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BY EMAIL

November 24, 2014

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Festival Hydro Inc.
Application for Rates
Board File Number EB-2014-0073

Please find attached Board Staff's submission in the above-noted proceeding. Festival Hydro Inc. and the intervenors have been copied on this filing.

Festival Hydro Inc.'s reply to the submission is due on December 3, 2014.

Yours truly,

Original Signed By

Birgit Armstrong

Encl.

ONTARIO ENERGY BOARD

STAFF SUBMISSION

2015 Distribution Rate Application
Festival Hydro Inc.

EB-2014-0073

November 24, 2014

Board Staff Submission
Festival Hydro Inc.
2015 Distribution Rate Application
EB-2014-0073

Introduction

Festival Hydro Inc. ("Festival Hydro") filed an application with the Ontario Energy Board on April 23, 2014 seeking approval for changes to its electricity distribution rates, to be effective January 1, 2015.

The Board held a technical conference on September 11, 2014 and a settlement conference on September 29 and 30, 2014.

Festival Hydro and intervenors filed a partial settlement proposal on October 23, 2014. The following issues remained unsettled:

- The value of the rate base, including the treatment of costs related to a new Transformer Station and a related by-pass agreement;
- The request for additional funding through an incremental capital module to recover additional costs related to a new Transformer Station ("TS"), including amounts related to depreciation treatment and the proposed establishment of a new deferral account to record incremental OM&A costs; and
- The proportion of Working Capital to be used to determine the Working Capital Allowance ("WCA") to be factored into the 2015 rate base;
- The level of Festival Hydro's operations, maintenance and administration ("OM&A") expenses for 2015 to be factored into the 2015 revenue requirement and recovered in distribution rates;
- The proposed fixed/variable ratio used to determine the distribution rates for General Service Greater than 50 kW.

On October 30, 2014, Board staff submitted that parties had considered the settled issues within the context of the Renewed Regulatory Framework for Electricity, and that the Board's approval of the proposal as filed would adequately reflect the public interest and would result in just and reasonable rates for customers.

The Board held an oral hearing to hear the unsettled issues on November 13 and 14, 2014. Prior to hearing closing arguments at the oral hearing, the Board accepted the partial settlement as filed.

The following are Board staff's submissions on the unsettled issues.

General Background: Festival Hydro's New Transformer station

Given its relevance to the majority of issues which remain to be decided, Board staff offers the following general background on the new transformer station owned and operated by Festival Hydro.

As part of Festival Hydro's 2013 IRM application (EB-2013-0214) Festival Hydro requested and was granted approval for cost recovery of a new 62 MVA Transformer Station on the south side of the City of Stratford through an incremental capital module ("ICM"). The utility substantiated the need for the station on its expectation that new load in the service territory would soon exceed that which could be reliably served on the existing Hydro One transformer station that supplied its customers[1].
In its Decision and Order, the Board found as follows[2]:

> *The Board accepts the evidence that a new transformer station is needed and is a non-discretionary expense to come into service in 2013. The Board is further persuaded by the evidence that the project evaluation was done thoroughly and the resulting solution is prudent.*

The Board approved an amount to be recovered in the ICM based on an eligible capital cost of $15.7M. Festival Hydro completed the TS project for a cost of $15.3M.

By the time that the TS went into service, in December 2013, load conditions in Festival's service territory had changed significantly relative to the forecast[3]. The new load that had been expected had not materialized. In the absence of new demand to be supplied, Festival Hydro determined that it would transfer 20MW of existing load from the Hydro One TS supplying the area and instead serve that demand from its own new

[1] EB-2012-0124, Reply submission, p7 l. 10-24
[2] EB-2012-0124, Decision and Order, April 4, 2013, p. 12, Exhibit K1.3
[3] EB-2014-0073, Oral Hearing Transcript Vol. 2, pages 46-49

station, thereby avoiding certain transmission costs that Hydro One would otherwise collect. This activity is also known as 'bypassing' an existing facility[4]. The amount of load to be bypassed was based on the configuration of the distributor's system and operational considerations.

In Board staff's view, the reasonableness of Festival Hydro's expectations and the prudence of its decisions, once it became clear that actual demand on its system differed significantly from its forecast, are key to the evaluation of the TS-related requests in this application.

Issue 1.1 Capital
Additions to Rate Base – Treatment of Bypass Agreement

Prior to this application, the Board was not aware of Festival Hydro's decision to bypass Hydro One's transformer station.

Bypass of a transmitter's existing facilities requires compensation under section 6.7.6 of the Transmission System Code, typically via a bypass agreement (BPA). The record of this proceeding shows that Festival Hydro's Board of Directors approved negotiation of a bypass in September 2013. Festival Hydro signed a BPA contract with Hydro One on December 18, 2013. The value of the BPA is an estimated $1.2M. The agreement provided for a final actual bypassed capacity to be measured within 180 days and final payment to be made 180 days after the invoice from Hydro One. As of November 14, 2014 Hydro One had not delivered the final invoice and Festival Hydro had not made the payment.[5]

At issue in this proceeding is how the BPA should be treated from a regulatory accounting perspective. In its 2013 audited financial statements, Festival Hydro recorded the liability to Hydro One for the BPA. Festival Hydro recorded an intangible asset of $1.2M related to the BPA liability. The amount is recorded separately from the ICM cost.

Festival Hydro has stated that it entered into the BPA because its customers benefit from lower retail transmission service rates ("RTSRs"). Festival Hydro concluded that because the bypass payment is directly linked to the TS, it should be treated as an intangible asset and amortized over the same useful life of 45 years.[6]

[4] Per Section 6.7 of the Transmission System Code.
[5] EB-2014-0073, Oral Hearing Transcript Vol. 1, page47.
[6] EB-2014-0073, Oral Hearing Transcript Vol. 1, page 50.

In the discussion that follows, Board staff does not support the recognition of the BPA as an asset for regulatory purposes and submits that it should not be allowed in rate base. Board staff submits that Festival's evidence provided in support of its treatment of the BPA is inadequate. It neither provides the purported support for Festival's decision nor does it clarify the matter for the Board.

Board staff submits that the bypass compensation is an expense to the distributor for bypassing Hydro One's TS. Finally, Board staff submits that, if the Board finds the expenditure to be eligible for recovery, the circumstances that led to the signing of the BPA mean that it would not be reasonable for Festival Hydro's customers to pay for the bypass as an asset which earns a return rather than an expense.

- **Treatment of BPA as an intangible asset for financial accounting purposes**

Festival Hydro has recorded the BPA commitment as an intangible asset. It has provided references to CGAAP, IFRS and the Board's Accounting Procedures Handbook (APH) which it claims demonstrate support for this treatment. Its external auditor, KPMG, provided an unqualified opinion of the 2013 general financial statements.[7]

The following information was taken from UTJ2.3 filed on November 18, 2014. This evidence is a memorandum to Festival Hydro's Board of Directors recommending negotiating a permanent bypass with Hydro One.

> In 2008, KPMG completed a review of the accounting treatment for a permanent bypass for another LDC. In their opinion, under either CGAAP or IFRS rules, this expenditure should qualify to be treated as part of the LDCs property plant and equipment. In addition, KPMG put forward the following arguments in support of inclusion in rate base:
>
> *Under CICA 3061, rate regulated PP&E are items of PP&E held for use in operations meeting all of the following criteria:*
> *(a) The rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.*

[7] EB-2014-0073, Oral Hearing Transcript . Vol. 1, pages 47-55 and Vol. 2, pages 34-39.

> *(b) The regulated rates are designed to recover the cost of providing the services or products.*
> *(c) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for any capitalized costs.*
>
> *Based on our understanding of the use of the transformer station and the rate setting process, it is reasonable to assume that the transformer station is an item of rate regulated PP&E.* [Emphasis added.]

Festival Hydro filed excerpts of minutes of a Board of Directors' held on September 26, 2013 at which the Directors approved negotiating the bypass with Hydro One.

> "The bypass agreement was reviewed. To bypass 20MW - the capital cost is $1.2M. KMPG confirmed it could be included in rate base as a cost of the station.
>
> It was moved by F. Mark that Management enter into negotiations with Hydro One to permanently by-pass approximately 20MW with the estimated cost of $1.2M, and include this amount in the overall TS Capital cost as directed by KPMG and this was seconded by D. Delamere."[8] *[Emphasis added]*

While KPMG may have provided an opinion for another LDC that a compensation payment should be included in rate base and earn a return over the life of the asset, the rationale on the record that supports that opinion is in sufficient in Board staff's view to reach that conclusion.

Festival Hydro also submitted that Hydro One Networks Inc.'s (HONI) treatment of its asset after receiving the BPA is also noteworthy. Festival reported that HONI reduced the value of its TS by the amount of the BPA payment[9] and therefore argued that including the intangible asset in rate base is neutral to Ontario's rate payers. Unfortunately, Festival Hydro did not provide evidence to substantiate this statement and Board staff was unable to find corroboration in HONI's current proceeding EB-2014-0140. Therefore, in Board staff's view, no weight can be given to this testimony.

[8] UTJ2.3 Letter filed on November 19, 2014.
[9] EB-2014-0073, Oral Hearing Transcript, Vol 2, p. 38

Festival entered into the contract with Hydro One. After recording the liability for the contract, Festival had to choose where to record the debit portion of the entry. Festival chose the intangible asset classification. Festival could have chosen to expense the cost or could have recorded the amount in the ICM variance account. Recording the intangible asset for financial accounting is only part of the process. Assessing the full recoverability of the asset value from ratepayers is the principal test for retaining the intangible asset on the balance sheet at year end.

The Board has not issued a decision or order on this issue. Festival did not bring the bypass payment to the Board's attention in the ICM application. There is no regulatory certainty yet regarding the recovery of any amount of the $1.2 million from ratepayers. Board staff submits that, in the absence of regulatory certainty, it is inappropriate for a regulated utility to recognize an intangible asset except as part of a variance account balance which the Board has to review.

- **Opinion of the Auditor**

In a further attempt to demonstrate the reasonableness of its treatment of the BPA, Festival Hydro brought a KPMG audit partner to testify before the Board. However, Board staff submits that the testimony of the auditor did not provide further clarity on the matter, as shown in the following exchanges:

After having established his experience in the electricity sector in Ontario[10] Mr. Stoll posed questions that prompted Mr. Ian Jeffreys to describe his role:

> MR. JEFFREYS: The role of the auditor is to undertake an audit of the financial statements as prepared by management and provide an opinion as to whether the financial statements are materially correct in all matters relative to the accounting standards chosen by management.
>
> MR. JEFFREYS: Those accounting standards that are relevant to an LDC are Canadian GAAP as modified by regulatory accounting direction.
>
> MR. JEFFREYS: The results of the audit are included in the financial statements and referred to in my letter of October 31st, 2014. KPMG has issued an unqualified auditor's report on the financial statements of Festival Hydro for the year ended December 31st, 2013.

[10] JT1.14.

> MR. JEFFREYS: It means that in our opinion the financial statements are presented fairly in all material respects in accordance with the accounting framework chosen by management.[11]

Yet in answer to a question from VECC, the following answer was given.

> MR. JEFFREYS: I'm going to remind you that in my role here as auditor, not financial-statement expert or financial expert, that that's a question I cannot answer.[12]

SEC also received the following reply from Mr. Jeffreys relating to capitalizing the bypass compensation.

> MR. RUBENSTEIN: So would it be -- let me ask you this question. In your opinion, would Festival Hydro's accounting treatment of the bypass compensation that's to be classified as an intangible asset and capitalize it -- is the correct treatment?
>
> MR. JEFFREYS: I can't answer that, because we do not provide opinions on single, standalone transactions.
>
> MR. RUBENSTEIN: Why can't you or why don't you?
>
> MR. JEFFREYS: That is not within the rules of professional conduct or our firm policy to do that. The role of the auditor is to provide an opinion on the financial statements taken as a whole.

In answer to questions from Board Member C. Long, Mr. Jeffreys replied as follows.

> MS. LONG: Mr. Jeffreys, I just want to be clear. Mr. Janigan asked you about the scope of your retainer. And as I understand it, it is, as an auditor, to review the financial statements and to give an opinion.
>
> I understand that it was not part of your mandate to provide a professional opinion on whether or not the bypass agreement should be considered to be an intangible

[11] EB-2014-0074, Oral Hearing Transcript Vol. 2, 34-36
[12] Tr. Vol. 2, page 70.

asset for regulatory purposes; is that correct?

MR. JEFFREYS: That's correct.

Board staff submits that the evidence and testimony provided by KPMG, or on behalf of KPMG, in this proceeding does not assist the Board in determining the nature and treatment of the bypass compensation costs for regulatory purposes.

- **Transmission System Code ("TSC")**

The following sections are taken from the Transmission System Code last revised on August 26, 2013.

> 6.7.6 Subject to sections 6.7.2, 6.7.7 and 6.7.8, for all or a portion of existing load a load customer may bypass a transmitter-owned connection facility with its own connection facility or the connection facility of another person, provided that the load customer compensates the transmitter. *[Emphasis added.]*

> 6.7.7 For the purposes of sections 6.7.6 and 11.2.1, but subject to section 6.7.8, the transmitter shall calculate bypass compensation*… [Emphasis added.]*

The TSC defines a capital contribution as follows.

> 6.3.2 Where a transmitter has to modify a transmitter-owned connection facility to meet a load customer's needs, the transmitter shall require the load customer to make a capital contribution to cover the cost of the modification. A capital contribution may only be required to the extent that the cost of the modification to the connection facility is not recoverable in connection rate revenues. *[Emphasis added.]*

A capital contribution is owing from a distributor when the transmitter incurs costs to modify its connection facilities. With bypass compensation, the transmitter is not incurring costs, it is losing revenue from load transferred to the distributor's facility. While the Accounting Procedures Handbook Article 410 at page 22 covers the treatment of payments from a distributor to another distributor or transmitter in relation to capital projects, these guidelines only apply for capital contributions. Board staff is not aware of accounting guidance or specific Board decisions related to bypass compensation payments. In staff's view, Festival has not made the case that this provision of adding payment amounts to rate base applies to the situation where the payment is for bypass compensation.

To the best of Board staff's knowledge, the Board has not defined what the term "compensation" means in the context of the TSC. The term is generally applied to OM&A expense categories in a rate application.

Submission

In Board staff's view, the BPA amount of $1.2M is an expense for bypassing Hydro One's TS. Festival has not justified the treatment of an intangible asset as an addition to rate base.

Board staff also notes that there is little practical basis for closing this amount to rate base. Board staff notes that the final BPA amount is still not determined and until Festival Hydro pays Hydro One, Board staff submits that there is as yet nothing to add to rate base.

Overall, Board staff recognizes that Festival ratepayers benefit from an annual reduction in RTSRs of about $475,000 as a result of the bypass agreement. But Board staff questions why Festival Hydro's customers have to pay Festival Hydro the return of and return on an addition to rate base of $16.5M including the bypass payment for 45 years – an additional cost with a net present value of $343,017[13].

Board staff submits that based on current evidence in this case, the TS is overbuilt for the load now and it is not clear when the station will provide the relief that was originally envisioned. Board staff submits that the load forecast at the time the TS was committed may have been optimistic but recognize that the decision to invest in expansion may have been preferable to doing nothing in the face of uncertainty.

Board staff recognizes that the bypass arrangement is a next-best alternative for a station that has been built and energized. Board staff supports the principle elucidated by VECC in the oral hearing that "when, in fact, it was discovered that the projections were wrong, the cost of the mitigation efforts should be resolved in a manner which is most fair and equitable to ratepayers."[14]

In the normal course, Board staff is of the opinion that bypass compensation is recoverable from ratepayers because the cost of this would be considered as part of the business case review of all options being considered to meet the capacity and reliability

[13] JT 1.1.5
[14] EB-2014-0073, Oral Hearing Transcript, Vol 2 pages 76

requirements. The challenge in this case is that the bypass compensation was not known at the time that the ICM proposal was approved and therefore not factored into the business case.

If the Board is satisfied that the BPA is a recoverable expenditure, Board staff submits that an alternative, non-rate base, treatment for the BPA would be fairer to ratepayers. Board staff observes that the Board could decide to allow recovery of the BPA payment as an expense. With this approach, the costs related to the BPA could be recovered over a certain period, such as three years, at a cost to ratepayers about $340,000 less than what the applicant has proposed, with no reduction in benefits of avoided RTSRs.

5.1 and 5.2 Incremental Capital Module True-up and additional ICM funding adder

As part of Festival Hydro 2013 IRM application (EB-2013-0214), the Board found as follows[15]:

> *The annual revenue requirement impact arising from the proposed cost of $7,854,730 is therefore approved for recovery through rate riders to be included on Festival Hydro's Tariff of Rates and Charges for 2013 rates and until the effective date of its next cost of service rate order.*

The approved revenue requirement for the ICM was based on a total eligible capital cost of $15,709,459, reduced to $7,854,730 as a result of the application of the half year rule. The Board's ICM policy stipulates that applicants in the last year of an IRM period should apply the half year rule given the expected filing of a rebasing application the following year. Festival Hydro was scheduled to file a cost of service ("CoS") application in 2013 for 2014 rates.

Festival Hydro requested and was subsequently approved a deferral of its CoS application to January 1, 2015.

As a result, Festival's rate rider was in place for 20 months rather than an originally expected 12 months. Festival Hydro is expected to recover a total of $1,091,548 through the ICM rate rider.

[15] EB-2012-0124,Decision and Order, April 4, 2013, p. 12, Exhibit K1.3

In its 2015 CoS application, Festival Hydro is requesting approval of an additional amount of $634,496[16] through a further rate rider. The additional rate rider is based on the following requests:

1. A true-up of capital cost in the amount of $389,681;
2. Recovery of incremental OM&A cost of $244,815.

Board staff notes that Section 2.2.6 of Chapter 3 of the *Filing Requirements For Electricity Distribution Rate Applications,* dated June 28, 2012 ("Filing Requirements") explicitly states that the Board will make a determination on the treatment of any difference between forecast and actual capital spending during the IRM term. In Board staff's view, the two aspects of the ICM true-up should be considered separately and treated as discrete items.

Incremental Capital Cost

Festival Hydro's requested true-up of the capital cost has two elements: a true-up of actual versus forecast capital spending, and an adjustment to depreciation based on the asset having been in service for 13 months by the time 2015 rates become effective.

In its Decision and Order (EB-2013-0214) the Board approved total costs for the TS of $15,863,113. Actual costs incurred amounted to $15,331,784. Festival is therefore seeking to true up its capital costs by a $551,330 reduction to the budgeted amount. The true-up of the depreciation treatment is a result of Festival deferring its rebasing application. In accordance with Board policy, the initial rate rider reflected half of the value of the asset; a full-year's depreciation would have been reflected in 2014 rates if Festival Hydro had rebased in 2014.

Festival Hydro's deferral of its rebasing application in 2014 thus created a revenue requirement deficiency for the 2014 rate year since there was no opportunity to implement a full year's depreciation for that year, as had been planned.

In its original application for 2015 rates, Festival Hydro sought to adjust for this deficiency by requesting a true-up calculation to reflect the full value of the TS over the eight month period (May 1, 2014 to December 31, 2014) that was not initially expected

[16] EB-2014-0073, Exhibit K2.4, p.2 and Revised Undertaking J1.2

when the rider was approved. Festival Hydro created a new ICM Rate model to this effect, resulting in a true-up amount of $326,336[17].

On November 10, 2014 Festival Hydro amended its request to reflect the fact that the TS was not energized until December 2013. Festival Hydro sought to true-up over 13 months (the actual time the station has been operational) rather than the additional 8 months that had not been anticipated in the original rider. Festival Hydro noted that this methodology was similar to the approach taken by Oakville Hydro[18].

Using this revised approach, Festival Hydro calculated a total revenue requirement of $1,506,659. Following cross-examination on its application of Capital Cost Allowance ("CCA"), Festival Hydro revised its requested revenue requirement to $1,481,229. The final applied for ICM revenue requirement reflects all of the following adjustments[19]:

- Reduction of the total capital amount by $551,330 to $15,311,782;
- Incremental Capital expenses represents the average of the 2013 and 2014 net asset balance for the TS balances as reported in E1/T1/S1, p. 3;
- A full year's depreciation of $337,644;
- Updated projected 2014 CCA claim of $1,017,000, reflecting depreciation schedules for actual costs at the asset component level.

Festival Hydro submits that it will collect a total amount of $1,091,548 through the existing rate rider by December 31, 2014. This leaves a deficiency of $389,681, which Festival Hydro proposes to recover through an additional ICM rate rider over a one-year period.

[17] EB-2014-0073, Exhibit 9/T3/S12, pp. 4-9
[18] EB-2014-0073, Transcript Vol. 1, p. 17 line 12-24. Staff notes that Oakville Hydro may have used this approach but that there was no specific Board finding on it given that rates in that proceeding were established via a settlement proposal accepted by the Board.
[19] EB-2014-0073, Revised Undertaking J1.2, p.1

Table 1: ICM Capital true-up calculation

Description	2013	2014	Total
Inc. Revenue Requirement – as originally filed EB-2012-0124)	$ 448,275	$ 672,412	$1,120,687
True-up Amounts:			
Inc. Revenue Requirement – true up of costs, depreciation and CCA	$ 113,941 ~~$ 115,897~~	$1,367,288 ~~$1,390,762~~	**$1,481,229** ~~**$1,506,659**~~
ICM Rate Rider collected/to be collected	$380,410	$ 711,138	**$1,091,548**
Variance arising on true up – additional inc capital requirement	($266,469) ~~($264,513)~~	$656,150 ~~$679,624~~	**$389,681** ~~**$415,111**~~

Festival Hydro proposed to use fixed/variable rate riders as per Incremental Capital Rate Rider Option A.

Submission

Board staff notes that in section 2.2.6 of the Chapter 3 of the Filing Requirements for the 2013 rate year, the Board determined that at the time of rebasing the Board will make a determination on the treatment of any differences between forecast and actual capital spending during the IRM term.

Board staff submits that the true-up calculation based on the TS's in-service period of thirteen months is reasonable and, given the range of variables influencing the costs to be recovered, a fair resolution for ratepayers. Board staff supports the incremental revenue requirement calculation of $389,681 based on the revised CCA amount of $1,017,000. Board staff submits that a true-up for actual in-service date is consistent with Board policy, and reflects Festival Hydro's accounting policies to account for assets in the month they enter service. Board staff notes that this methodology represents a reasonable reflection of the cost incurred by Festival Hydro. Board staff submits that while this methodology is a suitable for this case, it should not be taken as precedent in the future.

Incremental Operating, Maintenance and Administration ("OM&A") Expenses related to the new Transformer Station ("TS")

Festival Hydro submitted that it included incremental OM&A expenses associated with operating the new TS in 2013 and 2014 in the amount of $244,815 ($104,815 in 2013 and 140,000 in 2014) in the ICM variance account. It recorded the costs within Account

1508 for 2013 and 2014, taking as a guide the principles that were applied to the smart meter recovery process.

Festival Hydro submitted that since the ICM is intended for extraordinary capital expenses, the resulting OM&A from such capital expenses should also be considered extraordinary and considered in the same manner and be recoverable[20]. Festival Hydro further submitted that the OM&A expenses are simply part of the true-up along with the other elements of the ICM true-up for which it has applied. Festival Hydro stated that it did not know that it had to request a separate deferral and variance account from the Board.

Submission

In Board staff's view, Festival Hydro's request should not be accepted. Board staff does not accept the two arguments upon which Festival has based its request: the similarity of treatment to the smart meter cost recovery process and informal accounting guidance from Board staff.

Board staff sees no analogy with the smart metering program and submits that OM&A costs are not explicitly recoverable in the ICM, especially in the absence of a specific request. Pursuant to section 2.2.6 of the Chapter 3 of the Filing Requirements for the 2013 rate year, the Board determined that the treatment of any difference between forecast and actual capital spending during the IRM term will be dealt with at the time of rebasing. Board staff submits section 2.2.6 only concerned the true-up of capital spending related to a discrete ICM project. Board staff submits that at no time did the Board consider the inclusion of incremental OM&A expenses in a true-up calculation of capital expenses. Board staff notes that in the *Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors,* issued July 14, 2008, the Board specifically stated that capital expenditures mandated through government policy (e.g. smart meters) should continue to be dealt with outside of the IR plan[21]. Therefore, Board staff submits that the treatment of an ICM is clearly differentiated from government-mandated programs like the smart meter program.

[20] Interrogatory Response No. 172, 9-Staff-63
[21] Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, issued July 14, 2008, p. 34

Board staff notes that Festival Hydro agreed that the ICM model does not provide for a mechanism to include OM&A expenses[22]. Board staff submits that a true-up for OM&A expenses is clearly outside of the scope of an ICM true-up with respect of this application.

The second basis of Festival Hydro's argument for OM&A recovery is that it relied upon guidance from Board staff. In response to undertaking J1.5, Festival produced informal communication between Board staff and Festival Hydro as to the accounting treatment of the incremental OM&A[23], dated June 20, 2013. In the correspondence, Board staff advises tracking reported OM&A expenses in account 1508.

Board staff submits that Board staff's guidance is not and should never be taken to be equivalent to an order of the Board and that this is or should be well known among the staff and leadership of regulated entities. In the absence of a specific order of the Board, business and regulatory risks regarding accounting treatment or any other matter rest with the applicant. Even leaving this principle aside, Board staff also observes that the wording of Festival Hydro's request fails to provide sufficient context for a complete answer to be provided. For example, the note did not indicate that the Board had not approved the OM&A in question, it was simply asking what the accounting treatment would be.

Board staff notes that Festival Hydro simply failed to disclose the incremental OM&A expenses to the Board at the time of the ICM request. It also did not request any deferral account treatment. Therefore, the Board had no opportunity to consider the prudence or treatment of these claimed costs. Given that incremental OM&A is beyond the scope of the ICM policy, there should have been no reasonable expectation that it could be recovered in the absence of a specific decision of the Board. Board staff submits that OM&A expenses incurred during the 2013 and 2014 rate years are beyond the scope of the ICM policy, out of period and are therefore not recoverable.

Working Capital Allowance Factor

In its letter to Distributors of April 12, 2012 ("the Board's Letter"), the Board updated its Filing Requirements to establish its approach to the calculation of Working Capital Allowance ("WCA") for LDCs for 2013 cost of service applications. That approach,

[22] EB-2014-0073, Oral Hearing Transcript, Vol. 1, p. 87 lines 87 1-2
[23] EB-2014-0073, Oral Hearing Transcript, Vol. 1, p. 86 lines 13-28 and p. 87 lines 87-1-11

which continues to be in place in the 2014 Edition of the Filing Requirements, allows applicants to calculate their WCA either on the basis of the Board's 13% Allowance Approach or by filing a lead/lag study. The only exception to this approach is if the applicant has been previously directed by the Board to undertake a lead lag study on which its current WCA is based. Under those circumstances, an applicant proposing a revision to its WCA must file an updated study in support of its proposal.
The 13% Allowance Approach is calculated as follows:

> The 13% Allowance Approach is calculated to be 13% of the sum of Cost of Power and controllable expenses (i.e., Operations, Maintenance, Billing and Collecting, Community Relations, Administration and General).
> The commodity price estimate used to calculate the Cost of Power must be determined by the split between RPP and non-RPP customers based on actual data and using the most current RPP (TOU) price. The calculation must reflect the most recent Uniform Transmission Rates approved by the Board (EB-2012-0031), issued on January 9, 2014 for 2014 rates and effective January 1, 2014. The calculation must include the impacts arising from the new Smart Metering Entity charge approved by the Board on March 28, 2013 in its EB-2012-0100/EB-2012-0211 Decision and Order[24].

Prior to the issuance of the Board's Letter, the Board's default WCA factor had been 15%. The Board is currently examining its approach to WCA as part of its Review of Residential Customer Billing Practices and Performance, which is intended to examine factors beyond the impact of monthly billing on WCA.

Festival Hydro has filed its WCA on the basis of the 13% Allowance Approach. Based on the load forecast and other elements that were agreed in the settlement proposal, Festival Hydro proposes a WCA of $9,605,132 to be included in its rate base. Board staff notes that further updates to reflect the Board's approved cost of capital parameters for 2015, issued November 20, 2014 will be required.

Festival Hydro has not completed a lead/lag study, nor has it ever been directed to do so by the Board[25]. Festival Hydro stated that, it had not done and analysis of its cash

[24] Filing Requirements for Electricity Distribution Rate Applications, July 18, 2014, Chapter 2, s. 2.5.1.3, page 19
[25] EB-2014-0073, Oral Hearing Transcript vol. 1, page 20

flow requirements in terms of a lead/lag study, although it examines its cash flow needs as part of its budget process[26].

As stated in the Board's Letter, the Board's consideration of an appropriate default value for calculating WCA in the absence of a lead/lag study was based on a review of lead/lag studies filed in cost of service applications in the few years leading up to the issuance of the letter. The derivation of the 13% default value has not been provided, nor have the specific lead/lag studies been identified.

Energy Probe has filed a compendium at Exhibit K1.1, which contains lead/lag studies for Toronto Hydro, Hydro One Distribution, Horizon Utilities and Hydro Ottawa (collectively, "the original studies") conducted between 2006 and 2011, prior to the issuance of the Board's Letter. The Exhibit also contains new lead/lag studies conducted for Toronto Hydro, Hydro One Distribution and Horizon Utilities (the "new studies") in 2013 and 2014. All of the studies filed in this proceeding, with the exception of the Hydro Ottawa study, were conducted by Navigant Consulting. The results of these studies, as well as subsequent study results for other LDCs have been summarized below[27]:

Summary of Lead Lag Study Results		
LDC	**Original Study WCA Factor**	**New Study WCA Factor**
Toronto Hydro	12.90%	7.99%
Hydro One Distribution	11.50%	7.40%
Horizon Utilities	13.50%	12.00%
Hydro Ottawa	14.20%	14.20%[28]
Enersource		13.50%
London Hydro		11.42%
Veridian		13.40%

Energy Probe has calculated the simple average working capital percentage of the results of the original studies to be 13.03%. The average working capital percentage for the new studies, as calculated by Energy Probe in its summary is 11.42%.

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[26] EB-2014-0073, Oral Hearing Transcript vol. 1, page 31
[27] EB-2014-0073, Exhibit K1.1, page 2
[28] EB-2014-0073, Exhibit K1.1, page 2: Hydro Ottawa results included in both tables

The new studies filed contain numerous explanations for the decrease in working capital percentage. Navigant describes the following refinement to the methodology utilized in the new studies:

> Note that the prior studies are based on data of an older vintage and are mostly based on the customer weighting method for revenue lags. This is an obsolete methodology and HONI's current study is based upon the revenue weighting method for revenue lags[29].

Board staff agrees that the customer weighting approach for determining revenue lags is an improvement to the methodology.

Various other explanations are provided by Navigant to explain the decrease in working capital percentage between the original and new studies, including: a shift of customers to monthly billing frequencies; upgrades to Customer Information Systems; and changes to collection practices. In no case has the impact of each of these changes been quantified for the individual LDCs studied.

Board staff notes that there have been significant changes in the Service Lag component of the lead/lag studies as shown in the table below.

Service Lags Calculated in Original Studies		
LDC	**Service Lag**	**Reference**
Toronto Hydro	27.10	Exhibit K1.1, page 2
Hydro One Distribution	21.00	Exhibit K1.1, page 2
Horizon Utilities	30.27	Exhibit K1.1, page 2
Hydro Ottawa	30.24	Exhibit K1.1, page 2

Service Lags Calculated in New Studies		
LDC	**Service Lag**	**Reference**
Toronto Hydro	18.72	Exhibit K1.1, page 2
Hydro One Distribution	16.4	Exhibit K1.1, page 2
Horizon Utilities	25.02	Exhibit K1.1, page 2

[29] EB-2014-0073, Exhibit K1.1, page 151

Enersource	28.75	Exhibit K1.1, page 2
London Hydro	15.21	Exhibit K1.1, page 2
Veridian	22.30	Exhibit K1.1, page 2

These changes in service lag may be related to the change in methodology (referenced previously), changes in billing frequency, new processes, new CIS systems or other factors. However, the extent to which these factors affect the working capital requirements of Festival Hydro is not clear.

Festival Hydro bills its customers on a monthly basis. However, it testified that a utility's circumstances were a bigger driver of working capital than its billing frequency, noting the differences evidenced in a comparison between London Hydro, which bills monthly and Kitchener-Wilmot Hydro, which bills bi-monthly. Festival Hydro pointed out that the working capital for these two LDCs is very similar, despite the billing frequency differences[30]. Festival Hydro stated that examples of these characteristics would include payment terms and billing frequencies. Festival Hydro also stated that, although it monitors its line of credit, it has not done a specific calculation of its cash flow needs[31].

The Board has in the past found it to be inappropriate to adopt the results of a lead/lag study from one utility to apply to another utility without a thorough analysis concluding that the utilities are comparable. Most recently, in a Motion to Review and Vary by the School Energy Coalition for a review of the Board's Decision and Order in proceeding EB-2013-0147, the Board stated:

> The Board finds that using a consistent WCA default value in cases where lead/lag studies have not been conducted to be a better approach than attempting to use simplified methods to derive a utility-specific WCA value for each case from other lead/lag studies which may not reflect the unique circumstances of such utility[32].

[30] EB-2014-0073, Oral Hearing Transcript vol 1, page 29
[31] EB-2014-0073, Oral Hearing Transcript vol. 1, page 32
[32] EB-2013-0147/EB-2014-0055, Decision and Order, October 23, 2014, page 4

Submission

Board staff submits that Festival Hydro has calculated its WCA in accordance with the Board's policies, and that there is no evidence in this proceeding that would allow for specific reductions in the WCA factor to be directly applied to Festival Hydro.

As illustrated in Exhibit K1.1, clearly there is a wide range among LDCs in the revenue lags and expense leads that are calculated within the individual lead/lag studies filed to date. Board staff does not see merit in applying the full results of one study to any one utility. Given the uncertainty on the implications to Festival Hydro of various factors, it is reasonable for the Board to approve the WCA based on the Board's policy of 13%. However, Board staff submits that cCertain factors, such as the methodological change to revenue weighting and monthly billing for all customers, will certainly need to be a consideration as part of the Board's policy review of the WCA.

The Board may wish to order Festival Hydro to conduct its own lead/lag study prior to the next rebasing, though this should be based on the outcome from the Board's policy review in 2015.

Issue 1.2
OM&A

In response to interrogatories and undertakings, Festival Hydro updated its request for OM&A to be included in rates to $5,156,282. This amount includes a recent update to Appendix 2-M regulatory cost due to additional costs for an oral hearing[33]. The impact of this update on the test year OM&A budget is approximately 17,000.

During the oral hearing Festival Hydro provided an overview for the $1,163,575 (24.17%) increase since its last rebasing. Festival Hydro stated that 57% of these increases are considered by Festival Hydro as uncontrollable expenses; the remainder, 43%, are considered controllable expenses. Festival Hydro noted that uncontrollable expense include incremental OM&A associated with the new TS, the introduction of smart meters, transition from CGAAP to IFRS and increases to OMERS premiums. Festival Hydro submitted that the remaining 43% of cost increases are largely driven by increases in compensation. Festival Hydro noted that while it has not increased its

[33] Updated evidence, Appendix 2-M, November 10, 2014

headcount from 2015, cost increases are associated with wage progression of the existing staff complement. Festival Hydro also submitted that its collective agreement resulted in a 2.02% average increase for each year of the three year contract[34].

In cross examination with VECC, Festival Hydro stated that its change from the most to the second-last efficiency group since 2010 is due to the methodology for benchmarking which was adopted by the Board in 2013, a benchmarking study now incorporates a total cost model. Festival Hydro stated that its change from a Group 1 cohort to a Group 4 is due to the capital component of the study. When comparing the OM&A components of Festival Hydro's 2015 request versus actual 2013 OM&A cost of other distributors, Festival Hydro submitted that it is still has the twentieth-lowest OM&A per customer in the province.

Submission

Board staff takes no issue with Festival Hydro 2015 OM&A test year budget and finds its explanations for the increases to be plausible and justified. Board staff notes that Festival Hydro's OM&A per customer for the test year is $250.28.

Board staff notes that the weighted average OM&A per customer for all distributors based on the 2013 yearbook date is $324. When excluding distributors that serve a predominantly rural population the average OM&A per customer is $266[35]. Board staff submits that Festival Hydro's OM&A on a per customer basis demonstrates that it should be considered as one of the more efficient utilities with respect to OM&A costs and that the increase it is seeking is reasonable.

Issue 3.4
Fixed/Variable Split

In response to Board staff interrogatory No. 146 (7-OEB Staff-50) Festival Hydro submitted that in its original application Festival Hydro established rates based on the existing fixed/variable split. Festival Hydro also noted that the maximum fixed rate should be the greater of the directly related Minimum System with PLCC Adjustment or

[34] EB-2014-0073 Oral Hearing Transcript, p. 21-22
[35] 2013 Yearbook of Electricity Distributors, issued August 14, 2014, Tab - Stats by Customer Class http://www.ontarioenergyboard.ca/OEB/Industry/Rules+and+Requirements/Reporting+and+Record+Keeping+Requirements/Yearbook+of+Distributors#elec

the existing rate. Consequently, Festival Hydro proposed a fixed rate no greater than its current rate of $227.57 for the GS>50 customer class – in other words, it maintained its status quo.[36].

Festival Hydro further noted that moving the fixed charge significantly can result in some individual bill swings for customers within the same rate class. Festival Hydro noted that in the interest of rate stability and predictability for itself and its customers Festival Hydro feels it is appropriate that it maintain its rates as they are currently set[37]. Festival Hydro submitted that the Board's current Draft Report on Rate Design for Electricity Distributors (EB-2012-0410) signals that the Board may be moving towards increasing fixed charges, which would be consistent with at least maintaining the current fixed charge rather than lowering them.

Festival Hydro further noted that its fixed charge is comparable with other utilities.

Submission

Board staff notes that in Section 2.11.1 of the 2015 Filing Requirements the Board determined that[38]:

> If a distributor's current fixed charge is higher than the calculated ceiling, there is no requirement to lower the fixed charge to the ceiling, nor are distributors expected to raise the fixed charge further above the ceiling.

Board staff submits that Festival Hydro's maintenance of the status quo is consistent with the 2015 Filing Requirements.

Board staff is also of the view that, directionally, the Board's current initiative regarding rate design supports maintaining a fixed charge over the ceiling rather than lowering the fixed charge to the ceiling. Accordingly, staff supports Festival's proposal.

All of which is respectfully submitted

[36] EB-2014-0073 Oral Hearing Transcript, Argument-in-Chief, p. 96, lines 2-3
[37] EB-2014-0073 Oral Hearing Transcript, Argument-in-Chief, p. 96, lines 4-10
[38] Filing Requirements for Electricity Distribution Rate Applications, July 18, 2014, Chapter 2, s. 2.11.1, p. 53