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

January 31, 2019

Mr. Walter Malcom
President & CEO
InnPower Corporation
7251 Yonge Street
Innisfil, ON, L9S 0J3

Dear Mr. Malcolm:

Re: Inspection of Affiliate Transactions

The Ontario Energy Board (OEB) issued a letter to InnPower Corporation (InnPower) on August 10, 2018 advising that the OEB would be conducting an inspection of its affiliate transactions.

The objective of the inspection was to determine whether InnPower complies with the OEB's Affiliate Relationships Code and OEB guidance with regard to the accounting for revenues and costs of services provided to its non rate-regulated affiliates, including the allocation of those costs.

OEB staff has now completed the inspection, the results of which are included in the attached inspection report.

OEB staff has concluded that InnPower does not appear to be in compliance with the Affiliate Relationships Code. Consequently, we would like to organize a call with you to discuss next steps regarding this matter.

Yours truly,

Tony Stanco
Manager, Audit & Investigations
Phone: (416) 440-7614
Fax: (416) 440-7656
Email address: Tony.Stanco@oeb.ca

Cc. Glen McAllister, Chief Financial Officer, InnPower Corporation
Brenda Pinke, Regulatory/Conservation Manager, InnPower Corporation

ONTARIO ENERGY BOARD

Inspection Report

InnPower Corporation

Inspection of Affiliate Transactions

January 2019

Table of Contents

1. SUMMARY

The OEB's Audit & Investigations staff (staff) conducted an inspection of InnPower Corporation's (InnPower) affiliate transactions to ensure its allocation of costs and approach to costing and applicable revenue complies with the OEB's Affiliate Relationships Code for Electricity Distributors and Transmitters (ARC).

Staff found evidence that InnPower has not priced or costed the services provided to its affiliated entities in compliance with the ARC.

In particular, staff found that:

1. InnPower's pricing methodology for services provided to its affiliates was not based on market price or fully-allocated cost, as required by the ARC.
2. InnPower has not costed the services provided to its affiliates on a fully-allocated basis, as required by the ARC and the OEB's Accounting Procedures Handbook.
3. InnPower's service agreements did not include all the terms as required by the ARC.
4. InnPower has not established any processes of management review to ensure ongoing compliance with the ARC.

A complete description of the findings is detailed in **Appendix 1**.

2. REASON AND AUTHORITY FOR INSPECTION

The inspection was triggered by the OEB in its March 8, 2018 Decision and Order on InnPower's 2017 rates (the 2017 Cost of Service proceeding).[1]

The inspection was conducted under the authority of Part VII of the *Ontario Energy Board Act, 1998* (Act) by staff appointed as inspectors by the OEB's management committee under section 106 of the Act.

3. OBJECTIVE AND SCOPE

The main objective of the inspection was to determine whether InnPower complies with OEB Codes and accounting guidance with regard to the accounting for revenues and costs of services provided to its non rate-regulated affiliates, including the allocation of those costs.

[1] EB-2016-0085.

Staff reviewed InnPower's processes used to calculate the forecasted affiliate revenues and expenses submitted in the 2017 Cost of Service proceeding, as well as its 2018 year-to-date processes of recording its affiliate transactions.

4. METHODOLOGY

Staff reviewed InnPower's procedures, systems, and controls with respect to the tracking, recording, calculating, and reporting of affiliate transactions.

Staff interviewed key InnPower staff and reviewed supporting documents such as Service Agreements, policies and procedures, cost analyses, and accounting records.

5. LICENSEE PROFILE AND BACKGROUND

InnPower provides electricity distribution services to approximately 16,000 customers in the Town of Innisfil and the lands located in South Barrie.

InnServices Utilities Inc. (InnServices) is an affiliate of InnPower with responsibility for the water and wastewater services formerly provided by the Town of Innisfil. InnServices was incorporated as a municipal services corporation in 2015.

InnTerprises Inc. (formerly Innisfil Energy Services Limited) is also an affiliate of InnPower, wholly-owned by the Town of Innisfil, providing electricity-related products and services such as rentals of sentinel lighting and communication towers. InnPower, InnServices, and InnTerprises all share the same CEO.

InnPower provides the following services to its two affiliate companies:

- InnServices:
  - Financial Services (e.g. accounting, preparation of financial statements)
  - Billing Services (e.g. issuing bills, customer care, and collections)
  - Rental of office space
- InnTerprises:
  - Management Services
  - Accounting Services (e.g. billing and collection, accounts payable)

Finding 1 – InnPower's pricing methodology for services provided to affiliates was not based on market price or fully-allocated cost, as required by the ARC.

Staff found that InnPower did not perform any analysis to determine whether a reasonably competitive market exists and what a fair market value would be for the financial and billing services provided to its affiliates.

InnPower charges for its financial and billing services based on rates set out in Service Agreements in place with its affiliates. Current staff at InnPower could not provide an adequate explanation to show how those rates were determined.

For example, an "administrative fee" of 1% was added to the payroll costs for the financial services being provided to InnServices (about $334,000 in 2017). At the same time, payroll costs were marked up by 15% for the financial services provided to InnTerprises (about $18,000 in 2017). InnPower could not provide any supporting documentation for these markup percentages to show that they reflect either market prices or a calculation of fully-allocated cost.

In addition, InnPower charges rent to InnServices for about 280 square feet of office space. InnPower could not provide any documentation to support the amounts being charged as being either market price or the fully-allocated cost of that space.

The ARC specifies the following with regard to the prices charged for affiliate services:

> *2.3.3.6 Where a reasonably competitive market exists for a service, product, resource or use of asset, a utility shall charge no less than the greater of (i) the market price of the service, product, resource or use of asset and (ii) the utility's fully-allocated cost to provide service, product, resource or use of asset, when selling that service, product, resource or use of asset to an affiliate.*

InnPower cannot demonstrate that it is charging the greater of fair market value or fully-allocated cost, as per ARC Section 2.3.3.6.

InnPower did not adequately assess whether a reasonably competitive market exists for its affiliate services. However, regardless of whether a competitive market exists, InnPower should have determined the fully-allocated cost to provide that service. As described in the following section, InnPower did not adequately determine this cost.

Finding 2 – InnPower has not costed its services provided to affiliates on a fully-allocated basis.

Staff found that InnPower's methodology for costing the services provided to its affiliates is not on a fully-allocated basis, as required by the ARC and the OEB's Accounting Procedures Handbook guidance.

As defined in the ARC, "fully-allocated cost" means the sum of direct costs plus a proportional share of indirect costs. Indirect costs are costs that cannot be identified with a specific unit of product or service or with a specific operation or cost centre, such as overhead, administrative and general expenses.

Article 340 of the OEB's Accounting Procedures Handbook for Electricity Distributors also stipulates that the general method for charging indirect costs should be on a fully allocated cost basis. The methods used in the allocation of costs should also be documented and reviewed on a regular basis.

Staff found that InnPower primarily included labour costs as the direct costs for providing financial and billing services to its affiliates. These payroll costs are calculated based on employees filling out timesheets indicating the number of hours spent on affiliate services.

However, staff found that up until the 2017 Cost of Service rate proceeding, InnPower did not allocate any indirect costs, such as office supplies or IT costs, to its affiliate services. As a result, InnPower's recorded costs of affiliate services was not based on a fully-allocated cost as required by the ARC.

During its 2017 Cost of Service rate proceeding, InnPower acknowledged that its forecasted affiliate transactions for 2017 were based on incremental costs rather than fully-allocated costs. As a result, InnPower reviewed its forecasted general and administrative expenses and identified overhead costs attributable to financial services of $40,990 and to billing services of $125,240. InnPower has yet to record any of these actual overhead costs to its affiliates in the general ledger, pending the results of the OEB inspection.

Staff reviewed InnPower's methodology for calculating and allocating these overhead costs. Staff found that InnPower was unable to substantiate all of these costs. For example, in determining the proportion of office supplies and property insurance expenses allocable to affiliate services, InnPower deducted amounts deemed to be attributable to the cost of leasing out office space to a non-affiliated entity and therefore unrelated to InnPower operations. However, InnPower could not explain how it arrived at these non-allocable amounts. Therefore, InnPower could not demonstrate that the proportion of overhead costs allocated to affiliate services was reasonable and justified.

Staff also found that the methodology used by InnPower to calculate the cost of the billing services provided to InnServices does not reflect a reasonable allocation of all the direct and indirect billing costs involved. InnPower provides billing services to InnServices by adding water bill amounts to electricity bills. As a result, InnPower splits in half the total combined billing costs for both electricity and water bills to arrive at the costs of the water billing services provided to InnServices.

However, InnPower does not issue a water bill to every customer billed for electricity. Moreover, InnPower is able to determine some direct costs for issuing water bills, such as billing labour and meter reading costs. Therefore, staff is of the view that a more appropriate costing methodology should include these direct costs plus a reasonable proportion of indirect electricity billing costs, rather than simply splitting overall costs by half.

In addition, staff found that InnPower has not included any depreciation expense in its allocation of overhead charges to affiliates. Given that InnPower employees providing affiliate services make use of InnPower assets such as computer and office equipment, a proportion of depreciation costs for these assets should be allocated to the cost of providing those affiliate services. Allocable depreciation expenses in 2017 amounted to approximately $375,000, which would have resulted in an additional $22,000 in financial service costs and $91,000 in billing service costs.

Staff also found that InnPower erroneously used a mix of budgeted and actual costs to calculate allocable IT costs. As a result, InnPower did not use correct proportions to allocate these costs to its affiliate services.

Furthermore, staff noted that InnPower did not include any return on invested capital in its calculation of fully-allocated cost. Had InnPower performed sufficient analysis to determine that a reasonably competitive market does <u>not</u> exist, the ARC specifies that the fully-allocated cost to be charged should include a return on invested capital:

> *2.3.4.2 Where a reasonably competitive market does not exist for a service, product, resource or use of asset that a utility sells to an affiliate, the utility shall charge no less than its fully-allocated cost to provide that service, product, resource or use of asset. The fully-allocated cost shall include a return on the utility's invested capital. The return on invested capital shall be no less than the utility's approved weighted average cost of capital.*

InnPower's approved weighted average cost of capital was 5.58%.[2] Based on InnPower's forecasted expenses for 2017, this would have resulted in an additional

[2] 2017 Cost of Service proceeding.

$21,548 for financial service costs and $17,787 for billing service costs to be charged to its affiliate.

By not including a return on invested capital in its calculation of the fully-allocated cost, InnPower is not performing the calculation correctly as required by ARC.

Finding 3 – InnPower's service agreements did not include all the terms as required by the ARC.

InnPower has service agreements in place with both its affiliates, InnServices and InnTerprises. However, the service agreements do not include all the terms as specified in Section 2.2.1 of the ARC.

In particular, the service agreement with InnServices does not include cost allocation mechanisms for the services provided. The service agreement with InnTerprises does not include any cost allocation mechanisms, confidentiality arrangements, apportionment of risks, or a dispute resolution process.

As a result, InnPower is not including all the service level agreement terms required by ARC.

Finding 4 – InnPower has not established any processes of management review to ensure ongoing compliance with the ARC.

As specified in Section 2.7.1 of the ARC, a utility shall perform periodic compliance reviews and monitor its employees' compliance with the ARC. Staff found that InnPower does not have any such processes in place.

Given that the information used to record affiliate revenues and expenses are primarily based on InnPower employees allocating their time appropriately, management oversight and controls should be in place to ensure that the information collected is accurate and complete.

Furthermore, by not having documented pricing and costing methodologies in place, InnPower's management cannot be assured that affiliate transactions are being recorded in compliance with the ARC.