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.

REPLY SUBMISSIONS OF POWERSTREAM INC.

DELIVERED NOVEMBER 21, 2012

A. INTRODUCTION

1. PowerStream delivered its Argument-in-Chief on the outstanding issues on November 5, 2012. Written submissions were delivered by Board Staff, Consumers' Council of Canada ("CCC"), Energy Probe ("EP"), the School Energy Coalition ("SEC") and the Vulnerable Energy Consumers Coalition ("VECC"). PowerStream acknowledges the comment of SEC[1] that "we have been assisted by the open and co-operative approach of the Applicant, including the provision of information as requested, and a concerted attempt on their part to ensure that the issues that remain in dispute are clear." Throughout this proceeding, PowerStream has attempted to ensure that its evidence and responses to interrogatories and undertakings have been clear and that it has assisted the Board and parties in understanding both the Application and PowerStream's positions on the outstanding issues.

2. 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)

[1] SEC submission, at para.1.1.4

- Issue 8.2: Is the treatment of property, plant and equipment due to the transition to the new accounting standard appropriate? (not settled)

3. PowerStream repeats and relies upon the submissions in its Argument-in-Chief. PowerStream offers the following submissions on the outstanding issues in reply to those of Board Staff, CCC, Energy Probe, SEC and VECC. As noted previously, 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 – as in its Argument-in-Chief, PowerStream's submissions on depreciation are set out in the context of Issue 4.2.

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

4. As discussed in PowerStream's Argument-in-Chief, there are two aspects to this issue on which there is no agreement:

- PowerStream's proposed inclusion of a full year of depreciation for capital additions in the 2013 Test Year in order 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; and

- 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:

  - 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;

  - Second, for purposes of forecasting depreciation for this Application, PowerStream applied the half-year depreciation rule for all 2012 capital additions; and

- o 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.

5. PowerStream offers the following reply submissions in this regard. They have been arranged in the order set out above.

- **FULL YEAR DEPRECIATION:**

6. In its Application, PowerStream requested a full year of depreciation for capital additions in the 2013 Test year in order to provide additional funding for capital additions.[2] This resulted in an increase in depreciation expense of $1,883,000 and a corresponding increase in revenue requirement of $2,527,000 (when taxes are taken into consideration) as compared to the impacts that would result from use of the half-year rule.[3] In response to a Board Staff interrogatory[4], PowerStream explained that the inclusion of only a half year of depreciation in the 2013 Test Year additions in revenue requirement would create a significant funding shortfall during the IRM period as it would mean that in subsequent years until the next rebasing, there would only be a half year of depreciation in rates but a full year of depreciation expense with respect to the capital additions for 2013. PowerStream stated that this shortfall in depreciation is only partially offset by the amount of depreciation no longer required on assets becoming fully depreciated during an IRM period. PowerStream noted that the bulk of its assets are distribution assets with long lives and assets nearing or at the end of their accounting lives would have much lower costs than assets constructed at current costs and thus the annual depreciation expense would be correspondingly lower. [5]

Board Staff and Intervenor Submissions:

7. PowerStream's proposal was opposed by all other parties. The parties argued that the proposal is contrary to current Board policy and that this is a generic issue. Certain

[2] Exhibit D1, Tab 4, Schedule 1
[3] Technical Conference Undertaking JT1.5
[4] Response to Staff Interrogatory #33, Exhibit J1, Tab 4, Schedule 4.2, p. 1, filed August 31, 2012
[5] Exhibit J1, Tab 4, Schedule 4.2, pp. 1-2

intervenors raised issues related to "symmetry" – in that if depreciation were to be considered on a full year basis, then certain other revenue requirement components should be considered on the same basis.

PowerStream's Reply:

8. PowerStream submits that the significant mismatch between the depreciation allowance in rates and the actual depreciation incurred is a unique circumstance. The issue of customer additions, for example, was raised in the Oral Hearing and in intervenor arguments. PowerStream submits that this is not an analogous situation. It is correct to suggest that customer additions in 2013 are assumed at a half year impact, but in 2014 will have a full year impact. While that means that revenue from 2013 customer additions will be higher in 2014 than has been assumed for the purpose of setting 2013 rates, PowerStream's 2014 OM&A costs will also increase beyond those assumed in setting 2013 rates in order for PowerStream to service the greater number of customers for the full year. For example, for rate making purposes in 2013, PowerStream forecast staff additions using a half year assumption. In 2014, however, those staff costs will be incurred for the entire year. The additional benefits from additional 2014 revenue from customers forecast to be added in 2013 will be offset in whole or in part by the additional 2014 OM&A costs. 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 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] With depreciation, there are no new benefits that offset the lost depreciation resulting from the use of the six month assumption in the 2013 Test Year, and the analogy to customer additions is not appropriate.

9. Certain parties argue that there will be a benefit to PowerStream in the IRM period from assets that reach the end of their accounting lives during that period. PowerStream submits that with the long accounting lives of its distribution assets and the significantly lower values of those aged assets on which depreciation is being calculated, there is no

[6] Tr. Vol.1, pp. 26 to 27

effective offset to the lost depreciation on 2013 additions. Moreover, as discussed later with respect to the second aspect of this issue (depreciation methodology), the only source for recovery of depreciation on new additions during an IRM period is from the depreciation in rates available from assets becoming fully depreciated. In the 2010 to 2012 IRM period, depreciation on new additions was $18.2 million and was only partially offset by depreciation in rates for assets becoming fully depreciated of $3.5 million, leaving a shortfall of $14.7 million before any consideration of the issue of only a half year depreciation on the 2009 Test Year additions (discussed below in the context of depreciation methodology). Similarly for the years 2014 to 2016, following PowerStream's 2013 Test Year, there will be average annual additions of $104.7 million and assets becoming fully depreciated of $13.0 million[7]. PowerStream submits that in the IRM period following the 2013 rebasing, there is not enough depreciation in rates to meet the depreciation on new additions let alone provide depreciation to cover the difference between full year depreciation on 2013 additions versus the half year that is in rates.

10. While PowerStream submits that its approach to this matter – that is, using 12 months of depreciation for 2013 capital additions – is appropriate, PowerStream has considered this matter further. In order to address the potential for over-collecting depreciation, raised by Board Staff and Intervenors in their submissions, PowerStream proposes an alternative that uses "averaging" so that the amount for depreciation in rates more closely matches the actual depreciation. The table below is a variation of Exhibit K1.3 distributed at the Oral Hearing. The version below uses actual figures, on an incremental basis. The top of the table, under the heading "Half-year Rule", illustrates once again the problem of having only a half year of deprecation in rates. At the end of the Incentive Regulation period, PowerStream would have collected $7.532 million for depreciation in rates, but incurred $13.181 million in actual depreciation expenses, a shortfall of $5.469 million.

11. The lower part of the table, under the heading "Averaging Approach" establishes the depreciation allowance in rates by taking the total depreciation expense of $13.181

[7] Argument-in-Chief, p. 8

million and spreading it equally over four years at $3.295 million per year. As illustrated, over the four year cost of service and incentive regulation rate cycle, the total depreciation amount in rates would equal the depreciation expense incurred. This "averaging" method is similar to what is often done for regulatory costs.

12. This approach, if approved by the Board, would reduce the additional allowance for depreciation expense requested by PowerStream from $1,833,000 to $1,412,000.

Half-year Rule	all values in $million				
	Rebasing	**IRM Period**			**Total**
	2013	**2014**	**2015**	**2016**	
Depreciation in rates	1.883	1.883	1.883	1.883	7.532
Accounting depreciation	1.883	3.766	3.766	3.766	13.181
Difference	**0.000**	**-1.883**	**-1.883**	**-1.883**	-5.649
Averaging Approach					
	Rebasing	**IRM Period**			**Total**
	2013	**2014**	**2015**	**2016**	
Depreciation in rates	3.295	3.295	3.295	3.295	13.180
Accounting depreciation	1.883	3.766	3.766	3.766	13.181
Difference	**1.412**	**-0.471**	**-0.471**	**-0.471**	**-0.001**

13. Parties argued that this is a generic issue. PowerStream recognizes that the funding shortfall problem caused by having only a half year of depreciation in rates at rebasing,

but incurring a full year of deprecation during the Incentive Regulation period is an industry issue. PowerStream is of the view that the Board's Renewed Regulatory Framework (the "RRFE") may, in time, address this issue. In the meantime however, PowerStream maintains that the funding issue is an important, pressing and material issue (the under collection of $5.649 million greatly exceeds PowerStream's materiality threshold of $800,000) and the proposal to have the appropriate allowance for depreciation in the 2013 Test Year is a simple and effective solution that allows PowerStream to deal with this problem now.

14. PowerStream submits that the Board has, on occasion, adopted approaches that differ from the half-year rule. In the case of Greater Sudbury Hydro Inc.'s ("Sudbury Hydro's") 2009 cost of service rate application (EB-2008-0230), while the Board did not allow the utility to apply a full year of depreciation to all test year capital additions, it did adopt an alternative approach for the utility's new Customer Information System, which had an accounting life of only four years. Specifically, the Board allowed the utility to recover approximately 80% of the value of the asset through depreciation based on the number of months the asset would be in service through the IRM period (38 out of 48 months).[8]

15. Additionally, in dealing with applications for approval of Incremental Capital Modules under 3rd Generation Incentive regulation, the Board allows depreciation on the full value of the approved incremental capital asset(s) beginning with the year in which they go into service. In its *Supplemental Report on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors* dated September 17, 2008 (EB-2007-0673), the OEB wrote: "The incremental capital for which the Board may provide rate relief is the new capital sought in excess of the materiality threshold. The proceeding to consider an eligible distributor's application for rate relief would examine the reasonableness of the distributor's increased spending plan. If the application is approved, a rate rider would be established to reflect an amount sufficient to accommodate the portion of the approved incremental spending

---

[8] See pages 27-29 of the Board's December 1, 2009 Decision and Order in EB-2008-0230, available at: <http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/162813/view/dec_order_Greater_Sudbury_20091201.PDF>

that exceeds the threshold amount. **In calculating the rate relief, the Board has determined not to apply the half-year rule so as not to build in a deficiency for subsequent years in the term of the plan.**" [PowerStream's emphasis] PowerStream understands that the Board took this approach in the case of Oakville Hydro Electricity Distribution Inc.'s 2011 IRM application (EB-2010-0104), which included an Incremental Capital Module related to the construction of a new transformer station. PowerStream submits that its proposed approach to depreciation, and its alternative approach, represent reasonable and appropriate attempts to address the deficiency recognized by the Board in its Supplemental Report.

16. PowerStream repeats and stresses that the funding shortfall created by the use of a half year of depreciation is a serious issue and should be addressed in the present application, rather than waiting for potential future relief. While the implementation of the RRFE will be informed by the work of various stakeholder groups that will be meeting this fall and into 2013, it appears at this time that that any relief to PowerStream that may come from the RRFE project may only be available following another cost of service application.

- **DEPRECIATION METHODOLOGY:**

17. As noted above, the issue of PowerStream's depreciation methodology has three components:

- 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;
- Second, for purposes of forecasting depreciation for this Application, PowerStream applied the half-year depreciation rule for all 2012 capital additions; and

- Third, the question remains as to 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.

18. PowerStream submitted that its approach was consistent with Board policy noting[9] that 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."[10]

19. PowerStream submitted[11] that the half-year rule is an assumption for estimating purposes only and noted that the Board has separate guidelines, the *Accounting Procedures Handbook for Electricity Distributors* (the "APH") that deal with accounting for actual transactions. Furthermore, the APH does not mention the half-year rule. PowerStream argued that for the 2010 and 2011 historical years, its calculation of depreciation based on the actual additions and in-service dates is consistent with the APH and good accounting practice. It would be incorrect to record depreciation on the forecast additions rather than actual costs. Similarly, depreciation should be recorded on the actual in-service period rather than the estimated in-service period of six months. As discussed at paragraph 27 of PowerStream's Argument-in-Chief, "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.[12]"

Board Staff and Intervenor Submissions:

20. Board Staff notes that the key concern surrounding all three parts of this unresolved issue is whether or not the method used for recording depreciation on an actual basis in

[9] Argument in Chief, p. 9
[10] Filing Requirements, Chapter 2, at p.32
[11] Argument in Chief, p. 9
[12] See PowerStream's response to Undertaking J1.3, delivered November 1, 2012.

PowerStream's financial statements should be the same as that used for forecasting purposes. Board Staff is in agreement with PowerStream's submissions on this issue. Board Staff submits that any requirement by the Board that distributors be required to forecast in-service dates for assets would increase the complexity of the applications process, particularly if multiple years of cost forecasting are involved, without any certainty that it would improve the accuracy of the forecasts.

21. VECC observed that the use of half year depreciation rule is a well-established part of cost of service test year applications and, like Board Staff, sees the need to employ it to avoid complexities in rate proceedings. VECC stated that if the half year rule is a biased estimator, it becomes a generic matter for the Board to address for all utilities. CCC stated that there is merit in using the same methodology for accounting and ratemaking. EP and SEC argued that in the case of PowerStream the use of the half year rule for projected years produces a higher depreciation figure and therefore PowerStream should use estimated monthly in-service dates instead of the half year rule. EP and SEC make certain proposals as to how their methodology should be accommodated.

PowerStream's Reply

22. As noted above, Board Staff agrees with PowerStream's submission that it has followed the Board's guidelines in forecasting depreciation for rate filings and that it has followed the Board's guidelines in accounting for actual additions and depreciation.

23. PowerStream disagrees with the assertions by EP and SEC that PowerStream's accounting for depreciation has led to an over-recovery of depreciation expense through rates and therefore an overstatement of rate base.

24. PowerStream has provided evidence that not only is there no over collection of depreciation in rates during an IRM period but in fact there is a significant shortfall, for the following reasons:

- There is only a half-year of depreciation in rates for Test Year additions (e.g. 2009) despite the fact that there will be a full year of depreciation in the

subsequent years of the IRM period (e.g. 2010 to 2012). This half year depreciation shortfall occurs in each year of the subsequent IRM period as shown in Exhibit K1.3 filed at the October 29, 2012 Oral Hearing.

- The source for recovery of depreciation on new additions during an IRM period is from the depreciation in rates available from assets becoming fully depreciated.
- Capital additions and associated new depreciation expense during the IRM period far exceed the cost of fully depreciated assets and the associated depreciation expense available to offset the new depreciation cost, as shown below.

25. In the submissions, intervenors have suggested that the recovery of depreciation on the assets becoming fully depreciated during the IRM period provides a sufficient amount of depreciation in rates.

26. PowerStream notes that the record shows that there are capital additions in 2010 and 2011 of $127.1 million and $87.9 million respectively and forecasted additions for 2012 of $74.7 million.[13] The record also shows that for 2010, 2011 and 2012, the cost of assets becoming fully depreciated is $44.9 million, $21.7 million and $10.5 million respectively.[14]

27. The total capital additions for 2010 to 2012 noted above are $289.7 million. The total cost of assets becoming fully depreciated for 2010 to 2012 noted above is $77.1 million. PowerStream has used the average depreciation rate of 3.73% (based on Appendix 2-B for 2010 and 2011 CGAAP) and applied this to the additions and costs of fully depreciated assets for 2010 to 2012 to estimate the related depreciation expense shown in Table 4.2-1 below

[13] Appendix 2-B filed August 31, 2012 in response to Staff interrogatory #5
[14] Table SEC 17-1 filed August 31, 2011 in response to SEC interrogatory #17

Table 4.2-1: Depreciation on Asset Additions & Depreciation Provided by Fully Depreciated Assets ($ Millions)

	Depreciation on Additions			
Year Added	**2010**	**2011**	**2012**	**Total**
2010	$ 2.4	$ 4.7	$ 4.7	$ 11.9
2011		$ 1.6	$ 3.3	$ 4.9
2012			$ 1.4	$ 1.4
Total	**$ 2.4**	**$ 6.4**	**$ 9.4**	**$ 18.2**
	Depreciation provided by Fully Depreciated Assets			
Year Fully Depreciated	**2010**	**2011**	**2012**	**Total**
2010	$ (0.4)	$ (0.8)	$ (0.8)	$ (2.1)
2011		$ (0.4)	$ (0.8)	$ (1.2)
2012			$ (0.2)	$ (0.2)
Total	**$ (0.4)**	**$ (1.2)**	**$ (1.8)**	**$ (3.5)**
Shortfall in Depreciation provided by rates	**$ 2.0**	**$ 5.2**	**$ 7.6**	**$ 14.7**

28. Table 4.2-1, which excludes the issue of full year vs. half year depreciation in the Test Year and only considers additions and fully depreciated assets during the IRM years, shows that there is a large shortfall of approximately $14.7 million in depreciation provided by rates compared to actual depreciation costs.

29. PowerStream submits that the evidence clearly shows that there was no over collection of depreciation in rates in 2010 to 2012 compared to the actual depreciation costs and consequently there has been no overstatement of rate base.

30. PowerStream respectfully disagrees with the assertion by some intervenors that PowerStream's practices related to forecasting for rate filing and its accounting practices are inconsistent with Board policy. As noted in PowerStream's Argument in Chief (pages 9 to 10), the Board's Filing Requirements specify the "half-year rule" for forecasting depreciation on additions in the year. There is no such requirement in the Board's Accounting Procedures Handbook - the "half-year rule" is not even mentioned. PowerStream submits that there is no Board direction, policy or guidance that the method for forecasting and the method for accounting need to be identical. PowerStream submits

that the use of reasonable estimates for forecasting and use of actual data for accounting is both reasonable and consistent.

31. In the *Addendum to the Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment,* (EB-2008-0408, June 13, 2011), at Issue 6 (page 22), the Board considered a similar issue regarding the potential for differences in the calculation of depreciation in a rebasing year and in the following years during IRM. This can occur due to the requirement under IFRS to evaluate the useful life estimates for PP&E each year and update as necessary.

32. Depreciation is based on recovering the capital cost of an asset over its useful life – that is, cost divided by years of useful life equals the annual depreciation amount. A change in the useful life changes the depreciation amount for that asset. For example, a utility might rebase with its underground wires having an estimated useful life of 25 years and use this to calculate depreciation. In the next year, the utility might review its experience and determine that the useful life for underground wires should be 28 years and record depreciation on this basis in its accounting records. For example, on assets with a cost of $200M, this change in useful life would result in a reduction in the annual depreciation expense of $0.9 million, from $8 million to $7.1 million.

33. PowerStream submits that a change in useful life for an entire class of assets could have a greater impact on depreciation expense than the use of actual in-service month versus the assumption of six months in-service for additions. However, the Board did not provide for the tracking or recovery of the differences between asset lives used for the purposes of rebasing and those resulting from the review. At page 23 of the Addendum, the Board confirmed that "No ratepayer representative supported the creation of a variance account for these items." The Board determined that a variance account was not required to track these differences.

34. PowerStream agrees with Board Staff and VECC that monthly in-service dates cannot be reliably forecasted; that any requirement by the Board that distributors be required to forecast monthly in-service dates for assets would increase the complexity of the

applications process without any certainty that it would improve the accuracy of the forecasts; and that the introduction of such a requirement by the Board would also significantly increase the complexity of the review process for rate applications based on cost of service, particularly if multiple years of cost forecasting are involved.

35. Using the in-service period for depreciation based on the month the asset goes into service rather than an estimate of six months in-service is not a change in accounting policy – it is only a refinement of an accounting calculation. As for SEC's assertion that an accounting order is required for a change in accounting for depreciation from a half-year service assumption to the actual in-service month, there is no such requirement. Notably, Board Staff, who are very mindful of deviations from Board policy, did not raise this as an issue.

36. No intervenor arguing for a different regulatory treatment referenced any other rate proceeding where the Board has actually adopted their suggestion and PowerStream is not aware of any.

37. In fact, intervenors have accepted in rate proceedings for other distributors the accounting and depreciation regulatory methodology reflected in PowerStream's Application. For example in the case of Canadian Niagara Power Inc. (EB-2012-01120) which had 2013 as the Test Year (the same as PowerStream), the depreciation methodology used was the same as in PowerStream's Application – that is, actual depreciation calculated on in-service month and forecasted depreciation on test year additions using the "half-year rule". In that case, the intervenors accepted the results of that methodology as evidenced in the Board-approved Settlement Proposal.

38. For all of the above reasons, PowerStream submits that its use of the half-year assumption for forecasting and actual in-service date for accounting is consistent with Board policy and no adjustment to its rate base or 2013 depreciation forecast is needed as a result of its use of this methodology. PowerStream submits that its approach to the calculation of depreciation expense and the resulting impacts on rate base is both correct and appropriate.

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

39. PowerStream has outstanding promissory notes with its three shareholders (the Cities of Markham, Vaughan and Barrie, none of which is an affiliate of PowerStream) in the total amount of $166.1 million. The debt held by Vaughan and Markham was issued on June 1, 2004 at an interest rate of 5.58% (when the Board's deemed rate was 6.9%), 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 (when the Board's deemed rate was 6.9%), and again in PowerStream's 2009 forward test year cost of service rate application (when the Board's deemed rate was 7.62%). 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% (when the Board's deemed rate was 7.62%), to be consistent with the other two shareholders.

40. 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." However, the notes have been subordinated to PowerStream's non-shareholder debt, as evidenced by:

- Section 3.3 of each of the notes which provides that "*Any demand for accelerated payment is subject to the conditions of subordination*" (emphasis added);
- Postponement Agreements in respect of each of the Shareholders' notes (in section 2(i)) contain restrictions prohibiting the payment of the shareholder notes in advance of third party debt without the written consent of the debt holders; and

Similar restrictions related to previous third-party debt have been in place since 2002[15]

41. As a result of the subordination provision, 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 additional millions of dollars in penalties, and then the value of the Promissory Note itself. This makes the promissory notes effectively not callable.

42. Not only does PowerStream consider the notes to be long-term debt and not callable, but as PowerStream's witness panel testified, PowerStream's bank (TD Bank) considers the shareholder notes to be equity in determining PowerStream's debt-equity ratios[16].

43. In its determination of the appropriate rate to be used for the calculation of 2013 Test Year revenue requirement, PowerStream relied on the guidance in 2006 and 2009 OEB Cost of Capital reports:

- 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.'"

- 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.53):

---

[15] See Tr. Vol.1, at p. 78-79 and 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

[16] Tr. Vol.1, at p. 19

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

44. PowerStream submitted that its shareholder debt is long-term embedded debt at a rate of 5.58%, and therefore the continuation of the 5.58% rate for its shareholder Promissory Notes in the 2013 Test Year revenue requirement is reasonable and appropriate.

Board Staff and Intervenor Submissions

45. Board Staff agreed with PowerStream that the shareholders’ promissory notes are effectively not callable and submitted that the rate of 5.58% is appropriate.

46. EP argued that the notes are callable and the rate is variable. SEC argued that the notes are callable. CCC stated that it takes no position on the callability issue but argued that the rate is variable. VECC, SEC and CCC argued that PowerStream has not attempted to negotiate a lower rate for the notes at the time of the EDFIN refinancing. As for the rate that should apply to the notes for ratemaking purposes, some intervenors argued for the Board’s current deemed rate for long term while EP suggested that the appropriate rate is the Board’s deemed rate that existed at the time the postponement agreements were put in place.

PowerStream’s Reply:

47. PowerStream maintains that despite the callability provisions contained in the notes, the promissory notes are in effect non-callable, due to the subordination and signed Postponement Agreements. Section 3.1 of all three promissory notes does indicate that the shareholders may at any time accelerate payment of all or part of the outstanding principal. However, Section 3.3 states that this acceleration is subject to the conditions of subordination, and Section 3.2 states that any demand for accelerated payment is subject to and conditional on receiving confirmation from rating agencies that such repayment will not negatively affect the credit rating of the corporation. PowerStream submits that, given the subordination provisions and associated penalties, such a repayment would significantly increase the amount of debt and most probably would negatively affect the credit rating, so the condition of callability would not be met.

48. The promissory notes are treated as equity by the bank in calculating the ratios contained in the bank loan covenants[17]. In PowerStream's financial statements, the promissory notes are shown as long-term debt, and this is consistent with the manner in which PowerStream itself views this debt[18].

49. As debt holders refer to the promissory notes as "de-facto" equity, it helps to PowerStream to negotiate a lower rate on the market, as well as to maintain the debt-equity ratio[19] required in the borrowing covenants with lenders.

50. Since for all purposes the promissory notes are treated as long-term debt with a fixed rate, used to finance long-term investments, PowerStream did not consider renegotiating the terms of the promissory notes[20]. The terms of the promissory notes, including the rate of 5.58%, have not been changed since the creation of PowerStream; the rate was lower than the deemed long-term rate at the time of the debt issue and until only very recently, it has been consistently lower than the Board's deemed long-term debt rate.

51. The rate of 5.58% has been approved in two previous PowerStream rebasing applications and shareholder debt has consistently been treated as embedded long-term debt with a fixed rate, for both financing and regulated purposes.

52. Given the above, PowerStream submits that the actual rate of 5.58% should be used. PowerStream submits that to adopt a different approach now would be inconsistent with the Board's approach to embedded long-term debt.

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

53. PowerStream has adopted International Financial Reporting Standards ("IFRS") as at January 1, 2012. As required under IFRS, PowerStream was required to restate 2011 on an IFRS basis. PowerStream elected under IFRS to adopt the net book value ("NBV") of

---

[17] Tr. Vol. 1, at p. 19
[18] Application, Appendix 1, Schedule16, p. 2 and p.17
[19] Tr. Vol. 1, at p. 80
[20] Tr. Vol. 1, at pp. 80-81

fixed assets (Property, Plant and Equipment, or "PP&E") under Canadian Generally Accepted Accounting Principles ("CGAAP") as the opening value under IFRS at January 1, 2011.

54. Significant differences arise between the PP&E amounts recorded under IFRS compared to CGAAP for 2011 and 2012. These differences are related mainly to the differences in the depreciation recorded and the overhead costs that are capitalized into PP&E.

55. As discussed in PowerStream's Argument-in-Chief, 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 PP&E deferral account for distributors, the intent of which was to protect rate payers and utilities alike from impacts due to the changes in PP&E related to the change in accounting standards from CGAAP to Modified IFRS ("MIFRS"). At page 11 of the Addendum, the Board stated (emphasis in bold 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."

56. 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.[21] 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

[21] Addendum Page 31

December 31, 2012 that would have been capitalized under CGAAP but can no longer be capitalized under MIFRS.

57. As discussed in PowerStream's Argument-in-Chief, 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 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".[22] In PowerStream's case, that amount is $7.2 million.

58. 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 reiterates its submission 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. The outstanding issue relates to the calculation of the amount to be recorded in this account.

59. PowerStream has tracked the various differences, between what is recorded in the PP&E accounts under CGAAP versus IFRS, from the common starting point of January 1, 2011

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

(same NBV for PP&E) to December 31, 2012, up to the point of rebasing under MIFRS.

60. PowerStream calculated the balance in PP&E Deferral Account as a credit (payable to customers) of $2,386,855. In calculating the amounts for inclusion in the PP&E Deferral Account, PowerStream has included all differences between CGAAP and MIFRS related to PP&E arising in 2011 and 2012 including those differences that would become part of rate base in 2013.

61. In Technical Conference Undertaking JT1.4, PowerStream was asked to file a version of Board Appendix 2-EA, restricting the IFRS-CGAAP PP&E differences to only those differences that have been reflected in the PP&E component of rate base as of December 31, 2012. This approach resulted in a credit balance of $9,571,000 for the deferral account.

62. PowerStream provided further clarification to Undertaking JT1.4 in a filing dated October 12, 2012 in response to a request for additional information following the Settlement Conference. This document explained the difference of $7,184,145 between the PP&E deferral account amount of $2,386,855 as filed, and the amount of $9,571,000 as calculated in JT1.4. The variance of $7,184,145 is due to the higher value of construction work in progress ("CWIP") at December 31, 2012 under CGAAP of $37,093,000 compared to a MIFRS value of $29,909,000, a difference of $7,184,000. PowerStream stated that CWIP is part of PP&E and its addition to rate base is simply an issue of timing. PowerStream explained that, under CGAAP, a larger amount of overhead costs are capitalized resulting in lower operating costs ("OM&A") and that its current rates were set based on the full amount of these costs being capitalized under CGAAP and the corresponding lower OM&A costs.

Board Staff and Intervenor Submissions

63. Board Staff asserts that PowerStream's inclusion in the PP&E Deferral Account, of the approximately $7.2 million in PP&E differences that remain in CWIP at December 31, 2012, is inconsistent with Board policy. Staff acknowledges that the increase of $7.2 million in OM&A in 2012 under IFRS from the overheads not capitalized is significant

and is not in PowerStream's rates in 2012. Board Staff submits that if the Board decides to address this impact due to the change from CGAAP to IFRS, it should not be through the PP&E Deferral Account mechanism but by some other deferral account mechanism. Board Staff stated that the Board may wish to consider a one-time limited deferral account permitting PowerStream to record the amount and amortize it over a four year period, consistent with the amortization period of Account 1575."[23]

64. Intervenors disagree with Board Staff that this amount of $7.2 million is unrelated to the PP&E Deferral Account and therefore it could be considered an out of period cost. However, the Intervenors did agree with Board Staff that the inclusion of the CWIP difference in the PP&E Deferral Account was not the proper mechanism to address this. Intervenors proposed that this should be put into a separate deferral account, similar to the alternative offered by Staff and noted above.

65. The Intervenors suggested that the amount of $7.2 million should be reduced to $5.3 million to be recovered, the $1.9 million difference representing their calculation of a tax benefit arising from the $7.2 million being expensed rather than capitalized under IFRS. This resulting amount of $5.3 million would be recorded in a separate deferral account to be recovered over the same four years by means of a rate rider and attract interest at the prescribed rates for deferral accounts.

PowerStream's Reply

66. The issue is whether all differences in PP&E, between CGAAP and IFRS that affect the PP&E component of rate base, are taken into account in making the transition from rebasing under CGAAP to MIFRS or whether some of these differences, namely the $7.2 CGAAP-IFRS difference in CWIP at December 31, 2012, should be excluded. PowerStream believes that the exclusion of that difference would be arbitrary and inappropriate; the Intervenors agree that the difference should not be excluded, although, they would reduce the $7.2 million by what they consider to be an adjustment for taxes.

---

[23] See page 22 of the Board Staff submission.

67. If the Board accepts PowerStream's and the Intervenors' submissions that this amount must be considered for recovery then the issue becomes one of how this should accounted for - as a rate base adjustment as filed by PowerStream, or as the recovery of an OM&A cost as suggested by the Intervenors.

68. PowerStream respectfully submits that Board Staff's conclusion that the PP&E difference in CWIP at December 31, 2012 is outside the scope of the PP&E Deferral Account described in issue 2 of the Addendum Report is incorrect.

69. Board Staff state "The Rate Base PP&E mechanism was designed to specifically address any differences between costs recorded in the balance sheet accounts and costs built into rates."[24] Board Staff did not dispute the fact that the amount of CWIP at December 31, 2012 under CGAAP is significantly higher than under IFRS. Board Staff did not take issue with the fact that CWIP is part of PP&E and will, in time, become part of the PP&E component of rate base. Board Staff state that CWIP is not included in rate base until it goes into service. This last point merely confirms PowerStream's submission that CWIP is part of PP&E and its inclusion in rate base is simply a matter of timing.

70. CWIP does represent "costs recorded in the balance sheet accounts" and there is a material difference of $7,184,000 between what is recorded in this balance sheet account under CGAAP and IFRS as at December 31, 2012. This difference represents the lower amount recorded in the CWIP balance sheet account under IFRS that instead becomes part of OM&A. In their submission Board Staff acknowledge that this additional OM&A cost under IFRS is not in PowerStream's 2012 rates. PowerStream respectfully submits that it is clear that this amount represents "differences between costs recorded in the balance sheet accounts and costs built into rates" and is indeed related to PP&E and as such this amount falls within the scope of the approved PP&E Deferral Account.

71. PowerStream submits that failure to include the $7.2 million in CWIP under CGAAP at December 31, 2012, that would flow into rate base in the following years, but that never enters rate base under IFRS, is contrary to the Board's stated objective for the PP&E

[24] Board Staff Submission, page 13.

Deferral account – specifically, that the account provides, in the Board's words, "continuity of rate base and 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".

72. PowerStream also disagrees with Staff's suggestion that there has been uniform acceptance of its approach to completely exclude the IFRS-CGAAP PP&E differences remaining in CWIP. In discussing this point, Board Staff make reference to the Enersource Hydro Mississauga Inc. ("Enersource") rate case (EB-2012-0033).

73. Both PowerStream and Enersource were part of the working group assisting Board Staff in preparing their report to the Board that is referred to in the Addendum Report. PowerStream notes that both Enersource and PowerStream calculated in their prefiled evidence the PP&E Deferral Account amount based on including all IFRS-CGAAP PP&E differences including those remaining in CWIP at December 31, 2012.

74. In its response to Board Staff Interrogatory #55, Enersource agreed to make the change requested by Staff to reflect Staff's approach and noted that the IFRS-CGAAP CWIP difference is only $220,000. PowerStream suggests that this was merely expediency on the part of Enersource due to the very immaterial amount, and not an acceptance of the Board Staff approach. PowerStream submits that it cannot be assumed that the same approach would have been accepted by Enersource had the difference been material, as it clearly is in PowerStream's case.

75. In considering this issue, PowerStream has determined that the Board Staff approach, which excludes the IFRS-CGAAP PP&E differences remaining in CWIP, has not been uniformly adopted. PowerStream has reviewed the Guelph Hydro Electric Systems Inc. ("Guelph Hydro") rate proceeding (EB-2011-0123). The calculation of the PP&E Deferral Account balance, in Appendix 1 of the Settlement Agreement, uses PP&E amounts that include both the PP&E in-service amounts on the Appendix 2-B plus the CWIP amounts, which were shown as a separate amount at the bottom of Appendix 2-B. This is identical to the approach taken by PowerStream. PowerStream's review of the

record for that proceeding found no objections by Board Staff or Intervenors to this approach. In the Settlement Agreement that was approved by the Board, the parties agreed to the calculation of the PP&E Deferral Account amounts in Appendix 1. PowerStream submits that its calculation of the PP&E Deferral Account falls within the Board's guidelines in the Addendum Report. As noted above no parties objected to this approach in the Guelph Hydro case.

76. PowerStream agrees with SEC that the handling of the IFRS-CGAAP PP&E differences remaining in CWIP was not explicitly considered in the consultations on the transition to IFRS and the resulting Addendum Report and Board Staff methodology. However, PowerStream submits that its proposed approach is consistent with the Board's rationale for authorizing the establishment of the account – the provision of continuity of rate base and the avoidance of material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates.

77. PowerStream appreciates that this is a complex and unusual situation and has been informed by the submissions of Board Staff and Intervenors. PowerStream understands that Board Staff and Intervenors have concerns over the inclusion of CWIP in the calculation of the PP&E Deferral Account itself due to how it is applied to the MIFRS rate base. PowerStream acknowledges the Board Staff comment that due to the averaging of opening and closing in-service PP&E, only half of the higher CWIP amount under CGAAP would be included in 2013 rate base. However PowerStream notes that under CGAAP the remaining balance would be factored into rate base in future years and therefore the whole amount needs to be considered. If CWIP had been considered in the consultation, perhaps a better, albeit more complex, method to incorporate this into the PP&E Deferral Account rate base adjustment might have been developed that addressed Board Staff's concern regarding the timing of inclusion in rate base.

78. 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.

79. 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 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.

80. 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.

81. If the Board were to accept the Board Staff and Intervenors' position that the $7.2 million difference in CGAAP CWIP should not be adjusted through the PP&E Deferral Account, PowerStream submits that the Intervenors' proposal for separate deferral account treatment of the $7.2 million, less a tax benefit, for a net amount of $5.3 million as described in the EP and SEC submissions is an acceptable resolution.

ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 21ST DAY OF NOVEMBER, 2012.

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

TOR01: 5058665: v1