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

Cambridge & North Dumfries

2014 COS Rates Application

EB-2013-0116

Board Staff Submission

May 8, 2014

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Cambridge and North Dumfries Hydro Inc.

EB-2013-0116

Introduction

Cambridge and North Dumfries Hydro Inc. ("CND") filed a Cost of Service ("CoS") application EB-2013-0116 ("Application") with the Board on October 1 , 2013 for the 2014 rate year under Canadian Generally Accepted Accounting Principles ("CGAAP"). A Settlement Conference was convened on March 6 and March 7, 2014, and a partial settlement was reached. A Settlement Proposal based on the partial settlement was filed on April 2, 2014.

The Settlement Proposal listed 5 areas of disagreement:

- OM&A ((Issues 1.1, 1.2, 2.1, 3.1, 4.1, 4.2, 4.3, 5.1, 6.1, 6.2, 7.1, 7.4, 7.7 and 8.6);
- Long Term Debt (Issue 7.5);
- Interest Income (Issue 7.6);
- Design of the GS 50 – 999 kW Rate (Issue 8.3); and
- Removal Costs (Issues 7.1, 7.2, 9.1 and 9.2).

On April 29 and 30 the Board held a hearing on these matters. At the outset of the hearing, after hearing submissions on the Settlement Proposal, the Board accepted the partial settlement.

Board staff has reviewed the Application based on the four outcomes that underpin the Board's Renewed Regulatory Framework for Electricity ("RRFE") as stated in the Board's report.[1]

Board staff has detailed submissions relating to OM&A, the proposed rate for GS 50 – 999 kW, and Removal Costs. As to Long Term Debt and Interest Income, Board staff has no concerns with the Applicant's proposals as they are consistent with Board policy in these areas.

In preparing this submission, Board staff recognizes that CND's Application is one of the first under the RRFE, and as such, has reflected in its submission that this is a transition year.

[1] *Report of the Board Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach* October 18, 2012

OM&A

Customer Focus

In response to a Board staff interrogatory, CND stated that customer focus is part of its Mission Statement and that CND is delivering customer focus through programmes such as; holding a pre-application meeting with customers, participation and feed-back in an industrial survey, using social media such as twitter, e-Service forms on its web-site, “Home Connect” for customers to view their usage hourly as well as providing access to a library of energy savings tips, and using Google Analytics on its web site to track important metrics to assess customer preferences.[2]

CND also stated that it has developed a Scorecard which incorporates service quality and customer satisfaction and shows historical performance and trends.[3] Board staff notes that CND has identified 4 measures in the Scorecard that need development.

CND has pointed out that there are costs to customer focus in the areas of responding to customer feedback and preferences, Issue 3.1.[4] Board staff has itemized the significant costs in the following tables where the capital costs for customer focused applications and increased staffing costs are shown:

Capital Addition	
Bill Connect	$40,000
Outage Maangement System	$465,000
Interactive Voice Response	$150,000
Distribution Management System	$225,000
	$880,000

Cost of Staff Additions	
Communications Manager	$100,000
System Control Operators	$180,000
	$280,000

Board staff submits that CND has shown it is focussing on engaging its customers and improving service to them. However, as noted below in Operational Effectiveness, Board staff questions the pacing of expenses.

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[2] 1.2-Staff-3
[3] 2.1-Staff-5
[4] 3.1-Staff-6

Operational Effectiveness

CND has undertaken many initiatives to improve its operational effectiveness including e-Service solutions for its customers, various projects flowing from its Distribution System Plan, improved use of Information System Technology, enhancing the use of smart meter technology, outsourcing billing and mailing, cooperating with other utilities to lower purchasing costs, as well as other miscellaneous initiatives.[5] However, as confirmed through cross examination, many of these projects do not provide immediate benefits.

Board staff notes that there are currently few identified benefits resulting from these programs. By way of example, Home Connect is a program which allows customers to watch their usage and respond by reducing peak use. It also allows customers to pay their bills on line. When asked about the peak savings CND responded:

> *"MR. MILES: I will let Ron comment on that. I think if we're talking primarily here about residential customers, I am not sure that they would have a big enough impact on our system. On generators and on the transmission network, maybe. But I don't think the impact on our system is -- I don't know if you have anything to add, Ron?*
>
> *MR. SINCLAIR: Yes. I wouldn't describe it as a large impact. There is an impact for every customer who shifts their use out of our peak periods, but in terms of our total system peak, we would have to see a lot of residential load shifted outside the peak times, particularly in the summer with air conditioning."*[6]

When asked about paying on line, CND responded:

> *"MR. SHEPHERD: All right. The other thing you have done here is Bill Connect, which you've just implemented now, right, just last month.*
>
> *MR. MILES: That's correct.*
>
> *MR. SHEPHERD: And this basically allows people to pay their bill online, right?*
>
> *MR. MILES: That's right.*
>
> *MR. SHEPHERD: They get a bill by e-mail?*
>
> *MR. MILES: Electronically, yes.*
>
> *MR. SHEPHERD: And they go to their bank and they pay it and, bam, it's done.*
>
> *MR. MILES: Or they can pay it online directly through their bank.*
>
> *MR. SHEPHERD: Okay. And so you are expecting to get some pretty substantial savings out of this in the long-term, aren't you?*
>
> *MR. MILES: In the long-term, yes.*
>
> *MR. SHEPHERD: But you are not expecting to get any savings this year.*

[5] 6.2-Energy Probe-18
[6] Tr. Vol. 1 p. 148

> *MR. MILES: No. The numbers are too small. I believe we had something like about 300 customers sort of pre-signed up to -- that's 300 out of 52,000 customers. It will take time for us to promote it and get the penetration up."*[7]

In addition, CND has increased its work force compliment to meet demands due to IT and customer focus strategies, government policy, and succession planning. Since 2010, year-end positions for FTE's have grown from 59 in 2010 to 109 in 2013 and CND is planning to have 117 by year-end 2014.[8, 9] Board staff also notes that all new positions are not filled at the beginning of the year.[10] In fact CND was not able to hire all that they had planned in 2013.

> *"MS. HUGHES: So of the three vacancies that we had at the end of 2013, there were two control-room operators and one design engineer. One control-room operator has now been hired -- I believe the date is April 21st -- and the design engineer was hired on January 1st, 2014.*
>
> *Then the new hires in 2014, there is -- there are different dates, actually, in 2014 for the new hires for 2014."*[11]

CND points out that it takes 3 – 4 years to train people to be powerline workers and as they are being trained the potential retiree will still be on payroll. Only after the senior employee retires will benefits be seen.[12]

Board staff is concerned that CND is increasing its FTE's and other OM&A test year costs at a rapid pace with few current benefits flowing to the rate payer. It is not clear if many of the expected outcomes will materialize. Energy Probe developed a table that normalizes OM&A costs based on 4.2-Energy Probe-14 in an attempt to compare year over year change on a comparable basis.[13] The table also excludes property taxes. By way of undertaking, CND updated this table.[14] Based on the updated table, Board staff has estimated the compound annual increase in cost per customer from 2010 Board Approved to the 2014 Test Year to be 6.4%. Comparing the increase from 2010 Actuals to the 2014 Test Year Board staff estimate the increase is 7.4% annually. While there are many exogenous cost drivers such as the loss of water billing and smart meters, Board staff submit that the increases are too high.

The total OM&A cost envelope revealed similar increases as gleaned from the normalized information from Undertaking J1.5. CND's 2014 Test Year OM&A is a $4,229,743 increase from the $10,105,460 actual in 2010. This is an annual average increase of 8.4% per year. The Test Year OM&A is also a $1,329,673 or 10% increase from 2013. Issue 4.3 deals with capital and operating expenditure pacing. CND has a succession plan that seems to be rolling-out very quickly, but CDN has only provided

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[7] Tr. Vol. 1 p. 149
[8] 4.2-Energy Probe-16
[9] Tr. Vol. 1 p 66 lines 3 – 7
[10] Tr. Vol. 1 p 66 lines 8 - 11
[11] Tr. Vol. 1 p 67 lines 2 - 9
[12] Tr. Vol. 1 p. 30 Lines 20 - 25
[13] Exhibit K1.3 p. 16
[14] Undertaking J1.5

supporting evidence of employee ages and not their retirement expectations. CND also seems aggressive with other plans such as leveraging existing information through integrations of GPS and smart meter data for operations. Board staff notes that CND has itself admitted that the cost drivers are currently outpacing the benefits seen from these operational effectiveness initiatives, resulting in a net rate increase in the test year.[15] Board staff submits that CND should appropriately pace its programmes keeping OM&A increases in perspective.

Board staff notes that the Distribution System Plan and related costs of its capital plan have been settled, with most of the test year capital accepted as filed, and that CND has been increasing staff to meet its plan. It is staff's view that CND should therefore have an appropriate OM&A envelope to support its capital plan which likely means an increase to its OM&A of more than what the Board has approved in recent decisions such as in Enersource (2.5% increase annually from last historical year).[16] However, in consideration of staff's concerns over pacing due to the delayed impacts of benefits to customers, and that 10% is much greater than what the Board has been allowing, Board staff submits that the increase in OM&A based on the normalized costs in J1.5 should be limited to 5%, over 2013 actuals. This would result in a decrease of $680,000 in CND's OM&A costs or approximately 5% and would be consistent with the Board's decision on Burlington Hydro's 2010 cost of service application.[17]

Overall Comment

Board staff, while recognizing that this is a transition year and that CND is limited in the evidence it can bring forward to assess outcomes, submits that in CND's next cost of service application, further evidence of programmes should be provided and tangible outcomes identified.

GS 50 – 999 kW Class

CND is proposing to keep the fixed/variable relationship the same as the ratio from the current rate which is, 19/81. This results in the fixed charge increasing from the current $109.35 to $126.44 for 2014. The current ceiling found on Tab O2 of the updated cost allocation study is $96.99.[18] Board staff submits that the rate is moving further above the ceiling. It is the Board's policy not to permit movement further away from the ceiling.[19] Board staff submits that the fixed charge for this class be maintained at $109.35. CND should confirm in its reply submission the impact on the fixed variable split.

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[15] Tr. Vol. 2 P. 13 Lines 23 - 26
[16] Enersource Hydro Mississauga Inc. Decision and Order EB-2012-0033, December 13, 2012
[17] Burlington Hydro Inc. Decision and Order EB-2009-0259, March 1, 2010
[18] Exhibit 8 Tab 1 Schedule 2 Table 8-6
[19] *Report of the Board Application of Cost Allocation for Electricity Distributors, EB-2007-0667, Novermber 28, 2007*

Removal Costs

Background

Board staff summarized CND's proposal for the removal costs from 2012 to 2014 in the Table below:

Removal Cost Proposal

	2012 Historical	2013 Bridge Year	2014 Test Year
Removal Costs	$333,253	$639,000	$716,449
CND's Proposal	Included the total amount of $972,253 incurred in 2012 and 2013 in Account 1576		Reclassified as part of depreciation expense

CND stated that effective January 1, 2012, CND revised its capitalization policies under CGAAP to reflect changes that were required in accordance with the Board's regulatory accounting requirements and to align to the capitalization principles if CND were to adopt International Financial Reporting Standards ("IFRS").[20] One significant element of CND's new capitalization policy is that costs incurred to remove an existing asset from service are to be expensed and are no longer eligible to be included in the capital cost of the new asset. CND clarified in its response to a staff interrogatory that the removal costs refer to the costs of disposal with respect to assets that have been fully depreciated.[21] CND stated that there is no specific reference in CGAAP with respect to the treatment of removal costs as part of costs of new assets.[22] Board staff notes that CND is expected to adopt IFRS for the purpose of financial reporting effective January 1, 2015.

In its Argument in Chief, CND summarized its reasons of proposing to expense the removal cost of $716,449 in the test year as follows:

- The expensing of the removal cost in 2014 was due to the change of CND's capitalization policy in 2012. The July 17, 2012 letter issued by the Board ("the July 2012 letter") stated that the Board encourages and will permit distributors that have deferred the changeover to IFRS in 2012 to also implement regulatory accounting changes for depreciation expense and capitalization policies effective on January 1, 2012; and
- To be consistent with its financial accounting treatment in CND's 2013 Audited Financial Statements.

Board staff's submission addresses the following two issues with respect to CND's proposed treatments for the removal costs:

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[20] Exhibit 2, Tab 2, Schedule 2, Page 1
[21] 9.2-staff-40 a)
[22] 9.2-staff-40 b)

- Should the removal costs incurred in 2012 and 2013 be included in Account 1576?
- Should CND include the test year removal costs as depreciation expense instead of including them in rate base?

Removal costs in Account 1576

Should the removal costs incurred in 2012 and 2013 be included in Account 1576?

CND proposed to include and recover the removal costs of $333,253 and $639,000 in Account 1576, as incurred in 2012 and in 2013 respectively, mainly due to the following:

- CND understood that the stated purpose of Account 1576, per the Board July 17 2012 letter, is to record the accounting differences arising from the change of capitalization policy and depreciation expense policy change; and
- CND expensed the removal costs incurred in 2012 and 2013 due to CND's change of capitalization policy in 2012; and CND's recording of the financial differences arising as a result of this change in capitalization policy during the historic period is consistent with the stated purpose of Account 1576.

Board staff notes that the key issue for whether or not the removal costs in 2012 and 2013 should be included in Account 1576 is whether or not the removal costs are within the scope of the change of capitalization policy. Board staff submits that the removal costs incurred by CND in 2012 and 2013 should not be included in Account 1576 because the change in their treatment was not one that is properly characterized as a change in capitalization policy. The impact of excluding the removal costs in 2012 and 2013 for Account 1576 is that the accounts balance would increase from a credit of $3,241,779 per pre-filed evidence to a credit of $4,456,469.[23] Board staff's reasons are set out below.

First, although capitalization and depreciation expense policies are two main considerations with respect to the accounting treatment of Property, Plant and Equipment ("PP&E"), there are additional requirements that must be considered. These requirements include, among others, the treatment of losses or gains from the de-recognition of assets and asset impairment and asset retirement obligations. These considerations were referenced under the Board's report regarding the Transition to IFRS (EB-2008-0408) issued July 28, 2009 ("the 2009 Board Report"). Issue 3.3 regarding capitalization in the 2009 Board Report specifically addressed the fact that IFRS permits less capitalizing of indirect overhead and administration costs than is permitted under CGAAP. Issue 3.4 of the 2009 Board Report listed other PP&E related items that may be affected by the transition to IFRS, including gain and losses on disposition of assets, asset retirement obligations etc.

Second, the Board issued a letter "Accounting for Overhead Costs Associated with Capital Work" dated February 24, 2010 to provide further clarification with respect to Issue 3.3 of the 2009 Board Report. In that letter, the Board stated that the scope of the capitalization was limited to the capitalization of overhead costs.

[23] Undertaking J1.1

Third, Board staff notes that the regulatory accounting treatment of gains or losses from de-recognition of assets is clearly distinguished from the regulatory accounting treatment of capitalization of assets (i.e. the recognition of the assets). In Board staff's view, the removal costs issue in CND's Application are related to the de-recognition of the assets while capitalization policy is a distributor's determination of the threshold and criteria for the recognition of new assets in the distributor's books. CND confirmed at the oral hearing that its revised capitalization policy is intended to align CND with IFRS requirements and it applies prospectively to newly acquired assets.[24] CND also stated that the assets under question were group assets whose depreciation or amortization rates were determined by the Board previously.[25] As a result, Board staff submits that the accounting treatment for removal costs upon the retirement of the retired group assets has no relevancy to the accounting treatment of determining the costs eligible for capitalization of the new assets, which are normally established under a distributor's capitalization policy.

Fourth, in Board staff's view, the key intent of the July 2012 letter was to encourage and permit the distributors who remained under CGAAP for financial reporting to change their capitalization and depreciation expense policies in 2012 or 2013 to align with the IFRS requirements. Board staff submits that the Board did not require the distributors to change the regulatory accounting treatment for de-recognizing of the group assets that was specified under the CGAAP-based Accounting Procedures Handbook ("CGAAP APH"). This was clearly stated in the July 2012 letter where the Board stated that,

> The Board will not require distributors to seek Board approval in order to make these accounting changes that otherwise would have been required as specified in the **"CGAAP-based" APH (dated July 2007), which is applicable and in force for these distributors still under CGAAP.** [Emphasis Added]

Finally, Board staff notes that CND confirmed that the practice of including the removal costs in the cost of new assets prior to 2012 was not in conformity with the CGAAP APH's requirement of charging the costs into Accumulated Amortization.[26]

It appears to Board staff that CND may have linked the removal costs issue to account 1576 because the issue was one of "capitalization" and they were capitalizing these expenses previously, when in fact the proper treatment under the CGAAP APH was to book them to Accumulated Amortization. While Board staff acknowledge that the impact on the net asset values at the time would have been the same under either approach, Board staff submits that the Board should not place any weight on the "capitalization" label when deciding this matter.

[24] Tr. Vol. 1, Page 111
[25] Tr. Vol. 1, Page 105
[26] Tr. Vol. 1 p. 106

Removal Costs in the Test Year

<u>Should CND include the test year removal costs as depreciation expense instead of including them in rate base?</u>

Board staff submits that the key to this issue is whether or not CND should follow CGAAP or IFRS with respect to the regulatory accounting treatment.

Board staff is of the view that CND should maintain the regulatory accounting treatment under CGAAP APH for the amounts that it is forecasting for the 2014 rate year. This requires CND to charge the removal costs to Accumulated Amortization of the relevant assets. Board staff notes that CND filed its Application under CGAAP and not under Modified IFRS. In addition, CND has not yet adopted IFRS for financial reporting purposes. Board staff notes that CND is expected to adopt IFRS for its financial reporting purpose as at January 1, 2015. The impact of including the removal costs in the test year in the Accumulated Amortization of the relevant group assets (i.e. include the removal costs in rate base) is a reduction in CND's depreciation expense by $716,449. There is also an impact from an adjustment in CND's fixed asset continuity schedule for the removal costs of $333,253 in 2012, $639,000 in 2013 and $716,449 in 2014, which was provided by CND in its undertaking J1.9.

Board staff submits that how the removal costs are included in rates in the test year is directly related to how these costs should be treated as per the regulatory accounting treatment prescribed in the APH under CGAAP or IFRS, as applicable. The CGAAP APH requires that the removal costs for retired assets be charged to Accumulated Amortization of the relevant group assets. CND confirmed that this was the appropriate treatment in cross examination.[27] The APH effective January 1, 2012, which aligned distributors' regulatory accounting with the IFRS requirements for most parts ("the MIFRS APH"), requires that where a distributor for general financial reporting purposes under IFRS has accounted for the amount of gain or loss on the retirement of assets in a pool of like assets as a charge or credit to income, the distributor shall reclassify such gains and losses as depreciation expense and disclose the amount separately in its rate filing.

Because CND filed its CoS rate application on a CGAAP basis, Board staff submits that the regulatory accounting treatment for the removal costs for CGAAP, as required under the CGAAP APH, should be followed. As such, the removal costs incurred by CND in 2014 should be charged to Accumulated Amortization of the relevant group assets.

Board staff further submits that CND clarified at the oral hearing that there are other areas that will require changes when CND adopts of IFRS in 2015 but which CND did not address in this Application. These areas include post-retirement benefits and asset retirement obligations with respect to the constructive obligation for CND's distribution system plant. Because the extent and impact of the removal cost changes, and the other changes noted above, are only applicable under a MIFRS rate application, Board staff submits that it would be inappropriate to allow the MIFRS APH treatment for the removal costs, in the context of CND's current CGAAP Application.

[27] Tr. Vol. 1 P. 106 Lines 5 - 13

As a matter of good rate-making practice regulatory accounting principles, Board staff notes the principle that a differences between the audited financial statements and regulatory accounting should not be a reason to allow for a departure from CGAAP. The Board has and does retain the authority to establish regulatory accounting and regulatory reporting requirements. While IFRS accounting requirements are an important consideration in determining regulatory requirements, the objective of just and reasonable rates will continue to be the primary driver of such requirements.

It is up to the distributor to account for its transactions for the purpose of financial reporting. Even when the distributor fully converts to IFRS, the APH requires the distributor, for example, to disclose the amount of gains or losses from retirement separately in its rate filing.

Finally, on the quantum of the appropriate forecast for removal costs, Board staff notes that CND provided the estimated removal costs for 2015 to 2018.[28] The expected removal costs vary from $805,317 in 2015 to a low of $233,660 in 2018. CND's proposal for 2014 is a removal cost of $716.449. Board staff submits that the amount that should be embedded in rates going forward (as an adjustment to Accumulated Depreciation) be the average of the removal costs for the 2014 – 2018 period, which is $472,884. By treating the removal costs as an adjustment to Accumulated Depreciation, the impact on rates will be considerably less than expensing the whole amount.

****All of which is respectfully submitted.

[28] Undertaking J1.3