issues, was filed with the Board on November 1, 2011.

A Decision and Procedural Order No. 6 was issued on November 4, 2011 in which the Board accepted the Proposed Settlement Agreement and confirmed the oral hearing commencing on November 7, 2011. Further to the partial settlement accepted by the Board in the Decision and Procedural Order No. 6, the parties filed a Proposed Supplementary Settlement Agreement at the commencement of the oral hearing on November 7, 2011. The Board approved the settlement of this subset of issues as filed, but requested full reference to the evidence and interrogatories. The document, compliant with the Board request, was filed on November 10, 2011.

This submission on the unsettled issues reflects observations and concerns which arise from Board staff’s review of the case record including the oral hearing which was held on November 7, 8 and 10, 2011 and is intended to assist the Board in evaluating Hydro Ottawa’s application and in setting just and reasonable rates.

WORKING CAPITAL ALLOWANCE (“WCA”)

Background

Hydro Ottawa has proposed a WCA of 14.2% of the sum of the cost of power and controllable expenses. In its previous 2008 Cost of Service application, a WCA factor of 12.5% was accepted as part of the Settlement Agreement approved by the Board in its Decision and Order (EB-2007-0713).

In this Application, the 14.2% WCA factor was derived as a result of a lead-lag study prepared by Hydro Ottawa, and reviewed by Navigant Consulting Inc. (“Navigant”). Navigant’s third-party review and opinion on the appropriateness of the study is provided on the record as Exh B4-2-1, Attachment U.

Discussion and Submission

Service Lag

With one exception, Board staff takes no issue with the methodology used by Hydro Ottawa in its lead-lag study, and supported by Navigant. That exception is with respect to the customer weighting used to calculate the average service lag. All other leads and lags used in the study are weighted by costs or revenues whereas the service lag is weighted by customer numbers by customer class. Hydro Ottawa defended this approach under cross-examination:

[MR. AIKEN]: Can you explain to me why Hydro Ottawa believes customer weights are more appropriate than revenue weights in the calculation of the service lag?

MS. SCOTT: The service lag is a measure of when the customer receives the service to when the meter has been read. So at that point, the issue of dollars has not entered the equation.

So it's our opinion that weighing it by customer number is the most appropriate.¹

Board staff disagrees. While Board staff agrees that the amount of consumption and the dollars is irrelevant for the service lag within the class (i.e., whether a residential

¹ Oral Hearing Tr Vol 1 p16-17

customer consumes 500 kWh or 1500 kWh in a month, the service lag is 30.4 days), this is not the case between classes with different billing cycles.

While the numbers are hypothetical, Board staff finds the numbers shown in Energy Probe's example in its Compendium² to be illustrative. These numbers are set out below.

Service Lag Calculation Illustrative Example

	Customers	Revenue Per Customer	Revenues	Monthly or Bimonthly	Service Lag	Customer Weighted Lag	Revenue Weighted Lag
Class 1	99	1	99	B	30.4	30.096	15.200
Class 2	<u>1</u>	99	<u>99</u>	M	15.2	<u>0.152</u>	<u>7.600</u>
TOTAL	100		198			30.248	22.800
						15.352	

Assuming that there are 99 customers in Class 1, with \$1 in revenues per customer and an average service lag of 30.4 days (bi-monthly billing), and one customer with revenues of \$99 and an average service lag of 15.2 days (monthly billing), the customer-weighted average service lag is 30.248 days. If the average service lags for the classes were reversed (i.e. class 1 had monthly billing with a service lag of 15.2 days and class 2 had bi-monthly billing with a service lag of 30.4 days), the customer-weighted average service lag would be 15.352 days. As shown in the right-most column of the table above, the revenue-weighted average service lag would be 22.800 days for both scenarios. This makes sense as, in both cases, there is \$99 in revenue that must be funded as part of cash working capital for part of one month and another \$99 that must be funded over half of the longer 2-month service period until bill reading.

The use of customer weighting provides unintuitive results as can be seen from Tables 3 and 4 of Exh B4-2-1. The GS 1500-4999 kW and Large Use customers contribute no material impact on the customer-weighted service lag, and the GS 50-1499 kW class represents only 1.10% of customers. However, Exh K2-2-5 Tables 3 and 4, filed in response to an interrogatory, show calculations using sales as weights, and these customer classes correspond to over 54% of total sales.

The purpose of the lead-lag study and the WCA methodology is to determine the cash working capital that the utility needs to finance, taking into account leads and lags from when it must pay out costs and when it receives the revenues that recover costs. Over

² Exh M1.4, Energy Probe Research Foundation Compendium, p32

half of sales are accounted for by higher-demand customers for whom the service lag is 15.21 days. Using the customer-weighted average of 30.24 days significantly overestimates – by a factor of close to two times – the lag between the mid-point in the service period and when bills are read for these higher demand customers which generate more than half of Hydro Ottawa’s sales.

Board staff therefore submits that customer-weighting of the service lag by class is theoretically unsound, and that the service lag should be revenue-weighted. This is not the first time that this has been identified by Board staff and intervenors; in fact, this issue was raised in oral cross-examination and discussed in the submissions with respect to Horizon Utilities Corporation’s 2011 Cost of Service case (EB-2010-0131). In that application, Navigant conducted the lead-lag study for Horizon.

Monthly Billing

Board staff takes no position with respect to the impact of monthly billing. While Hydro Ottawa has indicated that it intends to move to monthly billing for all customers – which will result in a shorter average service lag of about 15.21 days – this will only occur subsequent to the implementation of its new CIS system, which is currently forecasted to be in late 2013. This is well beyond the 2012 test year and is thus “out-of-period”.

Comparisons

In the Board’s Decision and Order with respect to Horizon’s 2011 Cost of Service application, the Board stated:

The Board does accept Horizon’s argument that a lead/lag study is undertaken based on the individual characteristics of the distributor, and therefore comparisons to other distributors may not be appropriate. Nevertheless, the Board must take notice of the results of other study results such as those conducted for and filed by Hydro One Networks Inc. and Toronto Hydro Electric Systems Ltd. to ascertain reasonableness.

For the reasons set out above, the Board directs that a 13.5% working capital allowance will be used. This result is also more consistent with the results of the working capital allowance studies undertaken by Hydro One

(result being 11.9%) and Toronto Hydro-Electric Systems Limited (result being 12.9%).³

Board staff submits that such comparisons can be useful ancillary evidence. In fact, cases for both Toronto Hydro Electric-System Limited (“THESL”) and Horizon, along with Hydro One Networks, are referenced by Navigant in its letter supporting the lead-lag study completed by Hydro Ottawa. The Peer Groups for Ontario LDCs table shown on page 11 of Board staff’s Compendium⁴ shows that THESL and Hydro Ottawa are both included in the “Large City Southern Medium-High Undergrounding” and Horizon is in a similar category “Large City Southern High Undergrounding”. Hydro Ottawa is between THESL and Horizon in terms of number of customers. These utilities, along with Hydro One Networks, are amongst the largest electricity distributors in Ontario. Recognizing that such comparisons are not definitive in themselves, Board staff observes that Hydro Ottawa’s proposed WCA factor of 14.2% is larger than the 11.9% approved for Hydro One Networks, 12.9% for THESL and 13.5% approved for Horizon. In light of Board staff’s submission that the customer weighting of the service lag results in an upwardly biased WCA factor, Board staff submits that a WCA factor within the range of THESL and Horizon may be more appropriate.

LOAD FORECAST

Background

Hydro Ottawa used a statistical modeling software program from Itron Inc. to develop its system energy forecast. The model forecasts a test year system energy of 8,029,840 MWh based on historical systems purchases, weather data and GDP data.

The forecast system energy was adjusted by a loss factor to derive a billed load forecast. As noted in Technical Conference undertaking LT2.6, Hydro Ottawa is seeking Board approval for a test year billed load forecast before adjustments of 7,753,056 MWh or

³ Decision and Order [EB-2010-0131], July 7, 2011, p16

⁴ Exh M1.5, Board staff Cross-examination Compendium, p11. The table is taken from the Third Generation Incentive Regulation Stretch Factor Updates for 2010 (EB-2009-0392), February 17, 2010, available on the Board’s website at http://www.ontarioenergyboard.ca/OEB/Documents/EB-2009-0392/Report_2010_Stretch_Factor_Updates.pdf

7,753 GWh. This represents a 1.44% increase from 2010 actual billed load. Hydro Ottawa further adjusted its billed load forecast to include CDM and suite metering adjustments which have been settled under issue 3.3 in the settlement agreement filed November 1, 2011.

As noted at Exh C1-1-1 p9, the class sales forecast process consisted of 3 steps. First, the class sales forecast models were created. Second, the results of the class sales forecast regression models, which are billed monthly forecasts, were then converted to calendar month forecasts. Third, the results were subsequently calibrated to the loss factor adjusted system energy forecast.

Hydro Ottawa further explained the third step at the oral hearing:

[MS. SCOTT]: Separate to that, we do for each class a forecast of sales, and that's based on historical data and economic and weather variables. So for each class, we get a class sales.

But because we have the bi-monthly and the monthly billing, when we bill, say, for April, we're actually billing for -- it could be up to two months before, consumption that was done two months before.

So we need to actually translate billed monthly data into calendar month. And so, in order to do that, we need to scale the class sales to the system sales, because the system sales are on a calendar month.

So a scaling factor, which can be both positive and negative - it depends on the data - is applied to the class forecast for kilowatt-hour sales to adjust so that it meets the loss-adjusted system forecast.⁵

As set out in the evidence, prior to calibration to the loss factor adjusted system billed load forecast of 7,753 GWh, the sum of the class sales forecasts was 7,880 GWh. The load forecast data for the bridge and test year are summarized below:

⁵ Oral Hearing Tr Vol 1 p46

	GWh	2011	2012
1	System Load Forecast (Billed - loss factor adjusted, prior to adjustments for CDM and suite metering) Exh K3-1-5	7,679	7,753
2	Sum of Class Sales Forecasts (non-calibrated before adjustments) Undertaking L2.1	7,816	7,880

Discussion and Submission

Hydro Ottawa's system load forecast (before adjustments), row 1 in the above table, represents a 0.72% annual average load growth from 2010 Normalized Actual Year Load (7,644 GWh⁶) to 2012 Normalized Test Year. This growth rate is higher but comparable to the average annual growth for the weather normal actual load for the period 2005 to 2010 of 0.3%.⁷

The sum of class sales forecasts (non-calibrated), row 2 in the above table, represents 1.55% annual average load growth from 2010 Normalized Actual Year to 2012 Normalized Test Year. While the sum of the class sales forecasts provides a larger load forecast, the average annual load growth is less consistent with the 0.3% average annual growth rate for the period 2005 to 2010. Board staff submits that the system energy forecast (billed – loss factor adjusted) for the test year of 7,753 GWh is appropriate.

OPERATIONS, MAINTENANCE AND ADMINISTRATION (“OM&A”)

Background

For the 2012 test year, Hydro Ottawa is requesting Board approval of \$63,891,431 in OM&A expenses excluding taxes and amortization expenses. This represents a 4.2% increase over the 2011 bridge year and a 19.7% increase over 2010 actual. Both the core functions of operations and maintenance and the support functions (i.e. billing, administration, etc.) have increased by approximately 24% over 2008 actual, the last

⁶ Undertaking L2.1

⁷ Exh C1-1-1 p11, Table 9

rebasement year. The following table summarizes Hydro Ottawa's OM&A expenses by year.

	2008 Approved	2008 Actual	2009 Actual	2010 Actual	2011 Bridge	2012 Forecast	EB-2010-0133	
							2010 Bridge	2011 Forecast
Operations	13,062,448	11,752,560	11,364,065	11,971,416	12,061,906	11,883,322	14,996,358	15,269,439
Maintenance	5,111,153	5,183,949	5,171,079	5,663,033	8,462,994	9,274,548	6,006,658	6,086,041
SubTotal	18,173,601	16,936,509	16,535,144	17,634,449	20,524,900	21,157,870	21,003,016	21,355,480
%Change (year over year)			-2.4%	6.6%	16.4%	3.1%		
%Change (Test Year vs Last Rebasement Year - Actual)						24.9%		
Billing and Collecting	11,716,819	10,365,089	10,233,636	9,142,479	11,925,750	12,085,194	10,579,743	10,840,730
Community Relations	4,759,852	4,588,888	4,594,942	4,932,698	6,093,455	6,911,671	5,459,667	6,607,061
Admin and General	20,679,521	19,738,418	20,670,993	21,641,059	22,790,434	23,736,696	22,601,943	24,163,018
SubTotal	37,156,192	34,692,395	35,499,571	35,716,236	40,809,639	42,733,561	38,641,353	41,610,809
%Change (year over year)			2.3%	0.6%	14.3%	4.7%		
%Change (Test Year vs Last Rebasement Year - Actual)						23.2%		
Total	55,329,793	51,628,904	52,034,715	53,350,685	61,334,539	63,891,431	59,644,369	62,966,289
			0.8%	2.5%	15.0%	4.2%		

Source: Exh K4-1-1

In the Application and at the oral hearing, Hydro Ottawa stated that the 2012 OM&A reflects a 4% compensation and benefits increase and expenses related to priority initiatives which include the workforce strategy, customer service strategy, IT strategy and environmental sustainment strategy.

Forecasting OM&A

As noted in the table above, Hydro Ottawa's 2008 actual level of OM&A expenses was lower than Board approved (through settlement) by \$3.7M or 7%. As noted at Exh D2-1-1 and in the oral hearing,⁸ Hydro Ottawa explained that the variance was due to the May 1 commencement of the rate year, savings in the vegetation management program, lower meter maintenance costs, reduction in bad debt expense and some staff vacancies.

Board staff also notes that Hydro Ottawa's 2010 actual level of OM&A expenses was lower than the 2010 forecast provided in Hydro Ottawa's early rebasing application (EB-2010-0133) by \$6.3M or 11%. In response to an interrogatory, Exh K4-1-1, Hydro Ottawa stated that the variance was due to TOU and MDMR costs planned but not incurred, lower than expected maintenance costs for meters, delays in filling vacancies, and savings in expenses for consulting, communications and training.

⁸ Oral Hearing Tr Vol 1 p137

Discussion and Submission

While Hydro Ottawa stated several times during the oral hearing that it was on track with respect to its 2011 OM&A budget⁹, the actual full year results for 2008 and 2010 OM&A expenses were considerably below the forecasts provided in EB-2007-0713 and EB-2010-0133 respectively. As explained above, the variances are due to savings and efficiencies, as well as delays in planned expenses, e.g. TOU roll out.

Board staff notes that the current application was filed on June 17, 2011 and that an application update on September 14, 2011 revised capital spending for the CIS Project. It would not be completed by Q4 2012, as was originally planned, and would be delayed until Q3/Q4 2013. Staff also notes that the 2008 application included capital expenditure for a CIS transition project which did not proceed.¹⁰ While the CIS example is not related to OM&A, it is consistent with historical over forecasts of OM&A in 2008 and 2010.

Based on historical OM&A expenses, Board staff submits that the level of 2011 OM&A expenses is atypical, and not a reasonable basis on which to forecast 2012 OM&A expenses. As a minimum, any consideration of the 2011 OM&A in trending analysis should remove the one time costs related to smart meters, e.g. outside service costs related to call volumes as the TOU rates roll out, and the materials and welcome package to TOU rates. These expenses are estimated to be \$1.3M.¹¹

Similarly, Hydro Ottawa confirmed at the technical conference that there is no cost for the 2012 cost of service application in the 2012 revenue requirement.¹² Board staff submits that 2011 OM&A expenses should be reduced for some of the 2011 legal and intervenor costs in trending analysis, and suggest that reduction is in the range of \$200k.

With respect to the 2012 forecast, Board staff submits that the 2012 OM&A forecast is excessive and recommends that the Board consider reductions in compensation as discussed below.

Compensation

The total test year compensation is \$62,159,284 as reported at Exh D3-1-1 (Employee Compensation Breakdown) page 4. The total test year compensation in Attachment AC

⁹ Oral Hearing Tr Vol 1 p124

¹⁰ Exh B1-2-6

¹¹ Exh D1-1-2 p3

¹² Technical Conference Tr Vol 1 p56

to Exh D3-1-1 is \$63,651,951 which includes items such as Future Employee Benefits, Safety Clothing Equipment, Employee Assistance Plan and temporary services. The 2012 total compensation is 11.7% higher than 2011 bridge and 20.9% higher than 2010 actual. The contributing factors are economic increases, benefits increases and increases in the number of staff.

Analysis of compensation data and trends for the historical period vs bridge and test years is complicated by two factors:

- Tables in Exh D3-1-1 which report average annual compensation costs (base wage, overtime, incentive pay and benefits) are based on FTE for the historical period and headcount for the bridge and test year.
- For the bridge year and test year, Hydro Ottawa has adopted the principle of budgeting new positions at the half year and new apprentice positions at the beginning of the last quarter.

Discussion and Submission

Base Wages

At the oral hearing, Hydro Ottawa noted a total 4% increase on existing compensation, which includes a 1% increase for benefits.¹³

As noted in the evidence at Exh D3-1-1 page 5, a new three year collective agreement was reached with the IBEW which includes a 3% annual increase in unionized wages for 2010 to 2012.

Board staff confirms that the 3% increase 2012 vs 2011 for union staff is evident in the average yearly base wage data presented in detail at Attachment AC. These data do not include benefits, overtime or incentive, which are provided separately in Attachment AC.

The average yearly base wage increases 2012 vs 2011 are summarized below.

¹³ Oral Hearing Tr Vol 1, p121

Compensation - Average Yearly Base Wages (\$)	2011	2012
Executive	143,743	149,493 4.0%
Management	98,252	102,600 4.4%
Non-Union	72,303	76,747 6.1%
Union	67,283	69,232 2.9%

While Hydro Ottawa provided its rationale for the 3% increase for the union represented staff, Board staff submits that no rationale was provided for the 4% to 6% increase in average yearly base wages for the other staff groups. In cross examination on this matter, Hydro Ottawa referred to a 4% average increase and additional staff to explain the increases.¹⁴ As noted above, Hydro Ottawa had previously explained that the 4% increase included increases for benefits. Board staff submits that the average yearly base wage per employee, whether union or not, does not include the incremental cost of benefits as these data are presented separately in the table at Attachment AC. Similarly the average yearly base wage per employee is not affected by the impact of additional staff as these data are per employee.

The Board may wish to consider a 3% increase over 2011 average yearly base wages for these other employee groups (executive, management, non-union), which would reduce the total compensation by approximately, \$280k. The Board could consider instead a 2% increase over 2011 for the other employee groups reducing compensation by approximately \$448k, as 2% is the inflationary adjustment which Hydro Ottawa applied to the rest of the application. As a third option, the Board could consider limiting the average yearly base wage increase for the other employee groups to the GDP-IPI factor, issued on November 10, 2011, of 1.7%, which would reduce total compensation by approximately \$497k. Whichever option the Board chooses, it is Board staff's submission that Hydro Ottawa has not adequately supported compensation increases of greater than 3% for the other employee groups.

¹⁴ Oral Hearing Tr Vol 2 p65

Workforce Planning

Full time and temporary employee equivalents are summarized in the following table. The test year FTE include 17 staff transferred from the holding company.

	Last Rebasing Year 2008	Historical Year 2009	Historical Year 2010	Bridge Year 2011	Test Year 2012
Number of Full-Time Employees					
Executive	6	6	6	5	5
Management	96	101	102	107	127
Non-Union	39	37	38	38	41
Union	388	402	405	407	425
Total	529	546	551	557	598
Number of Temporary Employees					
Executive	0	0	0	0	0
Management	1	0	0	2	2
Non-Union	5	3	3	1	1
Union	4	4	5	5	5
Total	10	7	8	8	8

Source Attachment AC

At Exh D1-5-1 p7, Hydro Ottawa stated that the workforce planning model assumes that 75 percent of those eligible to retire will retire on their eligibility date or shortly thereafter.

Exh MT1.10, which provides data on staff eligible to retire and actual retirements for the period 2008 to 2011, was reviewed at the oral hearing. On a total period basis, 64 staff were eligible to retire, but only 35 have done so with 3 additional providing notice, resulting in a retirement rate of 59%. These data suggest that the Hydro Ottawa workforce planning model, with respect to retirements, initiated hiring at a pace that exceeds need by 10 staff.

At Exh D1-5-1, Hydro Ottawa identified its concerns about sustaining its trades and technical workforce in light of retirements in the next decade. A summary of apprentices hired for the period 2005 to 2010 was provided.

	2005	2006	2007	2008	2009	2010
Total Hired	8	10	16	18	3	6

As noted in the evidence at Exh K-4-2, Hydro Ottawa will hire 15 apprentices in 2011, with the full year impact of this hiring to be reflected in the test year. Board staff submits that this level of hiring is not consistent with the recent history but is more consistent with the level of hiring in the previous bridge (2007) and test year (2008).

Board staff submits that it is inefficient and costly to hire replacement staff at a rate higher than the staff attrition. Assuming 10 staff above requirements, the additional cost is approximately \$1M. Staff submits that total compensation be further reduced by this amount.

In total, staff submits that total compensation be reduced by somewhere between \$1.3M to \$1.5M (depending on which option the Board chooses for base wage increases discussed above). This would represent a decrease somewhere in the range of 2% to 2.4% from what was requested for compensation. Board staff notes that the impact of a compensation reduction on OM&A and ultimately revenue requirement, is dependent on the allocation of compensation to OM&A and capital programs.

COST OF CAPITAL

As noted in the Proposed Settlement Agreement, the parties agreed to the capital structure of 56% long term debt, 4% short term debt and 40% equity. The parties also agreed that the cost of capital parameters effective January 1, 2012 would be applied.

Long Term Debt (“LTD”)

Hydro Ottawa’s evidence documents nine LTD issuances. All debt is owed to Hydro Ottawa Holding Inc. (the “parent” or the “parent company”), although older debt is tied to external debt arrangements such as bond issuances, of the parent.

Hydro Ottawa’s proposal for LTD is documented in the table below, as updated in Exh E1-1-1 and in Exh K5-2-1.

Date of Issuance	Principal (\$'000's)	Actual or Deemed	Interest Rate	Issuance Costs	Admin. Costs	Total Rate
July 1, 2005	200,000	Actual	4.93 %	0.11 %	0.10 %	5.140 %
July 1, 2005	32,185	Deemed	5.900 %	NIL	NIL	5.900 %
Dec. 20, 2006	50,000	Actual	4.968 %	0.25 %	0.10 %	5.318 %
Dec. 21, 2009	15,000	Deemed	5.75 %	NIL	0.10 %	5.85 %
April 30, 2010	15,000	Deemed	5.87 %	NIL	0.10 %	5.97 %
July 5, 2011	15,000	Deemed	5.45 %	0.10 %	0.10 %	5.65 %
Sept. 1, 2011	15,000	Deemed	5.55 %	0.10 %	0.10 %	5.75 %
Dec. 1, 2011	15,000	Deemed	5.55 %	0.10 %	0.10 %	5.75 %
July 1, 2012	15,000	Deemed	5.55 %	0.10 %	0.10 %	5.75 %

All of these issuances are promissory notes to the parent. As noted in the evidence, the total principal is \$372M and the weighted debt rate cost is 5.386%.

Debt Issued Prior to 2008

Board staff takes no issue with the LTD issued in 2005 and 2006. The allowed rates for these debt instruments have been reviewed and approved by the Board in previous applications. Board staff notes that these instruments are tied to external bond issuances by the parent company to fund the loans, and differ only in terms of some timing differences and a 10 basis point administration charge.

While acknowledging that these are demand notes which are callable by the parent company, Hydro Ottawa testified that the utility and its parent have no intention of calling these demand notes.¹⁵ The Board has previously allowed the rates applicable in these instruments, and Board staff sees no reason why the previously approved rates should not continue to the maturity of these instruments.

Debt Issued on December 21, 2009 and April 30, 2010

Board staff makes the submissions on the following matters:

1. What is the Board's policy and practice by which debt from December 21, 2009 to 2012 should be assessed? and

¹⁵ Oral Hearing Tr Vol 1 p112-113

2. For each actual or planned instrument issued since December 21, 2009, is Hydro Ottawa's proposed LTD rate for that instrument compliant with the Board's policy and practice?

Since 2006, the parent company has not raised external debt to fund loans to Hydro Ottawa, relying on internal funds, such as proceeds from the sale of Telecom Ottawa. In 2009, the parent company and Hydro Ottawa signed a "Grid Promissory Note".¹⁶ While the Grid Promissory Note states that the effective date is January 1, 2009, it makes reference to the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* (EB-2009-0084), issued on December 11, 2009 (the "Cost of Capital Report"). Hydro Ottawa confirmed in a technical conference undertaking that the Grid Promissory Note was likely signed on December 18, 2009.¹⁷ In staff's view, all debt issuances based on the Grid Promissory Note should be compliant with the policies in the Cost of Capital Report.

The Cost of Capital Report states:

A Board panel will determine the debt treatment, including the rate allowed based on the record before it and considering the Board's policy (these Guidelines) and practice. The onus will be on the utility to establish the need for and prudence of its actual and forecasted debt, including the cost of such debt. [p54, emphasis added]

As noted above, all of Hydro Ottawa's debt is affiliated. The Cost of Capital Report states:

For affiliate debt (i.e., debt held by an affiliated party as defined by the *Ontario Business Corporations Act, 1990*) with a fixed rate, the deemed long-term debt rate at the time of issuance will be used as a ceiling on the rate allowed for that debt. [p53, emphasis in original]

¹⁶ In E1/1/1/Attachment AG, and filed in updated form in Exhibit MT1.11 showing the loan issued on July 5, 2011.

¹⁷ Undertaking LT2.1

Hydro Ottawa has documented rates of 5.85% for the \$15M issuance on December 21, 2009 and 5.97% for the \$15M issuance on April 30, 2010.¹⁸ The rate of 5.85% is composed of a base rate of 5.75% plus 0.10% for administrative costs. The 5.97% is similarly composed of a base rate of 5.87% plus 0.10% for administrative costs.

Hydro Ottawa's evidence is that both of these rates are below the Board's deemed LTD rate, which was 7.62%. Board staff submits that Hydro Ottawa's proposals for these rates are compliant with the guidelines in the Cost of Capital Report. It is not clear exactly how Hydro Ottawa determined the rates or in what manner the term of these issuances was reflected in the rate, but Board staff will not contest the inclusion of the 0.10% for administrative costs for these issuances.¹⁹

The July 5, 2011 Issuance under the Grid Promissory Note

In its original evidence, Hydro Ottawa proposed a rate of 5.75%. It has subsequently revised its evidence to a rate of 5.65% to correspond to the actual issuance on July 5, 2011. As documented in the table above, the 5.65% is composed of a base rate of 5.45% plus 0.10% for administrative costs and 0.10% for issuance costs.

Board staff submits that Hydro Ottawa's proposal is non-compliant with the Cost of Capital Report. Hydro Ottawa has stated that the deemed LTD rate that it calculated was 5.45% for a July issuance, but has not documented its calculation on the record. While such a calculation could be done using the methodology documented in Appendix C of the Cost of Capital Report, the Board did not issue any updates on the Cost of Capital parameters from March 3, 2011 (for rates effective May 1, 2011) until November 10, 2011 (for rates effective January 1, 2012). Therefore, the Board's deemed LTD rate on July 5, 2011 was 5.32%, as issued on March 3, 2011 for May 1, 2011 rates.

Board staff considers Hydro Ottawa's proposal to update the LTD rate for July 5, 2011 to be inconsistent with its argument for the treatment of the December 21, 2009 and April 30, 2010 issuances discussed above. For those issuances, Hydro Ottawa has relied on

¹⁸ Exh E1-1-1 p3 Table 1. While April 1, 2010 is listed as the issuance date for the second \$15 M issuance, this is corrected in Exh K5-2-1 and also corresponds to Schedule A of the Grid Promissory Note in Exh E1-1-1 Attachment AG

¹⁹ Board staff observes that the April 30, 2010 issuance uses a base rate of 5.87%, which corresponds with the deemed LTD rate issued by the Board for rates effective May 1, 2010, one day after this issuance. The rates for May 1, 2010 were documented in a letter issued by the Board on February 24, 2010, and so was known in advance of the April 30, 2010 issuance.

the 7.62% calculated for May 1, 2009 effective rates as a ceiling comparator. Even though the Cost of Capital Report was issued and hence the methodology was known, Hydro Ottawa did not calculate the LTD rates as a ceiling on the proposed rates of 5.85% and 5.97%, which would be analogous treatment to what it is proposing for the July 5, 2011 issuance.

Board staff also submits that the issuance cost of 0.10% should not apply. Hydro Ottawa is correct that transaction and other costs of the firm may be recoverable, as these are incremental to the rate agreed with the debt holder, which may be expected to include also the debt holder's costs. In this case, however, the parent company is not incurring issuance costs as it is not raising the debt financing from the market. As stated during the Technical Conference²⁰, the debt issued under the Grid Promissory Note is from funds the parent company has available from, at least in part, the sale of Hydro Ottawa Telecom Inc.

Further, in Argument-in-Chief, counsel for Hydro Ottawa stated:

Mr. Grue explained that in its approach to these costs, Hydro Ottawa's aim is to emulate the actual cost of a debt issuance into the market. That's at Volume 1 of the transcript, page 104.

He indicated and the evidence is the deemed rate is a pure interest rate. It's indicative of what an A-rated utility can achieve in the market for a pure interest rate. That's Volume 1 of the transcript, page 107.

The issuance fee covers the actual cost of issuing debt, such as lawyers' fees and underwriting fees from investment bankers that actually look after the issuance. That's at Volume 1 of the transcript, page 117.

The administration fee is different. It covers ongoing costs incurred on an annual basis, such as the trustee fees for the debt instruments, fees paid to rating agencies, fees paid for subscriptions to the Bloomberg and Consensus services, costs of meetings with rating agencies, investments bankers, and so on. That's at Volume 1 of the transcript, page 106.

This is a methodology that Hydro Ottawa has consistently followed since 2005. That's from Volume 1 of the transcript, page 106.²¹

²⁰ Technical Conference, Tr Vol 1 p69, p96-97

²¹ Oral Hearing Tr Vol 3 p15-16

The issuance fees under the Grid Promissory Note are not actual, but an “emulation” of what the costs would be if the parent company had gone to market. Board staff submits that as the parent company has not gone to market, no issuance costs should be recoverable from Hydro Ottawa’s ratepayers. Further, Board staff observes that Hydro Ottawa has not reflected issuance costs in the December 21, 2009 and April 30, 2010 issuances.

Board staff also notes that the 0.10% for issuance costs would seem to be high for issuances under the Grid Promissory Note. The Grid Promissory Note is akin to a pre-arranged mortgage or line of credit upon which Hydro Ottawa can draw up to the limit of \$75M. It is doing so through periodic advances of \$15M. A comparison of Exh E1-1-1, Attachment AG and Exh MT1.11 shows that the July 5, 2011 issuance is documented as a single line in Schedule A of the Grid Promissory Note, documenting the date, the amount advanced, unpaid balance, interest rate and initials of signators. Based on the 0.10% issuance cost, this amounts to an annual charge of \$15,000, until maturity, for each \$15M advance. Board staff submits that there is no evidence to support the reasonableness of this amount for the work involved.

Board staff also submits that the administration charge of 0.10% should not apply for this issuance. Hydro Ottawa has stated that its costs, or those of its parent, must be recoverable. Board staff submits that this will depend on whether the costs are incurred for the ratepayer or the shareholder and who benefits from these costs.

Hydro Ottawa documented the nature of the activities and costs of the parent company for which the administrative charge of 0.10% is designed to recover.²² The costs are for meeting with financial institutions, credit rating agency reports and even subscription to Bloomberg LLP to track the financial data used by the Board in the Board’s Cost of Capital methodology. Hydro Ottawa states that its ratepayers benefit from these services. Board staff disagrees. There is no evidence as to how Hydro Ottawa has used these services to obtain a reasonable rate for each issuance under the Grid Promissory Note. In fact, while the Grid Promissory Note has a maximum term of around 5.25 years to maturity on February 15, 2015, and advances have shorter terms, Hydro Ottawa’s starting point for the July 5, 2011 and later issuances is the deemed long-term (i.e. 30-year) rate; there has been no attempt to match the actual rate to the term of the issuance until maturity on February 15, 2015.

²² Exh K5-1-4 (d)

For these reasons, Board staff submits that the Board's deemed debt rate of 5.32%, in effect at the time, should be the ceiling on the allowed rate for the July 5, 2011 issuance.

Forecasted Issuances for September 1, 2011, December 1, 2011 and July 1, 2012

Hydro Ottawa has forecasted three more advances of \$15M in its evidence. For all of these forecasted debt advances, Hydro Ottawa has proposed a debt rate of 5.75%, as derived below.

Board's deemed LTD Rate	5.32%
(for May 1, 2011, issued March 3, 2011)	
Rounded to:	5.35%
Add: increase in rates in 2011, per BMO forecast in LT1.11	0.20%
Add: administration costs:	0.10%
Add: issuance costs:	0.10%
 Total	 5.75%

Hydro Ottawa has proposed to not update the debt rate for these forecasted issuances,²³ stating that its forecast is compliant with the Cost of Capital Report, specifically:

The Board will primarily rely on the embedded or actual cost for existing long-term debt instruments. The Board is of the view that electricity distribution utilities should be motivated to make rational decisions for commercial "arms-length" debt arrangements, even with shareholders or affiliates.

In general, the Board is of the view that the onus is on the electricity distribution utility to forecast the amount and cost of new or renewed long-term debt. The electricity distribution utility also bears the burden of establishing the need for and prudence of the amount and cost of long-term debt, both embedded and new. [Emphasis in original]²⁴

Board staff submits that Hydro Ottawa's proposals for these forecasted issuances is non-compliant with the Cost of Capital Report. Even if Hydro Ottawa wishes to forecast the

²³ Technical Conference Tr Vol 1 p110

²⁴ Cost of Capital Report p53

rate, this is affiliated debt. As such, any forecast must also meet the other conditions of the Cost of Capital Report, specifically:

Third-party debt with a fixed rate will normally be afforded the actual or forecasted rate, which is presumed to be a “market rate”. However, the Board recognizes a deemed long-term debt rate continues to be required and this rate will be determined and published by the Board. **The deemed long-term debt rate will act as a proxy or ceiling for what would be considered to be a market-based rate by the Board in certain circumstances.** These circumstances include:

For affiliate debt (i.e., debt held by an affiliated party as defined by the Ontario Business Corporations Act, 1990) with a fixed rate, the deemed long-term debt rate at the time of issuance will be used as a ceiling on the rate allowed for that debt. [Emphasis in original]²⁵

In other words, Hydro Ottawa can forecast the debt rate on the advances, but the forecasted rates are capped by the deemed LTD rate as issued by the Board.

Board staff submits that Hydro Ottawa’s proposal is inconsistent with the Cost of Capital Report. The 5.75% is clearly above the 5.32% deemed LTD rate. To begin with, Hydro Ottawa has rounded the rate up to 5.35% for unexplained reasons. Second, Hydro Ottawa has added a “conservative” adjustment upwards to reflect a January 2011 forecast from a BMO study filed in undertaking LT1.11. Despite its vintage, Hydro Ottawa rejected the need to update the BMO forecast during the Technical Conference. Finally, Hydro Ottawa has included each of the 0.10% issuance and 0.10% administrative charges.

It is worth noting that the September 1, 2011 advance has not occurred. Further, Hydro Ottawa forecasts that the December 1, 2011 advance is now not forecasted to occur until January 2012.²⁶ Board staff therefore assumes that only one of these advances will occur, along with the forecasted July 1, 2012 advance. Along with the three previous advances, this will then complete the \$75 M principal available under the Grid Promissory Note.

²⁵ Cost of Capital Report p53

²⁶ Oral Hearing Tr Vol 1 p109

Board staff submits that the issuance charge and the administrative charge should be disallowed, for the same reasons as documented with reference to the July 5, 2011 advance, namely:

- The parent company is not having to go to market to raise capital for the \$15 M advance to Hydro Ottawa and hence is not incurring issuance costs itself; and
- In using the deemed LTD rate there is no evidence of how Hydro Ottawa and its parent have attempted to match the rate of the advance to the term to maturity on February 15, 2015. There is thus no demonstrable benefit to ratepayers and the administrative costs should be borne by the shareholder, not ratepayers.

Board staff considers that the base rate, based as it is on January 2011 data, including the BMO report, is dated and should not be relied upon for producing a reasonable forecasted rate for 2012. In fact, the Board has recently published, on November 10, 2011, the updated Cost of Capital parameters for rates effective January 1, 2012. The updated deemed LTD rate is 5.01%. This is still a forecasted rate for LTD of about 30 years, while the advances from the Grid Promissory Note will have a term to maturity of only about 3 years. Therefore, Board staff submits that the 5.01% should be the ceiling on the allowed rate for these two advances in 2012 under the Grid Promissory Note.

Board Staff's Proposal

Board staff proposes the following to reflect this submission, applying the deemed LTD rate to advances under the Grid Promissory Note from July 5, 2011 onwards. The weighted average LTD rate assumes that only two advances will occur in 2012, and also accounts for the fact that the July 1, 2012 advance is only in effect for half of the year. Board staff therefore submits that the weighted average long-term debt rate should be 5.19%.

Description	Date of Issuance	Principal (\$'000's)	Interest Rate (%)	2012 Interest (\$'000)	Weighted Debt Rate Cost
Promissory Note to Hydro Ottawa Holding Inc.	July 1, 2005	200,000	5.14%	10,280.00	
Promissory Note to Hydro Ottawa Holding Inc.	July 1, 2005	32,185	5.90%	1,898.92	
Promissory Note to Hydro Ottawa Holding Inc.	December 20, 2006	50,000	5.32%	2,659.00	
Promissory Note to Hydro Ottawa Holding Inc.	December 21, 2009	15,000	5.85%	877.50	
Promissory Note to Hydro Ottawa Holding Inc.	April 30, 2010	15,000	5.97%	895.50	
Promissory Note to Hydro Ottawa Holding Inc.	July 5, 2011	15,000	5.32%	798.00	
Promissory Note to Hydro Ottawa Holding Inc.	January 1, 2012	15,000	5.01%	751.50	
Promissory Note to Hydro Ottawa Holding Inc.	July 1, 2012	15,000	5.01%	375.75	
Total		357,185		18,536.17	5.1895%

Comparisons to Other Utilities

During cross-examination and in its Argument-in-Chief, Hydro Ottawa has compared its proposed weighted average cost of LTD debt as reasonable based on comparisons with the analogous rates for other utilities, including THESL and Horizon.²⁷

Board staff submits that this has no determinative weight. These other utilities have a portfolio of debt instruments of various vintages, with rates established at the time of issuance of each debt instrument and reflective of market conditions at the time of issuance, and weighted by the principal of each instrument. The Cost of Capital Report applies the guidelines to the rate of each instrument. Comparisons to other utilities are not important for assessing the reasonableness of the weighted average cost of long-term debt.

SMART METERS

Background

In the Updated Application, Hydro Ottawa filed for final disposition of smart meter costs, and for inclusion of smart meter costs in rate base and revenue requirement for recovery in rates on an ongoing basis starting with the 2012 rate year. A Smart Meter Disposition Rider ("SMDR") is proposed to recover the deferred revenue requirement from 2006 up to December 31, 2011 for smart meters installed and associated operating expenses up

²⁷ Oral Hearing Tr Vol 1 p96-97 and Tr Vol 3 p12

to that same date, offset by the revenues received from the Smart Meter Funding Adder ("SMFA").

Hydro Ottawa filed a revised draft smart meter model as an attachment to the Proposed Settlement Agreement filed on November 1, 2011, showing a net deferred revenue requirement amount of \$1,511,585.63 to be recovered by the SMDR. The Board approved the Proposed Settlement Agreement and hence has approved the quantum to be recovered through the SMDR. Hydro Ottawa proposed recovery over a period of one year as a uniform SMDR of \$0.41/month from all metered customers.²⁸

The outstanding issue with respect to the SMDR is whether it should be uniform across all metered customer classes, or whether there should be class-specific SMDRs.

Discussion and Submission

The SMFA has been collected as a uniform amount from all metered customers. Up until late 2010, disposition of smart meter costs has generally been approved for recovery through a uniform SMDR. However, Guideline G-2008-0002²⁹ at page 13 contemplates that there could be other approaches, stating that:

"[i]n an application made for smart meter cost recovery in a non-cost of service proceeding, a distributor will need to file the following information in relation to the smart meter disposition rider ... :

- calculation of the disposition rider for recovery of capital and ongoing operating costs
- the methodology for allocating the disposition rider to different customer classes"

While Guideline G-2008-0002 refers to a non-cost of service process, Board staff submits that this is also pertinent for the calculation of the SMDR, to recover the remaining deferred revenue requirement of installed smart meters in a cost of service application, as is the case for Hydro Ottawa.

²⁸ Oral Hearing Tr Vol 1 p46-48

²⁹ Guideline G-2008-0002: Smart Meter Funding and Cost Recovery, October 22, 2008

In a stand-alone application by PowerStream Inc. (EB-2010-0209), PowerStream proposed to allocate just the costs to the classes after making a global reduction in the system wide revenue requirement to account for all revenues received up to the date of disposition.³⁰ VECC proposed that the SMDR should be class-specific and based on fully allocated costs and reflect not only the differing costs for smart meters in different classes but also that class specific costs should be offset by class specific revenues over the historical period in question. While acknowledging that the principle of cost causality should apply, the Board in its Decision in EB-2010-0209 also recognized that utilities had not been required to track information on a class-specific basis, and that, in PowerStream's case, VECC's proposal would result in significant rate volatility for ratepayers.

The Board noted that both PowerStream and VECC's proposed approaches were attempts to allocate the revenue requirement to metered customer classes based on allocated assets and costs. This is consistent with Guideline G-2008-0002. In EB-2010-0209, the Board found that the differences between PowerStream's and VECC's proposals were *de minimus* in the circumstances in that application. Board staff notes that, in keeping with the spirit and intent of the PowerStream decision, where the information is available, the VECC or PowerStream proposals could be considered in lieu of the uniform rider approach if they result in material differences in residual costs being allocated, as both are more consistent with the principle of cost causality.

In response to an undertaking during the Technical Conference, Hydro Ottawa provided an analysis of the capital costs per meter per class, and what would be the resulting class-specific SMDR based on the methodology that the Board approved for PowerStream. Undertaking L1.4 from the oral hearing updates LT1.14 to reflect the revised deferred revenue requirement of \$1,511,585.63 approved as part of the Proposed Settlement Agreement. The per meter costs from L1.4 are replicated below:

³⁰ PowerStream's methodology entailed allocating: 1) the return on capital and amortization expense based on the class capital costs; 2) OM&A based on number of meters; and 3) PILs based on the class revenue requirement before PILs. PowerStream originally proposed the allocation method for the Smart Meter Incremental Revenue Requirement Rate Rider ("SMIRR"), but, in its reply submission accepted Board staff's proposal that the same approach should also apply to the calculation of the SMDR.

Customer Class	Per Unit Costs (\$)
Residential	145.17
General Service <50KW	371.35
General Service 50-1500KW	794.91
General Service 1500-5000 KW	1,804.27
Large Users	2,022.77

Board staff notes that:

- Hydro Ottawa has documented that all metered customer classes have “smart meter” costs. While Smart Meter deployment per minimum functionality, as noted in O.Reg. 425/06, only relates to the Residential and GS < 50 kW classes, Hydro Ottawa has included meter conversion and deployment for all metered customer classes. Costs are incurred for all metered customers who also “benefit” from the “smart meters”, and thus recovery of costs should be from all metered customers based on the principle of cost causality.
- The per meter capital costs increase according to the demand level of customers in the class. Board staff submits that the per meter costs are not atypical of what has been seen in applications by other utilities to date.

Board staff submits that, all else being equal, the revenue requirement on a per unit basis will be higher for a higher capital cost per meter. The operating costs may not be directly related to the capital costs on a per unit basis, but during the smart meter deployment phase, the capital costs have predominated. Hydro Ottawa’s witness agreed with this premise that, on a per unit basis, the higher the capital cost the higher will be the revenue requirement.³¹ By extension, and since the SMFA has been uniform for all metered customers, the deferred revenue requirement per meter will be higher for customer classes with higher per meter capital costs.

In its decision with respect to PowerStream’s smart meter application, the Board found that the cost allocation approach proposed by PowerStream for the smart meter incremental revenue requirement rate rider, which Board staff submitted should also apply for the calculation of the SMDR, was reasonable.

³¹ Oral Hearing Tr Vol 1 p84-86

Hydro Ottawa has noted, in its discussion in LT1.14 and during the oral hearing and in its Argument-in-Chief, that it has made certain assumptions with respect to the quantification and allocation of some operating and capital costs (e.g. with respect to collectors) for the purposes of doing the analyses for class-specific costs and SMDRs in LT1.14 and L1.4. As such, Hydro Ottawa proposed that the SMDR be a charge of \$0.41/month for one year to be collected uniformly from all metered customers.

Board staff submits that the Board should approve the SMDR based on the class-specific results of L1.4. Board staff's analysis of L1.4 suggests that Hydro Ottawa's calculations may be closer to the VECC "full cost allocation" methodology, as both the deferred revenue requirement and the SMFA revenues and interest are reflected in the determination of class-specific SMDR. Board staff does not necessarily endorse the VECC approach since the Board has not required, to date, a class-specific allocation of both revenues and costs for either the SMFA or the SMDR; but staff notes that both the VECC approach and the one approved by the Board in PowerStream result in SMDR that are directionally similar vs those proposed by Hydro Ottawa, as all metered customer classes are involved. If this were not the case, Board staff would have supported a re-calculation of the SMDR based on the PowerStream approach previously approved by the Board.

That said, Board staff submits that the Board may also wish to consider that a certain degree of cross-subsidization of the smart meter program has been explicitly approved by the Board in the past. This was most evident in the manner in which the original SMFA of 30 cents per residential customer was established (i.e. collected from all metered customer classes). Hydro Ottawa's approach of employing a uniform SMDR for the residual costs would be consistent with the Board's past practice in how it established the initial funding.

LOST REVENUE ADJUSTMENT MECHANISM ("LRAM")

Background

Hydro Ottawa is seeking LRAM recovery of \$851,769 and carrying charges of \$7,169 for 2009 and 2010 OPA CDM programs.³² Hydro Ottawa based the 2010 LRAM on estimated results for the Updated Application filed on September 14, 2011. At the oral hearing, and in undertaking L1.7, Hydro Ottawa confirmed that the actual 2010 results are higher, such that the total recovery should be \$969,573 with carrying charges of

³² Exh I3-1-1 Updated Application

\$10,194. However, the Applicant stated at the oral hearing, that it would not revise the Application or seek recovery of the difference in a future application.³³

In technical conference undertaking LT2.13, the Applicant was asked by VECC to provide, for the period 2008-2010, the impact of not achieving the CDM included in the approved 2008 load forecast. These data were further revised with respect to third tranche programs and 2009 and 2010 OPA results in oral hearing undertaking L1.6. These data indicate an overcollection of \$541,801.

Discussion and Submission

At the oral hearing, VECC cross examined Hydro Ottawa with respect to the results of LT2.13 and the return of the overcollection related to the 2008 load forecast to ratepayers. Hydro Ottawa responded that the 2008 adjusted load forecast was part of a settlement package and noted that there was no request for true-ups of other things.³⁴ Hydro Ottawa also stated that it would not have applied for an adjustment if higher CDM results had been achieved in the period 2008-2010.

The Board's *Guidelines for Electricity Distributor Conservation and Demand Management* (EB-2008-0037) provide for LRAM to compensate distributors for lost revenues associated with CDM activities. The intent of the LRAM in the electricity sector is to keep distributors revenue neutral for CDM activities implemented during the IRM term since their rates do not reflect incremental CDM activities. Unlike the gas sector, it is Board staff's submission that the expectation in electricity has been that future LRAM claims pertaining to the test year (including true-ups to previous rebasing forecasts) would be unnecessary once a distributor rebases and accordingly updates its load forecast. This approach results in rate certainty for base rates.

Board staff notes that the current CDM Guidelines state the following with respect to LRAM claims.

Lost revenues are only accruable until new rates (based on a new revenue requirement and load forecast) are set by the Board, as the savings would be

³³ Oral Hearing Tr Vol 2 p4

³⁴ Oral Hearing Tr Vol 1 p 77

assumed to be incorporated in the load forecast at that time³⁵.

In its 2008 test year application, Hydro Ottawa had the opportunity to reflect CDM savings on a forecast basis for all programs planned to be deployed up to and including the test year, and intervenors had the opportunity to challenge that forecast. In that particular case, parties settled on the final load forecast which the Board approved. To the extent that forecasted savings were not achieved is, in Board staff's view, not relevant. To proceed with a true-up of the effects of CDM activities embedded in a rebasing year would be counter to the expectations in the CDM guidelines and counter to the regulatory certainty principle that final rates means no retroactive adjustment unless specifically addressed in the Board's decision. While Board staff supports the notion of symmetry in an LRAM, it does not support the notion of a revenue adjustment that flows from truing up a rebasing year. The same would hold true in Board staff's view if the forecast savings were exceeded for the period in question.

Board staff notes that while the Board has made a specific request of Hydro One in its most recent cost of service application, "to track the differences between its CDM forecast volumes and those which can be reasonably demonstrated to have been effected"³⁶, the Board has not made such a request of other distributors to Board staff's knowledge, including the subject applicant.

Board staff has taken a similar position with respect to the true-up of a rebasing year for CDM effects in Hydro One Brampton's 2012 IRM application (EB-2011-0174).

Board staff has no concerns with Hydro Ottawa's LRAM request for the 2009 and 2010 programs and has no further submissions to make on that matter.

MODIFIED INTERNATIONAL FINANCIAL REPORTING STANDARDS

Background

Hydro Ottawa will adopt MIFRS on January 1, 2012. The overall impact of MIFRS is summarized in the following table from Exh J1-1-1, as provided in the Updated Application.

³⁵ Section 5.2: Calculation of LRAM, Guidelines for Electricity Distributor Conservation and Demand Management (EB-2008-0037)

³⁶ Decision with Reasons, Hydro One Networks Inc. [EB-2009-0096] April 9, 2010, p5

Table 1 – MIFRS Impact to Rate Base

Rate Base	CGAAP \$000	MIFRS \$000
2011 Net Fixed Assets	\$547,513	\$547,391
2012 Net Fixed Assets	578,717	578,873
Average Net Fixed Assets	\$563,115	\$563,132
Cost of Power	680,576	680,576
OM&A	65,698	75,988
Working Capital Requirement @ 14.2%	105,971	107,432
Rate Base	\$669,087	\$670,564
Increase in Rate Base		\$1,477

Table 2– MIFRS Impact to Revenue Requirement¹

Revenue Requirement	CGAAP \$000	MIFRS \$000	Difference \$000
OM&A	\$65,698	\$75,988	\$10,290
Depreciation	47,416	39,405	(8,011)
Return on Capital @ 6.95%	46,494	46,596	102
PILs	8,567	6,312	(2,255)
Service Revenue Requirement	168,174	168,301	127
Revenue Offsets	(9,026)	(9,026)	0
Base Revenue Requirement	\$159,148	\$159,276	\$127
MIFRS Deferral Account ²	\$0	\$39	\$39
Increase in Revenue Requirement	\$159,148	\$159,315	\$167

Componentization and Depreciation

International Accounting Standard 16 (“IAS 16”), *Property, Plant and Equipment (PP&E)* requires that an item of PP&E, where the cost of the parts is significant in relation to the total cost of the item, be separated into components. In addition, the useful lives of the components should be identified separately. Accordingly, these components are to be depreciated separately using the asset useful lives determined by management as required by IAS 16. Under Canadian General Accepted Accounting Principles (“CGAAP”), Hydro Ottawa used the asset service lives prescribed by the Board for its PP&E.

The Report of the Board, Transition to International Financial Reporting Standards, EB-2008-0408, issued on July 28, 2009 (“Board Report on IFRS”) stated at page 21:

The Board will facilitate a joint depreciation study for electrical distribution utilities. The aim of the study will be to determine depreciation methodologies and rates that will be applied to all electrical distribution utilities for the purpose of setting rates and regulatory reporting. The study must give due weight to the IFRS requirements regarding depreciation, including componentization. Until the study is completed and the resulting depreciation rates are modified or adopted by the Board, electrical utilities will continue to use their present depreciation rates.

Any electrical utility retains the option of demonstrating, through a well-founded depreciation study, that the Board should approve specific depreciation methodologies and rates for that utility.

The joint depreciation study commissioned by the Board was conducted by Kinectrics Inc. (the “Kinectrics Report”) and issued on July 8, 2010. In the cover letter to the Kinectrics Report, the Board emphasized that the Board expects distributors to reflect their consideration of the information contained in the Kinectrics Report when they present an IFRS-based rates application to the Board³⁷.

Hydro Ottawa initiated its MIFRS project in 2008. Through internal analysis and review with assistance from Hydro Ottawa’s IFRS project partner Ernst & Young, Hydro Ottawa determined components and useful lives of its assets. In the Application, Hydro Ottawa identified that it was one of the six distributors selected to collaborate with Kinectrics on the depreciation study commissioned by the Board. Hydro Ottawa also stated that with few exceptions, it was within the ranges suggested as a guideline by Kinectrics. Areas where differences were noted are largely due to certain specific asset replacement practices at Hydro Ottawa or differing environmental conditions³⁸.

Hydro Ottawa’s Application with respect to componentization and depreciation required supplementary evidence which was provided through interrogatory responses, technical conference questions and undertaking responses and cross examination at the oral hearing.

³⁷ Page 2 of July 8, 2010 letter to All Licensed Electricity Distributors re Depreciation Study for Use by Electricity Distributors, Consultant Final Report EB-2010-0178 – Transition to International Financial Reporting Standards

³⁸ Exh J1-1-1, p7

In response to a Board staff interrogatory (K11-1-1), Hydro Ottawa provided a summary of the internal analysis of Components and Estimated Useful lives of PP&E. The internal analysis provided a general comparison to the Kinectrics Report in a table which illustrated the differences between Hydro Ottawa's componentization and asset service lives and those provided in the Kinectrics Report.

As noted in the Updated Application, the overall impact of MIFRS related componentization and asset service lives is a reduction in depreciation of \$8.0M.

In response to SEC technical conference question 18(c), Hydro Ottawa completed an analysis which compared the depreciation expenses using its componentization and asset service lives with those using the componentization and typical useful lives provided in the Kinectrics Report. The result indicated that application of the Kinectrics Report would reduce depreciation further by approximately \$2.0M. In the response to the question, Hydro Ottawa stated that the analysis was not rigorous or accurate and that it did not accept that the comparison with the Kinectrics Report was appropriate or relevant. Further, at the oral hearing, Hydro Ottawa noted that it has not applied technical useful life, but appropriate useful life with consideration for Hydro Ottawa practices, local operating conditions and weather.³⁹

Hydro Ottawa informed the Board at the oral hearing that its external auditor has reviewed the IFRS opening balance sheet. The external auditor found that the components and useful lives as determined by management appear to be reasonable. Hydro Ottawa later provided, in its undertaking response L2.5, the results of Ernest & Young's audit of the opening IFRS statement of financial position as at January 1, 2011.

Discussion and Submission

Board staff notes that the componentization and depreciation issue can be broken down into two sub-issues:

- 1) Whether an independent and objective depreciation study is needed by Hydro Ottawa for the Board to set the just and reasonable rates under MIFRS?
- 2) Whether the asset useful lives used in the calculation of the depreciation expense by Hydro Ottawa are appropriate for rate making purposes?

³⁹ Oral Hearing Tr Vol 2 p72

Board staff notes that there was lengthy discussion at the oral hearing related to whether the Board requires an independent and objective study from distributors and if so, whether Hydro Ottawa's internal analysis can be considered as an independent and objective study. SEC specifically cited⁴⁰ the Accounting Procedure Handbook issued under CGAAP about the need for an objective depreciation study. SEC suggested that the Kinectrics Report is an objective starting point, while Hydro Ottawa suggested that its internal analysis is an appropriate starting point since its IFRS project started well before the Kinectrics Report was issued. Hydro Ottawa stated in the oral hearing that its depreciation study is a distributor specific study.

In Board staff's view, whether the depreciation study conducted by Hydro Ottawa is an independent and objective study is less relevant for the Board in setting just and reasonable rates as long as the depreciation study gives due consideration of the Kinectrics Report. In the cover letter to the Kinectrics Report, the Board clearly stated that "*a generic depreciation study could assist utilities with IFRS compliance in addition to providing considerable regulatory benefits*". However, neither IAS 16 nor the Board Report on IFRS nor the cover letter to the Kinectrics Report require distributors to conduct an independent and objective study.

Hydro Ottawa stated in reply to cross examination that its internal analysis of the components and useful lives of PP&E started as early as 2008 and involved accountants, engineers and Hydro Ottawa's IFRS project partner Ernst & Young.⁴¹ Hydro Ottawa was one of the six distributors that provided input to the Kinectrics depreciation study. Subsequently after Kinectrics Report was issued, Hydro Ottawa made minor changes after comparing its components and useful lives with those in the Kinectrics Report. Hydro Ottawa provided detailed explanations at the technical conference and the oral hearing in relation to the areas of departure from the Kinectrics Report. Board staff submits that Hydro Ottawa has given due consideration to the Kinectrics Report and has applied the Kinectrics Report to their specific circumstances.

Regarding the appropriateness of components and asset useful lives in Hydro Ottawa's 2012 rate application under MIFRS, Board staff note that Ernst & Young, in its audit capacity for Hydro Ottawa, has reported that based on the procedures performed and the

⁴⁰ Oral Hearing Tr Vol 2 p82

⁴¹ Oral Hearing Tr Vol 2 p99

audit evidence provided, that the components and useful lives determined by Hydro Ottawa management are reasonable.⁴²

Board staff also notes that most of Hydro Ottawa's components and useful lives are in line with the Kinectrics Report. Hydro Ottawa has supported its componentization and asset lives anecdotally at the technical conference and oral hearing and the responses appeared reasonable. For example, Hydro Ottawa's componentization and useful lives of transformers were extensively questioned by SEC in cross examination because the 30 year useful life chosen by Hydro Ottawa appears shorter than the typical useful lives of the three relevant transformers in the Kinectrics Report. However, Board staff notes that Hydro Ottawa's explanation of high loading on the transformers and oil spill supports the shorter useful life of the transformers. In addition, the 30 year useful life falls within the range of the useful lives of relevant types of transformers noted in the Kinectrics Report.

As a result, Board staff submits that the components and useful lives used by Hydro Ottawa in developing its depreciation expense for its 2012 rates are reasonable.

Capitalization

Under IFRS and specifically IAS 16, costs that are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management cannot be capitalized into PP&E and hence must be expensed. Hydro Ottawa performed an analysis of cost allocations to determine which costs are not considered directly attributable and therefore do not meet the criteria for capitalization under IFRS. As noted in the Updated Application, the overall impact of MIFRS related to capitalization of overhead costs is an increase in OM&A of \$10.3M⁴³.

In response to a Board staff interrogatory (K11-1-2), Hydro Ottawa provided a table that illustrated the differences between the allocation of overhead costs for the test year on a CGAAP vs MIFRS basis. This table was more detailed than the evidence provided in the Application at Exh J1-1-1. Examples of those overhead costs that are not considered directly attributable to self-constructed assets are Human Resources, Information Technology, Finance and Regulatory.

⁴² Oral Hearing Tr Vol 2 p78-79 and L2.5

⁴³ Exh J1-1-1, Updated Application

In cross examination, SEC sought a more detailed breakdown of overheads and provided a list filed by Guelph Hydro Electric Systems Inc. (EB-2011-0123) in response to an interrogatory as an example of the level of granularity SEC was seeking. Hydro Ottawa filed that comparison on November 10, 2011.⁴⁴

Discussion and Submission

The Board Report on IFRS at page 16 states:

The Board will require utilities to adhere to IFRS capitalization accounting requirements for rate making and regulatory reporting purposes after the date of adoption of IFRS. The utility will file a copy of its capitalization policy, identifying any updates to the policy, as part of its first cost of service rate filing after IFRS adoption. Revenue requirement impacts of any change in capitalization policy must be specifically and separately quantified.

Staff submits that the Board was not prescriptive in the Board Report on IFRS and subsequent documentation about the granularity of evidence required to support changes in capitalization as a result of adoption of MIFRS. Staff is satisfied that Hydro Ottawa has provided sufficient evidence in its response to interrogatories and undertakings.

In response to a staff interrogatory (K11-1-3), Hydro Ottawa stated that it has consulted “with professional advisors regarding the change in capitalization of overhead throughout the IFRS transition project.” Hydro Ottawa also stated that formal consultation on capitalization with the external audit team would occur during Q4 of 2011. Staff notes that there is no reference to the consultation on capitalization in the Ernst & Young documentation provided with undertaking L2.5. If that formal consultation has concluded, staff invites Hydro Ottawa to provide the results of that consultation in its reply submission.

Capital Contributions

At Exh J1-1-1 page 14, Hydro Ottawa stated that “the amount of capital contributions under IFRS has decreased because of lower overhead amounts being capitalized.”

⁴⁴ Undertaking L2.8

As noted in the Proposed Supplementary Settlement Agreement, the participating intervenors agreed that contributions remain in PP&E as separate line items and be depreciated at the same rate as the assets to which they relate.

Discussion and Submission

SEC has questioned the amount of the capital contributions in the test year and how and why it is lower than the capital contribution under CGAAP. Hydro Ottawa explained that due to the decreased capitalized amount of PP&E resulting from the accounting change to MIFRS, the customer contribution is similarly lower since it is dependant on the amount capitalized in the capital program.

Staff notes that Hydro Ottawa's external auditor agrees with the capital contribution amounts in its audit of opening balances of IFRS.

At L2.5 page 16, the audit opinion of Ernst & Young, it states:

With respect to contributions received from customers, we reviewed the analysis performed by management to assess the appropriate recognition of the contributions (immediate or deferred and amortized). Based on the procedures performed, we concurred with the conclusions that have been reached by management.

Board staff has no concerns with the quanta or treatment of test year contributions.

Deferral Accounts

In its Application filed on June 17, 2011, at Exh J4-1-1, Hydro Ottawa sought the Board's approval of three new deferral accounts in relation to the transition to MIFRS:

Deferral Account in Relation to PP&E

Hydro Ottawa sought approval of this account to recover the difference in CGAAP rate base vs MIFRS on the January 1, 2011 MIFRS transition date. On June 13, 2011, the Board issued an Addendum to the Board Report on IFRS. At page 11 of the addendum, the report states:

The Board therefore authorizes a generic deferral account to capture PP&E differences arising only as a result of the accounting policy changes caused by the transition from CGAAP to MIFRS. It is for use by utilities to record PP&E differences arising during the period since their last rebasing under CGAAP up to their first rebasing under MIFRS, including utilities using IRM rate-setting methodology.

Accordingly, it is Board staff's view that there was no further need to examine the evidence on the request for the deferral account in relation to PP&E.

Deferral Account in Relation to Pensions/Other Post Employment Benefits

Hydro Ottawa has elected to apply the IFRS 1 exemption to recognize all cumulative actuarial losses in retained earnings on January 1, 2011. Hydro Ottawa recorded a reduction in retained earnings and a credit to long term employee benefit obligations of \$2.8M on January 1, 2011. The Applicant sought approval for the deferral account to capture the opening balance sheet adjustment.

As noted in the Proposed Supplementary Settlement Agreement, the participating intervenors agreed with the proposal to establish the deferral account and the parties agreed to amortize the amount over the average remaining expected lives of the employees. Board staff has no concerns with this approach.

Deferral Account in Relation to Asset Disposals

At page 41 of the Board Report on IFRS, it states:

Where a utility for financial reporting purposes under IFRS has accounted for the amount of gain or loss on the retirement of assets in a pool of like assets as a charge or credit to income, for reporting and rate application filings the utility shall reclassify such gains and losses as depreciation expense and disclose the amount separately. Where a utility for financial reporting purposes under IFRS has reported a gain or loss on disposition of individual assets, such amounts should be identified separately in rate filings for review by the Board.

At Exh J1-1-1, Hydro Ottawa stated that losses on pooled asset disposal largely result from early asset disposal due to unforeseen events. The Applicant stated that it does not have any data to support an accurate forecast. As a result, no estimates have been

included in the rate application for gains or losses from disposals of pooled assets. Hydro Ottawa is seeking approval for a deferral account to capture gains or losses on disposal of pooled assets.

Discussion and Submission

Staff notes that in relation to a deferral account for asset disposals, the Addendum to the Board Report on IFRS stated:

The Board is not persuaded that a generic account is necessary. The Board is not aware of any reliable data at this time to satisfy the Board that the adoption of IFRS accounting changes will apply to all utilities in a similar or consistent manner, or that the adoption that will cause material impacts for all utilities due to ongoing increase in volatility. In addition, the Board believes that it will be difficult to distinguish the differences arising from IFRS accounting policy changes from other differences, and this difficulty will increase with increasing time post-transition.

At the first cost of service application after the transition, a utility will be expected to provide a forecast of asset useful lives, and gains and losses from retirements, as part of its application. This forecast will be reviewed by the Board and the likelihood of large variances from the forecast can be assessed. Utilities can apply to the Board for a utility-specific variance account if they can demonstrate the probability of significant ongoing volatility.

One of the criteria for establishing a deferral account is materiality. Hydro Ottawa has provided no indication of the materiality of losses on pooled asset disposals. At the oral hearing, Hydro Ottawa stated that it needed experience in order to determine the materiality.⁴⁵ Hydro Ottawa also indicated in reply to cross examination by SEC that it has no evidence demonstrating the probability of ongoing volatility since it doesn't have a basis to do a forecast.⁴⁶

Staff observes that Hydro Ottawa started its IFRS project in 2008. Staff also notes that Hydro Ottawa suggested that it could obtain sufficient information on the losses on

⁴⁵ Oral Hearing Tr Vol 2 p189

⁴⁶ Oral Hearing Tr Vol 2 p189

pooled asset disposals in a period of two to three years.⁴⁷ Staff submits that given the lack of information on materiality and Hydro Ottawa's failure to collect information on the losses on pooled asset disposal in the period 2008 to 2011, that the Board has sufficient reason to deny the request for the deferral account.

If the Board is inclined to grant the deferral account, staff submits that the account would likely be a temporary measure that reduces the risk to the Applicant and ratepayers until the forecasting of the gains or losses improves with experience. Hydro Ottawa should seek disposition of the balance in deferral account in its next cost of service application and request the termination of the account along with a forecast for the next test period.

- All of which is respectfully submitted -

⁴⁷ Oral Hearing Tr Vol 2 p189 In 26