EB-2011-0054

ONTARIO ENERGY BOARD

IN THE MATTER of the *Ontario Energy Board Act 1998*, 1998, S.O. 1998, c.15 (Schedule B);

AND IN THE MATTER of an Application by Hydro Ottawa Limited for an Order or Orders approving just and reasonable rates and other service charges for the distribution of electricity to be effective January 1, 2012.

FINAL ARGUMENT
ON BEHALF OF THE
SCHOOL ENERGY COALITION

November 22, 2011

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1 GENERAL COMMENTS

1.1 *Introduction*

1.1.1 This is the Final Argument of the School Energy Coalition ("SEC").

1.1.2 On June 17 2011 Hydro Ottawa Limited ("Hydro Ottawa" or the "Applicant") filed an Application for distribution rates, effective January 1, 2012, on a cost-of-service basis. The process included extensive interrogatories, a technical conference, settlement conference, and a two day oral hearing.

1.1.3 A Partial Settlement Agreement was filed with the Board on November 1, 2011. After the Partial Settlement Agreement was filed, the Parties continued negotiations on a number of discrete areas with respect to the transition to modified International Reporting Financial Standards (MIFRS). On the first day of the oral hearing on November 7, 2011, a Supplementary Settlement Agreement was presented to the Board dealing with most of those issues.

1.1.4 The ratepayer groups who intervened in this proceeding have worked together throughout the process to avoid duplication. Where SEC is in agreement with specific submissions of other parties, we have avoided where possible repeating their arguments, but have instead adopted their reasoning.

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1.2 *Overview of Submissions*

1.2.1 ***OM&A*** The Application proposes a 19.8% increase in OM&A spending for the Test Year relative to the last year of actuals in 2010. In SEC's submission, this is far in excess of a reasonable amount, looked at from any perspective.

1.2.2 SEC concludes that a reasonable Test Year OM&A budget is $57,685,753. Further, SEC agrees with Board Staff that the Applicant's workforce size is an opportunity to curb its forecasted OM&A expenses, although a much larger reduction is warranted.

1.2.3 ***Long Term Debt*** SEC submits that the long-term debt rate calculated by the Applicant is inappropriate. The specific interest rates applied to a majority of its Promissory Notes held by its holding company misapply the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities.*

1.2.4 Additionally, the Applicant's insistence on embedding issuance and administration costs in the long term debt interest rate is wholly inappropriate.

1.2.5 In the result, SEC proposes a long term debt rate of 5.0034%.[1]

1.2.6 ***Smart Meter Disposition Rider*** While SEC is a firm believer in the principle of cost causality; we have concerns with respect to the quality of the available data to allocate the costs by class. SEC seeks guidance from the Board with respect to what is the appropriate level of granularity and accuracy required in these circumstances.

1.2.7 ***IFRS Issues***. The conversion from Canadian Generally Accepted Accounting Principles (CGAAP) to International Financial Reporting Standards (IFRS) has resulted in four unresolved issues in this proceeding:

(a) ***Depreciation.*** SEC raises the issue of whether the Board, in its response to the move to IFRS, has intended to reduce the standard it had previously imposed on utilities for establishing and setting depreciation rates. It is submitted that relaxing that discipline is neither necessary nor appropriate. As a result, the depreciation amount used by the Applicant is too high, and should be reduced by $2,042,897.

(b) ***Capitalization of Overheads.*** SEC asks the Board to establish a standardized set of expectations with respect to which overheads are still to be capitalized, and in what circumstances. In order to ensure that the Applicant is kept whole in the event of a new standard, we propose a variance account for this expense category.

(c) ***Contributions and Grants.*** Reduced capital costs of assets will lead to reduced contributions and grants in capital projects, increasing the share of the cost borne by ratepayers, unless utilities adjust their calculations of project economics. We propose that the Board determine whether the old calculation produced fair results and, if so, that the Board require the Applicant to adjust its model so that its contributions and grants continue on the same basis.

(d) ***Gains and Losses Account.*** The Board has clearly established the parameters for considering a variance account for gains and losses on the disposition of assets. The Applicant has made no attempt to come within those parameters, and so the account requested should not be approved.

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[1] Calculated as the weighted average of SEC Proposals in section 5.1

2 WORKING CAPITAL (Issue 2.2)

2.1 *Working Capital Allowance*

2.1.1 SEC submits the appropriate Working Capital Allowance should be 11% as a result of corrections to service and collection lags. SEC has reviewed the argument of Energy Probe Research Foundation on this point, and adopts their analysis.

3 LOAD FORECAST (Issue 3.1)

3.1 *Forecasted Sales by Rate Class*

3.1.1 SEC submits that the appropriate forecasted sales by rate class, before CDM adjustments, should be 7,816,845 Mwh. The CDM adjustment should then be prorated across all rate classes. SEC has reviewed the argument of Energy Probe Research Foundation on this point, and adopts their analysis.

4 OM&A (Issue 4)

4.1 *Overall OM&A Expenses (Issue 4.1)*

4.1.1 The Applicant is proposing that rates be adjusted to reflect an increase in OM&A expenses (for the purposes of SEC's argument, OM&A excludes property taxes[2]) from $55,329,793 embedded in rates to $63,891,431.[3] As discussed below, SEC submits that the appropriate total OM&A budget for the Test Year is $57,685,753, which represents a 10% increase over 2010 actual.

4.1.2 The Applicant has consistently underspent on OM&A relative to its Board-approved 2008 OM&A budget. As a result, their Test Year forecast presents an incomplete picture of the actual increase that the Applicant is seeking. Compared to 2010 actuals, the Applicant is seeking an increase of 19.8% from $53,350,685, and over 2008 actuals an increase of 23.8% from $51,628,904. These increases, SEC submits, are substantially in excess of a reasonable level for a utility with the characteristics of the Applicant.

4.1.3 While SEC does have comments with respect to individual expenses, specifically its employee levels, it is important for the Board to view the OM&A budget as an envelope. While the Applicant takes the position that an increase of 4.2% in OM&A spending between the Bridge Year and Test Year is reasonable, it must be considered in the context of an increase in spending during the previous year. Between 2010 and the current Bridge Year, the increase is forecast to be 15%.[4]

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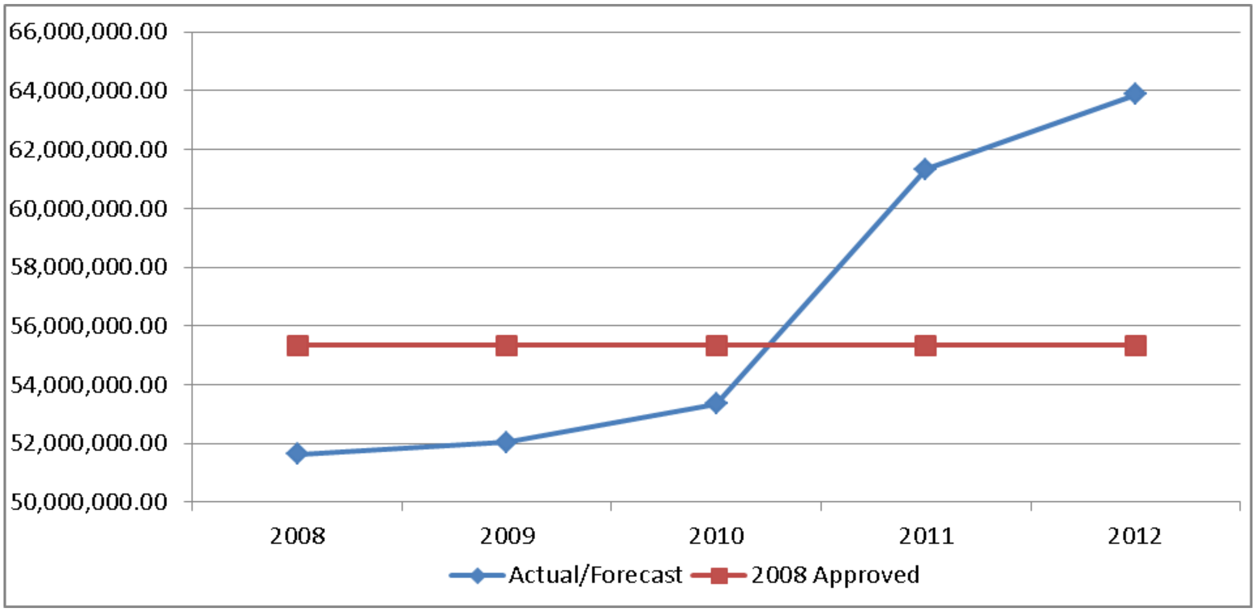
[2] Issue 4.5, the appropriateness of the test year forecast of property taxes was contained in the Settlement Agreement.
[3] K4-4.1-1. 2008 Approved versus 2012 Forecast.
[4] *Ibid.*



1.1.1 Between 2008 and 2010, the average growth in OM&A expenses was 1.65%, while average customer growth was only 1.5%.[5] While projected customer growth has increased since 2010, it has only done so marginally, up to 1.8% for 2011 and 1.9% for 2012. These growth levels do not warrant OM&A increases of 10% per year over two years.

1.1.2 In two recent cost of service decisions of medium to large utilities, the Board has provided guidance on the level of OM&A increases that is appropriate for a utility to adequately manage its operations. In EB-2010-0132, the Board found with respect to Hydro One Brampton Inc. ("Brampton") OM&A expenses that:[6]

> …. an increase of 10% over 2009 actual spending is reasonable. Given the 2.2% per annum forecast growth in customers, this allows for slightly less than 3% per annum increase in spending per customer, which is more than the rate of inflation.

4.1.4 In EB-2010-0131, the Board found with respect to Horizon Utilities' ("Horizon") OM&A expenses that: [7]

> Given that there is very little, if any, growth forecast the Board finds that the increase requested by Horizon is excessive. The Board finds that OM&A spending of $42 million, before adjustments for property taxes, LEAP and

[5] C1-1-1-p13-Table 10
[6] EB-2010-0132, Decision and Order at p.23.
[7] EB-2010-0131, Decision and Order at p.31.

> OMERS expenses, for the 2011 test period is appropriate. This represents an average annual increase of slightly more that 3% since the last Board-approved budget in 2008. **As this represents a 6% increase over 2010 actual spending**…[emphasis added].

4.1.5 SEC agrees with the submission of Energy Probe and submits that the Board should apply similar principles in determining appropriate total OM&A spending for the Applicant in the Test Year. The first step in applying the same principles would be to determine the appropriate base year. SEC submits that for Hydro Ottawa, it should be 201. 2011 is inappropriate because of the significant 15%, year-over-year increase in the OM&A expenses. 2010 represented a modest increase from each of the previous years' actual spends, and is more reflective of the Applicant's historical OM&A expenses since its last rebasing.

4.1.6 Applying the 6% increase (derived from the Horizon decision) over that base year results in an OM&A expense of $56,551,726.

4.1.7 The Applicant in its Argument-in-Chief has asked the Board to refrain from using 2010 as an appropriate base year for the 2012 OM&A Test Year forecast. In doing so, they rely on evidence that there were nonrecurring items that produced savings in years previous to 2011 that would not make it an appropriate base year for an increase of OM&A costs. [8] SEC disagrees.

4.1.8 It stretches credibility for the Applicant to argue that the substantial OM&A budget increases of $8 million between 2010 and 2011 are based on nonrecurring savings in that 2010, especially when between 2008 and 2010 the total increase was $1.7 million.

4.1.9 Hydro Ottawa's Director of Finance Mr. Simpson during cross-examination explained that these non-recurring savings in 2010 where based on, a) compensation savings in excess of the vacancy allowance ($2.1 million), b) delay in time-of-use rollout ($1.2 million), and c) change of bad debt expense methodology ($800k).[9] SEC submits that even if these numbers are taken to be an accurate reflection of the savings, it only accounts for $4.1 million of the increase between 2010 and 2011, leaving a remaining increase of $3.9 million or 6.8% year-over-year.

4.1.10 SEC submits that the approach used by the Board in Brampton is more appropriate in this proceeding. Applying 10% over the most recent Historical Year actuals (derived from the Brampton decision) yields an OM&A expense of $57,685,753. It reflects a reasonable and appropriate increase in OM&A expenses for the Test Year over a 2 year old base year. 10% over two years (or 5% a year) is more than a full percentage point

[8] Tr.3:5-6.
[9] Tr.1:122-123.

per year over the Applicant's growth rate plus inflation rate.[10]

4.1.11 Further, SEC agrees with the submissions by VECC, that if the Applicant is granted an increase in its OM&A budget over 2010 of an amount even close to what is requested, it would effectively remove the benefits of incentive regulation on operating costs.

4.2 ***Employee Levels (Issue 4.4)***

4.2.1 One of the largest OM&A cost-drivers is that of compensation costs which are primarily driven by the number of utilities FTE. Hydro Ottawa has increased its employee count considerably since its last rebasing year, and is projected to dramatically increase its headcount during the test year. Since 2008, the Applicant is projecting 13% more employees between the 2011 bridge year and the 2012 test year 7.4%. This includes an additionally 20 management and 18 union positions over the 1 year.[11]

4.2.2 SEC agrees with Board Staff that the Applicant has an opportunity to control its ever increasing costs by reducing its growth in employee headcount. While the Applicant in its Application discusses the need to train and replace its aging workforce, an argument utilities make in virtually all cost-of-service applications, the empirical evidence does not appear to support that argument. The Applicant's actual retirements lag their projected retirements by a significant margin.[12] This is not surprising considering its workforce planning strategy assumes that 75% of those eligible will retire upon their eligibility date, whereas the actual retirement rate is 59%.

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[10] Average growth rate for 2011 and 2012 of 1.85% (C1-1-1-p13-Table 10) + inflation rate of 2% (D1-1-2-p.8)=3.85%
[11] D3-1-1-AC
[12] MT 1.10

5 LONG-TERM DEBT RATE (Issue 5.2)

5.1 *Overview*

Outstanding Promissory Notes between Hydro Ottawa Ltd. and Hydro Ottawa Holdings							
Date of Issuance	Principal ($000's)	Actual or Deemed	Interest Rate	Issuance Costs	Admin Costs	Total Rate	SEC Proposal
July 1, 2005	200,000	Actual	4.93%	0.11%	0.10%	5.140%	4.93%
July 1, 2005	32,185	Deemed	5.90%	NIL	NIL	5.900%	5.01%
Dec 20, 2006	50,000	Actual	4.968%	0.25%	0.10%	5.318%	4.968%
Dec 21, 2009	15,000	Deemed	5.75%	NIL	0.10%	5.97%	5.75%
July 5, 2011	15,000	Deemed	5.45%	0.10%	0.10%	5.65%	5.32%
Sep 1, 2011	15,000	Deemed	5.55%	0.10%	0.10%	5.75%	5.01%
Dec 1, 2011	15,000	Deemed	5.55%	0.10%	0.10%	5.75%	5.01%
July 1, 2012	15,000	Deemed	5.55%	0.10%	0.10%	5.75%	5.01%

For ease of reference, SEC has included the above table whose data is taken directly from Ex. K5-5.2-1.

5.2 *Interest Rate*

5.2.1 SEC submits that the Board's *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities ("Cost of Capital Report")* is clear with respect to the treatment of long term debt issued to an affiliate: [13]

> 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.
>
> - For debt that is callable on demand (within the test year period), the deemed long-term debt rate will be a ceiling on the rate allowed for that debt. Debt that is callable, but not within the period to the end of the test year, will have its debt cost considered as if it is not callable; that is the debt cost will be treated in accordance with other guidelines pertaining to actual, affiliated or variable-rate debt.

[13] EB-2009-0084 *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities*, dated December 11, 2009

….

5.2.2 The application of the Cost of Capital Report requires the Board to set the affiliate debt rate ceiling at the deemed long term rate at the time of issuance, if the affiliate commits to the debt long term. With respect to the Dec 1 2011 and July 1, 2012 issuances, the interest rate on those issuances should be the deemed rate set by the Board's Cost of Capital letter of November 10, 2011 setting the long-term rate at 5.01%. Additionally, since the Applicant has in fact not yet issued its Sep 1, 2011 issuance, the deemed rate for that tranche must also be set at 5.01%

5.2.3 With respect to all five issuances of the Grid Promissory Note[14], beginning with the Dec 21, 2009 issuance, the Applicant has taken the position that the interest rate should be set at the deemed rate plus an additional markup to reflect its position on the forecast of interest rates in the future. [15] SEC submits that such an approach is inappropriate and not in compliance with the Cost of Capital Report. It is further inappropriate in light of the recognition by the Applicant that its holding company is not actually issuing any long-term debt to fund the Grid Promissory Notes issuances.[16]

5.2.4 Additionally, the Cost of Capital Report clearly lays out the Board's expectations for the treatment of debt that is callable on demand. In cases where a debt instrument is callable within the test year, affiliate debt or not, the deemed long-term debt rate will be the ceiling on the rate allowed for the debt. The Promissory Notes between the Applicant and its holding company are repayable within the Test Year at any time without penalty.[17] SEC submits that this callable provision in a Promissory Note whose interest rate is above the deemed rate requires that the Applicant deem the instrument with the most up-to-date rate of 5.01%.

5.2.5 SEC disagrees with Board Staff's submissions with respect to debt issued prior to 2008. While previously the Board has approved these rates during its 2008 cost-of-service application, this was before the release of the Board's Cost of Capital which includes an updated method of approaching a utility's cost of long term debt.

5.2.6 The Applicant has taken the position that while some of the Promissory Notes are repayable within the Test Year, a document is issued every year by the affiliate lender expressing an intention that they not be repaid.[18] Applicant further stated that the repayment provisions in the Promissory Notes are only for structural flexibility.[19] SEC submits that this wholly irrelevant. There is no legal requirement prohibiting repayment

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[14] The Grid Promissory Note including each of the $15k issuances of 21/12/2009, 5/07/2011, 01/09/2011, 01/12/2011, 01/07/2012.
[15] TC Tr.1:69
[16] K5-5.2-3
[17] E1-1-1-AG
[18] Tr.3:13
[19] Tr.1:113

of the Promissory Notes and its holding company similarly has no legal authority to refuse repayment. Whether or not that is correct, the fact is that there is no legally binding amendment to the callability of the notes, and the lender can at any time require payment. Therefore these notes are in fact repayable in the year. The Board's Cost of Capital Report is clear, and so is the wording of the Promissory Notes.

5.3 *30 Year Debt Rate Applied to Short Term Loans*

5.3.1 SEC has reviewed the submissions of Energy Probe and substantially agrees with its characterization of the issue with respect to Applicant's use of a fixed rate on a 30 year loan for its Grid Promissory Note issuances, which are loans that range from 2.5 to 5 years. Additionally SEC agrees with Energy Probe's submissions with respect to inappropriateness of ratepayers being adversely affected by the terms of the indenture between the Applicant's holding company and the trustee for its bondholders.

5.3.2 While SEC understands the Applicant's approach of accumulating a number of small issuances of debt until it has a sufficient amount to refinance with an external debt offering, it is concerned with the lack of evidence provided.[20] SEC agrees that there may be a premium that would be required for external debt on small issuances, although the Applicant has not provided any specific premium rates that have been quoted by its bankers and advisors, and as a matter of fact no premium is being paid. SEC submits that if the Applicant (or its holding company) plans to go to the market within the IRM period with the accumulated debt, then it might be appropriate for the Applicant to use a 30 year debt rate. If not, the Applicant should use a debt rate for a five year (or shorter) debt rate such as is available from Infrastructure Ontario. The issuance would then be revisited in the Applicant's next cost of service application.

5.4 *Issuance and Administration Cost*

5.4.1 It is important to recognize that no debt has been issued by the holding company to fund the Grid Promissory Note issuances between itself and the Applicant. Thus there are no actual issuance costs for the Applicant to pass on to ratepayers. The Applicant position is that it is trying to emulate the costs of a debt issuance into the market.[21] SEC submits that ratepayers should not have to pay more than the actual cost of debt. In the case of affiliate debt, the framework is set out in the Board's Cost of Capital Report and does not include issuance costs on a hypothetical debt offering in the market.

1.1.1 With respect to administration costs which include rating agency fees, subscriptions fees and other costs,[22] SEC agrees with the submissions of Board Staff and Energy Probe, that the Applicant has not provided sufficient evidence on the basis for the specific charge. Regardless, SEC submits that any costs incurred by the administering the debt cannot be passed through to the Applicant. Those costs are those of the lender

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[20] Tr:1:111

(holding company) and not of the borrowers (Applicant).[23] They are subsumed in the market interest rate.

[21] Tr.3:15
[22] TC Tr.1:92-94
[23] TC Tr.1:43-45

6 SMART METER DISPOSITION RIDER (Issue 7.1)

6.1 *Smart Meter Disposition Rider*

6.1.1 While SEC is a firm advocate of cost causality in the allocation of costs between rate classes, the Board should only do so when it is comfortable that the data that would underpin such an order is adequate. SEC is concerned with the quality and granularity that is available in this case to allocate costs per class as requested by VECC in LT1.14 and updated in L1.4. SEC invites the Board to provide guidance with respect to the level of data granularity required for recovery by class.

6.1.2 The Board in its decision in EB-2010-0209 with respect to an application by PowerStream Inc. for an SMIRR Rate Rider, specifically discussed in broad terms its unease with cost allocation approaches when the Board itself has not requested data collection by class: [24]

> The Board is mindful that a cost allocation approach for the prospective revenue requirement should ideally be based on a class specific revenue requirement calculation. However, the Board is concerned about distributors' ability to track all individual costs on a class specific basis at this point in the smart meter initiative, given that the instructions that have been issued by the Board in the recent past have not included this requirement. The requirements for the tracking of smart meter related costs have evolved to the point where no class by class tracking has been required since the initial implementation plans were filed.

6.1.3 The Applicant states that it not does have the proper data to create rates by class, nor was it required by the Board to collect that data.[25] While there was separate tracking of meter and installation costs, they did not do so for demand and collector meters.[26] In attempting to devise class specific rates, the Applicant had to use general assumptions which they themselves are not comfortable applying to determine individual revenue requirement per class.[27] During cross-examination on the assumptions made by the Applicant with respect to collect and demand meters, Ms.Scott stated: [28]

> And I think the issue is that if we have a collector -- collectors are located on various locations in order to receive the information from the smart meters that are around it. We could put a collector on a general service customer and the majority of the information it's collecting is from residential.
>
> So what class would that be assigned to? That, to us, is not clear.

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[24] EB-2010-0209, Decision and Order at p. 16-17.
[25] LT 1.14 at p.2.
[26] LT 1.14 at p.3.
[27] LT 1.14 at p.4.
[28] Tr.1:56

6.1.4 Ms. Scott further discussed how the assumptions where made and the Applicant's confidence in them:

> The assumption that we've made is to prorate these costs based on the meters that are installed in each class. As I said, I don't think that -- maybe it is; maybe it's not. But **I don't have any confidence that it is necessarily the best assumption.**[29] [emphasis added]

6.1.5 SEC submits that in this specific situation it not clear that a class-specific allocation is appropriate. SEC does not take a position either way, but asks that the Board clarify the level of data necessary to implement a class-specific allocation.

[29] Tr.1:57

7 LRAM (Issue 10.1)

7.1 *LRAM*

7.1.1 SEC has reviewed the arguments of VECC with respect to the Applicant's LRAM claim and adopts their submissions. SEC agrees with VECC that that the Applicant should have to refund ratepayers the difference between its forecasted CDM savings and its actual savings for 2008, 2009 and 2010. This amount would total (excluding interest effects) $161,386 for 2008 and $380,416 for 2009 and 2010.[30]

[30] L1.6 – using the lost revenue calculations for 2008, 2009 and 2010.

8 MODIFIED IFRS (Issue 11)

8.1 *Overview*

8.1.1 The conversion of regulated utilities from Canadian Generally Accepted Accounting Principles (CGAAP) to International Financial Reporting Standards (IFRS) has been a major issue over the last few years. The Board initiated a consultation that resulted in an initial Board report in 2009 on the Transition to IFRS (the "2009 Board Report"). Certain details remained to be determined, and for that purpose the Board established a working group. That group's report led to an Addendum to the 2009 Board Report in 2011 (the "2011 Board Addendum").

8.1.2 Most of the IFRS related issues in this proceeding were resolved by way of the Supplementary Settlement Agreement. Two major ones remain: the useful lives (and therefore depreciation rates to be used for assets), and the implementation of the rules relating to the capitalization of overheads. Two other issues also have to be considered: the calculation of contributions and grants, and the Applicant's request for a variance account for gains and losses on the disposition of assets.

8.1.3 The following analysis deals with each of those four issues in turn.

8.2 *Useful Lives and Depreciation*

8.2.1 The Applicant has proposed new useful lives for their assets that are, on average, shorter than the Typical Useful Lives proposed in the Board's "Asset Depreciation Study for the Ontario Energy Board" by Kinectrics dated July 8, 2010 (the "Kinectrics Report"). The impact of using those shorter useful lives is that revenue requirement for the Test Year is estimated to be higher (compared to the depreciation rates implied by the Typical Useful Lives in the Kinectrics Report) by $2,042,897[31]. In addition, the amount to be repaid to ratepayers through the PP&E Variance Account is proposed by the Applicant to be about $2 million lower than it would be using the Kinectrics Report.

8.2.2 ***What is the Test?*** The initial issue, it is submitted, is whether the Board intends, in the transition to IFRS, to **reduce the standard** that it will apply when utilities establish or revise depreciation rates. The old standard required independent evidence of new useful lives in order for the Board to approve the change. The Applicant submits that, under IFRS, the Board has abandoned its supervisory role, and now allows utilities to set new useful lives, and thus increase or decrease revenue requirement, in their discretion. SEC believes that the existing, more rigorous standard should continue under IFRS.

8.2.3 This analysis starts with the Board's rules for depreciation under CGAAP. The

[31] Tr. 2:132.

Accounting Procedures Handbook, at page 21 of Article 410, says: [32]

> This APHandbook does not provide prescriptive guidance in terms of the amortization methods to be used, the asset categories, the estimated useful lives, or amortization rates. Instead, **it is expected that in the absence of an objective study to support changes to the current methods, lives, or rates, utilities will continue to use methods, lives or rates consistent with past practice**. Note that the Board may review the selected amortization methods, useful lives, and amortization rates, as it considers necessary. [emphasis added]

8.2.4 The Applicant's witnesses confirmed that, under the existing rules, they continued to use the depreciation rates established some years ago by the Municipal Electric Association, as that was their "past practice".[33]

8.2.5 The question, therefore, is what has changed under IFRS. What is clear is that from a financial accounting point of view, the change is mainly one of procedure, not principle. For example, the following principles were true under CGAAP, and continue to be true:

(a) The basic concept of depreciation as the spreading of cost less residual value over the useful life of an asset.[34]

(b) The responsibility of management to establish useful lives of assets.

(c) The need to use the best available evidence in setting useful lives.[35]

(d) The expectation that useful lives will continue to be "a matter of judgment based on the experience of the entity with similar assets".[36]

8.2.6 Some things are different, however. One of the most important is componentization, the principle that the major components of an asset have to be assigned individual useful lives, and depreciated separately[37]. SEC does not take issue with the thoroughness or correctness of the Applicant's componentization process.

8.2.7 One other IFRS change is of more importance in the current context. Under IFRS, there is a positive obligation on management to review useful lives of all assets at least once a year[38]. A full depreciation study is not required every year, but management must turn their mind to it and ensure that any known changes in useful lives are implemented.[39]

[32] M2.1 at p. 7.
[33] Tr. 2:84.
[34] APH Article 410 at p. 20. Ex. M2.1at p. 6. Tr2:82. IAS #16 at para. 50. Ex. M2.1 at p. 13.
[35] Tr.2:86-7.
[36] IAS #16 at para. 57. Ex. M2.1at p. 13.Tr.2:93.
[37] Tr.2:71.
[38] IAS #16 at para. 51. Ex. 2.1 at p. 13.
[39] Tr.2:91.

Under the CGAAP rule, the utility could continue to rely on the existing useful lives approved by the regulator, whether or not they continued to be reflective of the actual useful lives of the assets.[40]

8.2.8 One of the implications of this change is that utilities can no longer rely on the old MEA depreciation rates, which are clearly too short relative to actual experience.[41] The Board addressed this in both the 2009 Board Report and subsequent communications.

8.2.9 In the 2009 Board Report, the Board notes that Board Staff proposed a generic depreciation study to assist utilities who will have to update their useful lives under IFRS. The Board goes on to agree with that suggestion, and sets out its expectations in that regard:[42]

> The Board will undertake a depreciation study for electricity distributors. Until the study is completed and the resulting asset service lives are modified or adopted by the Board, electricity distributors may continue to use their present service lives for rate setting purposes. Some electricity distributors may choose to undertake a distributor-specific depreciation study or to participate in a study undertaken by a group of distributors rather than await the outcome of the Board study, and produce the results in their rate applications.

8.2.10 Subsequently, in a letter to distributors dated July 8, 2010, and in the process of releasing the generic depreciation study by Kinectrics, the Board said the following:[43]

> Effective on transition to IFRS, the Board will no longer prescribe service lives for Property, Plant and Equipment recorded in the accounts of the distributors. So as not to depend on a rate-ruling from the regulator to define the service life (rate rulings have no status under IFRS standards as currently written), distributors are to have identified asset service lives that meet the International Accounting Standards Board (IASB) requirements.

8.2.11 The Board goes on to say:[44]

> 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 Board.
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> ….When appearing before the Board in future cost of service proceedings after the initial IFRS cost of service proceeding, distributors will be expected to provide update information to the Board regarding the useful lives of their assets, along with justification for any changes.

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[40] Tr.2:85.
[41] Tr.2:113 and Ex. L2.6.
[42] 2009 Board Report at p. 21. Ex. M2.1 at p. 10.
[43] M2.1 at p.11.
[44] M2.1 at p. 12.

8.2.12 The Applicant reads that letter, together with the 2009 Board Report, as saying that the old requirement for an independent – "objective" – study in order to change depreciation rates has been removed. In its place, says the Applicant, appears to be a rule that if the financial auditors are satisfied, that is enough.[45]

8.2.13 To the best of our knowledge, this is the first time the Board is being asked to consider whether – and if so, to what extent – it has relaxed its standard for the setting and changing of depreciation rates. In our submission, if the Board accepts the position of the Applicant the Board will be allowing the utilities discretion to set their own rates, without proper oversight. This is not, in our view, proper cost of service regulation.

8.2.14 We reach that conclusion based on two different analyses:

(a) The proposed interpretation of the July 8, 2010 letter is inconsistent with the Board's practice and would produce regulatory results that are not reasonable.

(b) The Board's general principles of regulation, including its overall approach to the move to IFRS, rest on an understanding that, whatever is required for accounting purposes, the Board still has, and must exercise, its mandate to set "just and reasonable rates". If that is inconsistent with the accounting rules, it is the accounting rules that must give way.

8.2.15 Dealing first with the interpretation of the July 8, 2010 letter, we note that the first quote above could be read, on its plain words, as requiring distributors to set their depreciation rates based on accounting rules, with no further Board restraints or requirements. This reading cannot be correct, for the following reasons (among others):

(a) The distributors have an obligation to review useful lives every year. Read as proposed, distributors could change their depreciation rates annually, without any regard for Board approval or supervision, despite the fact that rates are set by the Board assuming that a certain amount of depreciation is collected in those rates. For example, a distributor could collect $10 million in rates for depreciation, but increase useful lives and thus only reduce rate base by $5 million. This would result in double collection of the capital cost of assets.

(b) Nowhere in the letter does the Board discuss any change in, or direct its mind to, the evidentiary standard on which depreciation rates should be based. The Board says that it will not provide a standard set of rates, but it does not state that it is changing the evidence it expects from utilities when they propose new depreciation rates. A change of this magnitude

[45] See Tr.2:90, 99,150.

(going against the Board's normal expectations) would in our submission be explicit if it were intended.

(c) On the next page, the Board makes clear that any changes to IFRS-based lives (i.e. after the initial set) must be put forth in a cost of service application, with "justification".

In our submission, the more reasonable interpretation of this letter is that the Board recognizes that utilities will no longer be able to use the MEA depreciation rates, and so is telling them that they have to establish new depreciation rates. The Board is also providing the Kinectrics Report for guidance, while emphasizing that utility management still has the ultimate responsibility for proposing reasonable depreciation rates. **The Board is not, in our submission, purporting to change its existing rule that changes to depreciation rates require objective evidence sufficient to satisfy the Board.**

8.2.16 The other way of looking at this is from basic regulatory principles. The Board has made clear in the 2009 Board Report that its regulatory mandate is paramount, notwithstanding changes to accounting rules.[46]

8.2.17 What are the regulatory principles and practices that arise in this case? We can suggest the following:

(a) Regulated entities are not given carte blanche to set accounting policies and standards that affect rates. The Accounting Procedures Handbook stipulates, on virtually every material point, how accounting is to be done in the rate-making context. This is not just for consistency. It is also because rates should not be in the discretion of the utility's accounting staff.

(b) Even within the rules of the APH, every accounting judgment is subject to scrutiny by the Board if it can have a rate impact.

(c) The Board recognizes that sometimes one size does not fit all, so allows utilities to deviate from the norm, but only on the presentation of solid supporting evidence.

(d) Where evidence deals with highly technical issues, such as engineering estimates or economic or statistical analysis, the Board normally expects that evidence to be supported by an independent review of some kind. The most obvious example is perhaps lead-lag studies to set distributor-specific working capital. However, the same concept is often applied to

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[46] EB-2008-0408 *Report of the Board, Transition to IFRS,* dated July 28, 2009, p.6 ("2009 Board IFRS Report")

things like asset condition assessments, benchmarking studies, and many other areas. In each case, the factor that drives the need for independence is the technical nature of the subject. It is not practical for the Board to delve deeply into all of the technical details of these subjects, so the Board prefers to require the evidence of independent experts.

8.2.18 In SEC's submission, allowing depreciation to be set by utility management based on judgment only, without the rigorous analysis expected from an independent study, puts too much of revenue requirement within the unchecked control of the utility, and effectively outside the control of the regulator. It is not practical for the Board to do a line by line analysis of the judgment calls by the utility, but without independent support that would be required unless the Board is abdicating its supervisory responsibility. If this was the Board's intent on the conversion to IFRS, in our view this would have been stated by the Board very clearly. It was not so stated, likely because it is inconsistent with the Board's approach to rate regulation.

8.2.19 Given this analysis, it is SEC's submission that the Board could assist all utilities by stipulating the level of evidence that it will normally expect from a utility seeking to establish or change depreciation rates. In our submission, there are three possibilities:

(a) A properly conducted depreciation study by independent experts.

(b) A review carried out by utility management.

(c) No pre-set requirement.

SEC submits that the appropriate rule is that set out in (a), which is consistent with the existing rule that depreciation rates can only be changed after an objective study.

8.2.20 ***The Hydro Ottawa "Study".*** The Applicant submits that they did do a study, and in fact at one point sought to say that it had been reviewed and approved by their auditors. We will deal with the allegation of an "independent review" later, but it is first appropriate to look briefly at whether the analysis by the Applicant was sufficiently rigorous that, aside from the independence issue, it can be relied on by the Board.

8.2.21 There are essentially two ways that a qualified person can establish the expected useful lives of assets:

(a) Gather and analyze empirical data, reaching objectively verifiable conclusions on future expectations; or

(b) Guess, i.e. rely on anecdotal evidence and professional judgment, without any empirical foundation.

8.2.22 While the Applicant will no doubt dislike the term "guess", and it is probably unfair, there is no dispute that the Applicant's approach to establishing useful lives was in the second category, not the first. This was put to the witnesses in cross-examination, and there was no doubt about the result:[47]

> MR. SHEPHERD: And so if I understand what your engineering department did correctly – and I don't mean this in a perjorative way, don't get me wrong – they sat around and said: Okay. We know our system. How long is this stuff going to last? What do we have that tells us the reasons why it would last this length or this length? And later, then, when they had the Kinectrics Report: If our number is different from Kinectrics, why? That's what they did, right?
> MR. SIMPSON: Yes.

8.2.23 The more rigorous way of doing this is to prepare what are called survivor curves, which show through data analysis exactly what the utility's experience is with each category of asset. The Applicant's witnesses agree that this is the most rigorous approach[48], and in fact said in their direct evidence that they had backup data for their "study".[49]

8.2.24 However, when asked to file all of their survivor curves, it turned out they had only a few, but they were very significant ones, done properly, and showing clear trends.[50] **The problem? They apparently didn't use them in setting depreciation rates.**

8.2.25 A review of the survivor curves provided shows the following (these are examples only):

(a) The Applicant proposes a useful life for wood poles of 45 years.[51] The survivor curve for wood poles shows that the half life for a pole (i.e. when half have failed) is about 75 years.[52] Indeed, at 45 years more than 95% are still operational.

(b) The Applicant proposes a useful life for pole-mounted transformers of 30 years.[53] The survivor curve for that asset class shows that the half life is about 90 years[54], and at 30 years about 98% are still operational.

(c) The Applicant proposes a useful life for XLPE underground cable of 35

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[47] Tr.2:156.
[48] Tr.2:149.
[49] Tr.2:72.
[50] L2.6.
[51] M2.1 at p. 26.
[52] L2.6 atp. 5
[53] M2.1 at p.31.
[54] L2.6 at p.6

years.[55] The survivor curve for that asset class shows that the half-life is about 55 years,[56] and at 35 years about 90% are still operational.

8.2.26 In our submission, it would in any case be unacceptable for the Applicant to file a depreciation "study" that simply lacked empirical evidence supporting the lives proposed, which is what we initially thought was the case here. It is significantly worse to file a document that chooses lives that are inconsistent with the empirical evidence already known to the Applicant.

8.2.27 The next and last aspect of this analysis is the question of whether this really is an "independent" study of some sort.

8.2.28 Here is the chronology:

(a) The Applicant filed its Application based on CGAAP, and expressly stated that it had not filed a depreciation study.[57]

(b) In response to an interrogatory, the Applicant filed its internal study[58], which it admits is "cursory".[59] The internal study was prepared by management, and does not refer to Ernst and Young as providing any input or review[60].

(c) In oral evidence, the Applicant claims that Ernst and Young has "audited" its internal depreciation review.[61]

(d) Pressed to provide an "audit opinion" on the review, all the Applicant can provide is a Powerpoint presented to its Audit Committee, purporting to "audit" the opening balance sheet for January 1, 2011, but expressly stating that (unlike any normal audit) third parties cannot rely on their audit report.[62] This is only a private report for the Audit Committee.

8.2.29 The Applicant provides no evidence that Ernst and Young, an accounting firm, has any expertise in establishing the useful lives of utility assets. To the best of our knowledge, no depreciation study presented to this Board at any time has ever been carried out by an accounting firm, and to the best of our knowledge no accounting firm claims that level of expertise. In fact, all that Ernst and Young has done is determine whether they will accept the judgments of management on depreciation for the purposes of financial

[55] M2.1 at p. 31.
[56] L2.6 at p. 4.
[57] D5/1/1 at p. 1.
[58] Tr.2:98.
[59] Tr.2:145.
[60] Tr.2:102-103
[61] Tr.2:105
[62] L2.5.

reporting.

8.2.30 In our submission, this is not similar to having a firm with an expertise in utility assets carry out a proper review of useful lives.

8.2.31 ***Conclusion.*** Some utilities are undoubtedly fully capable of carrying out a rigorous depreciation study, and when they do so the Board may be willing and able to assess if it has been done properly. The Board should leave itself that flexibility, in our view, even if in the vast majority of cases an independent study would be preferable.

8.2.32 However, a rigorous internal study must rely, not solely on judgment and anecdotal evidence, but on empirical analysis producing defensible results. In this case, the work done by the utility does not come close to meeting any reasonable test.

8.2.33 The question, then, becomes what the Board should do in the absence of any reliable evidence on the appropriate useful lives of Hydro Ottawa's utility-specific assets. In our submission, the Board, in addition to providing guidance on the evidentiary level required in order to change depreciation rates and revenue requirement, should:

(a) Decrease revenue requirement by $2,042,897, the amount by which the Applicant's depreciation in the Test Year exceeds the depreciation based on the best available evidence, the typical lives in the Board's Kinectrics Report.

(b) Increase opening rate base (and increase the credit in the PP&E Deferral Account) by a similar amount, representing the change in depreciation in the Bridge Year that would result from using the Kinectrics typical useful lives.

(c) Direct the Applicant to carry out an independent depreciation study before its next rebasing application.

(d) Allow the Applicant, once the independent study has been completed, to file an application seeking an accounting order to change its depreciation rates for the balance of its IRM term. This would work like a Y Factor, but would provide the Board with an opportunity to review and test the results of the depreciation study before allowing it to have rate implications. In this respect, an application for an accounting order provides a better structure than establishing a variance or deferral account in advance.

8.2.34 It is submitted that, based on the evidence before the Board, allowing rates to be set based on the useful lives proposed by the Applicant would be arbitrary, as the useful lives are not supported by proper evidence, and therefore those rates would not be just and reasonable.

8.3 ***Capitalization of Overheads***

8.3.1 The Board, in the 2009 Board Report, specifically considered the existing problem of overhead capitalization policies that vary greatly amongst utilities, and concluded that the new IFRS rules would give the Board the opportunity to "standardize regulatory accounting" in this area.[63]

8.3.2 However, the Board will have seen from the applications already before it that the interpretation of the new IFRS rule on overhead capitalization is not 100% consistent. While the concept is clear, and has been properly described by the Applicant both in the Technical Conference[64] and in the oral hearing, the Board has no assurance at this point that all distributors will apply the concept the same way.[65] In fact, the cross-examination of the Applicant's witnesses on this point clearly revealed the complexities of this new rule, and the issues that can arise in practice.[66]

8.3.3 In response to this, SEC asked Hydro Ottawa to provide a more detailed breakdown of the overhead expenses they are capitalizing, and those they are not.[67] The response is a breakdown of about 85 categories of expenses, identifying which were capitalized under CGAAP and under IFRS.

8.3.4 In our submission, an opportunity will be lost unless the Board reviews this breakdown, and similar documents provided by other LDCs with cost of service applications before the Board this year, and provides guidance to distributors on a standardized approach that the Board considers appropriate.

8.3.5 SEC has no specific submissions on the overhead expense categories the Applicant is capitalizing, or has ceased to capitalize. There is insufficient evidence on the record in this proceeding to look at their choices in a critical way, and it is a level of detail that may not be the most productive use of the Board's time in a hearing context. For example, while we are surprised that the Applicant elects not to capitalize known project-specific work in certain circumstances, we are not able to conclude that their judgment on this was incorrect.[68]

[63] M2.1, p. 39. 2009 Board IFRS Report at p. 16.
[64] TC pp. 28-34, Ex. M2.1 at p. 48-54.
[65] Tr.2:157-158.
[66] E.g. Tr.2:171-177.
[67] L2.8.
[68] Tr.2:171-172, and elsewhere.

8.3.6 However, it is submitted that capitalized overheads can represent a material increase in the revenue requirement of distributors, and therefore a reliable set of guidelines would assist the Board, the utilities, and the ratepayers.

8.3.7 To that end, SEC proposes that the Board review the detailed overhead capitalization approaches used by the distributors currently filing applications, and provide a comprehensive list of the items that the Board believes are appropriately capitalized under IFRS in normal circumstances. Further, SEC proposes that the Board establish a variance account for the Applicant so that, in the event that the Board's list is different in the end from the Applicant's list, the cost consequences of that change can be recorded in a variance account for future review and disposition by the Board.

8.4 ***Contributions and Grants***

8.4.1 The other aspect of the change in the capitalization of overheads is that the capital cost of new assets may be reduced, and that has an impact on the calculation of contributions and grants. In the case of the Applicant, the amount of contributions and grants in the Test Year is expected to go down by $2 million due to this effect.[69]

8.4.2 On this point, we put to the witnesses a discussion we had with Guelph Hydro on the same point.[70] In that discussion, Guelph Hydro makes clear that, since the actual amounts they are spending do not change, their contributions and grants should not change either. If that means adjusting how they calculate those amounts, that is what will happen.

8.4.3 The Applicant came to the opposite conclusion, saying that they decided if the capital cost of an asset changes for accounting reasons, then the contribution should also change.[71] In the short-term, this has the effect of increasing rate base and thus increasing rates.[72]

8.4.4 From the utility's point of view, this is neutral. Any change in contributions and grants does not change what the utility collects. What changes is whether that amount - $2 million this year, for example – is paid by developers and others seeking capital spending by the Applicant, or is paid by the ratepayers.

8.4.5 The Applicant characterizes this difference of opinion as follows (referring to their own internal discussions):[73]

> MR. SIMPSON: It's an item we've had long and heated discussions about and

[69] Tr.2:178.
[70] M2.1 at p. 62-4.
[71] Tr:2:179.
[72] Tr:2:183.
[73] Tr:2:179.

are open to either of the discussions [sic] either way.

8.4.6 SEC agrees that either approach – adjusting the model to get the same contribution, or allowing the contributions to be reduced – can be supported. However, in our submission the Board should make a determination as to whether the old method over-collected, or not. If it did, the Hydro Ottawa approach of reducing contributions and grants is correct. If the old method produced a fair result, in our submission Hydro Ottawa should be required to amend their calculation model to collect the same amount as previously.

8.5 ***Variance Account for Gains and Losses***

8.5.1 The Applicant is seeking a deferral account in which it would record the amounts of any gains and losses on the disposition of assets in the Test year and beyond. The reason this arises is that, under CGAAP the pooling of assets buried these gains and losses in the pooled balance. Under IFRS, pooling is no longer allowed.[74]

8.5.2 In cross-examination, SEC took the witnesses through the Board's policy on this, outlined in the 2011 Board Addendum, and asked them questions to determine whether they have attempted to comply with the policy.[75] The answer, clearly, is that they have not attempted to do so.[76]

8.5.3 In these circumstances, we agree with Board Staff that it would be inappropriate to allow the deferral account proposed.[77]

[74] Tr.2:184.
[75] 2.1 at 66.
[76] Tr.2:185-189.
[77] Board Staff Submission at p. 36-38.

9 OTHER MATTERS

9.1 *Costs*

9.1.1 SEC hereby requests that the Board order payment of our reasonably incurred costs in connection with our participation in this proceeding. It is submitted that the School Energy Coalition has participated responsibly in all aspects of the process, in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted this 22th of November, 2011.

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Mark Rubenstein

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Jay Shepherd

Counsel for the School Energy Coalition