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November 5, 2012

Delivered by Email and Courier

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
26th Floor, Box 2319
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: PowerStream Inc. (Licence ED-2004-0420)
2013 Electricity Distribution Rates Application EB-2012-0161

We are counsel to PowerStream Inc. ("PowerStream"), the Applicant in the above-captioned matter. Accompanying this letter is PowerStream's Argument-in-Chief dated November 5, 2012.

Should you have any questions or require further information, please do not hesitate to contact me.

Yours very truly,

BORDEN LADNER GERVAIS LLP
Per:

Original signed by James C. Sidlofsky

James C. Sidlofsky

cc: Kristi Sebalj, Ontario Energy Board
Martin Davies, Ontario Energy Board
Intervenors of Record (electronic copies only)

TOR01: 5045175: v1

EB-2012-0161

IN THE MATTER OF the *Ontario Energy Board Act*, 1998, being Schedule B to the *Energy Competition Act*, 1998, S.O. 1998, c.15;

AND IN THE MATTER OF an Application by PowerStream Inc. to the Ontario Energy Board for an Order or Orders approving or fixing just and reasonable rates and other service charges for electricity distribution to be effective January 1, 2013.

ARGUMENT-IN-CHIEF OF POWERSTREAM INC.

DELIVERED NOVEMBER 5, 2012

A. INTRODUCTION

1. PowerStream Inc. ("PowerStream") is a corporation incorporated under the Ontario *Business Corporations Act* (the "OBCA") and is the electricity distributor for eleven municipalities in York Region and Simcoe County including Markham, Vaughan, Barrie, Richmond Hill and Aurora. PowerStream serves about 340,000 customers in those communities, making it the second largest municipally owned distributor in Ontario. PowerStream is owned by The Corporation of the City of Markham (34.2%), The Corporation of the City of Vaughan (45.3%) and The Corporation of the City of Barrie (20.5%). PowerStream has no affiliates as defined in the OBCA.[1]

2. PowerStream filed its 2013 forward test year cost of service distribution rate application (the "Application") with the Ontario Energy Board (the "Board") in May of this year.

3. In its application, PowerStream sought approval to charge rates effective January 1, 2013 to recover a service revenue requirement of approximately $179 million. After revenue offsets of approximately $9 million, the base revenue requirement was approximately $170 million. As initially filed, the application indicated a revenue deficiency of approximately $7.8 million.

[1] Application, Appendix 1, Schedule 8

4. A three-day settlement conference was conducted in this proceeding from October 3 to 5, 2012 at the Board's direction, and that was continued by way of a conference call among the parties.

5. Through the efforts of all of the parties, a settlement was reached on 26 of the 30 issues on the board-approved issues list. Two of the remaining issues are partially settled, and the final two are unsettled. The settlement agreement was filed on Wednesday, October 24, 2012, in keeping with the timeline in Procedural Order No.3.

6. The settlement has reduced the service revenue requirement, increased slightly the revenue offsets, and reduced the base revenue requirement when compared with the amounts requested in the application. Among the key elements of the settlement are the following:

- The new service revenue requirement has been reduced from $178.9 million to $172.1 million for a reduction of $6.8 million;

- Revenue offsets have been increased from $9.1 million to $9.8 million;

- The resulting base revenue requirement has been reduced from $169.9 million to $162.2 million;

- When revenue at current rates is taken into account, the 2013 Test Year revenue deficiency has been almost eliminated through the settlement. The settlement has reduced it by almost $7.8 million, so that from a revenue deficiency of $7,826,000, the 2013 test year revenue deficiency based on the settled issues will be $44,000;

- For the purposes of settlement, the parties have accepted PowerStream's forecasted capital expenditures of approximately $114.3 million for the 2013 Test Year, and have accepted a reduction of approximately $6 million in Operations, Maintenance and Administration ("OM&A") for a settled OM&A forecast of $80 million;

- For the purposes of settlement, the parties have accepted the harmonization of rates for PowerStream's north and south rate zones; and

- For the purposes of settlement, the parties have accepted the realignment of PowerStream's rate year with its fiscal year (January 1st – December 31st) and an effective date of January 1, 2013 for PowerStream's Schedule of Rates and Charges for the 2013 Test Year.

7. Based on the Application, the bill impact for the typical Residential customer consuming 800 kWh of electricity per month in PowerStream's South rate zone, which includes Markham, Vaughan, Richmond Hill and Aurora, would have been an increase of 2.6%, or $2.83 per month. The bill impact for the typical Residential customer in the North zone (Barrie) would have been a decrease of 4.4%, or $5.09 per month. The bill impact for the typical General Service < 50 kW customer consuming 2,000 kWh of electricity per month in PowerStream's South rate zone would have been an increase of 0.7%, or $1.95 per month. The bill impact for the typical General Service < 50 kW customer in the North zone would have been a decrease of 2.1%, or $5.93 per month.

8. Based on the settlement, and subject to the Board's disposition of the outstanding issues, the bill impact for the typical Residential customer consuming 800 kWh of electricity per month in PowerStream's South rate zone will be an increase of 0.5%, or $0.54 per month. The bill impact for the typical Residential customer in the North zone will be a decrease of 6.0%, or $6.98 per month. The bill impact for the typical General Service < 50 kW customer consuming 2,000 kWh of electricity per month in PowerStream's South rate zone will be an increase of 0.5%, or $1.28 per month. The bill impact for the typical General Service < 50 kW customer in the North zone will be a decrease of 2.0%, or $5.80 per month.

9. At the commencement of the oral hearing on the outstanding issues, held on October 29, 2012, the Board approved the Settlement Agreement.

B. UNSETTLED MATTERS:

10. The following issues are outstanding:

- Issue 2.1: Is the proposed rate base for test year 2013 appropriate? (partially settled)
- Issue 4.2: Is the proposed level of the depreciation/amortization expense for 2013 appropriate? (not settled)
- Issue 6.1: Are the proposed test year cost of capital parameters appropriate? (partially settled)
- Issue 8.2: Is the treatment of property, plant and equipment due to the transition to the new accounting standard appropriate? (not settled)

11. The revenue requirement shown in the Settlement Agreement reflects adjustments arising out of the settled issues. For unsettled or partially settled issues, the agreement uses PowerStream's applied-for values. The rate base and return on rate base may change as a result of the Board's disposition of the outstanding issues, and the Board's determination of the fourth issue may affect the balance for disposition in PowerStream's Property, Plant and Equipment deferral account. For the reasons set out below, PowerStream submits that the question set out in respect of each of the outstanding issues should be answered in the affirmative, and respectfully requests that the Board approve PowerStream's approaches to each of these matters as set out in the Application. PowerStream offers the following submissions on the outstanding issues. PowerStream notes that Issue 2.1 is only outstanding (and treated as partially settled in the Settlement Agreement) because the rate base calculation currently shown in the Settlement Agreement may change depending on the Board's determination of Issue 4.2, which relates to depreciation. Accordingly, there are no separate submissions on Issue 2.1 – PowerStream's submissions on depreciation are set out in the context of Issue 4.2.

C. ISSUE 4.2: IS THE PROPOSED LEVEL OF THE DEPRECIATION/ AMORTIZATION EXPENSE FOR 2013 APPROPRIATE? (INCLUDES ISSUE 2.1)

12. At page 18 of the Settlement Agreement, the parties describe the two aspects of this issue on which there is no agreement:

> "In its Application, PowerStream requested a full year of depreciation for capital additions in the 2013 Test Year in order to increase revenue requirement to more adequately fund capital additions. This increased depreciation by $1,883,000 and revenue requirement by $2,527,000 compared to the use of the half-year approach. The Parties agreed that this request should be determined by the Board.
>
> The second matter relates to the accounting method PowerStream used to calculate depreciation for 2010 and 2011, and proposes to continue to use for 2012 and forward. This has three components. First, for the 2010 and 2011 actual years, PowerStream has calculated depreciation based on an assets' in-service date, which Parties agree is a more accurate approach than the half year depreciation approach. Had PowerStream used the half-year approach in 2010 and 2011, which is the method used in setting base rates which were subsequently adjusted for those years, depreciation would have been $1,263,000 higher, in total for those two years, with a corresponding reduction in net book value of property, plant and equipment ("PP&E") as of January 1, 2013. This fact has no impact on the forecast 2013 depreciation. Second, for purposes of forecasting depreciation for this Application, PowerStream applied the half-year depreciation rule for all 2012 capital additions. In its response to Energy Probe IR#32, PowerStream provided the depreciation expense for 2010 and 2011 based on the half-year rule. The Intervenors have proposed that the 2012 depreciation expense will also be $500,000 lower than the figure set forth in the application, reflecting an estimate of the difference between using in-service dates and the half-year rule in 2012. This would increase the $1,263,000 PP&E differential accordingly. Third, the issue remains whether if the in-service method will be used in the 2013 Test Year and beyond, the forecast of depreciation expense for the Test Year should be adjusted to reflect an in-service month approach. The Parties agreed that the determination of the three elements of this matter should be decided by the Board."

13. With respect to PowerStream's use of a forecast of a full year of depreciation for rate making purposes, PowerStream acknowledges that the Board's *Filing Requirements for Electricity Transmission and Distribution Applications, June 28, 2012* (the "Filing Requirements") state that "… the Board's general policy for electricity rate setting is that capital additions would normally attract six months of depreciation expense."

14. In its pre-filed evidence, PowerStream included a full year of depreciation expense ("depreciation") in the calculation of revenue requirement for the 2013 Test Year rather than a half year.[2]

15. The use of a full year of depreciation rather than a half year increases depreciation by $1,883,000. The corresponding increase in revenue requirement is $2,527,000.[3]

16. PowerStream has proposed that the use of a full year of depreciation is appropriate for the Incentive Regulation Mechanism ("IRM") period that follows the cost of service rate year. The capital additions for 2013 would attract a full year of deprecation in 2014 and subsequent years until the next rebasing. The use of only a half year of depreciation in the rates established in 2013 creates a significant funding shortfall during the IRM period.[4]

17. PowerStream compared the new depreciation expense on additions to the depreciation expense provided in rates from assets becoming fully depreciated. PowerStream found that the new depreciation expense amount on additions significantly exceeded the amount of depreciation in rates provided by fully depreciated assets. This resulted in what would be expected in the situation – the bulk of PowerStream's assets are distribution assets with long lives, in many cases from 25 to 50 years. Assets purchased 25 to 50 years ago would have much lower costs than assets constructed at current costs, and thus the annual depreciation expense would be correspondingly lower. Continued growth also contributes to higher amounts of additions and related depreciation expense compared to fully depreciated assets and their annual depreciation expense that is no longer required. In other words, any benefit that may be gained from recovery of depreciation on fully depreciated assets is far outweighed by the loss of depreciation on recently added assets.[5]

18. At the Oral Hearing, PowerStream provided a table (Exhibit K1.3) that illustrated, in simple terms, the funding shortfall created by having only a half year of depreciation

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[2] Exhibit D1, Tab 4, Schedule 1
[3] Technical Conference Undertaking JT1.5
[4] Exhibit D1, Tab 4, Schedule 1
[5] Exhibit D1, Tab 4, Schedule 1

approved in rates in the 2013 test year. In the subsequent three year IRM period the actual depreciation on 2013 additions was twice the amount approved in rates.[6]

19. In a presentation to PowerStream's Board of Directors dated September 21, 2011 that provided an update on the development of the 2012 and 2012 budgets that would underpin the cost of service rate application, the funding shortfall was shown in real, rather than illustrated terms as \$4.5 million in 2014, \$6.5 million in 2015 and \$8.5 million in 2016. This is evidenced in the following exchange between Ms. Girvan and Mr. Macdonald:[7]

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      MS. GIRVAN:  Okay.  So if you turn to the same schedule on page 8
that says "Preliminary 2012 budget and five-year outlook, core
business," can you explain to me what this budget gap number is?
      MR. MACDONALD:  Yes.  So this -- I think it's probably most
helpful to look at the outlying years, 2014, '15 and '16.  What it's
getting to, again -- and it's just a model to show us.  It's the
shortfall we would have during IRM period, is to do the things that we
want to do, including OM&A expenditures to pay our staff and other
things, as well as pay the depreciation and return on capital
expenditures.
      So it's a way to show us some of the challenges during an IRM
period.
      MS. GIRVAN:  So what's the relationship, then, between budget gap
and the ROE numbers?
      MR. MACDONALD:  We've locked in the ROE to get the gap, because
another assumption is we want to provide our shareholders with the
allowed return.  And at that time, I believe the Board-published rate
was 9.4, or plus or minus a point.
      So it's pinning -- it's pinning the return to our shareholder at
the allowed rate, making some assumptions about OM&A, modest growth
over time, and also plugging in our capital plan, which shows in
depreciation and return, as well.
      MS. GIRVAN:  Okay.  And what does the number at the bottom, the
note at the bottom, mean? "To achieve 8 percent ROE on real-time rate
base, the budget gap in 2012 would be 4.9 million."
      MR. MACDONALD:  So that would be -- can you help me there?
      MS. YOUNG:  I think what they're trying to clarify here is that
if you look at the top number of 8 percent, there would be a budget gap
of $1.8 million to get to that 8 percent.  I believe the star on the
8 percent there is saying that you'd actually need 4.9 to get to the
8 percent on the deemed ROE.
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20. A large part of the gap between PowerStream's projected earnings and comparable earnings at the Board allowed rate of return can be attributed to the shortfall in recovery

[6] Tr. Vol.1, pp. 26 to 27
[7] See Tr. Vol.1, pp. 108-110 and PowerStream's response to CCC IR#1(b)

of depreciation on capital additions. As discussed in paragraph 15, above, in 2014 a full year of depreciation on 2013 additions will add $1.9 million to depreciation expense. In addition there will be new additions in 2014. The settled upon capital expenditures for 2013 are $114.3 million. The Five Year Capital Plan (Exhibit B1, Tab 2, Schedule 1, Page 11, Exhibit 4) shows capital expenditures for 2014 through 2016 of $94.3 million, $113.4 million and $106.3 million respectively, or an average of $104.7 million per year. In Technical Conference Undertaking JT1.14, PowerStream provided the original cost of assets becoming fully depreciated over the period 2011 to 2023. The costs of assets becoming fully depreciated in 2014 to 2016 are $14.2 million, $12.8 million and $12.1 million or an average of $13.0 million per year. There will be a much greater addition to depreciation expense from the average additions of $104.7 million than can be provided from the depreciation no longer required from fully depreciated assets costing $13.0 million on average for these years. During the IRM period, PowerStream estimates there will be $91.7 million more in capital additions (average of $104.7 million) than the cost of assets being fully depreciated (average of $13.0 million) each year. Based on the average rate of depreciation for 2013 additions of 4.53%, this translates into an annual shortfall of approximately $4 million in depreciation expense, between depreciation on new additions less depreciation provided by fully depreciated assets.

21. PowerStream indicated that it had been providing input into the Board's *Renewed Regulatory Framework for Electricity Distributors* in conjunction with other large distributors. However, PowerStream stressed that the funding shortfall created by the use of a half year of depreciation was a serious issue and that it should be addressed in this its application rather than wait for potential future relief.[8] While PowerStream is aware that the Board's October 18, 2012 Report on a *Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach* does not specifically speak to this issue, implementation of the approaches to rate making that are set out in the Report will take time (the Report contemplates the various options for rate applications set out therein being in place for applications for rebasing effective May 1, 2014) and the

[8] See PowerStream's response to Board Staff IR #33.

Board's determinations in this regard will be informed by a stakeholder consultation process that will take place this fall and into 2013. Accordingly, depreciation-related issues may be considered and addressed in the process leading to new distribution rate application filing requirements for May 2014 applications, but that will not assist PowerStream in this rebasing proceeding.

22. PowerStream respectfully submits that that the use of a full year of depreciation is appropriate and necessary to address a significant funding gap, and that it should be used in the calculation of the revenue requirement for 2013.

23. With respect to the second aspect of this outstanding issue (PowerStream's depreciation methodology), PowerStream has used the months in which assets went into service in 2010 and 2011 for the purposes of calculating depreciation and the resulting net book value of its assets. For the 2012 Bridge Year and the 2013 Test Year, PowerStream has used approximations – one-half year for 2012 and, for the reasons discussed above, a full year for 2013.

24. The Board's June 28, 2012 Filing Requirements provide that "… the Board's general policy for electricity rate setting is that capital additions would normally attract six months of depreciation expense. Variances from this "half-year" rule, such as calculating depreciation based on the month that an asset enters service, must be documented with supporting rationale."

25. In its pre-filed evidence, PowerStream included six months of depreciation expense on forecast capital additions in calculating depreciation expense for the 2012 Bridge Year. This is consistent with the Board policy noted in paragraph 24, above. The estimated depreciation for the 2013 Test Year is discussed separately.[9]

26. The filing requirements, as quoted in paragraph 24 above, provide guidance on how to estimate depreciation for additions in forecast years for rate filing purposes. For filing purposes, the use of six months depreciation on additions is the standard. The "half-year

[9] See Exhibit D1, Tab 4, Schedule 1.

rule" is an assumption for estimating purposes only and the assumption is that on average new additions will be in-service for six months. This is the same assumption that PowerStream used in preparing its 2012 and 2013 budget amounts for depreciation.

27. The Board has separate guidelines, the Accounting Procedures Handbook for Electricity Distributors (the "APH"), that deal with how to account for actual transactions. There is no mention in the APH of the "half-year rule". For the 2010 and 2011 historical years, PowerStream has calculated depreciation expense based on the actual additions and actual in-service dates. This is consistent with the APH and good accounting practice. It would be incorrect to record the forecast additions rather than the actual costs. Similarly PowerStream believes it would be inappropriate to use an estimate based on the "half-year" rule rather than the actual in-service dates to record depreciation on the actual additions. PowerStream submits that for those years, where the utility has information with respect to the timing of additions, it is appropriate to use that information. It would not be appropriate to take a similar approach with 2012 and 2013, as complete information on 2012 additions will not be available to PowerStream until after year-end, and PowerStream does not have sufficient information as to when assets would be going into service in the 2013 Test Year.[10]

28. PowerStream submits that the use of an average of six months depreciation on forecast capital additions for the 2012 Bridge Year is fully consistent with Board policy, as is PowerStream's use of an approximation (one year, for the reasons discussed above) for depreciation in the 2013 Test Year. PowerStream is also of the view that the recording of depreciation on actual additions based on the in-service date is also consistent with Board policy.

29. PowerStream submits that its approach to the calculation of depreciation expense and the resulting impacts on rate base are both correct and appropriate.

[10] See PowerStream's response to Undertaking J1.3, delivered November 1, 2012.

D. ISSUE 6.1: ARE THE PROPOSED TEST YEAR COST OF CAPITAL PARAMETERS APPROPRIATE?

30. As noted above, this issue is partially settled. Table 6.1 at page 24 of the Settlement Agreement sets out the various debt instruments issued by PowerStream. Only three are at issue – these are the Promissory Notes held by PowerStream's three shareholders – the City of Vaughan, the City of Markham and the City of Barrie, totaling $166.1 million. As noted in paragraph 1, none of the three shareholders are affiliates as defined by the OBCA. The debt held by Vaughan and Markham was issued on June 1, 2004 at an interest rate of 5.58%, which has remained unchanged since the notes were issued. Until recently, the rate has consistently been lower than the Board's deemed rate for long-term debt. The 5.58% rate was reviewed and approved by the Board in PowerStream's 2006 electricity distribution rate application, and again in PowerStream's 2009 forward test year cost of service rate application. At the time of the merger with PowerStream Inc., the Barrie Hydro note had a rate of 6.5%. After the Barrie Hydro/PowerStream amalgamation the interest on the note payable to Barrie was reduced to 5.58%.

31. Each of the shareholder notes contains an acceleration provision whereby the shareholder may "accelerate payment of all or part of the outstanding Principal, together with any interest accrued and unpaid thereon, without penalty, by way of written notice to [PowerStream] no less than 90 days in advance."[11] However, the notes have been subordinated to PowerStream's non-shareholder debt.[12] This is evidenced in a number of ways:

- Section 3.3 of each of the notes provides that "Any demand for accelerated payment is subject to the conditions of subordination outlined herein."

- Section 4 of each of the notes provides as follows:

  4.1 The payment of the Principal and all interest on this Note is subordinated to the indebtedness issued by Amalco [now PowerStream](or any predecessor of Amalco) to the Electricity Distributors Finance Corporation ("EDFIN") insofar as no such payment shall be made if and for so long as

[11] See Section 3.1 of each of the Promissory Notes delivered October 12, 2012.
[12] See Section 4 of each of the shareholder promissory notes, filed with the Board on October 12, 2012.

an Event of Default (as defined in the relevant series supplement to the Master Custodial Agreement) has occurred and remains outstanding.

4.2 The Town further agrees to subordinate the indebtedness owed it hereunder to debt issued by Amalco from time to time to a financial institution or other third party for the purposes of Amalco or its subsidiaries on such terms as the lender may reasonably request.

4.3 The Town shall execute such documents as may be reasonably required by Amalco to evidence such subordination.[13]

32. PowerStream's third party long-term debt in 2013 will total $311.3 million. The Postponement Agreement in respect of the shareholder notes[14] provides (at section 2(i) of the Postponement Agreement) as follows:

"**Restriction on City Notes Payments.**

(i) No subordinated Debt Principal Payments. Unless previously consented to in writing by the Trustee and as otherwise permitted in this Section 2, no payments (whether on account of principal, interest, premium, indemnification, fees, expenses or otherwise) in respect of any of the City Notes may directly or indirectly be paid by the Corporation [PowerStream Inc.] to any of the Cities or received and retained by any of the Cities in cash or other property or by set-off or any other manner prior to the payment in full of all Debentures."

33. Similar restrictions prohibiting the payment of the shareholder notes in advance of third party debt without the written consent of the debt holders have been in place since 2002.[15]

34. The effect of this provision is that should any of the shareholders accelerate the payment of its Promissory Note (in other words, should the Promissory Note be called), PowerStream will first be liable for the payment of $200 million to its debenture holders, plus what Ms. Young, PowerStream's Vice President, Finance, estimates to be additional millions of dollars in penalties, and then the value of the Promissory Note itself. As Ms.

[13] The above wording is from the Promissory Note held by the City (formerly the Town) of Markham, dated June 1, 2004.
[14] Copies of the Postponement Agreement were filed with the Board on October 12, 2012.
[15] See PowerStream's response to Undertaking J1.5, and the accompanying copies of postponement agreements executed by the City of Barrie, the City of Markham (formerly the Town of Markham) and the City of Vaughan, filed November 1, 2012.

Young testified, the Promissory Notes are effectively not callable.[16] Not only does PowerStream consider the notes to be long-term debt and not callable[17], but PowerStream's bank (TD Bank) considers the shareholder notes to be equity in determining PowerStream's debt-equity ratios.[18]

35. As noted above, PowerStream's actual debt rate of 5.58%, dating back to 2004 and unchanged since the original issuance of the Markham and Vaughan notes, was approved in its 2006 and 2009 rate rebasing proceedings. PowerStream notes that the Board's cost of capital parameters for Applications for May 2009 rebasing showed a deemed long-term debt rate of 7.62%.[19] In conjunction with the merger of PowerStream and Barrie Hydro, the parties agreed that the interest rate on the Barrie note would be reduced to match the 5.58% set out in the Markham and Vaughan notes. It was not until last year that the Board's deemed rate was slightly below the contract rate, at 5.48% for cost of service applications for January 1, 2011 rate changes and 5.32% for cost of service applications for May 1, 2011 rate changes.

36. In the December 20, 2006 *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* (EB-2006-0088 and EB-2006-0089), the Board stated (at p.12):

> "Long-term debt is a major component of a distributor's capital structure. As noted previously, for ratemaking purposes the term of the debt should be assumed to be compatible with the life of the asset. With electricity distributors, the asset life can extend beyond 30 years. Typically, debt is incurred at the time when assets are put in service and the cost of that debt at the prevailing market prices. This means that a distributor may be holding long-term debt at rates that differ according to when the debt was incurred. This is often called 'embedded debt.'"

37. The Board went on to state (at p.13):

> "The Board has determined that for embedded debt the rate approved in prior Board decisions shall be maintained for the life of each active instrument, unless a new rate is negotiated, in which case it will be treated as new debt."

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[16] Tr. Vol.1, at pp. 21-22
[17] Tr. Vol.1, at pp. 18-19
[18] Tr. Vol.1, at p. 19
[19] A copy of the Board's February 2009 letter setting out the cost of capital parameters for 2009 cost of service applications can be found at:
http://www.ontarioenergyboard.ca/OEB/_Documents/2009EDR/Board_ltr_CostofCapital_20090224.pdf

38. Clearly, the Board acknowledged that long-term debt instruments are appropriate and that the rates may differ according to when they were issued. PowerStream submits that this is a long-standing and widely accepted regulatory principle and practice in setting rates.

39. In the *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities*, dated December 11, 2009 ("the 2009 Report"), the Board states (at p.52):

> "The Board wishes to reiterate that the onus is on the distributor that is making an application for rates to document the actual amount and cost of embedded long-term debt and, in a forward test year, forecast the amount and cost of new long-term debt to be obtained during the test year to support the reasonableness of the respective debt rates and terms."

40. As noted above, "embedded debt" refers to long-term debt at previously approved rates. PowerStream's shareholder debt is "embedded debt' and the rate of 5.58% is documented in the evidence.

41. At page 53 of the 2009 Report, the Board states:

> **"The Board will primarily rely on the embedded or actual cost for existing long term debt instruments."** (Board's emphasis)

42. This statement by the Board is clear – the existence of embedded debt at existing rates is to be primarily relied on by the Board in setting distribution rates. PowerStream submits that its shareholder debt is long-term debt embedded debt at a rate of 5.58%.

43. For all of the above reasons, PowerStream submits that the continuation of the 5.58% rate for its shareholder Promissory Notes in the 2013 Test Year revenue requirement is reasonable and appropriate.

E. ISSUE 8.2: IS THE TREATMENT OF PROPERTY, PLANT AND EQUIPMENT DUE TO THE TRANSITION TO THE NEW ACCOUNTING STANDARD APPROPRIATE?

44. In its June 13, 2011 *Addendum to the Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment,* (EB-2008-0408), referred to here as the "Addendum", the Board approved a property plant and equipment ("PP&E) deferral account for distributors.

45. The intent of the PP&E deferral account was to protect rate payers and utilities from impacts due to the changes in PP&E related to the change in accounting standards from Canadian Generally Accepted Accounting Principles ("CGAAP") to Modified International Financial Reporting Standards ("MIFRS"). At page 11 of the Addendum, the Board wrote (emphasis added):

> *"The Board will approve the proposed PP&E deferral account. The account addresses the unique circumstance of a change in accounting standards and provides for the* ***continuity of rate base****. The account allows utilities to* ***avoid the potential for material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates.*** *The deferral account also facilitates monitoring of the extent of potential impact during the IRM period, and provides the opportunity to identify any unusual circumstances requiring attention before completion of the IRM period.*
>
> *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."*

46. In accordance with the Addendum, PowerStream has included PP&E differences between CGAAP and IFRS arising in 2011 and 2012, relating to PP&E that will be included in rate base.[20] This is necessary to maintain the continuity of rate base and avoid material out of period costs not included in current rates. PowerStream has included in its deferral account balance the sum of $7,184,000 related to overheads on work in progress at December 31, 2012 that would have been capitalized under CGAAP but can no longer be capitalized under MIFRS.

47. Put simply, under CGAAP, overheads on capital work in progress in a given year would become part of the utility's rate base in the following year, when the project went into service. In the absence of the change in accounting standards and the move to rebasing under MIFRS rather than CGAAP, any portion of the difference remaining in construction work in progress ("CWIP") at December 31, 2012 and therefore not captured in rate base under CGAAP in 2012, would have become part of the rate base in

[20] Addendum Page 31

2013 under CGAAP. This is still the case under MIFRS for permitted overheads, but fewer overheads may be capitalized under MIFRS. The difference between overhead costs capitalized under CGAAP compared to MIFRS becomes an expense under MIFRS in 2012, a period prior to rebasing under MIFRS – it becomes a "material out-of-period cost", to use the terminology of the Addendum – and never becomes part of rate base under MIFRS. This difference, if not captured in the PP&E deferral account, is effectively "orphaned".[21] In PowerStream's case, that amount is $7.2 million.

48. Rates in 2011 and 2012 are based on CGAAP. Any difference between overhead costs capitalized in CGAAP compared to MIFRS that is not captured in the PP&E deferral account, becomes a cost not included in current rates. PowerStream submits that under general regulatory principles a material cost arising that is beyond the control of management and not in current rates would normally be eligible for deferral account treatment. In this case the Board has already created a deferral account for this express purpose – specifically, Account 1575 CGAAP-IFRS PP&E Transitional Amounts.

49. As noted above, the amount at issue for PowerStream is $7.2 million. This amount far exceeds PowerStream's materiality threshold for this Application – it is approximately nine times PowerStream's materiality threshold, and corresponds to approximately 25% of PowerStream's net income for 2012. If the $7.2 million amount related to CWIP is not allowed in the deferral account, PowerStream must expense (write off) this amount in 2012, thereby reducing 2012 net income by 25%.

50. PowerStream submits that the change to a MIFRS rate base in 2013 must allow for the utility to be made whole in the circumstances described above, where the change in accounting practice has orphaned amounts that would have become part of the Test Year rate base in the absence of the change. By including these amounts in the PP&E deferral account, PowerStream has taken this into account.

51. PowerStream submits that its approach to the PP&E deferral account, including its calculation of the amounts to be included in the PP&E deferral account and its

[21] Tr. Vol.1, at p.31

application of the balance to the calculation of its 2013 revenue requirement is appropriate and in compliance with the Addendum, in that it provides for continuity of rate base and avoids the potential for material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates.

52. PowerStream submits that the PP&E deferral account balance as filed is correct, and requests that the Board approve the disposition of the balance of $2,386,855 over a four-year period as proposed by PowerStream.

F. CONCLUSION:

53. For all of the foregoing reasons, PowerStream respectfully requests that the Board approve PowerStream's approach to each of the outstanding issues.

54. With the Board's approval on the basis requested by PowerStream, bill impacts will be as shown in the Settlement Agreement.

ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 5TH DAY OF NOVEMBER, 2012.

Original Signed by James C. Sidlofsky
James C. Sidlofsky
Counsel to PowerStream Inc.

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