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FRASER MILNER CASGRAIN LLP**ONTARIO ENERGY BOARD**

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VIA E-MAIL & COURIER

January 25, 2008

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, Suite 2700
Toronto, Ontario
M4P 1E4

EB-2007-0713

OEB BOARD SECRETARY	
File No:	Sub File: 19
Panel	PV, RR
Licensing	HT
Other	DC
00/04	

Dear Ms. Walli:

**Re: Hydro Ottawa Limited;
2008 Electricity Distribution Rates;
Board File No. EB-2007-0713**

I am writing on behalf of Hydro Ottawa to file the following with you in the light of yesterday's hearing of the Settlement Proposal dated January 23, 2007 (see pages 3, 42, and 45 of the transcript):

- a revised version of the Settlement Proposal;
- a revision-marked version of the Settlement Proposal indicating each revision – see pages 5, 6, 14, and 17 – plus the revision of the "header" on each page; and
- the PwC Opinion (as defined at the top of page 5 of the Settlement Proposal), even though it has not been revised, in order to have it consolidated with the two versions of the Settlement Proposal.

Yours very truly,

JHF/ko
Encls.

cc: All Intervenors

January 8, 2008

Mr. Wojciech Zielonka
Chief Financial Officer
Hydro Ottawa Limited
3025 Albion Road North
Ottawa, Ontario K1G 3S2

Accounting Opinion on Change in Overhead Capitalization Policy

To Hydro Ottawa Limited:

We have been engaged to report on the appropriate application of Canadian generally accepted accounting principles ("Canadian GAAP") to the specific transaction described below. This report is being issued to Hydro Ottawa Limited for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with Canadian generally accepted standards for such engagements.

The facts, circumstances and assumptions relevant to the specific transaction as provided to us by the management of Hydro Ottawa Limited ("Hydro Ottawa") are as follows:

In the normal course of business, Hydro Ottawa capitalizes costs incurred to construct items of property, plant and equipment. Hydro Ottawa includes in the amount capitalized for such assets some "overhead" costs attributable to the capital work.

Hydro Ottawa's policy and methodology to capitalize overhead costs were described and documented in the following documents:

- Capitalization Policy FIN5-001.01 effective July 26, 2005
- Cost Allocation Rates effective January 1, 2004

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Effective January 1st, 2008, Hydro Ottawa has updated its policies and procedures with respect to capitalization of overhead costs in the following documents:

- Capitalization Policy FIN5-001.02 effective January 1, 2008
- Cost Allocation Rates Procedure 001-02 associated with the Capitalization Policy above effective January 1, 2008

The context and the rationale for this update is further described in the Hydro Ottawa Memo “Change in Overhead Capitalization – Accounting Treatment” dated December 19, 2007 (the “Memo”) reproduced in Appendix A, and in particular in paragraphs 2 to 21 of said memo.

As described in paragraphs 17 to 21 of the memo, the updated methodology derives principally from a review that was performed by KPMG LLP and management of Hydro Ottawa and summarised in a report by KPMG dated August 16, 2007.

The most significant changes arising from the updated policy and procedure relate to the two following items:

- a) Estimation and allocation of the indirect costs subject to capitalization

The pool of overhead costs described in the July 26, 2005 and January 1, 2008 versions of the Capitalization Policy remained materially the same, but the estimation of those costs directly attributable to capital projects was revised.

The attribution of indirect costs to capital under the previous estimation approach ascribed a larger proportional share of indirect costs to direct capital expenditures than direct operating expenditures. Hydro Ottawa has an ongoing and intensive capital program. Consequently, the relative weighting of capital spending as compared to operational spending resulted in a higher proportion of indirect costs attributed to the capital program following this approach. Under the revised policy, the indirect costs subject to capitalization are those that are determined through a “causal linkage”. Guidance for the “causal linkage” is determined to be “costs that would be eliminated over time (in 3 to 5 years) if Hydro Ottawa did not have a capital program.” Our understanding of the “3 to 5 years” notion is that in the event of a gradual or temporary reduction in the capital program, some staff in particular would be retained even if underutilized as it may be difficult to rehire and retrain new staff if and when the program were to increase again.

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However, in the event of a drastic and expected to be long lasting decline in activity, the costs could be eliminated in a matter of weeks or months.

- b) Reduction in the number of “allocation rates” used to allocate the costs subject to capitalization to the individual assets constructed, as well as a simplification of the method to apply the rates.

The previous procedure included seven allocation rates to recover direct and indirect costs, which were allocated based on activity or cumulative cost drivers. However, the procedure involved a “cascading” approach whereby these allocation rates included allocations from the indirect cost pools, as well as their own direct costs. The application method applied the allocation rates in a manner that layered them, requiring successive calculations such that certain rates became dependant on others.

The revised procedure was simplified to have four direct inputs with no indirect costs built in and three allocation rates to apply the indirect costs identified to be attributable to capital projects. The application is a “single step” approach based on the four direct inputs with no cascading or layering of rates requiring multiple calculations.

The previous policy and procedure was considered to result in the capitalization of amounts in excess of amounts “directly attributable” under paragraph 5 of Section 3061 *Property, Plant and Equipment* of the Accounting Handbook of the Canadian Institute of Chartered Accountants (the “CICA Handbook”). However, as described in paragraphs 6 and 9 of the Memo, this policy and procedure was accepted as part of the regulatory regime of Hydro Ottawa and therefore was considered to be in accordance with GAAP based on the exception provided by paragraph 34 of Section 1100 *Generally Accepted Accounting Principles* of the CICA Handbook.

The management of Hydro Ottawa has included the new capitalization policy as part of the 2008 rate application recently submitted to its regulator for approval.

In our opinion the revised methodology with respect to capitalized overhead described above is in conformance with Canadian GAAP.

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The appropriate accounting principles to be applied to the accounting change described above are as follows:

The change in the capitalization policy implemented on January 1, 2008, should be accounted for as a change in accounting policy on a prospective basis by Hydro Ottawa. Accordingly, the disclosure requirements of paragraph 29 of Section 1506 *Accounting Changes* of the CICA Handbook should be considered.

Our report is based on the following authoritative support and other supporting rationale:

The relevant guidance with respect to changes in accounting policies, changes in estimates and corrections of errors is found in Section 1506. Paragraph 5 provides the following definitions:

- (a) **Accounting policies** are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.
- (b) A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.
- (c) **Prior period errors** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
 - (i) was available when financial statements for those periods were completed; and
 - (ii) could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

The issue is therefore to determine which of the three categories is applicable for the change in the overhead capitalization methodology implemented on January 1, 2008.

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It is clear that from a basic policy point of view, Hydro Ottawa was capitalizing some overhead costs under the previous policy and procedure and will continue to capitalize some overhead costs under the new policy and procedure.

The change in methodology can be summarised as being one that moved from identifying “directly attributable” overhead costs subject to allocation to capital projects based on a “fully allocated cost” approach to a methodology that is more based on a “causal linkage” approach. Influencing factors for this change were:

- the new information provided by Deloitte & Touche, in their June 8, 2007, report on accounting guidelines and industry practices as they relate to including overhead allocations in the costs capitalized to Property Plant and Equipment;
- the completion in August 2007 of the exhaustive review by the management of Hydro Ottawa under the supervision of KPMG;
- the amendments to Section 1100 that would no longer permit a “fully allocated cost” approach by January 1, 2009.

In order to conclude, it is therefore required to determine if the predominant characteristic of changing how overheads are allocated falls within the concept of “principles, bases, conventions, rules and practices” as described in (a) above or within the concept of “estimate” as described in (b) above.

Determining what costs are “directly attributable” under paragraph 5 of Section 3061 remains an estimation process. Like other estimates, this estimation process is performed by establishing a systematic methodology that falls clearly within the notion of “principles, bases, conventions, rules and practices” of (a) above.

It is clear that Hydro Ottawa had one such methodology before and has a new one after. The methodology is simply trying to determine whether a specific cost should be part of the cost basis of an asset or be expensed as incurred and in what manner it is to be applied to a specific item of property, plant and equipment.

On the other hand, the definition of “change in accounting estimate” under Section 1506 is intended to apply to “adjustments of the carrying amount of any asset or liability” or to the “amount of the periodic consumption of an asset”. What this implies is that sooner or later, new information will allow the estimate to be “proven right or wrong”, such as the final recoverable amount of an account receivable, the settlement of a contingent

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liability or the estimated life of an item of property, plant and equipment. In the case of the capitalization of overhead, there is no such notion as the future will never tell whether the amount capitalized was “right or wrong” and therefore the change in methodology would not constitute a change in estimate.

The information obtained indicates that the effects of the change in methodology will be significant on an annual basis from a quantitative point of view. However, regardless of the magnitude of the amounts, none of the information obtained points to any of the indicators of an “error” described in Section 1506, paragraph 5 c) reproduced earlier in this report. The magnitude of the effects of the change is due in part to the change from a “fully allocated” to a “causal linkage” cost approach and in part due to a more strict application of “directly attributable” as contemplated by paragraph 5 of Section 1506 to eliminate the need to rely on the “rate regulated” exception afforded by paragraph 34 of Section 1100. Accordingly, this is not considered to be a “prior period error”.

Consequently, we consider that this new approach constitutes a change in accounting policy.

Under 1506.14 (b), as this change in policy is made on a voluntary basis, it is required that the change in policy can be applied in a reliable manner and provides more relevant information. On the basis that the revised policy is relatively simpler to apply than the previous one, there is no indication that Hydro Ottawa will not be able to apply it in a reliable manner. From a relevance point of view, as described in paragraph 27 of the Memo, the revised methodology is more in line with the observed trend of applying more conservative approaches to capitalization of overhead and similar indirect costs and it is in accordance with Canadian GAAP on a stand alone basis, i.e. without the need to rely on an exception afforded to rate regulated activities. Accordingly, this change should allow Hydro Ottawa to report its performance in a more relevant manner. Furthermore, as previously mentioned, such a change would have been required in any event by January 1, 2009, in order for Hydro Ottawa to be in compliance with Section 1100 of the CICA Handbook.

Finally, under paragraphs 19 to 27 and 50 to 53 of Section 1506, the change in policy would by default be applied on a retroactive basis under paragraph 19(b). However, the following arguments were considered to determine that it would be neither be practicable to apply such a change retroactively nor would it be appropriate in any case.

- a) As described in paragraph 26 of the Memo, management of Hydro Ottawa has determined that retroactive application would not be practicable as it would require

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making retroactive judgements on the cost structure that existed at the time to determine what costs, if any, would not have been capitalized, rebuilding the burden rates and applying these new burden rates based on cost drivers that may not have been captured in the past, all this for the thousands of individual line items carried in the property, plant and equipment subledger, and then recomputing depreciation;

- b) Amending the accounting records retroactively would lead to a situation where Hydro Ottawa would unilaterally override the effects of rate decisions that were imposed onto it by the regulator in the past and were to be applied in the future, and thus giving a result that is inconsistent with the basic principles of accounting in a rate regulated situation;
- c) The recent amendments to Section 1100, in particular the new paragraph 32B, the deletion of paragraphs 34 and 35 and the existing transitional provisions in paragraph 33 provide that any changes in measurement arising from the elimination of the "rate regulated" exception is to be applied prospectively.

The ultimate responsibility for the decision on the appropriate application of Canadian generally accepted accounting principles for the specific transaction described above rests with Hydro Ottawa management as preparers of the financial statements, who should consult with its auditors. Our judgment on the appropriate application of Canadian generally accepted accounting principles for the specific transaction described above is based on the facts, circumstances and assumptions provided to us. Should the facts, circumstances or assumptions differ, our conclusion may change.

This report is intended solely for the information and use of Hydro Ottawa Limited and may be used in the context of Hydro Ottawa Limited's rate application with the Ontario Energy Board and is not intended to be and should not be used by anyone other than these specified parties or for any other purpose.

PricewaterhouseCoopers LLP

Chartered Accountants

FINAL

December 19, 2007

To: Memo to File

From: Director of Finance and Chief Financial Officer

CHANGE IN OVERHEAD CAPITALIZATION – ACCOUNTING TREATMENT

- 1) The intent of this memo is to determine the appropriate accounting treatment for Hydro Ottawa Limited's (HOL) change to its allocation of indirect costs (overhead) to capital projects. Under Section 1506 of the Canadian Institute of Chartered Accountants' (CICA) Handbook, the application of a change in accounting practice is assessed based on whether an error has occurred or it is due to a change in policy or estimate. An error requires a prior period adjustment, a change in accounting policy is to be applied retrospectively or prospectively depending on considerations around reasons for the change and practicality of application, whereas a change in estimate is implemented prospectively.

BACKGROUND

- 2) Upon the amalgamation of the five predecessor utilities on November 1, 2000, HOL adopted the capitalization policy and allocation procedure of one its predecessors, Ottawa Hydro, until it conducted its own review in 2003. An HOL policy and procedure was updated as a result of the 2003 review, the results of which were applied in the preparation of the audited 2003-year end financial statements.
- 3) As an infrastructure-based business, HOL's operations are capital-intensive with the majority of its expenditures being earmarked for capital projects and the subsequent ongoing maintenance of these assets. Historically it has always used "burden" rates to apply overhead to its projects/programs, as do most entities in the utility sector. Each utility has its own policies in this regard to determine what costs qualify for capitalization and what methodology is to be used to apply this overhead to individual assets. HOL's practice has been to fully allocate its overhead costs to capital projects using budgeted burden rates and to perform a true up at year-end based on its actual costs.
- 4) As part of their audit of the financial statements for the year ended December 31, 2003, Deloitte & Touche (D&T), HOL's former auditors, analyzed the policy, procedure and related indirect cost allocation model. They were satisfied that the model was working as intended. D&T indicated at the time that "administrative overhead costs may be allocated to the capital projects if they are qualifying capital costs under the Ontario Energy Board (OEB) rules and if this is consistent with industry practice." The

capitalization policy and related procedure and model used previously has been applied consistently to date.

- 5) During the last seven years HOL's strategic direction has gradually shifted from a not-for-profit municipally owned utility to a commercially run, profit oriented business. In 2003 HOL hired a new Chief Operating Officer, who began transforming the Company to a commercially run business. As a result of this development the focus of the Company turned from maintaining infrastructure to building and replacing infrastructure, which dictated how HOL prioritized its workload and how it deployed its workforce. This affected more than just the frontline groups, but also the way the support groups such as Finance, Human Resources, Information Technology and others viewed their responsibilities and the association of their departmental costs with the capital program. This change in the Company's philosophy along with the introduction of an asset management plan further emphasized the Company's focus on capital. The 2003 capitalization review reflected this increased focus on capital while respecting both OEB and GAAP guidelines on capitalization and industry practice.
- 6) HOL's previous capitalization and overhead policy were submitted to the OEB as part of its 2006 Electricity Distribution Rate Application. The Application was approved in early 2006 and since that time the OEB has not questioned the methodology. Consequently, the overhead amount is considered to be an approved cost which is part and parcel of the capital assets and is recovered through the rate approval process via its inclusion in the amortization of capital assets.
- 7) It is a best and common practice that all organizations review on a periodic basis their financial and operational policies and procedures for appropriateness. External influences such as significant changes to legislation, generally accepted and/or regulatory accounting principles and internal changes such as organizational redesign and modifications to business practices or business lines, usually cause the re-examination of corporate policies for their appropriateness. In the absence of the above, the passage of time, usually 3-5 years, also triggers a review of all major corporate policies and financial estimates contained there in.
- 8) Recent pronouncements by professional accounting bodies affecting rate regulated entities such as the amendments to Section 1100 of the CICA Handbook that would eliminate exceptions for rate regulated starting January 1, 2009 and the proposed adoption of IFRS in Canada in 2011 (2010 for comparatives), the filing of the 2008 rate application and the passage of time has prompted HOL to review its capitalization policy and allocation procedure. In addition, the methodology for allocating overheads was considered to be unnecessarily complicated and could be simplified to allow for financial planning and budgeting in a timelier manner without unduly sacrificing the precision of the measurements.
- 9) Paragraph 3061.20 of the CICA Handbook states that (**emphasis added**) "The cost of an item of property, plant and equipment includes direct construction or development costs and overhead costs **directly attributable** to the construction or development." The notion of "directly attributable" is not further defined in the CICA Handbook and remains largely a matter subject to professional judgment. Rate regulated entities are

provided with an exemption to the application of Section 1100, as CICA Handbook paragraph 1100.34 states that "...an entity is not required to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulations..." Consequently the determination of those overhead costs to be capitalized by HOL could vary from those of a non-regulated industry. HOL's capitalization of overheads however would still be in conformance with Generally Accepted Accounting Principles (GAAP), as a rate-regulated entity until December 31, 2008 when the exemption for rate-regulated entities is removed from Section 1100 of the CICA Handbook.

- 10) The development of the past and present cost allocation models also considered OEB prescribed accounting guidelines within its Accounting Procedures Handbook (APH), specifically articles 230 – Definitions & Instructions, Article 340 – Allocation of Costs & Transfer Pricing and Article 410 – Capital Assets. These guidelines provide guidance in those particular areas where the CICA Handbook allows for differences in accounting treatment for rate-regulated enterprises. In the case of overhead capitalization the APH does not provide any further guidance.
- 11) Currently, there are no "across the board standard industry practices" regarding the accounting for overheads within a capitalization policy. Depending on corporate structures, past practices and regulatory oversight, the inclusions/exclusions and allocation methodology can vary from entity to entity. Most utilities do not publicly disclose in detail their process of capitalization. The OEB Accounting Procedures Handbook articles provide guidance but no definitive rules on the components of construction costs. In 2005 the CICA issued an Accounting Guideline on Disclosures by Entities subject to Rate Regulation (AcG-19) requiring note disclosure on the differences between normal GAAP and GAAP allowed for rate regulated entities. In the area of overhead capitalization, HOL, similar to other utilities in Canada, did not disclose specific differences on the topic of overhead capitalization practices. This was based on HOL's management conclusion that any difference could not be quantified without the incurrence of significant efforts and may not be accurately quantified. The inability to quantify the difference resulted in a reporting deficiency in HOL's financial statements for the years ended December 31, 2005 and 2006 however as the deficiency did not give rise to a material misstatement of the financial statements the external auditors were still able to provide an unqualified opinion.
- 12) The CICA released a Rate Regulated Operations Exposure Draft in March 2007, which proposed to remove CICA Handbook paragraph 1100.34 and eliminate from all other Accounting Sections of the CICA Handbook any paragraphs that provide recognition and measurement guidance to rate regulated entities. In the absence of specific Canadian GAAP for regulated entities those, entities that would desire to continue to apply "rate-regulated-type accounting" would likely have to adopt policies consistent with Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS 71), of the US Financial Accounting Standards Board (FASB). There is a perception that rate-regulated entities are afforded more leeway in the capitalization of indirect costs and that if CICA Handbook paragraph 1100.34 is removed the increased flexibility to capitalize indirect costs is removed. AcG-19 would continue to provide disclosure guidance to rate regulated entities.

- 13) The Accounting Standards Board (AcSB) has decided to proceed with its proposal to remove the temporary exemption in Section 1100 for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009. The amendment to Section 1100 will apply prospectively. One of the CICA's published reasons¹ for the elimination of the Section 1100.34 exemption is to align recognition and measurement for rate-regulated and non-rate-regulated entities prior to the adoption of International Financial Reporting Standards by 2010 for comparative purposes.
- 14) As mentioned above, in the absence of specific guidance for rate-regulated entities within the CICA Handbook, utilities may choose at that time to follow US guidance. FAS 71, paragraph 9 states the following: Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:
- a) It is probable (*probable* is used in this Statement with its usual general meaning, rather than in a specific technical sense, and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for ratemaking purposes.
 - b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

FAS 71 does not specifically address what construction or development costs, other than interest, may be capitalized. In the absence of specific guidance, HOL's current interpretation is that the guidance in CICA Handbook section 3061.20 on "directly attributable" costs would apply. It would therefore appear that with the removal as of January 1, 2009 of the 1100.34 exemption for rate-regulated entities, a capitalization model that would capitalize costs other than those that are considered "directly attributable" may not be GAAP.

CURRENT DEVELOPMENTS

- 15) In view of the changing accounting environment with respect to rate-regulated entities, HOL engaged D&T during the spring of 2007 to research accounting guidelines and industry practice as they relate to including overhead allocations in the costs capitalized to Property, Plant & Equipment. D&T's report² concluded that there is a significant variation amongst utilities across Canada and the United States as to capitalization policies and specifically the capitalization of overhead. The report noted that there has been a tendency to move from more aggressive to more conservative capitalization policies. Eventual convergence with International Financial Standards and the exposure

¹ Accounting Standards Board Decision Summary – August 22, 2007

² Deloitte & Touche Report - June 8, 2007

draft discussing the elimination of rate regulated accounting in Canada would also be contributing factors towards a more conservative approach.

- 16) HOL also engaged Fraser Milner Casgrain LLP (FMC), the counsel retained for the 2008 rate application, to conduct research for regulatory decisions on the issue of capitalization versus expensing expenditures. FMC's work to date covers decisions made in the last five years by the following regulators: the OEB, the Alberta Energy and Utilities Board, the British Columbia Utilities Board and the National Energy Board. In short, their research suggests there is no hard and fast rule when one is deciding whether to capitalize or expense an overhead cost. To the contrary, well-accepted business principles are applied on a case-by-case basis, having regard to the facts of each case.
- 17) HOL staff also conducted an informal web based review to determine how other entities interpret *directly attributable* overhead costs. Two reports issued by KPMG were considered by staff to be the most relevant and current. They are, a study undertaken on behalf of NB Power Group of Companies and another on behalf of Union Gas Limited. In both studies KPMG was retained to conduct an independent study of the companies' process for capitalizing overhead costs and in the case of NB Power, this study addressed the allocation of corporate service costs from their holding company.
- 18) HOL engaged the same KPMG Managing Director who participated in the NB Power and Union Gas reviews to assist in a review to update HOL's estimate of the amount of overhead costs related to capital work and ensure its capitalization and allocation policies reflect any change in the methodology to identify and allocate overhead costs to be capitalized. The common principle that KPMG has deduced from its review of accounting and regulatory guidance and industry practice is "That any assignment of indirect costs to a capital project should be done based on some reasonable causal link or association with the capital activity."
- 19) This principle of "causal link and association" has been incorporated by HOL into the current review of overhead costs attributable to the capital program. The resulting methodology and related estimates, discussed below, resulted in the reduction of overheads costs that qualified for capitalization as compared with the past practice of fully allocating overhead costs. The current methodology as outlined in the KPMG report³ is seen to be more reflective of current industry practice and is consistent with a trend towards less capitalization of overheads by professional accounting bodies.
- 20) As was mentioned earlier, the allocation model has also been simplified to eliminate a complex multiple step process of assigning overhead costs amongst support activities i.e. Finance, Human Resources etc. and then reassigning a portion of the support activity costs estimated to be *directly attributable* to capital work and then to specific capital projects. Only three burden rates, Engineering, Supervision and Administration have been established in the current model. These burdens are applied independently to the appropriate cost drivers of each individual project to simplify the allocation process.

³ KPMG Report – Review and Update of Overhead Capitalization Estimates - Aug 15, 2007

This also allows overhead costs to be applied more precisely to particular projects that share causal links with the various types of overhead costs

- 21) In summary, KPMG reviewed HOL's updated policy on capitalization and found it to be reasonable and in accordance with industry standards and practice related to overhead capitalization. KPMG also reviewed the cost drivers (for overhead allocation) and validated the appropriateness of the overhead costs that are to be allocated to capital projects. KPMG found the proposed overhead capitalization results developed in the study and presented in their report to be fair and reasonable.

ACCOUNTING TREATMENT ANALYSIS

- 22) At issue is the interpretation of "*directly attributable*" contained in CICA 3061.20 as it relates to HOL's indirect or overhead costs. HOL has strong arguments to consider that a portion of Facility and Operational general and administration (G&A) costs are *directly attributable* to capital projects. However it is more difficult to demonstrate what IT, HR, Finance, Holdco and Corporate costs are *directly attributable* to capital projects. As mentioned earlier, there appears to be a move towards more conservative accounting standards in Canada and in many other jurisdictions, in particular under IAS 16. Therefore, it is possible that some indirect costs, which are currently capitalized under GAAP by non-rate regulated entities, could cease to be eligible for capitalization in the future thereby compounding the impact on rate-regulated entities.
- 23) HOL's reassessment of estimated overhead or indirect costs that are *directly attributable* to capital work has resulted in approximately \$6.5M⁴ of overhead costs that would previously have been capitalized that are now identified in the 2008 budget as OM&A costs. Although the magnitude of this change is large, it has evolved over a 4-year period. Previously these costs would have been capitalized and amortized over 4 to 50 years depending on the asset type to which they were assigned.
- 24) Accounting changes can be considered a change in an accounting policy. Under Section 1506, an accounting policy is defined as specific principles, bases, conventions, rules and practices an entity applies when preparing and presenting its financial statements. The CICA Handbook section 1506.35 states "A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate." Initial discussions by Hydro Ottawa with various accounting professionals suggested that the change in indirect costs being allocated to capital was a change in accounting estimate. Hydro Ottawa engaged PricewaterhouseCoopers (PwC) to render an opinion on whether its Capitalization policy is in accordance with GAAP and to confirm that the accounting change, resulting from the change in indirect costs being allocated to capital, is a change in estimate to be applied prospectively. In the conduct of PwC's work which involved consulting HOL's current and past external auditors the consensus of professional opinion suggests a change in accounting policy is more

⁴ Audit Committee Memo – Revision of Capitalization Policy and Allocation Procedure Based on Updated Estimates – Aug 21, 2007

appropriate than a change in estimate. This consensus derives from the magnitude of the OM&A impact (\$6.5M⁴) coupled with gradual change in circumstances in HOL's business. Furthermore, the change in methodology does not meet the definition of a change in estimate contained in Section 1506.05 (b), i.e. it is not an "an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities". An estimate is usually associated with a currently uncertain amount that will eventually become exact as new information becomes available or new developments occur such as a valuation allowance on an account receivable or the useful life of a capital asset. In the case of overhead capitalization, the amount considered to be *directly attributable* will never become exact and therefore proven right or wrong. Finally, a change in methodology such as the one instituted by HOL is consistent with the notion of a change in "principles, bases, conventions, rules and practices" as contained in the definition of Accounting policies in CICA 1506.05 (a).

- 25) The CICA Handbook section 1506.48 (Accounting Changes) states, "Corrections of errors are distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision, as additional information becomes known." As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information. The amount of overheads allocated to capital is inherently an estimate; there is no right or wrong amount. These decisions ultimately rely on professional judgment and as long as HOL's allocations are reasonable in comparison to the others in the industry as outlined in the D&T report⁵, there is no evidence to indicate that the change in methodology is due to the existence of an error in the past.
- 26) Once the accounting change is determined to be as a result of a policy change, retrospective application is the default treatment. There are however qualifications on retrospective application per CICA Handbook Section 1506.23 "When retrospective application is required by paragraph 1506.19(a) or (b), a change in accounting policy shall be applied retrospectively except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change." Section 1506.50 goes on to say, "In some circumstances, it is impractical to adjust comparative information for one or more prior periods to achieve comparability with the current period." In management's opinion the retrospective application of this policy change would be extremely difficult and complex due to the thousands of line items on work orders being transferred to the fixed asset sub ledger on an annual basis, the need to reprogram the JD Edwards enterprise business system to reverse and rerun the depreciation calculations and the problem with translating historical business unit costs into the structure needed to apply the new allocation model. Management also feels that this change would not enhance the utility of the financial statements to the user, nor the comparability of financial results, as any restated Company's costs would be incongruent with its approved OEB revenue requirements.

⁵ Deloitte & Touche Report - June 8, 2007

CONCLUSION

- 27) Based on the information gathered, it is management's opinion that HOL's change to better reflect a more current approximation of overhead costs *directly attributable* to its capital work be considered a change in an accounting policy. The CICA Handbook Section 1506.14 permits changes in accounting policies if the change "(a) is required by a primary source of GAAP or (b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows". Since this change in accounting policy cannot be considered a change required by a primary source of GAAP currently, the change must result in reliable and more relevant financial information. CICA Handbook Section 1506.15 states "Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance and cash flows". Management believes the new policy is more reflective of industry practice and is inline with the trend towards more conservative policies for the capitalization of costs. The complexity of implementing this accounting change retroactively, as well as the disjoint that would occur between the approved regulated revenue based on the previous capitalization policy would not result in reliable and more relevant financial information to users of the financial statements. Although the removal of the exemption from section 1100 is not mandatory until January 1, 2009 and is to be applied prospectively, Hydro Ottawa Limited will adopt the change commencing January 1, 2008. It is Hydro Ottawa Limited's belief that this change in accounting policy should be applied prospectively beginning January 1, 2008 in order to align it with its 2008 rate application, which is designed to recover costs based on the 2008 fiscal year. Prospective application of the policy commencing January 1, 2009 would result in a misalignment between costs and its approved 2008 rates which would carry forward to its next rebasing which is anticipated to be in 2011.

Settlement Proposal

Hydro Ottawa Limited
2008 Electricity Distribution Rates
EB-2007-0713

January 23, 2008

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I. INTRODUCTION

This Settlement Proposal is filed with the Ontario Energy Board ("the "Board") in connection with the application of Hydro Ottawa Limited ("Hydro Ottawa"), including the supporting evidence, for an order or orders approving or fixing just and reasonable rates effective May 1, 2008 for distribution service and, in particular, the specific relief that Hydro Ottawa requested as described in Exhibit A1-4-1.

II. SETTLEMENT CONFERENCE

A Settlement Conference was held in one of the Board's hearing rooms on January 9, 10, and 11, 2008 and was continued, in conference calls, on January 17 and 18, 2008 in accordance with Rule 31 of Board's *Rules of Practice and Procedure* and the Board's *Settlement Conference Guidelines*. This Settlement Proposal arises from the Settlement Conference.

Hydro Ottawa, the following intervenors, and the Board's technical staff ("Board Staff") participated in the Settlement Conference:

- Consumers Council of Canada ("CCC"),
- Energy Probe Research Foundation ("Energy Probe"),
- School Energy Coalition ("SEC"), and
- Vulnerable Energy Consumers Coalition ("VECC").

PowerStream Inc. is also an intervenor. PowerStream Inc. did not, however, participate in any part of the Settlement Conference.

III. ISSUES

The Settlement Proposal deals with all of the issues listed in Appendix "A" to the Board's Procedural Order No. 2 dated December 12, 2007 (the "Issues List") even when there is no settlement of an issue. A copy of the Issues List is provided in Schedule A hereto (pp. 25-28) for ease of reference.

IV. SETTLEMENT CATEGORIES

Each issue dealt with in this Settlement Proposal falls within one of the following four categories:

1. **complete settlement** – an issue in respect of which Hydro Ottawa and the other parties agree with the settlement;
2. **incomplete settlement** – an issue in respect of which Hydro Ottawa and the other parties were only able to agree on some, but not all, aspects of the issue;
3. **partial settlement** – an issue in respect of which Hydro Ottawa and some, but not all, of the other parties agree with the settlement; and
4. **no settlement** – an issue in respect of which Hydro Ottawa and the other parties are unable to reach an agreement to settle the issue.

The following table presents the outcome of the Settlement Conference:

Table 1: Outcome of Settlement Conference

Complete Settlement	Incomplete Settlement	Partial Settlement	No Settlement
28 issues: 1.1, 1.2, 1.3, 1.4, 1.5, 1.6, 2.1, 2.2, 2.3, 3.1, 3.2, 3.3, 3.5, 3.6, 3.7, 4.1, 5.1, 6.1, 6.2, 6.3, 7.1, 8.1, 8.2, 8.3, 8.5, 8.6, 8.7, 9.1	one issue: 4.2	one issue: 3.4	one issue: 8.4

Issue 9.2 is not included in Table 1 because the Board disposed of this issue in its Decision on Request for Interim Rates dated January 10, 2008: "[t]he Board denies Hydro Ottawa's request that its existing distribution rates be declared interim effective January 1, 2008" (p. 5). The parties accordingly did not discuss this issue at the Settlement Conference.

V. PARAMETERS OF SETTLEMENT PROPOSAL

The Settlement Proposal has been prepared in accordance with Rule 32 of the Board's *Rules of Practice and Procedure* and the Board's *Settlement Conference Guidelines* by Hydro Ottawa in consultation with CCC, Energy Probe, SEC, and VECC. They discussed every issue and negotiated each agreement to settle an issue. They are collectively, then, the "parties" to this Settlement Proposal. Board Staff also participated in the discussion of each issue during the Settlement Conference, as contemplated by the Board's *Settlement Conference Guidelines* (p. 5), but Board Staff is not a party to

this Settlement Proposal. The parties nevertheless consulted with Board Staff during the preparation of this Settlement Proposal.

The Settlement Proposal describes the agreements reached on the settled issues, including the rationale for each of them, and delineates the scope of any dispute over the incompletely settled issue, the partially settled issue, and the unsettled issue. All of the parties agree with each complete settlement unless otherwise indicated. The Settlement Proposal provides a direct link between each settled issue and the supporting evidence in the record to date plus, as indicated in the settlement of Issue 3.4, the PWC Opinion accounting opinion of PricewaterhouseCoopers LLP on the change in Hydro Ottawa's capitalization policy dated January 8, 2008 (the "PwC Opinion") that Hydro Ottawa previously distributed to the participants in the Settlement Conference.

The evidence on each settled issue is identified individually by reference to its exhibit number in an abbreviated format; for example, Exhibit A1, Tab 8, Schedule 1 is referred to as Exhibit A1-8-1. Hydro Ottawa's response to an interrogatory is described by citing Board Staff or the name of the party, as the case may be, and the number of the interrogatory (e.g., Board Staff Interrogatory #1). The identification and listing of the evidence that relates to each issue is provided to assist the Board.

The parties who agree with the settlement of each issue are of the view that the evidence provided is sufficient to support the Settlement Proposal in relation to each such issue. They are also of the view that the quality and detail of this evidence, together with the corresponding rationale, will allow the Board to make findings on each settlement.

According to the Settlement Guidelines (p. 3), the parties must consider whether a settlement proposal should include an appropriate adjustment mechanism for any settled issue that may be affected by external factors. Hydro Ottawa and the other parties consider that no settled issue, except for Issue 5.1, requires an adjustment mechanism. The settlement of Issue 5.1 includes the adjustment mechanism.

The issues listed in the "Complete Settlement" column of Table 1 (p. 4 above) have been settled by parties as a package (the "Settlement Package") and none of the parts of this Settlement Package is severable. If the Board does not accept the Settlement Package, in its entirety, then there is no Settlement Proposal (unless the parties agree that any part(s) of the Settlement Package that the Board does accept may continue as part of a valid settlement proposal). None of the parties can withdraw from the Settlement Proposal except in accordance with Rule 32.05 of the Board's *Rules of Practice and Procedure*. Finally, unless stated otherwise, the settlement of any particular issue in this proceeding is without prejudice to the rights of the parties to raise the same issue in any future proceeding before the Board whether or not Hydro Ottawa is the applicant or one of the applicants.

The documents and other information provided, the discussion of each issue, the offers and counter-offers, and the negotiations leading to the settlement – or not – of each issue during the Settlement Conference are strictly confidential and without prejudice. None of the foregoing is admissible as evidence in this proceeding, or otherwise, with the following two exceptions:

- ~~the accounting opinion of PricewaterhouseCoopers on the change in Hydro Ottawa's capitalization policy dated January 8, 2008 (the "PwC Opinion") that Hydro Ottawa previously distributed to the participants in the Settlement Conference; and~~
- the PwC Opinion and the need to resolve a subsequent dispute over the interpretation of any provision of this Settlement Proposal.

VI. OVERVIEW OF SETTLEMENT PROPOSAL

Hydro Ottawa and the other parties to the Settlement Proposal aimed for, and achieved, a comprehensive settlement such that there are complete settlements of 28 of the 31 issues remaining on the Board's Issues List. The incompletely settled issue (4.2) and the unsettled issue (8.4) are now, in effect, two parts of a single issue: the use of a deferral account (Issue 4.2) as a mechanism to recover the revenue deficiency arising in the first four months of the Test Year (Issue 8.4). Hydro Ottawa and the other parties to the Settlement Proposal agreed that these two issues should be addressed by means of argument alone; they prefer written argument.

Hydro Ottawa and the other parties also agreed that the partially settled issue (3.4) should be addressed in an oral hearing of Hydro Ottawa's evidence on this issue. Hydro Ottawa is concurrently filing, as additional evidence on Issue 3.4, the PwC Opinion.

Table 2 on the next page presents the causes of the revenue deficiency for the Test Year:

Table 2: Causes of Revenue Deficiency

Cause	Application \$000	Settlement \$000	Change \$000
Increase in Amortization Expense	(\$9,638)	(\$6,706)	(\$2,932)
Increase in Revenue Offsets	3,491	3,491	0
Increase in OM&A Expenses	(15,151)	(12,911)	(2,240)
Increase in Return on Capital	(4,606)	(2,209)	(2,397)
Change in Payment in Lieu of Taxes	(1,186)	1,049	(2,235)
Moving Low Voltage Charges to Cost of Power	556	556	0
Load Growth	1,340	1,563	(223)
Total Deficiency	(\$25,195)	(\$15,166)	(\$10,029)
Smart Meter Rate Adder	0	(4,017)	4,017
Net Change		(\$19,183)	(\$6,012)

The impact of the "settlement case" on the total electricity bill for a Residential customer using 1,000 kWh/month is 0.8%; however, this impact could vary depending on the Board's decision on Issue 3.4 below. The impact of the "application case" was 1.6%.

Hydro Ottawa has identified the following as the main drivers of the revenue deficiency in Table 2:

- The capitalization process (see issue 3.4 below) is one main driver. The settlements of Issues 1.1, 1.3, 2.2, 3.1, 3.2, and 3.3 (if approved by the Board) would mitigate the bill impact of this driver.
- The Smart Meter program (see Issue 6.1 and 6.2 below) is the other main driver. Hydro Ottawa's Smart Meter installation program was more than 60% complete by year-end 2007. Hydro Ottawa is accordingly well ahead of most other distributors on a percentage basis. The settlement of Issues 6.1 and 6.2 ensures that Smart Meter spending and the resultant bill impacts are both transparent through 2010.

VII. ISSUE-BY-ISSUE SETTLEMENTS

1. Rate Base (Exhibit B)

1.1 Is the proposed Rate Base for Test Year 2008 appropriate? (B1)

- **Complete Settlement:** Hydro Ottawa's forecast of its Rate Base for the Test Year was \$581,765k; however, the forecast is now subject to the adjustment of the Working Capital Allowance pursuant to the settlement of Issue 1.3, the adjustment for Smart Meters pursuant to the settlement of Issue 6.1, and the adjustment for the accelerated amortization period for stranded meters pursuant to the settlement of Issue 3.3. The resultant forecast of Rate Base for the Test Year is \$545,806k subject to further adjustment, however, depending on the Board's decision on Issue 3.4 below. The other parties have accepted Hydro Ottawa's forecast, including any such adjustment, as appropriate in the context of the Settlement Package.

- **Evidence:** The evidence on this issue includes the following:

Exhibits B1-1-1, B2-1-1, B3-1-1
SEC Interrogatory #19
VECC Interrogatory # 37

1.2 Is the proposed Capital Expenditures forecast for Test Year 2008 appropriate? (B3)

- **Complete Settlement:** Hydro Ottawa's forecast of its Capital Expenditures for the Test Year was \$81,796k or \$66,451k net of contributed capital; however, the forecast is now subject to the adjustment for Smart Meters pursuant to the settlement of Issue 6.1. The resultant forecast of Capital Expenditures for the Test Year is \$72,112k, or \$56,767k net of contributed capital, plus Capital Expenditures for Smart Meters that would be recovered through a rate adder; see Issues 6.1 and 6.2 below. These Capital Expenditures are subject to further adjustment, however, depending on the Board's decision on Issue 3.4 below. The parties have accepted Hydro Ottawa's forecast, as so adjusted and as may be further adjusted, as appropriate in the context of the Settlement Package.

- **Evidence:** The evidence on this issue includes the following:

Exhibits B1-1-1, B1-2-2, B3-2-2, B3-4-1, B3-4-2, B3-5-1, B3-5-2
Board Staff Interrogatories #1,5-7,9,10,12
SEC Interrogatories #4, 10, 19, 40
CCC Interrogatory #7

VECC Interrogatories #15-18, 30, 34, 41b, 46

1.3 Is the Working Capital Allowance for Test Year 2008 appropriate? (B3)

- **Complete Settlement:** Hydro Ottawa's forecast of its Working Capital Allowance for the Test Year was \$92,733k. Hydro Ottawa did not use a lead-lag study but, rather, it used "the 15% of specific O&M accounts formula approach" for the Test Year; see page 15 of the Board's *Filing Requirements for Transmission and Distribution Applications* dated November 14, 2006. Hydro Ottawa proposed to adjust its forecast to reflect the following:
 - (a) the decrease of the wholesale transmission rates of Hydro One Networks Inc. ("HONI");
 - (b) the commodity rate forecast contained in the *Ontario Wholesale Electricity Market Price Forecast* dated October 12, 2007 and prepared by Navigant Consulting Inc. for the period from November 1, 2007 through April 30, 2009;
 - (c) 12.5% of the "specific O&M accounts," rather than 15%, based on the results of a lead-lag study conducted by Toronto Hydro-Electric System Limited ("THESL") for its 2008 test year; and
 - (d) the settlement of Issues 3.1, 6.1, and 6.2 below.

The resultant forecast of the Working Capital Allowance is \$75,704k. The other parties have accepted Hydro Ottawa's forecast, as so adjusted, as appropriate in the context of the Settlement Package.

- **Evidence:** The evidence on this issue includes the following:

Exhibit B3-6-1
Board Staff Interrogatory #57g
SEC Interrogatory #46
VECC Interrogatory #31

1.4 Is the proposed Capital Expenditures forecast for 2009 and 2010 appropriate? (B4)

- **Complete Settlement:** Hydro Ottawa prepared a forecast of its Capital Expenditures for 2009 and for 2010, and developed a capital adjustment factor with a deferral account alternative, because of its concern that the Board's 3rd Generation Incentive Regulation Mechanism ("3GIRM"), which is now being developed, would exclude a capital investment factor as did the Board's 2nd

Generation Incentive Regulation Mechanism. The other parties do not accept Hydro's capital adjustment factor and, therefore, the related forecasts of Capital Expenditures.

Hydro Ottawa proposed to postpone the Board's consideration of this issue and Issues 1.5 and 1.6, together with the related part of Issue 4.2, until the Board issues its Report on the 3GIRM. The Board would do so by adjourning the proceeding *sine die* when issuing its final order approving Hydro Ottawa's 2008 rates. Hydro Ottawa will await the outcome of the 3GIRM process and, in the event that Hydro Ottawa is not satisfied with the 3GIRM in this regard, the Board would resume this proceeding at the request of Hydro Ottawa to consider this issue and Issues 1.5, 1.6, and 4.2 (in pertinent part) below. The other parties have accepted Hydro Ottawa's proposal as appropriate in the context of the Settlement Package.

- **Evidence:** The evidence on this issue includes the following:

Exhibits B4-1-1, B4-2-1, B4-3-1, B4-3-2
Board Staff Interrogatories #9, 46-54, 58
SEC Interrogatories #4-9
CCC Interrogatories #7, 15-17
VECC Interrogatories #6, 32-35

1.5 Is the proposal to establish an adjustment mechanism for Capital Expenditures beyond the 2008 test year appropriate?

- **Complete Settlement:** See Issue 1.4 above.
- **Evidence:** See Issue 1.4. above.

1.6 Is the proposed Capital Adjustment Factor for 2009 and 2010 appropriate? (B4)

- **Complete Settlement:** See Issue 1.4 above.
- **Evidence:** See Issue 1.4 above.

2. Operating Revenue (Exhibit C)

2.1 Is the proposed forecast of 2008 Test Year Throughput Revenue appropriate? (C1)

- **Complete Settlement:** Hydro Ottawa's forecast Throughput Revenue for the Test Year was \$149,110k; however, the forecast is now subject to adjustment to reflect the Settlement Package. The resultant forecast of Throughput Revenue is \$139,305k plus the revenue derived from the rate adder for Smart Meters; see Issues 6.1 and 6.2 below. This forecast is subject to further adjustment, however, depending on the Board's decision on Issue 3.4 below. The other parties have accepted Hydro Ottawa's forecast, as so adjusted and as may be further adjusted, as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibit C1-1-1
Board Staff Interrogatories #13-15

2.2 Are the proposed customers/connections and load forecasts (both kWh and kW) for Test Year 2008 appropriate, including the impact of CDM and weather normalization? (C1)

- **Complete Settlement:** Hydro Ottawa's load forecast for the Test Year reflected forecast of "savings" arising from conservation and demand management ("CDM") programs. This forecast of CDM savings was based on forecasts published by the Ontario Power Authority (the "OPA").

Hydro Ottawa proposed to adjust its load forecast by reducing its CDM savings by one-third, from 64,000 MWh to 42,667 MWh and from 11 MW to 7.3 MW, in consideration of the "natural conservation" that may be inherent in the OPA's forecast of CDM savings. The resultant load forecast for the Test Year is presented in Table 3 on the next page. The other parties have accepted Hydro Ottawa's load forecast, as so adjusted, as appropriate in the context of the Settlement Package.

Table 3: Revised Load Forecast

	Revised 2008 Forecast including CDM adjustment
Sales(kWh)	
Residential	2,261,678,461
General Service <50 kW	774,937,986
General Service 50-1500 kW	3,120,930,871
General Service 1500-5000 kW	837,604,031
Large User	649,903,952
Streetlighting	40,114,500
Sentinel Lights	92,512
Unmetered Scatterd Loads	20,244,150
Total	7,705,506,464
Sales (kW)	
General Service 50-1500 kW	7,373,411
General Service 1500-5000 kW	1,757,833
Large User	1,167,396
Streetlighting	107,223
Sentinel Lights	257
Total	10,406,120
Standby Charge (kW)	
General Service 50-1500 kW	15,000
General Service 1500-5000 kW	144,960
Large User	4,800
Total	164,760

Evidence: The evidence on this issue includes the following:

Exhibits A2-2-2, C1-2-1, C1-2-2
Board Staff Interrogatories #13-23
SEC Interrogatories #26, 27
CCC Interrogatory #18
VECC Interrogatories #33, 36

2.3 Is the proposed forecast of Test Year 2008 revenues from other regulated rates and charges appropriate? (C2)

- **Complete Settlement:** Hydro Ottawa's forecast of revenues from other regulated charges for the Test Year was \$7,586k. The other parties accept the forecast as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibits C2-1-1, C2-1-4
Board Staff Interrogatory #38
SEC Interrogatory #29
CCC Interrogatory #19
VECC Interrogatory #37b

3. Operating Costs (Exhibit D)

3.1 Is the overall Test Year 2008 OM&A forecast (including compensation) appropriate, for the following categories:

- **Operations and Maintenance**
- **Billing and Collection Costs**
- **Administrative and General Costs**
- **Insurance, Bad Debt, Advertising and Charitable Donation Costs**
- **Other Distribution Costs**
- **Smart Meter Expenses?**
- **Complete Settlement:** Hydro Ottawa's forecast of net OM&A for the Test Year, including Smart Meters, was \$59,328k. The other parties were concerned about this level of net OM&A compared to the levels in 2006 (actual) and 2007 (estimate).

The parties accordingly decided to discuss the forecast on an "envelope" basis. Hydro Ottawa proposed a reduction of \$1.5M in the net OM&A envelope. Hydro Ottawa has not determined precisely how the reduction will be implemented; however, there are no major programs or activities that would be eliminated. Hydro Ottawa will instead make reductions in a number of different areas so that there will be reductions in all of the major groupings of OM&A

accounts in general and, in particular, Operations, Maintenance, Billing and Collections, Community Relations, and Administration.

The resultant forecast of net OM&A for the Test Year is \$57,828k but this amount is reduced by another \$740k, to \$57,088k, because \$740k will be recovered in the rate adder for Smart Meters; see Issues 6.1 and 6.2 below. This forecast of net ~~OMA~~OM&A is subject to further adjustment, however, depending on the Board's decision on Issue 3.4 below. The other parties accept this forecast, as so adjusted and as may be further adjusted, as appropriate in the context of the Settlement Package.

- **Evidence:** The evidence on this issue includes the following:

Exhibits D1-1-1, D1-1-4, D1-2-1, D1-5-1, D1-5-2
Board Staff Interrogatories #36-38
SEC Interrogatories #30-32, 34-36, 42
VECC Interrogatories #25, 39, 40, 42, 44, 45

3.2 Is the Test Year 2008 forecast of PILs (Capital Taxes and Income Taxes) appropriate? (D2)

- **Complete Settlement:** Hydro Ottawa's forecast of PILs for the Test Year was \$13,675k; however, it did not reflect the recent revisions of the federal income tax rate, the provincial capital tax, and the federal capital cost allowance (CCA) rates. Hydro Ottawa will adjust its PILs forecast accordingly; this adjustment is consistent with the Board's procedure "to effect income tax rate changes as part of the 2008 Incentive Regulation Mechanism (2008 IRM) application process:" see the Board's letter dated November 21, 2007 to "All Licensed Electricity Distributors" and to "All Participants in Proceedings EB-2006-0087, EB 2006-0088 and EB-2006-0089." Hydro Ottawa will also adjust its forecast to reflect the completely settled issues. The resultant forecast of PILs for the Test Year is \$11,440k subject to further adjustment, however, depending on the Board's decision on Issue 3.4. The other parties accept this forecast, including any such further adjustment, as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibits D2-1-1, D2-2-1
Board Staff Interrogatories #62-65
SEC Interrogatory #43

3.3 Is the proposed level of the Amortization expense for 2008 appropriate?

- **Complete Settlement:** Hydro Ottawa's forecast of Amortization expense for the Test Year was \$43,754k. The other parties have accepted Hydro Ottawa's amortization rates, calculation methodology, and specific levels of amortization costs for the Test Year with the exception of the amortization period (four years) and thus the amortization rates and costs for stranded meters.

O. Reg. 426/06 allows Hydro Ottawa to recover the cost of stranded meters over a period to be determined by the Board. Hydro Ottawa applied to recover these costs over a period of four years. The other parties were concerned about the resultant bill impacts in the Test Year, and subsequently, although they recognize that a longer period would also have bill impacts arising from a slower decline in Rate Base.

Hydro Ottawa has proposed an amortization period of six years in response to their concerns. The resultant forecast of \$40,822k reflects not only the six-year period, but also the recovery of the Amortization expense for Smart Meters through a rate adder; see Issues 6.1 and 6.2 below. This forecast is subject to further adjustment, however, depending on the Board's decision on Issue 3.4 below. The other parties have accepted this forecast, including any such further adjustment, as appropriate in the context of the Settlement Package.

- **Evidence:** The evidence on this issue includes the following:

Exhibit D1-7-1, D3-2-2
Board Staff Interrogatories #44, 55
VECC Interrogatory #47

3.4 Is the capitalization process (policy and procedure) appropriate? (B1)

- **Partial Settlement:** Hydro Ottawa applied for the Board's approval of its new capitalization process (policy and procedure) effective January 1, 2008. Hydro Ottawa's current estimate of the resultant increase of OM&A is \$6.5M. CCC, Energy Probe, and VECC have accepted Hydro Ottawa's new capitalization process in principle and, in addition, they have accepted the \$6.5M increase as appropriate in the context of the Settlement Package. SEC has not accepted Hydro Ottawa's new capitalization process in principle.
- **Evidence:** The evidence on this issue includes the following:

Exhibits A2-2-2, B1-3-1, B3-2-2, D1-1-1, D1-1-4
PwC Opinion
Board Staff Interrogatories #28, 29
SEC Interrogatories #17, 18, 32
VECC Interrogatories #23-26, 28, 29, 38, 41, 42

3.5 Are the proposed Distribution Loss Factors appropriate? (D1)

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's Distribution Loss Factors as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibits D1-8-1, D1-8-2, D1-8-3
Board Staff Interrogatories #40-42

3.6 Is the recovery of amounts relating to Lost Revenue Adjustment Mechanism and Shared Savings Mechanism appropriate? (D3)

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's LRAM/SSM claims, including carrying charges, and the calculation of the related rate riders as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibit D3-2-1 updated
CCC Interrogatory #8

3.7 Is the proposed allocation of Holding Company costs appropriate? (D1)

- **Complete Settlement:** Hydro Ottawa's forecast of total Holding Company costs to be allocated to the utility in the Test Year was 39% (\$2,140k); this percentage was the same as Hydro Ottawa's estimate for 2007. The other parties have accepted this forecast as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibits D1-1-1, D1-1-4, D1-2-1, D1-6-1
Board Staff Interrogatory #34
SEC Interrogatory #36
CCC Interrogatory #3
VEC Interrogatories #10, 24

4. Deferral and Variance Accounts (Exhibit E)

4.1 Is the proposed clearance of various deferral and variance account balances appropriate?

- **Complete Settlement:** The other parties have agreed that Hydro Ottawa's proposed clearance of the various deferral and variance account balances is appropriate in the context of the Settlement Package for the following reasons:
 - (a) The audited balances for these accounts as at December 31, 2006 was (\$1.0M) but by October 31, 2007 this credit had accumulated to (\$7.1M). An additional \$6.1M would be paid back to customers in a timely manner by clearing the balances as at October 31, 2007.
 - (b) Interest accrues when there are delays in clearing account balances.
 - (c) If any adjustments were required as part of Hydro Ottawa's year-end audit in 2007, 2007 or as a result of subsequent decisions of the Board, these adjustments would be recorded in the variance and deferral accounts for December 2007, the appropriate month. Accumulated amounts in these accounts, including any adjustments, would be part of the next application to clear these accounts.
 - (d) The amounts accumulated to October 31, 2007 are actual balances although unaudited. The Board has approved recovery of forecast amounts, which are even less certain, for the same accounts as part of the 2006 rate process (e.g., EB-2005-0378 in which HONI received approval to recover forecast balances to April 30, 2006).
 - (e) The clearance of the commodity portion of Account 1588 (RSVA power) is consistent with the Board's Decision with Reasons dated December 9, 2004 in the following proceedings: RP-2004-0064, RP-2004-0069, RP-2004-0100, RP-2004-0117, and RP-2004-0118 (the "Regulatory Assets Decision").

Hydro Ottawa and the other parties have also agreed that the accounting methodology for the amounts cleared to customers should be the same as for the recovery of regulatory assets in accordance with the Regulatory Assets Decision. Specifically, both the amount approved by the Board and the actual amount cleared to customers will be recorded in Account 1590. At the end of the 12-month period, "as there will be a residual (positive or negative) balance in the Regulatory Asset Recovery Account (1590), the balance shall be disposed of to rate classes in proportion to the recovery shares that were established when rate riders were implemented" (para. 9.0.19 at p. 88).

- **Evidence:** The evidence on this issue includes the following:

Exhibit E1-1-1 updated
Board Staff Interrogatories #56-62, 74
VECC Interrogatories #1, 49, 50

4.2 Are the proposed new variance and deferral accounts for the test year appropriate?

- **Incomplete Settlement:** Hydro Ottawa applied for four new deferral accounts for the Test Year: one for the revenue deficiency that arises from the four-month variance between the Test Year and the rate year, two for revenue-requirement impact of its capital additions in 2009 and in 2010, respectively, and one for environmental costs. The other parties have only agreed to the establishment of the deferral account for environmental costs.

Hydro Ottawa applied for a deferral account for the revenue deficiency as an alternative to its application for the Board's approval of interim rates effective January 1, 2008 and a rate rider as the means of recovering the revenue deficiency. The other parties did not agree that there would be any revenue deficiency and, even if there is one, they did not agree that Hydro Ottawa should recover it. Their individual positions in this regard are partially set out in their respective submissions on interim rates in accordance with ordering paragraph 2 of the Board's Procedural Order No. 2 dated December 12, 2007.

Hydro Ottawa applied for two deferral accounts – one for 2009 and another for 2010 – as an alternative to its application for the Board's approval of (a) its forecasts of Capital Expenditures in 2009 and in 2010, respectively, and (b) the related capital adjustment factor to recover revenue-requirement impact of the corresponding capital additions. The Board's consideration of the latter has been postponed; see Issues 1.4, 1.5, and 1.6 above. Hydro Ottawa and the other parties have agreed to likewise postpone the Board's consideration of the two capital-related deferral accounts.

- **Evidence:** The evidence on this issue includes the following:

Exhibit A1-5-1, E1-2-1
Board Staff Interrogatory #59
VECC Interrogatories #2, 6

5. Cost of Capital (Exhibit F)

5.1 Is the proposed Test Year weighted average cost of capital appropriate?

- **Complete Settlement:** The other parties have agreed with Hydro Ottawa's proposed capital structure, cost of debt (both long-term and short-term), and cost of equity or ROE (i.e., the rate of return on common equity). They have also agreed with Hydro Ottawa's proposal to update the ROE using January 2008 values in accordance with Appendix B of the *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors* dated December 20, 2006. Hydro Ottawa and the other parties have accordingly agreed that the weighted average cost of the capital for the Test Year, as so updated, would be appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibits F1-1-1, F1-1-2, F1-1-3, F1-1-4
Board Staff Interrogatory #12
SEC Interrogatory #
CCC Interrogatory #10
VECC Interrogatories #12, 51

6. Smart Meters (Exhibit D3)

6.1 Has Hydro Ottawa correctly applied the Board's Decision in EB-2007-0063 (Smart Meter Combined Proceeding)?

- **Complete Settlement:** Hydro Ottawa applied to include not only its Board-approved amounts of Smart Meter spending to April 30, 2007 in Rate Base for the Test Year, but also its forecast of Smart Meter spending from May 1, 2007 to December 31, 2008.

Hydro Ottawa's Smart Meter spending, therefore, would be recovered in rates rather than, as in previous years, in a rate adder. The other parties were concerned, however, that Hydro Ottawa's proposal would not make its Smart Meter spending as transparent as they would like to make it on an ongoing basis. Hydro Ottawa and the other parties have accordingly agreed on a compromise; namely, Hydro Ottawa would recover actual Smart Meter spending to April 30, 2007 by including it in Rate Base and would recover subsequent Smart Meter spending in a rate adder (calculated at \$1.15 per month for all metered customers).

This rate adder would collect \$4,017k from metered customers to recover the return on Rate Base, the Amortization expense, OM&A expense, and PILs related to Smart Meter spending. This amount is accordingly excluded from the revenue requirement for the Test Year. Any differences between the revenue requirement calculated from the actual Smart Meter spending and the amounts collected through this rate adder would be recorded in a variance account and cleared through future distribution rate adjustments consistent with the approach approved for THESL in the combined Smart Meter proceeding (EB-2007-0063).

Hydro Ottawa has also agreed to provide an annual report of its Smart Meter spending for 2008, 2009, and 2010. The report for each year will be filed with the Board and served on the other parties by April 30th of the subsequent year.

- **Evidence:** The evidence on this issue includes the following:

Exhibit D3-1-1
Board Staff Interrogatories #25, 39, 43, 45, 56
CCC Interrogatory #11
VECC Interrogatories #15, 27, 47, 48

6.2 Is the proposed elimination of the Smart Meter Rate Adder appropriate?

- **Complete Settlement:** See Issue 6.1 above.
- **Evidence:** See Issue 6.1 above.

6.3 Is it appropriate to record the IESO MDM/R costs in the Smart Meter OM&A Variance Account (1556)?

- **Complete Settlement:** Hydro Ottawa applied to record its IESO MDM/R costs in Account 1556. Hydro Ottawa did so as a means of seeking confirmation from the Board that it would recover its prudently incurred costs in connection with the MDM/R process. The other parties have agreed that Hydro Ottawa should recover such costs through Account 1556 or otherwise if the Board does not approve Hydro Ottawa's use of Account 1556 for this purpose.
- **Evidence:** The evidence on this issue includes the following:

Exhibit D3-1-1

7. Cost Allocation (Exhibit H)

7.1 Are the revenue to cost ratios in the cost allocation for Test Year 2008 appropriate?

- **Complete Settlement:** The Application, for obvious reasons, does not reflect the following Report of the Board: *Application of Cost Allocation for Electricity Distributors* dated November 28, 2007 (the "Cost Allocation Report"). The Board established ranges for the revenue-to-cost ratios for each rate class in the Cost Allocation Report. The parties agreed that it was appropriate for the transformer ownership credits to be allocated only to those customer classes that receive the credits. Furthermore, the Settlement Package would result in each class falling within its range with the exception of Sentinel Lights. The Sentinel Light class is *de minimus*: 95 lights that have been grandfathered and that will not be replaced when they fail.

There are two adjustments that are required to bring the revenue-to-cost ratios within the Board's ranges. One is a decrease in the revenue requirement for the Large Use and the Unmetered Scattered Load classes and the other, an increase in the revenue requirement for the Residential and Street Lighting classes

The following table presents the initial and the revised revenue-to-cost ratios as well as the ranges in the Cost Allocation Report:

Table 4: Revenue-to-Cost Ratios

Class	Initial Revenue to Cost %	Revised Revenue to Cost %	Cost Allocation Report
Residential	93%	94%	85%-115%
GS < 50 kW	112%	112%	80%-120%
GS > 50 < 1500 kW	100%	100%	80%-180%
GS > 1500 kW	151%	151%	80%-180%
Large Use	125%	114%	80%-115%
Street Lighting	56%	71%	70%-120%
Sentinel Lighting	34%	34%	70%-120%
UMSL	132%	119%	80%-120%
Backup Standby	100%	100%	80%-115%

- **Evidence:** The evidence on this issue includes the following:

Exhibits H1-1-1, H1-2-1
Board Staff Interrogatories #67, 68, 70
SEC Interrogatory #44
VECC Interrogatory #53

8. Rate Design (Exhibit I)

8.1 Is the full schedule of rates as proposed appropriate?

- **Complete Settlement:** Hydro Ottawa and the other parties have agreed that Hydro Ottawa's rate schedule will be appropriate when it is revised to reflect the Settlement Package, including this issue, and the Board's decisions on Issues 3.4 and 4.2 above and Issue 8.4 below.

The Cost Allocation Report set criteria with respect to fixed service charges. Hydro Ottawa's fixed service charges for the GS > 50 < 1500, GS > 1500 < 5000, and Large Use classes will be kept at their current base level with the current Smart Meter adder removed and the proposed new Smart Meter adder included.

For the GS < 50 class, the Board's criteria would have resulted in a small increase to the fixed service charge; however, Hydro Ottawa has agreed to make a further increase because the fixed service charge for this class is unusually low by current standards. Hydro Ottawa accordingly proposed to increase this fixed charge, to the mid-point of the range determined in Hydro Ottawa's cost allocation model, and the other parties have accepted the proposal as appropriate under the circumstances.

- **Evidence:** The evidence on this issue includes the following:

Exhibit I1-6-1 updated
Board Staff Interrogatory #67
VECC Interrogatory #4

8.2 Is the derivation of the proposed base distribution rates appropriate?

- **Complete Settlement:** See Issue 8.1 above.
- **Evidence:** See Issue 8.1 above.

8.3 Is the derivation of the proposed rate riders appropriate?

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's calculation of the proposed rate riders related to the clearance of the various deferral and variance account balances; see Issue 4.1 above. They have likewise accepted the proposed rate riders related to LRAM/SSM; see Issue 3.6 above. The proposed calendar year rate rider is no longer feasible; see Issue 8.4 below.
- **Evidence:** The evidence on this issue includes the following:

Exhibit E1-1-1 updated
Board Staff Interrogatories #56-62, 74
VECC Interrogatories #1, 49, 50

8.4 Is it appropriate that Hydro Ottawa implement a mechanism to recover revenues not recovered in the January to April 2008 "Deficiency Period"?

- **No Settlement:** Hydro Ottawa applied to recover a revenue deficiency of \$3.5M that would arise in the first four months of the Test Year. Hydro Ottawa proposed to do so by means of an interim rates mechanism and, in the alternative, a deferral account mechanism. Hydro Ottawa's rationale for either mechanism is the same.

A deferral account is now the only mechanism available to Hydro Ottawa. The other parties do not agree that Hydro Ottawa should have a deferral account for this purpose; see Issue 4.2 above.

- **Evidence:** The evidence on this issue includes the following:

Exhibit I1-3-2
Board Staff Interrogatory #57
CCC Interrogatories #1, 4
VECC Interrogatories #1, 4, 5, 54

8.5 Are the proposed interim standby rates for 2008 appropriate?

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's proposed interim standby rates for 2008, subject to adjustment in accordance with the Settlement Package and the Board's decision on Issue 3.4 above, as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibit I1-3-1

8.6 Are the proposed changes to Retail Transmission rates appropriate?

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's proposed Retail Transmission rates as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibit I1-5-1 updated
Board Staff Interrogatories #72-74
VECC Interrogatory #55

8.7 Are the proposed new LV rates appropriate?

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's proposed new LV rates as appropriate in the context of the Settlement Package.
- **Evidence:** The evidence on this issue includes the following:

Exhibit I1-4-1
Board Staff Interrogatory #71
VECC Interrogatories #3, 55

9. Other Issues

9.1 Is the proposed implementation of 2008 rates appropriate?

- **Complete Settlement:** The other parties have accepted Hydro Ottawa's implementation of 2008 rates effective May 1, 2008.
- **Evidence:** The evidence on this issue includes the following:

Exhibit A1-2-1

Schedule A to Settlement Proposal

Hydro Ottawa Limited

2008 Electricity Distribution Rates

EB-2007-0713

Issues List from Procedural Order No. 2

1. Rate Base (Exhibit B)

- 1.1 Is the proposed Rate Base for Test Year 2008 appropriate? (B1)
- 1.2 Is the proposed Capital Expenditures forecast for Test Year 2008 appropriate?
(B3)
- 1.3 Is the Working Capital Allowance for Test Year 2008 appropriate? (B3)
- 1.4 Is the proposed Capital Expenditures forecast for 2009 and 2010 appropriate? (B4)
- 1.5 Is the proposal to establish an adjustment mechanism for Capital Expenditures beyond the 2008 test year appropriate?
- 1.6 Is the proposed Capital Adjustment Factor for 2009 and 2010 appropriate? (B4)

2. Operating Revenue (Exhibit C)

- 2.1 Is the proposed forecast of 2008 Test Year Throughput Revenue appropriate? (C1)
- 2.2 Are the proposed customers/connections and load forecasts (both kWh and kW) for Test Year 2008 appropriate, including the impact of CDM and weather normalization? (C1)
- 2.3 Is the proposed forecast of Test Year 2008 revenues from other regulated rates and charges appropriate? (C2)

3. Operating Costs (Exhibit D)

- 3.1 Is the overall Test Year 2008 OM&A forecast (including compensation) appropriate, for the following categories:
 - Operations and Maintenance
 - Billing and Collection Costs
 - Administrative and General Costs
 - Insurance, Bad Debt, Advertising and Charitable Donation Costs
 - Other Distribution Costs
 - Smart Meter Expenses?

- 3.2 Is the Test Year 2008 forecast of PILs (Capital Taxes and Income Taxes) appropriate? (D2)
- 3.3 Is the proposed level of the Amortization expense for 2008 appropriate?
- 3.4 Is the capitalization process (policy and procedure) appropriate? (B1)
- 3.5 Are the proposed Distribution Loss Factors appropriate? (D1)
- 3.6 Is the recovery of amounts relating to Lost Revenue Adjustment Mechanism and Shared Savings Mechanism appropriate? (D3)
- 3.7 Is the proposed allocation of Holding Company costs appropriate? (D1)
- 4. Deferral and Variance Accounts (Exhibit E)**
 - 4.1 Is the proposed clearance of various deferral and variance account balances appropriate?
 - 4.2 Are the proposed new variance and deferral accounts for the test year appropriate?
- 5. Cost of Capital (Exhibit F)**
 - 5.1 Is the proposed Test Year weighted average cost of capital appropriate?
- 6. Smart Meters (Exhibit D3)**
 - 6.1 Has Hydro Ottawa correctly applied the Board's Decision in EB-2007-0063 (Smart Meter Combined Proceeding)?
 - 6.2 Is the proposed elimination of the Smart Meter Rate Adder appropriate?
 - 6.3 Is it appropriate to record the IESO MDM/R costs in the Smart Meter OM&A Variance Account (1556)?
- 7. Cost Allocation (Exhibit H)**
 - 7.1 Are the revenue to cost ratios in the cost allocation for Test Year 2008 appropriate?

8. Rate Design (Exhibit I)

- 8.1 Is the full schedule of rates as proposed appropriate?
- 8.2 Is the derivation of the proposed base distribution rates appropriate?
- 8.3 Is the derivation of the proposed rate riders appropriate?
- 8.4 Is it appropriate that Hydro Ottawa implement a mechanism to recover revenues not recovered in the January to April 2008 "Deficiency Period"?
- 8.5 Are the proposed interim standby rates for 2008 appropriate?
- 8.6 Are the proposed changes to Retail Transmission rates appropriate?
- 8.7 Are the proposed new LV rates appropriate?

9. Other Issues

- 9.1 Is the proposed implementation of 2008 rates appropriate?
- 9.2 Is the proposal to declare Hydro Ottawa's existing rates interim as of January 1, 2008 to recognize the "Deficiency Period", appropriate?

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