**Ontario Energy Board**
P.O. Box 2319
27th. Floor
2300 Yonge Street
Toronto ON M4P 1E4
Telephone: 416- 481-1967
Facsimile: 416- 440-7656
Toll free: 1-888-632-6273

**Commission de l'Énergie de l'Ontario**
C.P. 2319
27e étage
2300, rue Yonge
Toronto ON M4P 1E4
Téléphone; 416- 481-1967
Télécopieur: 416- 440-7656
Numéro sans frais: 1-888-632-6273

Ontario

**BY E-MAIL AND WEB POSTING ONLY**

November 28, 2006

To All Natural Gas Utilities and Electricity Local Distribution Companies (LDCs)

**Re: Approval of Accounting Interest Rates Methodology for Regulatory Accounts Board File No. EB-2006-0117**

Introduction

On May 26, 2006, the Board announced its intention to implement a new approach for setting interest rates for use by Ontario natural gas utilities and electricity LDCs for regulatory accounts under the Uniform System of Accounts (USoA). The key objectives of the plan were to derive an accounting interest rate methodology that would reflect market rates and be responsive to changes in market conditions. This approach would also be beneficial in an incentive rate-making regulatory regime where the review of interest rates for accounts is not undertaken as part of an annual rate application process.

As part this plan, Board staff issued a proposal paper on interest rates for regulatory accounts. This proposal consisted of a prescribed one-year interest rate based on the one-year Canada treasury bill, which could be updated every quarter. For construction work in progress (CWIP), it comprised a two-tier approach. Interest rates for construction projects lasting up to one year would be based on the aforementioned one-year Canada T-bill rate and interest rate for project lasting more than one year would be based on a longer-term interest rate based on the Scotia Capital Inc. All Corporates Mid-Term Average Weighted Yield.

After considering stakeholder comments on the proposal, the Board decided to adopt interest rates that are somewhat different than the rates proposed in the staff paper.

Interest Rate Methodology Approved

The Board approves an interest rate for deferral and variance accounts equal to the three-month bankers' acceptance rate, as published on the Bank of Canada's website, plus a fixed spread of 25 basis points.

For CWIP, the Board-approved rate of interest is the Scotia Capital Inc. All Corporates Mid-Term Average Weighted Yield, as published on the Bank of Canada's website, which includes a corporate spread over the similar term Government of Canada bond yields. This rate is applicable to all projects under construction whether the construction period is one year or less, or more than one year.

The rates in effect for 2006 are provided in Appendix A.

These two prescribed rates will be reviewed each quarter and updated if the change is 25 or more basis points. They will be published on the OEB web site under "What's New" prior to the start of each quarter. The quarterly rates will cover the following periods, annually: Quarter 1 (January-March); Quarter 2 (April-June); Quarter 3 (July-September); and, Quarter 4 (October-December).

In terms of the timing of the interest rates determination, the three-month actual bankers' acceptance rate at the month end, one month prior to the start of the quarter (e.g., November 30 for quarter starting January 1), plus a 25 basis points fixed spread, would be obtained prior to the quarter beginning and published on the OEB web site shortly thereafter effective for the next quarter (e.g. January 1 to March 31). For the CWIP interest rates, the same procedure will be followed to determine and publish the all corporates rate, expect that no spread would be added since this rate already includes a corporate spread.

Implementation Procedures for New Interest Rates

*Electricity LDCs*

This accounting interest rates policy is effective from May 1, 2006 for electric LDCs to align with the beginning of the 2006-07 rate year. Accordingly, the quarterly rates that impact carrying charges for accounts in 2006 are Q2 2006 (April-June), Q3 2006 (July-September) and Q4 2006 (October-December). The effective rates are provided in

Appendix A. The rates for Q1 2007 (January-March) will be published in December 2006.

The current list of accounts in the USoA for electricity LDCs covered by this accounting interest rate policy is provided in Appendix B. Prescribed interest rates under this policy also will be applicable to other electricity sector generic or LDC-specific accounts approved by the Board in the future.

LDCs are required to update their accounts to reflect these interest rates in time for their Q4 2006 filings under section 2.1.1 of the Reporting and Record-keeping Requirements (RRR), which are due by January 31, 2007. Adjusting accounting journal entries shall be made for the accounts to which these rates apply beginning on May 1, 2006. Note that information previously filed for Q2 2006 and Q3 2006 under the RRR is not required to be re-filed since the accumulated changes will be reported in the Q4 2006 filings.

The previous interest rates approved for regulatory accounts are effective to April 30, 2006. These rates also applied to the calculation of projected carrying charges (to April 30, 2006) for regulatory asset account balances submitted in LDCs' 2006 rate applications. Therefore, no differences exist in the interest rates used for accounting and rate-setting purposes (i.e., account balance dispositions in 2006 rates). It should be noted that the new interest rates also apply to account 1590, Recovery of Regulatory Assets, to which the regulatory asset amounts approved by the Board for recovery in rates are to be recorded effective May 1, 2006. The associated revenues collected in rates over the approved period (May 1, 2006 to April 30, 2008) will offset the regulatory asset amounts recorded in this account.

*Gas Utilities*

For gas utilities, where the Board has approved a specific interest rate in a previous proceeding, that rate will remain in effect until the Board reviews the matter in a subsequent rate proceeding. At that time, the Board may direct the utility to use the rates prescribed under this accounting interest rates policy beginning in the Q4 2006 (October-December) period. This rate is shown in Appendix A.

The accounts in USoA for gas utilities affected by this policy are generally approved and established under account 179, Other Deferred Charges, for a variety of variance and deferral accounts and account 115, Construction Work in Progress – Utility Plant. Prescribed interest rates under this policy also will be applicable to other gas sector accounts approved by the Board in the future.

It is the Board's view that there should be consistency in the use of the same accounting interest rates methodology amongst the rate-regulated companies in the energy sectors. Comments received from the gas utilities on the staff paper were supportive of proposals regarding the use of market-based rates and quarterly updates of these rates.

## Review of Issues Arising From Consultation

A review of stakeholder comments on key issues arising from Board staff paper is summarized in Appendix C. The Board's determination of these issues is reflected in the formulation of this policy.

Inquiries on this accounting interest rate policy should be directed to Ben Baksh at 416-440-8128. The Board's toll free number is 1-888-632-6273.

Yours truly,

*Original Signed By*

Peter H. O'Dell
Assistant Board Secretary

# APPENDIX A

## Prescribed Interest Rates for Approved Accounts under the Uniform System of Accounts of Gas Utilities and Electricity LDCs

| Quarter by Year[1] | Bank of Canada Website Reference Date | Posted 3 month Bankers' Acceptances | Spread | Effective Interest Rate for Accounts[2] | Scotia Capital All-Corporates Mid-Term Yield for CWIP[3] |
|---|---|---|---|---|---|
| A | B | C | D | **E = (C+D)** | **F** |
| Q1 2006 | N/A | N/A | N/A | **N/A** | **N/A** |
| Q2 2006 | 28/02/2006 | 3.89 | 0.25 | **4.14** | **4.68** |
| Q3 2006 | 31/05/2006 | 4.34 | 0.25 | **4.59** | **5.05** |
| Q4 2006 | 31/08/2006 | 4.32 | 0.25 | **4.59** | **4.72** |
| Q1 2007 | 30/11/2006 | TBD | 0.25 | **TBD** | **TBD** |
| Q2 2007 | 28/02/2007 | TBD | 0.25 | **TBD** | **TBD** |
| Q3 2007 | 31/05/2007 | TBD | 0.25 | **TBD** | **TBD** |
| Q4 2007 | 31/08/2007 | TBD | 0.25 | **TBD** | **TBD** |

Footnotes:

1 Q1 is January to March
Q2 is April to June (except 2006 for electricity LDCs which involves a May to June period as interest rates are effective May 1, 2006)
Q3 is July to September
Q4 is October to December

2 The Board-approved interest rate for deferral and variance accounts is the three-month bankers' acceptances, as published on the Bank of Canada's website, plus a fixed spread of 25 basis points. The effective quarterly rate is revised if it changes 25 or more basis points from the pervious quarter's published rate.

3 For construction work in progress (CWIP), the Board-approved rate of interest is the Scotia Capital Inc. All Corporates Mid-Term Average Weighted Yield, as published on the Bank of Canada's website, which includes a corporate spread over the similar term Government of Canada bond yields. The effective quarterly rate is revised if it changes 25 or more basis points from the pervious quarter's published rate.

# APPENDIX B

## Prescribed Interest Rates Applicable to Variance and Deferral Accounts and CWIP of Electricity LDCs

The following accounts are authorized for the purposes of recording carrying charges at a rate of interest prescribed by the Board, effective May 1, 2006. These prescribed interest rates also will be applicable to other generic accounts or LDC-specific accounts approved by the Board in the future.

### Variance and Deferral Accounts

| | |
|---|---|
| 1508 | Other Regulatory Assets |
| 1508 | Other Regulatory Assets - Sub-account OEB Cost Assessments |
| 1508 | Other Regulatory Assets - Sub-account Pension Contributions |
| 1518 | Retail Cost Variance Account - Retail |
| 1525 | Miscellaneous Deferred Debits |
| 1525 | Miscellaneous Deferred Debits, Sub-account Payments to Customers |
| 1548 | Retail Cost Variance Account - STR |
| 1550 | LV Variance Account |
| 1555 | Smart Meter Capital and Recovery Offset Variance Account |
| 1556 | Smart Meter OM&A Variance Account |
| 1562 | Deferred Payments in Lieu of Taxes |
| 1563 | PILs contra account |
| 1572 | Extraordinary Event Losses |
| 1574 | Deferred Rate Impact Amounts |
| 1580 | Retail Settlement Variance Account - Wholesale Market Service Charges |
| 1582 | Retail Settlement Variance Account - One-time Wholesale Market Service |
| 1584 | Retail Settlement Variance Account - Retail Transmission Network Charges |
| 1586 | Retail Settlement Variance Account - Retail Transmission Connection Charges |
| 1588 | Retail Settlement Variance Account - Power |
| 1588 | RSVA Power - Sub-account Global Adjustments |
| 1590 | Recovery of Regulatory Asset Balances |
| 1592 | 2006 PILs and Taxes Variances |
| 2425 | Other Deferred Credits |

### Construction Work in Progress Account

| | |
|---|---|
| 2055 | Construction Work in Progress |

Notes:

1) Carrying charges are not applicable to accounts 1565 and 1566.
2) In accounting for carry charges of approved accounts, LDCs are required to record the applicable carrying charges in a separate interest sub-account of the applicable account.
3) Where the Board has disallowed an amount recorded in an account, all associated carrying charges recorded in relation to that amount shall be removed from the account and interest sub-account.

## APPENDIX C

### Review of Stakeholder Comments Arising from Board Staff Proposal

The Board staff proposal paper, “Interest Rates for Regulatory Accounts of Utilities,” was issued for stakeholder consultation on May 26, 2006. Submissions on the staff paper were received from Hydro One Networks, Toronto Hydro, Hydro Ottawa, Enersource, Veridian, Shibley Righton for Schools Energy Coalition, Union Gas, Enbridge Gas, Oglivy Renault for Natural Resource Gas, Ontario Power Generation and Energy Cost Management Inc.

There were three key issues identified from the stakeholder comments that the Board reviewed and with respect to which the Board made decisions. These are summarized below.

**i. Use of a borrowing rate instead of an investment rate for variance and deferral accounts**

*Stakeholders’ position:*

Some stakeholders stated that a borrowing rate based on the three-month bankers’ acceptances instead of an investment rate, such as Board staffs’ proposed one-year Canada T-bill, should be applied to regulatory accounts. Some stakeholders stated that the regulatory accounts have to be financed, either internally or externally, therefore a borrowing rate should be used.

*Staff’s recommendation:*

In terms of using a borrowing rate for interest, staff acknowledges that there is an argument that a borrowing based rate can be used. However, staff notes that regulatory accounts expected to be recovered in future rates are generally asset accounts, and are therefore more like investments. Accordingly, an investment based interest rate may be more appropriate to apply to regulatory accounts.

A general concern with a borrowing rate approach is that it favours an assumption that all regulatory account balances are supported through borrowing. It is difficult to quantify what amounts are borrowed to support these balances on an industry-wide basis. Many LDCs use internally generated funds (e.g. excess cash or surplus working capital) to support some or all of these regulatory account balances, so specific borrowing is not quantifiable. It can be debated that these internally used funds represent an opportunity cost to the LDC and in that case, it could be argued a forgone investment opportunity (e.g., T-bill or GICs).

An analysis was done to compare the staff proposed rate on regulatory accounts, the one-year Canada T-bill rate plus a corporate spread of the three-month corporate paper rate over the 90-day T-bill rate, to the three-month bankers’ acceptance rate. (Rates were taken from the Bank of Canada’s website.) Over the period from 2001 to mid-2006, an average difference of 27 basis points existed between the two rates. Therefore, it can be concluded that a standard bankers' acceptance rate as posted on the Bank of Canada website plus a static spread of 25 basis points, will approximate the rate proposed by staff over time.

*Board conclusion:*

The Board determined that the three-month bankers' acceptance rate plus a static spread of 25 basis points would be used for regulatory accounts.

### ii. Use of Weighted Average Cost of Capital (WACC) versus mid-term investment yield for CWIP

*Stakeholders' position:*

Some electricity LDCs commented that the WACC of each LDC should be used as the rate for CWIP. Some also commented that the Report of the Board on the 2006 EDRH stated that WACC should be used for CWIP.

*Staff's recommendation:*

Staff did not recommend adoption of WACC for reasons as follows:

- The Accounting Procedures Handbook (APH) for electricity LDCs is the recognized regulatory instrument on accounting policies and procedures and already has established the use of the IDC-base (interest during construction) method (i.e., the LDC's debt cost rate per the 2001 EDRH).
- The Board has historically only approved IDC-based carrying charges for CWIP in the gas sector. (To clarify a common misunderstanding in the electricity and gas Uniform System of Accounts, it should be noted that while interest for CWIP is recorded in an account named "Allowance for Funds Used During Construction" which may imply that interest is based on the WACC, interest for CWIP has been IDC-based in Ontario.)
- The natural gas utilities (with long history of rate regulation by the Board) did not identify WACC as the preferred method in their comments on the staff paper.
- The current IDC approach provides for continuing consistency and symmetry in treatment in the two energy sectors.
- The 2006 EDR Board Report and the 2006 EDRH were intended for a one-year application process (2006) and therefore they should not be viewed as having longer term implications beyond 2006 rates, or implications affecting ongoing accounting policies established in the APH.

*Board conclusion:*

The Board wishes to clarify that the APH sets accounting policies and procedures governing the USoA for electricity LDCs. The CWIP issue reviewed in the context of 2006 EDR process was limited to the 2006 rate year and intended for rate-setting purposes only. No specific procedure has been undertaken to amend the IDC-based policy established for CWIP in the APH. Accordingly, the Board has concluded that the WACC method referenced for use in the 2006 rate process should not be adopted for accounting purposes. The mid-term Scotia Capital all-corporates yield proposed rate in the staff paper is to be used for CWIP.

**iii. Use of one interest rate for construction work in progress (CWIP) instead of the proposed two-tiered rate**

*Stakeholders' position:*

Some stakeholders stated that this two-tiered rate for CWIP would be too burdensome on LDCs to administer. The two-tiered rate encompassed a short-term rate for projects less than one year and a mid-term rate for projects greater than one year. This would entail having to make assumptions on the life expectancy of projects and potential adjustments when these assumptions are changed in addition to having to maintain separate and more detail records.

*Staff's recommendation:*

Staff recommended one rate be applied to all CWIP balances regardless of the time duration of such projects.

*Board conclusion:*

The Board approved the use of one rate, at the rate indicated in item 2 above, for ease of administration and record keeping by users.