Ontario Energy Board | **Commission de l'énergie de l'Ontario**

Ontario

EB-2007-0931

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

AND IN THE MATTER OF an application by PUC Distribution Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective May 1, 2008.

BEFORE: Paul Vlahos
Presiding Member

Bill Rupert
Member

DECISION

PUC Distribution Inc. ("PUC" or the "Company") filed an application with the Ontario Energy Board, received on November 30, 2007, under section 78 of the *Ontario Energy Board Act*, *1998*, seeking approval for changes to the rates that it charges for electricity distribution, to be effective May 1, 2008.

PUC is one of over 80 electricity distributors in Ontario that are regulated by the Board. In 2006, the Board announced the establishment of a multi-year electricity distribution rate-setting plan for the years 2007-2010. On May 4, 2007, as part of the plan, the Board indicated that PUC would be one of the electricity distributors to have its rates rebased in 2008. Accordingly, PUC filed a cost of service application based on 2008 as the forward test year.

The Board issued a Notice of Application and Hearing dated December 14, 2007. The Vulnerable Energy Consumers Coalition ("VECC") intervened in the proceeding. The evidence in the application was tested through written interrogatories from Board staff and VECC. Board staff and VECC filed written submissions and PUC filed written reply submissions. The submissions phase was completed on April 7, 2008.

The full record is available at the Board's offices. The Board has chosen to summarize the record to the extent necessary to provide context to its findings on certain issues.

RATE BASE

For a distributor, rate base consists of net fixed assets (gross fixed assets minus accumulated depreciation and any contributed capital) plus an allowance for cash working capital. Net fixed assets are determined as the average of the beginning and the end year values, and reflect capital additions for the test year. The Board's guidelines stipulate a level of cash working capital equal to 15% of the sum of OM&A expenses and the cost of power. The cost of power consists of the commodity cost of power and transmission charges.

The Board deals below with the following issues: smart meters; capital expenditures; and working capital.

Smart Meters

PUC is not one of the 13 distributors currently authorized by the Government to undertake smart meter activities and is not named in the combined smart meter proceeding, EB-2007-0063. PUC does not intend to install smart meters until authorized to do so by the Board. However, in order to meet the Government's targets for smart meter installations for itself and the other participants in a northeastern Ontario group of distributors, the Company has formulated a plan to install 31,522 smart meters in 2008. This would consist of 30,587 residential smart meters and 935 meters for General Service < 50 kW customers.

PUC estimated capital expenditures for smart meters of $6,200,000, before capitalization of overhead, and $365,000 for associated operating expenses in 2008. The Company included these expenditures in its 2008 rate base and revenue requirement in its original filing. PUC also recorded an expenditure of $53,625 in 2007, relating to: 1) formation of a northeast Ontario smart metering working group; 2) hiring of a consultant; 3) evaluation of AMI and smart meter installation vendors; and 4) preparation of the 2008 smart meter capital expenditure budget.

The Company modified its proposal for smart meters. It now proposes to address the recovery of smart meter costs through a smart meter rate adder and the use of deferral and variance accounts established for this purpose. PUC has not proposed a specific smart meter rate adder. PUC proposes to use the OEB smart meter rate adder model to determine the final smart meter rate adder for 2008 rates. The resulting smart meter rate adder would be applied to all metered customers. In its reply submission, PUC acknowledged that this would also require that $6,200,000 be removed from capital expenditures and rate base and that $365,000 be removed from operating expenses.

VECC argued that the smart meter rate adder should be discounted to recognize the uncertainty associated with PUC actually being authorized and able to complete the proposed deployment of smart meters by the end of 2008. VECC submitted that the level of discounting is a matter of judgement, but suggested that a 2008 smart meter rate adder be set between 50% and 75% of the adder assuming full deployment in 2008. PUC opposed an arbitrary discount factor.

<u>Board Findings</u>

The Government has established a phased approach to the implementation of smart meters across the province. Unless there are exceptional circumstances, the Board is not inclined to order the deployment of smart meters for distributors that have not received government authorization via regulation. The Board concludes that PUC does not represent an exceptional circumstance. The Board agrees with PUC that the proposed smart meter spending should not be included in the 2008 rate base. The Board also will require reduction of 2008 OM&A expense by the $365,000 related to smart meters.

The Board finds that it is appropriate to set a revised smart meter rate adder for PUC. The new rate adder will be $1.00 per month per metered customers. This rate adder takes account of the funds already collected, the cost estimates provided by PUC, and the Ministry of Energy’s December 21, 2007 letter to London Hydro indicating that the Ministry intends to recommend to Cabinet that Regulation 427/06 be amended to authorize more distributors to install smart meters. This higher rate adder will allow PUC to collect additional funds and will reduce the need for a further application to the Board as and when authorization to proceed is received.

Capital Expenditures

The Company proposed $5,422,771 in non-smart meter capital expenditures for 2008. Table 1 provides a summary of actual or budgeted capital expenditures for 2006 to 2008.

Table 1: Summary of Capital Expenditures 2006-2008

Project	2006 actual	2007 budget	2008 budget
Install services to meet customer demand	$ 776,639	$ 748,705	$ 760,698
Replace wooden poles	420,988	422,997	700,929
Convert to 12 kV south of Wellington St. E	288,145	581,621	787,866
Construct miscellaneous lines and switches	222,196	317,248	163,007
Install underground service in new subdivisons	163,240	277,063	260,811
Distribution and transmission station equipment	-	583,194	1,065,599
Extend 35 kV along Third Line East	-	-	489,020
All other capital projects	1,484,836	900,409	1,194,841
Capital expenditiures, excluding smart meters	3,356,044	3,831,237	5,422,771
Reallocation of overhead from smart meter project	-	-	537,612
Total capital expenditures, excluding smart meters	**$ 3,356,044**	**$ 3,831,237**	**$ 5,960,383**
Overhead included in capital expenditure totals	$ 125,369	$ 207,750	$ 960,431

As noted in the preceding section of this Decision, the Board has not authorized PUC to include the estimated cost of installing smart meters in its 2008 rate base. The Company noted that its smart meter budget included $537,612 of capitalized overhead, which the Company said would have to be absorbed by other capital projects if the smart meter program is not carried out in 2008.

In support of its proposed capital program, PUC filed two reports – an internal report on long-term capital and O&M needs, and a review of PUC's capital expenditure and O&M plans prepared by BDR North America Inc. and Metsco Inc. Those reports documented the condition of PUC's system and the need to renew the system.

The Company noted that it had budgeted $875,000 for capital expenditures in 2007 that did not occur. These carry-over expenditures for 2008 include: $400,000 for pole replacements; $220,000 for 35 kV cables at substations; and $255,000 for TS equipment.

As indicated in the last row in Table 1, the amount of overhead capitalized in 2008 is expected to be significantly higher than in previous years due to a change in policy as recommended in the Full Absorption Cost Allocation Report prepared for by the Company by RDI Consulting Inc.

VECC made no specific submissions regarding PUC's proposed capital program. However, VECC questioned the Company's ability to complete the proposed 2008 system renewal and voltage conversion projects, in light of PUC's inability to meet its budgeted 2007 capital spending due to internal staffing issues and lack of external contractor resources.

In its reply submission, the Company concurred that the availability of qualified labour is severely limited across northern Ontario. However, the Company noted that it will use an apprenticeship approach to acquire the necessary human resources.

Section 2.3 of the Board's Filing Requirements for Transmission and Distribution Applications states that an applicant should file profitability indices ("PI") related to customer additions and system expansions, where applicable, as part of its rate application and in support of the proposed rate base and capital expenditures. Board staff noted that PUC did not provide such information in its application.

In response to a Board staff interrogatory, PUC stated that the economic analyses that would largely form the necessary basis for PI values for customer demand projects was not completed for projects proposed in this application. However, it intends to review and improve the method used to calculate and handle contributed capital in the future.

VECC commented that, as the Company did not carry out the required economic evaluations for its Customer Demand projects to determine capital contribution requirements and as there is no allowance for such contributions in the rate base, 2008 rates would be overstated if any contributions are subsequently established during this year. To mitigate against any such overstatement, VECC suggested that the Board should approve less than the requested spending levels for Customer Demand projects, suggesting a "nominal" 10% reduction, as an example.

In its reply submission, the Company stated that the Board's Distribution System Code (the "DSC") does not outline the method for calculating a Profitability Index , and that, in Ontario, the Profitability Index is applicable to natural gas distributors but not to electricity distributors. PUC also stated that Appendix B of the DSC outlines the method for conducting an economic evaluation to determine what, if any, capital contribution is required for "expansion facilities" projects.

PUC submitted that customer demand capital expenditures in 2006 and 2007 were for upgrades to existing services and to connect new services along PUC's existing distribution network, and that these should not be considered as system expansions for purposes of the analysis required by Appendix B of the DSC. PUC also noted that the 2008 amounts shown in Table 1 for "Install services to meet customer demand" and "Install underground services in new subdivisions" are net of budgeted capital contributions of $150,000 and $360,000, respectively. Those amounts exceed the 10% nominal reduction proposed by VECC.

Board Findings

PUC has proposed that the amount of overhead it would have capitalized on its smart meter spending ($537,612) be included in its spending for other capital projects. The Board does not understand the basis for that reallocation. Capitalization of overheads should be driven by the size and nature of capital projects. It is counterintuitive to maintain the same amount of overhead capitalization when the total capital budget is lower by $6.2 million. Accordingly, the $537,612 of overhead that has been reallocated should be included in OM&A expenses.

There is no doubt that the proposed levels of capital expenditure are extraordinary compared to historical norms. Extraordinary spending proposals must be supported by compelling evidentiary support which is commensurate with the extent of the increases sought. The evidence in this case goes some way for the need for increased spending, but not to the level proposed.

The Company maintains that it will be able to staff up to carry out the work in 2008. The Board shares VECC's concerns, however, about the ability of the Company to actually complete its 2008 capital expenditure program given its inability to complete a much smaller program in 2007. The Board approves capital expenditures of $4.9 million or approximately 90% of the proposed 2008 capital expenditure budget after the adjustment for capitalized overhead and exclusive of smart meters for purposes of calculating the 2008 rate base.

Working Capital

VECC submitted that the cost of power component of PUC's working capital determination should reflect the transmission charge reductions approved for 2008. In its reply submission, PUC submitted that the estimated cost of energy used for the working capital allowance calculation is reasonable compared to 2007 actual results.

Board Findings

Later in this Decision, the Board accepts PUC's proposed transmission charges; therefore, the cash working capital does not change on account of transmission charges. However, later in this Decision, the Board finds a lower OM&A expense for 2008 than proposed. In its Draft Rate Order, PUC should therefore re-calculate the cash working capital which will be lower than the amount proposed.

In Chapter 2 of the Board's filing requirements for distributors, the Board suggests that, when filing, the cost of power will be that available from the most recent Board-approved RPP. In the Board's view, there are benefits and no cost for the electricity distribution sector and for the Board to have one common cost of commodity power forecast. As long as the Board is required to produce a cost of power forecast in its responsibility to set RPP prices, and to the extent that the Board's forecast covers a period which can subsume in whole or in large part the test period for setting distribution rates, it makes good sense to utilize that forecast. Applying individual efforts by each distributor can lead to inconsistencies among distributors, can be expensive and is unnecessary. The Navigant forecast used by the Board to set RPP prices for May 1, 2008 onward covers the Company's test year filing. The Board prefers that the use of Navigant's forecast prices should be used in this case and it so finds. The Board directs the Company to reflect in its re-calculation of cash working capital an all-in supply cost of $0.0545/kWh derived from Board's Price Report issued April 11, 2008.

OPERATING COSTS

Operating costs include OM&A expenses, depreciation and amortization expenses, payments in lieu of taxes (PILs taxes), and any transformer allowance payments to customers. PILs taxes are proxies for capital and income taxes that, otherwise, would have to be paid if the distributor was not owned by a municipality or the Ontario government.

The final PILs tax allowance for ratemaking purposes is determined after the Board makes its findings on other relevant parts of the Company's application.

Operating costs also include interest charges on the Company's debt. These are dealt with in the cost of capital section of the Decision.

The Board deals below with the following issues: Controllable OM&A Expenses; and PILs Taxes.

Controllable OM&A Expenses

Table 2 shows the components of the proposed controllable OM&A expenses for 2008 and compares them with previous years.

Table 2: Controllable OM&A Expenses

	2006 Board Approved	2006 Actual	2007 Bridge	2008 Test
Operations	$ 1,496,528	$ 2,051,174	$ 2,156,507	$ 3,018,799
Maintenance	1,793,258	1,430,922	1,448,545	2,277,648
Billing and Collections	959,171	941,104	934,991	1,338,873
Community Relations	375,332	428,632	408,719	473,852
Administrative and General Expenses	2,215,726	1,832,913	2,361,110	1,397,298
Total Controllable OM&A	**$ 6,840,015**	**$ 6,684,745**	**$ 7,309,872**	**$ 8,506,470**

PUC has no employees of its own; it has a services agreement with its affiliate PUC Services Inc. ("PUC Services") to operate its distribution system. PUC noted that $1.5 million of the difference in OM&A costs from 2006 to 2008 is owing to: (i) additional smart meter costs, (ii) the one-time reduction in 2006 costs as a result of an adjustment for prior period pension expense and (iii) increased staff levels as detailed in the Long-

Term Capital and OM&A Needs Report and the Review of Capex and O&M Plan. PUC stated that smaller items such as the PCB removal program and wage rate increases over the two-year period accounted for the remainder of the difference.

In its decision related to PUC's 2006 rate application (RP-2005-0020/EB-2005-0412), the Board expressed concern about the adequacy of the information provided by PUC in support of its application and stated that in its next rate case the Company must provide detailed financial information on its operations, and details of costs incurred by its affiliates in providing services to the Company.

To address the Board's concerns, PUC engaged a third party, RDI Consulting Inc., to undertake a review, which culminated in the Full Absorption Cost Allocation Report. PUC stated that it was implementing the recommendations of this review effective January 1, 2008.

PUC noted that its shared services costs in 2008 totaled $3.2 million, or just under 40% of its total controllable OM&A costs. Board staff noted that the Company has proposed a significant increase in these costs for 2008 of 20%, or $560,390, over 2007 levels.

The Company explained that this increase was due to three factors. The first was a new cost of capital charge, accounting for $381,391 of the increase. This charge applies to all PUC affiliates and is designed to recover the financing costs by PUC Services for assets used to service the affiliates. PUC justified this charge on the basis of the Report which recommended the implementation of such a charge.

The second factor was a "Use of Assets Charge", a depreciation expense related to assets used by PUC and owned by PUC Services. This has an impact of $89,564 and was explained by the Company as being the result of the use of additional vehicles by the utility due to the increased operations staff and the implementation of upgraded software driven by the need to better maintain records. The Company further stated that the asset charge allocation had also been revised to use more appropriate allocators as per the Report.

The third factor was the joint services allocation, which increased by $89,435. The Company explained that this increase was due to a reduction in the percentage of joint services costs allocated as per the Report, offset by wage increases of 3% and the addition of a shared billing supervisor and a shared IT manager.

VECC interrogatory #18a sought to isolate the impacts of implementing the recommendations of the Report from general cost increases in this area. PUC's response indicated that $175,728 of the 2007-2008 increase of $560,390 resulted from the Report's recommendation and the remainder of $384,663 was due to changes in actual costs incurred by PUC Services.

PUC also noted that one other reason for the increase in OM&A costs since 2006 is because of a one-time $350,000 reduction in 2006 costs as a result of an adjustment for prior period pension expense. PUC explained that the adjustment had come about as a result of an external review of its regulatory accounting procedures aimed at ensuring compliance with the Accounting Procedures Handbook. PUC stated that the review revealed that PUC had overstated OMERs costs for the 16-month period ending May 1, 2006. The adjustment, which was processed in 2006, resulted in 2006 expenses appearing to be lower than normal. PUC reiterated that the adjustment resulted in a one-time reduction in 2006 expenses pertaining to a prior period pension expense and understates the true costs in 2006. PUC submitted that the 2006 expense level used to compare to the 2008 test year should exclude the credit that reduces 2006 costs.

PUC stated that PUC Services expects to increase staff complement from 45 employees in 2006 to 54 employees in 2008, an increase of 20%. In response to a Board staff interrogatory, PUC identified anticipated wage increases of 3% in 2007 and 2008. In its reply argument, PUC clarified that one additional employee was hired in 2007 and nine additional employees are proposed for 2008, but of the nine additional employees, only one employee, a billing supervisor, is a shared employee.

PUC stated that the additional employees will not be hired until the final outcome of this proceeding is known; if the proposed rates are not approved, not all proposed employees will be hired and not all proposed programs will be implemented.

PUC justified the proposed increases on the basis that the current level of OM&A and capital programs are inadequate to maintain and upgrade its distribution infrastructure. As part of its application, PUC filed an independent report conducted by METSCO on the Company's OM&A and capital needs, confirming these concerns, which had originally arisen based on an internal report prepared by PUC staff.

VECC, in its submission, stated that the implicit wage increases of 3% appeared reasonable and that the forecast staff increases were generally supported by PUC's long term capital needs and OM&A report.

Board Findings

As noted earlier in this decision under "Rate Base – Capital Expenditures", the Board has found that $537,612 of overhead that PUC proposed to include in capital expenditures should be included in OM&A expenses for the test year.

The Board accepts PUC's explanation that a comparison in controllable OM&A from 2006 should reflect the $350,000 credit applied in 2006. The Board also notes that the 2008 controllable OM&A proposed expenses will be reduced by $365,000, to $8,141,470, to eliminate 2008 smart meter OM&A. After those adjustments, the proposed 2008 controllable OM&A expenses are $8,679,082 (that is, $8,506,470 per Table 2, plus the $537,612 of reallocated overhead, less $365,000 of smart meter OM&A). That amount is higher than actual 2006 expenses (adjusted for the $350,000 pension credit) and projected 2007 expenses by approximately 23% and 19%, respectively.

In determining an appropriate amount for controllable OM&A expenses, the Board has considered that a 20% increase in shared services expenses over 2007 is excessive. The Board will allow an increase of $0.5 million in overall controllable OM&A expenses for 2008 over 2007. This represents an increase from the 2007 level of just under 7%, which the Board considers reasonable in the circumstances facing the Company. The Board therefore approves a total amount of controllable OM&A expenses of $7,810,000 for ratemaking purposes in the 2008 test year.

PILs Taxes

In response to Board staff interrogatory #2 (d), PUC submitted a PILs calculation that excluded the interest addition and deduction, and used the combined effective tax rate of 33.5%.

VECC submitted that the Board has already addressed the treatment of interest in PILs calculations in its EB-2007-0723 Decision regarding PUC's 2007 rates. VECC noted that in response to VECC interrogatory #21, PUC updated its CCA schedule calculations for 2008 to reflect the impact of the March 2007 Federal budget. VECC submitted that these revised values should be used in PUC's 2008 PILs calculations.

Board Findings

In calculating the PILs provision, the Board directs PUC to reflect in its Draft Rate Order the new combined income tax rate for 2008 of 33.5%, the Ontario capital tax exemption amount of $15 million, and the new applicable CCA class rates. The final PILs amount that PUC will use in its Draft Rate Order will reflect changes resulting from other Board findings in this decision, as appropriate.

OPERATING REVENUES

For the purposes of setting base distribution rates for the electricity sector, the Board determines the operating revenues from sales and subtracts revenues associated with certain other charges levied by the distributor other than base rates. The Board deals below with the issue of load forecast.

Load Forecast

The Company's load forecast was developed using a normalized average consumption ("NAC") estimate for a given rate class multiplied by a customer count forecast for that rate class. The NAC value is based on 2004 consumption data that was developed with the assistance of Hydro One. PUC's load forecast is based on a forecast customer count of 41,610 for 2008, an increase of 0.1% annual average growth during the 2006 to 2008 period; the historical growth rate was 0.2% per annum. The resulting load forecast is a negative 0.3% annual average kWh change from 2006 to 2008 which compares with a historical negative 0.6% per annum change.

Board staff observed that the Company's methodology utilized only a single year of weather-normalized historical load to determine the future load. Board staff noted that this assumed that no CDM improvements had occurred over the past few years and that none were expected in the immediate future, and might therefore result in a filed load forecast that is about 1%-2% higher than the data would suggest. VECC indicated that while it had similar concerns about this approach, it was not clear that, in the short term, a better alternative existed. VECC stated that the Company's approach is preferable to the one suggested by Board staff.

In its reply argument, PUC stated that it was also concerned that the weather-normalized kWh forecast used to design the proposed rates is too high based on recent historical usage. PUC stated that the Hydro One weather-normalization data was based on 31 years of average weather which is reflective of times when Sault Ste Marie had much colder winters than it does now. PUC also submitted that it may be more appropriate to use the average usage per customer from the past 5 years as the NAC values for 2008.

Board Findings

The Board will accept PUC's load forecast for setting PUC's 2008 rates as originally filed. Notwithstanding PUC's contention regarding weather normalization and average use, there is no other specific quantitative proposal by the Company for the Board to consider for purposes of setting rates in this proceeding.

CAPITALIZATION / COST OF CAPITAL

Capitalization refers to the financing of total rate base through common equity, preference share capital (if applicable), long term debt and short term debt. Cost of capital refers to the cost rates for debt and preference share capital and the Board-authorized rate of return on common equity.

PUC's actual capital structure is 90% debt and 10% equity. However, the Company stated that it intends to restructure its capital structure to conform to the Board's final deemed capital structure, comprising of 60% debt and 40% equity.

Table 3 summarizes PUC's proposed capitalization and cost of capital.

Table 3: Proposed Capital Structure/Cost of Capital

Parameter	PUC Proposal
Capital Structure	53.3% debt (composed of 49.3% long-term debt and 4.0% short-term debt) and 46.7% common equity
Short-Term Debt Rate	4.77%, but to be updated
Long-Term Debt Rate	6.35% for a long-term debt with its parent company (affiliated debt) and for forecasted new third-party debt. PUC used a forecast rate of 5.82% in its Application originally.
Return on Common Equity	8.69%, but to be updated.

In its application, PUC stated that it intends to incur new third-party debt in 2008. PUC provided a calculated cost rate of 5.82% for the affiliated debt in 2007 and 2008, and also used the 5.82% rate as the forecasted rate for the new third-party debt. PUC noted that the municipal debt instruments are being renegotiated.

Board staff submitted that, as per the Board's guidelines for the cost of capital set out in its *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* ("Board Report"), the updated deemed debt rate should be used for the new debt which was forecasted for 2008, but had not been set. VECC noted that PUC's proposed cost of capital was consistent with the policies documented in the Board Report.

PUC clarified its cost of capital proposal further in its reply submission, stating that its intent in its application was to use the deemed equity rate at the updated equity rate of return level, the lower of its actual long term debt rate with the shareholder and the Board's updated long term debt rate, and the Board's updated short term debt rate.

Board Findings

The Board finds PUC's proposals regarding capitalization and cost of capital reasonable. The Board notes that renegotiation of the affiliated debt has not been completed and the forecasted rate for the new third-party debt is unchanged from the Company's original application. It is the Board's view that both forms of debt should be considered new debt and attract the updated cost of long term debt pursuant to section 2.2.1 of the Board Report. The Board deals with the updates of the components of the cost of capital under the "Implementation Matters" section at the end of this Decision.

COST ALLOCATION AND RATE DESIGN

Revenue to Costs Ratios

PUC filed results of a cost allocation study in the Informational Filing EB-2007-0001, based on its 2006 approved revenue requirement and rates. In its current application, PUC proposed to increase its distribution rates proportionately more to those rate classes with revenue to cost ratios below 100% and proportionately less to those with ratios above 100%. The result of this re-balancing can be seen in the following table, by comparing columns 1 and 2. For ease of comparison, the Board's target range is shown in column 3.

Table 4: Revenue to Cost Ratios (%)

Customer Class	Informational Filing Col 1	Current Application Col 2	Board Target Range Col 3
Residential	90	93	85 – 115
GS < 50 kW	137	120	80 – 120
GS > 50 kW	132	128	80 – 180
Street Lights	17	40	70 – 120
Sentinel Lights	38	40	70 – 120
USL	82	82	80 -- 120

PUC noted that a move to the lower boundary of the Board's target range for the Street Lights and Sentinel Lights rate classes would increase total customer bills by 66% and 71%, respectively. VECC argued that rates for the Street Lights class should be increased to yield a ratio of 44% and rates for the Sentinel Rates class should be increased to yield a ratio of at least 54%, to bring both ratios halfway to the lower boundaries stipulated in the Board's policy. VECC also submitted that the Board should direct PUC to implement increases in 2009 and beyond, to reach a revenue to cost ratio in the acceptable range.

Board staff and VECC noted that the general service classes would have ratios above 100% if PUC's proposed rates were implemented, and submitted that the rates could be decreased if more revenue were generated from the Street Lights and Sentinel Lights rate classes.

Board Findings

As the Board has noted in its Cost Allocation Report regarding revenue to cost ratios, cost causality is a fundamental principle in setting rates. However, observed limitations in data affect the ability or desirability of moving immediately to a revenue to cost framework around 100%. The Board's target ranges are a compromise until such time as data is refined and experience is gained.

The Board is prepared to adopt the general principle that, where the proposed ratio for a given class (Column 2) is above the Board's target range (Column 3), there should be a move of 50% toward the top of the range from what was reported in its Informational Filing (Column 1). None of PUC's classes are in this situation. Where the revenue to cost ratios in the Informational Filing (Column 1) are below the Board's ranges (Column 3), the rates for 2008 shall be set so that the ratios for these classes shall move by 50% toward the bottom of the Board's target ranges.

Under this approach, rates for two classes would be adjusted to achieve the following revenue to cost ratios:

Streetlights	44%
Sentinel Lights	54%

The Board expects the Company to achieve the remaining 50% move by equal increments in years 2009 and 2010.

As a result of these findings, there will be a lower net revenue requirement that needs to be recovered from the other classes. Of these classes, the two General Service rate classes will be over-contributing based on the Company's proposal. The Board finds that the additional revenue from the Street Lights and Sentinel Lights rate classes shall be allocated to the General Service classes so that the over-contribution will be reduced. The allocation shall be prorated on the basis of forecast revenue for the two classes. The Board expects the Company to apply this allocation method when it applies for rate adjustments in 2009 and 2010.

In filing its Draft Rate Order, the Company shall provide the information necessary to establish its compliance with the above directions for 2008 rates.

Fixed Charges

With one exception, no changes to the monthly service charges were proposed. The exception is a proposal to increase the monthly service charge of the GS < 50 kW class from \$11.20 to \$15.40. PUC's rationale for the proposed change is to reduce revenue volatility from that rate class. Board staff and VECC noted that the monthly service charge would be below the 2006 ceiling amount calculated by the cost allocation model in the PUC's Informational Filing.

Board Staff noted that the monthly service charge to customers in the GS > 50 – 4,999 kW rate class is above the ceiling calculated in the Informational Filing. However, Board staff noted that PUC's proposal not to change the service rate is consistent with the Board report, *Cost Allocation for Electricity Distributors*, dated November 28, 2007.

Board Findings

The Board finds PUC's monthly service charge proposals to be reasonable and approves them.

Retail Transmission Service (RTS) Rates

On October 17, 2007, the Board issued its EB-2007-0759 Rate Order, setting new Uniform Transmission Rates for Ontario transmitters, effective November 1, 2007. The Board approved a decrease of 18% to the wholesale transmission network rate, a decrease of 28% to the wholesale transmission line connection rate, and an increase of 7% to the wholesale transformation connection rate. PUC receives only network service from the transmitter. It does not incur costs for line connection or transformation connection services.

On October 29, 2007, the Board issued a letter to all electricity distributors directing them to propose an adjustment to their retail transmission service (RTS) rates to reflect the new Uniform Transmission Rates for Ontario transmitters effective November 1, 2007. The objective of resetting the rates was to minimize the prospective balance in variance accounts 1584 and 1586 and also to mitigate intergenerational inequities. PUC proposed to decrease its rates Retail Transmission Service Rate – Network by approximately 11%. VECC submitted that these rates should be reduced by at least 18%, which is the reduction in the wholesale charge.

PUC submitted that it had considered its wholesale cost from May 2006 to September 2007, and projected that the cost at the new wholesale rate would have been $4.096 million. PUC's revenue during the same period based on its currently approved retail transmission rates was $4.577 million. PUC submitted, therefore, that only an 11% reduction in its retail transmission rates is required.

Board Findings

The Board notes that there is a variance account mechanism for all distributors to capture differences between their transmission costs and the charges to their customers. The issue is not whether the distributors or the customers would be financially harmed. Good ratemaking suggests that, to the extent possible and practical, rates and charges at a point in time should reflect the most current information so that any differences captured in variance accounts would be minimized. This would lead to smoother rate making and reduced concerns about inter-generational inequities.

The Board notes that PUC had reduced its Retail Transmission Service Rates- Network in 2006, adapting to the amount in its variance account at that time. In light of PUC's review of its revenues and costs in the interim, the Board finds that PUC's proposed reduction of its Retail Transmission Service Rates- Network by 11% is acceptable.

DEFERRAL AND VARIANCE ACCOUNTS

The table below shows the deferral and variance account balances that PUC is seeking to recover. All amounts, except for the balance in Account 1590, are as at December 31, 2006 plus forecast interest to April 30, 2008. The balance in Account 1590 reflects both forecast interest and the expected recoveries through the existing rate rider over the period January 1, 2007 to April 30, 2008.

Table 5: Deferral and Variance Accounts Proposed for Disposition

ACCOUNT	ACCOUNT NAME	BALANCE
1508	Other Regulatory Assets	$ 509,595
1518	RCVA – Retail	(152,514)
1548	RCVA – STR	56,068
1580	RSVA – Wholesale Market Service Charge	(510,825)
1584	RSVA – Retail Transmission Network Charges	(468,200)
1588	RSVA – Power	(592,397)
1590	Recovery of Regulatory Asset Balances	540,928
Total		**$ (617, 345)**

PUC's proposal is to refund these balances to customers over two years beginning May 1, 2008.

Account 1508 – Other Regulatory Assets

PUC is requesting the disposition of the balances of 1508 sub-account OEB cost assessments and 1508 sub-account OMERS costs that were generated up to April 30, 2006. No party noted concerns with these balances.

The Board approves disposition of these balances over two years.

Accounts 1580, 1584, 1588 – Retail Settlement Variance Accounts

Under section 78 (6.1) of the *Ontario Energy Board Act 1998*, the Board is obligated to review each quarter the balance in Account 1588, RSVA – Power. The Board recently announced that it intends to launch an initiative on a review and disposition process. The Board also indicated that it is considering extending this initiative to include all the RSVA accounts, including Accounts 1580, RSVA – Wholesale Market Service Charge, and 1584, RSVA – Retail Transmission Network Charge. The Board, therefore, does not approve clearance of these accounts at this time.

Accounts 1518, 1548 – Retail Cost Variance Accounts

The Board's announced review noted above may include also RCVA accounts. For that reason, the Board finds that it would be appropriate to await the outcome of this initiative and therefore will not order disposition of the Company's RCVA accounts in this proceeding.

Account 1590

PUC is proposing to dispose of the April 30, 2008 forecasted balance in this account. Board staff noted that the Board, in its Phase 2 decision for the Review and Recovery of Regulatory Assets, determined that the balance in this account should be recovered over three years (ending April 30, 2008) and that any residual balance should be disposed of at the end of the period. Board staff pointed out that the final balance cannot be determined in advance of April 30, 2008, when the rate rider ends. VECC submitted that the approach by PUC was inconsistent with the Board's Phase 2 decision.

In its submission, Board staff sought clarification of the quantum of the balance of this account. VECC submitted that any questions regarding the appropriateness of the balances (including interest calculations) in this account and related regulatory asset accounts needed to be resolved before they are disposed of. In its reply submission, the Company implied that the interrogatory responses had already addressed the issues regarding the calculation of the balance in 1590.

Board Findings

The Board finds that it is not appropriate to forecast the principal balance in this account or to dispose of this account at this time. The current rate riders for regulatory assets were designed to recover the approved amounts over two years. Those rate riders expire on April 30, 2008, after which PUC will be able to accurately determine the residual balance.

Request for New Deferral Accounts

In its application, PUC proposed to establish three new accounts:

1. Full year return and depreciation on smart meter assets for 2009 and 2010
2. Meter Data Management Repository Account
3. Capital works during the non-rebasing years

PUC withdrew its request for the first two accounts in its reply argument.

PUC's request for account "Capital works during the non-rebasing years" is to record the revenue requirement associated with the cost of construction during the non-rebasing years. Board staff stated that this account is analogous to including a capital investment factor in a year where an electricity distributor's application for distribution rates is subject to an Incentive Rate Mechanism ("IRM") process.

Board staff noted that PUC's request may be premature as the mechanism for the 3rd Generation IRM has not yet been finalized and may include a capital component.

VECC noted that the Company's response to interrogatories indicated that this account would address the revenue requirement impact of variances in the forecasted capital spending for the test year. VECC submitted that capital spending for the test year should be dealt with in the application, and not through a deferral account. VECC concluded that it is premature to approve new accounts at this time, and that the use of such accounts should be established on an industry wide basis and be based on a common set of rules established at that time.

PUC, in its reply submission, stated that it understands that the proposed account is analogous with a capital investment factor in an IRM year. However, PUC further stated that, as of the date of its reply submission, the Board had not approved the capital component in the 3rd Generation IRM, and that it is only prudent for PUC to request the establishment of a new deferral account for capital works during the non-rebasing years.

<u>Board Findings</u>

The Board does not approve a deferral account for capital expenditures in non-rebasing years. The Board is currently considering the structure of its 3rd Generation IRM framework, including whether capital expenditures should be incorporated in some fashion in rates during the incentive period. PUC has not made a case that its needs may not be met by that process. For PUC, the issue is best dealt with in that process.

SERVICE RELIABILITY INDICES

Board staff submitted that, despite the apparent degradation in system reliability, there is no information on whether or how PUC has addressed service reliability improvement in conjunction with developing and implementing its asset management plan.

In its reply submission, PUC explained that the tables provided in its application had errors in the underlying data, and provided revised figures, with explanations.

<u>Board Findings</u>

The Board is undertaking a separate consultation on Electricity Service Quality Regulation and will look at these issues more closely on an industry-wide basis.

IMPLEMENTATION MATTERS

Cost of Capital Update

In mid-2006, the Board initiated a consultative process to examine the cost of capital applicable to the Ontario electricity distribution sector. This process was conducted in conjunction with the development of the 2nd Generation Incentive Regulation plan. The product of these consultations was the Board Report, issued December 20, 2006 noted earlier in this decision under "Capitalization/Cost of Capital". The Board Report considered the extensive consultation record and established, in part, guidelines for setting and updating the cost of capital parameters for distribution rate-setting from 2007 onwards, including the return on common equity ("ROE"), the deemed short-term debt rate, and, as appropriate, the deemed long-term debt rate.

The Board Report established that the approved ROE to be used for rate-setting purposes should be calculated by application of the formula in Appendix B of the Board Report. In setting the ROE for the establishment of 2008 rates, the Board has used the *Consensus Forecasts* and published Bank of Canada data for January 2008, in accordance with the Board's guidelines. In fixing new rates and charges for PUC, the Board has applied the policies described in the Board Report. Based on the final 2007 data published by *Consensus Forecasts* and the Bank of Canada, the Board has established the ROE to be 8.57%.

The Board Report also established that the short-term debt rate should be updated using the methodology in section 2.2.2 of the Board Report. The Board has set the short-term debt rate at 4.47% using data from *Consensus Forecasts* and the Bank of Canada for January 2008.

The Board Report also established that the deemed long-term debt rate should be updated using the methodology in Appendix A of the Board Report. The deemed long-term debt rate acts as a proxy for or ceiling on the allowed debt rate for new, affiliated or variable rate debt, and may be applicable for establishing the embedded cost of debt in the test year period depending on the nature of the distributor's debt financing. The Board has set the deemed long-term debt rate at 6.10% based on data from Consensus Forecasts and TSX Inc. for January 2008.

Draft Rate Order

The Board has made numerous findings throughout this Decision. These are to be appropriately reflected in a Draft Rate Order prepared by the Company.

The Board issued an Interim Rates Order on April 17, 2008 declaring rates interim as of May 1, 2008. However, as the Company was three and one half months late in filing its application, and given the time that is typically required to settle matters before the Rate Order can be issued, the Board has determined that the effective date of the new rates shall be July 1, 2008, the date of implementation. The current rates therefore shall continue until July 1, 2008. For additional clarity, the new rates to be filed by the Company shall be calculated on the basis that the revenue requirement arising from this Decision is recoverable over a twelve month period, but the new rates will not be effective and implemented until July 1, 2008.

The July 1, 2008 effective date is predicated on the Company complying with the timelines set out at the end of the Decision and its Draft Rate Order properly reflects the Board's findings. Should these not be reasonably adhered to, the effective date may be further delayed.

In filing its Draft Rate Order, it is the Board's expectation that the Company will not use a calculation of a revised revenue deficiency to reconcile the new distribution rates with the Board's findings in this Decision. Rather, the Board expects the Company to file detailed supporting material, including all relevant calculations showing the impact of this Decision on the Company's proposed revenue requirement, the allocation of the approved revenue requirement to the classes and the determination of the final rates. The Draft Rate Order shall also include customer rate impacts and detailed calculations of the revised variance account rate riders.

A Rate Order will be issued after the processes set out below are completed.

1. The Company shall file with the Board, and shall also forward to VECC, a Draft Rate Order attaching a proposed Tariff of Rates and Charges reflecting the Board's findings in this Decision, within 14 days of the date of this Decision.

2. VECC may file with the Board and forward to the Company any responses to the Company's Draft Rate Order within 20 days of the date of this Decision.

3. The Company shall file with the Board and forward to VECC responses to any comments on its Draft Rate Order within 26 days of the date of this Decision.

A cost awards decision will be issued after the steps set out below are completed.

4. VECC shall file with the Board and forward to the Company their respective cost claims within 26 days from the date of this Decision.

5. The Company may file with the Board and forward VECC any objections to the claimed costs within 40 days from the date of this Decision.

6. VECC may file with the Board and forward to the Company any responses to any objections for cost claims within 47 days of the date of this Decision.

The Company shall pay the Board's costs of, and incidental to, this proceeding upon receipt of the Board's invoice.

DATED at Toronto, May 22, 2008
ONTARIO ENERGY BOARD

Original Signed By

Paul Vlahos
Presiding Member

Original Signed By

Bill Rupert
Member