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**Susan Frank**

Vice President and Chief Regulatory Officer  
Regulatory Affairs

BY COURIER

October 10, 2006

Ms. Kirsten Walli  
Secretary  
Ontario Energy Board  
Suite 2700, 2300 Yonge Street  
P.O. Box 2319  
Toronto, ON.  
M4P 1E4

Dear Ms. Walli:

**EB-2006-0088/EB-2006-0089 – Multi-year Electricity Distribution Rate Setting Plan Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089) – Hydro One Networks' Response to Written Questions from Other Parties**

In accordance with the procedure outlined at the Technical Conference on September 21, 2006 by Mr. Kaiser (September 21, 2006 Transcript, page 109), I am attaching ten (10) copies of Hydro One Networks' responses to written questions from OEB Staff and the School Energy Coalition. An electronic copy of the written questions will be sent by email to both [boardsec@oeb.gov.on.ca](mailto:boardsec@oeb.gov.on.ca) and to [edr@oeb.gov.on.ca](mailto:edr@oeb.gov.on.ca).

Participants to this proceeding will also be provided with a copy of the written questions by email.

Sincerely,

ORIGINAL SIGNED BY S. FRANK

Susan Frank

Attach.

c. EB-2006-0088/EB-2006-0089 Participants

**IN THE MATTER OF a consultation by  
the Ontario Energy Board on the Cost of  
Capital and 2<sup>nd</sup> Generation Incentive  
Regulation for Electricity Distribution  
Companies.**

**TECHNICAL CONFERENCE QUESTIONS**

**RESPONSE TO BOARD STAFF QUESTIONS**

**1. Access to Capital**

Please provide any information available on situations where your distribution utility has experienced difficulties in obtaining financing for capital investments on reasonable terms. What reasons were given for the inability to raise capital or on unreasonable (i.e. above-market rates)?

**Response**

Hydro One has to date been able to arrange financing on reasonable terms, in part due to the relatively stable and transparent regulatory environment.

**2. Merger and Acquisition Valuations**

Please provide information available specifically on the valuation (relative to the net book value) of your distribution utility (if you were considering or effected the sale or merger of your utility) or of another distribution utility that you were considering or effected a merger or acquisition with.

**Response**

Hydro One embarked on an acquisition program in the 2000 – 2001 time periods. These acquisitions were undertaken to obtain synergies in the distribution business and in this respect Hydro One may have paid in excess of ‘book value’ for these LDCs.

No acquisitions have been undertaken since this time period. In a letter dated April 15, 2004, the Minister of Energy directed Hydro One not to enter into further transactions involving the acquisition or divestiture of local distribution companies or distribution assets.

**3. Impact on Sector Rationalization**

What impact (positive or negative), if any, might changing capital structure for most Ontario electricity distributors have on the prospects of physical consolidation of electricity distributors?

**Response**

There is no impact.

#### **4. Return on Equity – Cannon Methodology**

Several parties have suggested that the Board retain the existing method of calculating the ROE as documented in Dr. Cannon’s paper “Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario”, dated December 1998, and consistent with the ROE methodology used in rate regulation of natural gas distributors under the Board’s “Draft Guidelines on a Formula-Based Return on Common Equity for Regulated Utilities”. If the Board was to retain the current methodology:

- a. Should the ROE be updated for May 1, 2007 distribution rate adjustments?
- b. What should the starting point for the ROE applicable to electricity distributors (e.g., 9.88% from the first Distribution Rate Handbook or 9.00% as calculated in the 2006 Electricity Distribution Handbook)?
- c. If updates to the ROE are not done annually (e.g. under IRM), then how should the ROE update be done at the time that distributors file rebasing applications?

#### **Response**

- (a) Yes, in Hydro One’s view, if the Board were to retain the current methodology, the ROE should be updated at the time the May 1, 2007 distribution rate adjustments are implemented.
- (b) The starting point should be ROE last approved by the Board in a full cost of service application. In Hydro One’s case this would be the 9.88% ROE from the first Distribution Rate Handbook. The 9.88% ROE should continue to be the base until a new base is established in a full cost of service application.

The 9.88% ROE was based on a 6.20% long Canada yield, which would have produced an ROE of 9.13% for 2006 in the 2006 Distribution Rate Handbook based on the forecast long Canada yield of 4.75% that was utilized in the 2006 Handbook.

- (c) ROE updates should be done on an annual basis. If updates are not done annually, the ROE update should be done at the time that distributors file rebasing applications as follows:

The Board should rely on the most recent consensus forecast available prior to the release of its Cost of Service decision to establish the forecast 10-year Canada bond yield. The 30-year forecast bond yield would then be set by adding the actual daily spread between the 10 and long term benchmark bonds for the month corresponding to the date of the consensus forecast.

The 6.2% 30-year Canada yield upon which the 9.88% ROE was based would then be subtracted from the new forecast 30-year Canada yield. Seventy-five percent of the difference between the 6.2% yield and the new forecast long-term yield would then be added to the 9.88% ROE to establish the new distribution ROE.

As an alternative to the application of the automatic adjustment mechanism, applicants could file full cost of capital/ROE evidence as part of their rebasing applications.

### **5. Return on Equity and Rebasing**

The staff proposal currently would have the IRM price cap formula applied to existing Board-approved distribution rates, largely set through 2006 EDR applications.

a. Does the change in the inflation or price escalator factor of the price cap index, measured by GDP-IPI (Final Domestic Demand) as proposed by staff, reasonably track or proxy also the changes in the debt rates and market returns (and therefore the distributors ROE) year to year?

b. If so, is an ROE adjustment required in 2007 and while a distributor is subject to the price cap index? What are the implications of not changing the Return on Equity (ROE) currently allowed in a distributor's approved distribution rates until the distributor files a Cost of Service (rebasing) rate application during the period 2008 to 2010?

### **Response**

- (a) The proposed inflation factor in the 2GIRM would in theory track inflation-driven changes in costs of capital (debt rate and returns on equity) over time. However, the inflation factor does not account for changes in the cost of capital that are the result of changes in the real cost of capital or risk premiums. The real cost of capital, as indicated by the yield on Government of Canada inflation-indexed bonds, is currently at relatively low levels. An increase in the real cost of capital would not be captured in the proposed inflation factor of the 2GIRM, but would be captured in the long Canada component of the automatic adjustment mechanism.
- (b) As noted in 5a, changes in the cost of capital are driven not only by changes in expected inflation, but also by changes in the real cost of capital and risk premiums. If the cost of equity rises because the real cost of capital rises, the failure to adjust the currently allowed ROE using the automatic adjustment mechanism could deprive the utility of the ability to earn a compensatory return. In the short-term the impact should not be material, however this issue does need to be addressed as part of the 3<sup>rd</sup> generation IRM design.

## **6. Capital Structure**

Several distributors have raised concerns about migrating quickly to a new capital structure. Consider a scenario whereby the Board were to phase in the change from the existing size-related capital structure to the common structure, for rate-making purposes, over several years. For example, a large distributor with over \$1 billion in rate base might move from its deemed 35% equity to 40% over two years, to mitigate possible rate impacts on ratepayers. As another example, a small distributor with a rate base of less than \$100 million could migrate from its current deemed 50% equity to 40% equity over three years, to mitigate the impact on corporate restructuring and on the distributor's shareholder(s). This change in the capital structure would be accomplished through the K-factor while the distributor is under an incentive rate mechanism (IRM) scheme, and a distributor migrating to the new capital structure would also factor such migration into its Cost of Service rebasing application.

- a. What are the implications, advantages and disadvantages of such an approach?
- b. Are there alternative approaches that the Board might consider?

### **Response**

(a & b) There is no impact on Hydro One.

However, at times when there is an expectation of high bill impacts, such as might result from the rapid migration to a new capital structure, rate smoothing is an accepted mechanism that has been used previously to mitigate bill impacts resulting from recent proceedings as prescribed by the rate handbook. Therefore Hydro One recommends that the Board adopt a rate smoothing approach in dealing with migration to the new capital structure. This is particularly important given the recent significant changes in the distribution customers' electricity bills due to increases in commodity charges as well as the respective distribution charges. It would be helpful if the Board were to provide guidelines to the LDCs impacted by the proposed changes in terms of the acceptable bill impacts and expected timelines for phasing in these changes.

## **7. Load Concentration - Related Business Risk**

While Board staff have proposed a common capital structure applicable to all distributors, several stakeholders have commented on business risk, possibly related to a material loss of revenues due to the loss of a customer or business sector served by the distributor and where that customer or business sector constitutes a significant portion of the load and distribution revenues for the distributor.

- a. Could any significant risk that might materialize due to the loss of a significant load concentration be mitigated by Z-factor (or analogous) treatment?

b. If yes, then what would be the criteria for identifying an occurrence of such an event (e.g. what percentage of distribution revenue attributable to loss of a single customer should be the threshold for identifying a material revenue loss)?

**Response**

(a & b) This is not a problem for Hydro One.

While Z factor adjustments could be considered as a mechanism to deal with lost revenue due to material loss of load, Hydro One would recommend against using this approach. The concept behind Z-factor adjustments is to deal with unexpected cost increases that are driven by outside factors beyond management's control. In as much as loss of customers may be beyond management's control this is a risk that is a part of every utility's business. Furthermore, it is expected that a material loss of load is likely to happen on a rare and non-frequent basis. Therefore it would be inappropriate to include an automatic adjustment for such a rare event.

A more appropriate approach would be for an affected utility to apply for a variance account in the event of a material loss of load that could then be dealt with at the next rebasing event when the Board could consider this impact on setting that utility's rates.

**8. Short-term Debt**

At the Technical Conference, staff heard that not all working capital is funded by short-term debt and that some may be funded by long-term debt.

a. What percentage of your actual working capital is funded by short-term debt?

b. What percentage of your rate base does short-term debt represent?

**Response**

(a) Hydro Ones working capital is funded in the same way as the entire rate base with all components of the capital structure (36% common equity, 4% preferred equity, 60% debt). As discussed, on line 27 of page 1, at Exhibit B1, Tab 2, Schedule 1 of RP-2005-0020/EB 2005-0378, Hydro One uses short term debt largely to fund requirements between long term debt issues, to meet unexpected requirements, and as a contingency in the event that markets are not receptive to long term issuance for a period of time.

(b) Hydro One's unfunded Short Term debt is approximately 2.5% of rate base. This information can be found in Hydro One's Distribution filing RP 2005-0020/EB-2005-0378, at Exhibit B1, Tab 1, and Schedule 1

## **9. Incremental Capital Expenditures**

Some distributors at the conference expressed concern over aging infrastructure and the need for increased investment in that infrastructure to maintain appropriate levels of service.

a. What are your known circumstances of where this could arise (addressed to distributors)?

b. Should incremental capital spending that is not attributable to load growth be treated outside of the price cap index (similar to what is proposed for CDM)? If so, should it be eligible for Z-factor treatment?

c. Are there alternative approaches that the Board might consider?

d. If the Board were to provide for special treatment of these investments, should a threshold apply? If so, how might that be expressed (e.g., percentage of current CapEx budget less depreciation)?

### **Response**

(a) Please refer to Hydro One's evidence at Exhibit D1, Tab 2, Schedule 1 of proceeding RP 2005-0020/EB 2005-0378 which contains information pertaining to the Asset Condition Assessment study that was carried out in respect of Hydro One's distribution assets.

(b) Capital spending is normally an integral part of any incentive model and therefore capital investments could be readily included in the incentive model. Hydro One made such a proposal with its submission to add the CI factor in the price adjustment equation.

However, if the Board wishes to consider treating incremental capital spending outside the price cap index this could be done but is likely to lead to greater complexity in making adjustments to prices. Apart from the price cap adjustments through the incentive model, the Board would have to deal with separate adjustments to account for CDM, Smart Meters and capital investment related costs. The more separate elements outside the price cap formula the more complex and time consuming is the overall process for adjusting prices.

Given that the intent of the 2GIRM is to have a simple mechanistic process for making adjustments the Board should avoid adding separate mechanisms that are not subject to a mechanistic adjustment since that would take away from the intent of the proposed transitional model.

It is preferable to keep capital investment separate from Z-factor considerations since this factor is meant to deal with expenditures imposed by outside changes that are beyond management's control, whereas capital spending for the most part is within the purview of management's control.

- (c) Hydro One is of the view that the most effective way to deal with incremental capital investments is to make these an integral part of the incentive model. At the recent Technical Conference Hydro One expressed its preference for the UK-type incentive model where OM&A and capital costs are forecast for the incentive plan period.
- (d) Yes, a threshold could be used by the Board to deal with urgent issues related to special treatment of capital investments. By way of example, Hydro One proposed the use of a threshold in the setting of a CI factor (please refer to slide 4 of Elenchus Research Associates presentation at the Technical Conference).

#### **10. CI Factor**

During the technical conference, Mr. John Todd proposed a methodology for a CI-factor as part of the IRM price cap formula as a means for including incremental capital expenditures not related to load growth as an increment to the price cap index.

- a. What are the implications, advantages and disadvantages of adopting such an approach?
- b. Mr. Todd suggested that a distributor file an Asset Condition Assessment Study as support for the proposed CI-factor. Such a study does not directly indicate the cost of incremental capital expenditures needed to address deficiencies in the system. What information on the proposed capital expenditures should a distributor be required to file in addition to the Study?
- c. What are the implications of adopting this approach where CapEx plans are not reviewed and approved by the Board?
- d. The CI-factor methodology as proposed seems to start from a 2006 rate base. Hydro One Networks has a 2006 rate base that has been reviewed during its 2006 distribution rate application by virtue of applying on a forward test year. However, most electricity distributors filed 2006 distribution rate applications on the basis of a 2004 historical test year with allowable adjustments. Hence, the public information for most distributors reflects a 2004 rate base. What changes need to be done to the CI formula to properly adapt it for when 2006 distribution rates are calculated on a 2004 historical rate base?
- e. Should the load growth factor be weather normalized? If so, how should this be done?
- f. Some of the parameters for the calculation of the CI-factor, as proposed, may not be readily available from prior filings where the data were subject to review by the Board. By what process would the Board review and test



the reasonableness of the parameters if a distributor were to apply for a CI-factor?

**Response**

- (a) The CI factor will achieve the objective of providing a simple and mechanical adjustment that recognizes that some LDCs require a level of capital investment that results in a growth in the rate base during the plan period. This mechanism will help LDCs to maintain acceptable levels of reliability and power quality for customers connected to their distribution systems. The process implications of the proposal are (i) the onus is on the filing LDC to produce the evidence to support the submission, e.g. an Asset Condition Assessment study, (ii) the LDC to perform the calculation to produce its CI, and (iii) for the Board to approve the submitted CI factor.

The primary advantage of the proposed mechanism is that it reduces the risk that an LDC will under-invest in its distribution system due to the capital investment disincentive implicit in a price cap mechanism with no CI factor. The CI Factor addresses this problem in a manner that is simple, consistent with the Staff price adjustment proposal, flexible (only those LDCs that require it need apply), and should result in an increase in knowledge of the status of distribution assets.

There are no obvious disadvantages, given that the proposed mechanism includes several features that ensure that an LDC will not forecast high capital expenditures in order to justify higher rates and then invest less than the forecast used to justify the CI factor. Not only will the prudence of the capital expenditures be reviewed as part of the rebasing applications, but any LDC that attempts to “game” the streamlined 2<sup>nd</sup> generation IR mechanism will compromise its credibility as it enters the more critical 3<sup>rd</sup> generation IR mechanism.

- (b) It is proposed that the level of capital expenditure be dealt with at an aggregate level and that there will be no submission of detailed capital project information during the 2GIRM adjustment period. The LDC would provide a detailed list of capital projects for the entire period (including 2GIRM) at the next Cost of Service review, at which time the Board will examine the prudence of capital projects and make any adjustments to rate base on a going forward basis. In this way there is no difference in the treatment of a LDC that submits a proposed CI factor for automatic adjustment during 2GIRM from a LDC that does not seek an adjustment but goes ahead with capital investments and allows its rate base to grow during the same period. In both cases there is a risk of disallowance of costs and loss of credibility if the LDCs do not provide accurate information or fail to carry out the intent.
- (c) As noted in the response to part (b) the Board will have the opportunity to review the capital expenditures at the time of the next Cost of Service proceeding and make any adjustments to the rate base at that time. It would be impractical for the Board to have to approve details of capital plans during 2GIRM as this would

complicate the simple process envisioned for the transition period. The fact that the Board may disallow the adjustment should be sufficient incentive for the LDCs to provide as accurate information as possible, and this reduces the need for Board's approval of capital plans during 2GIRM.

- (d) The starting point are the approved 2006 rates and the associated rate bases irrespective of how those rate bases was arrived at, i.e. either through a future test year or through adjustments to historic test year. The mechanism adopted for setting the 2006 rates was approved by the Board and nothing has changed since to suggest that a different approach is now needed for those utilities that chose a 2004 historic test year. The starting point for moving forward with 2GIRM for all LDCs is now the same. Therefore, there is no need to change the CI formula.
- (e) The load growth factor should be normalized and standard techniques exist for doing this. A description of the technique used by Hydro One for weather normalization can be found at Exhibit A, Tab 14, Schedule 3 of proceeding RP 2005-0020/EB 2005-0378.
- (f) All relevant factors required for calculating the CI factor can be extracted from the information filed as part of the LDCs 2006 rate setting process. There is no need for the Board to review this information since it has already been reviewed and approved as part of the previous rate proceedings.

## **11. Declining Customer Base**

Some distributors have documented declines in their customer bases.

- a. Would it be reasonable to adjust the X-factor, for example, to 0.7 for a distributor that has negative growth in its customer base over the period 2002 to 2005?
- b. Are there alternative approaches that the Board might consider to address constraints on operating efficiencies possible under declining customer base conditions?

### **Response**

- (a) The issue of adjusting the X-factor to account for negative growth was discussed at the Technical Conference. It is to be expected that an LDC faced with a declining customer base and reduction in load will face increased cost pressures that would likely require productivity savings greater than the 1% proposed for 2GIRM to mitigate the impact. Given the diversity of LDC costs, the range in efficiency improvements, varied customer base and geographic location it is unreasonable to expect that a one-size-fits-all adjustment to the X-factor would be sufficient to deal with the problem. More likely one would expect that a range of adjustments to the X-factor would be required to deal with the variety of the above noted issues. In this respect if the Board were to adopt this approach one could envisage the need for a schedule of adjustments to the X-factor

differentiated by levels in load loss. In the absence of this understanding it is difficult to see how the Board could establish a suitable threshold by which to reduce the X-factor. Therefore, it seems to Hydro One that making arbitrary adjustments to the X-factor to reflect changes in customer base in advance of Cost of Service considerations is inappropriate.

- (b) As noted in the response to (a) above, an alternative to the proposal to adjust the X-factor arbitrarily is to address this issue through a Cost of Service review.

**12. Smart Meter Incremental Funding**

In the July 25, 2006 Staff discussion paper, staff proposed incremental amounts of smart meter funding of \$1.00 per month per metered customer for distributors working to achieve the Government's objective of 800,000 smart meters in place by the end of 2007, and \$0.30 per month per metered customer for other distributors.

- c. Are the proposed increments reasonable?
- d. If not, what should they be, and why?

**Response**

- (c) The current funding amounts do not cover the costs associated with Hydro One's smart meter program. Furthermore, Hydro One believes that it should be explicitly listed as part of the group that receives the incremental funding of \$1.00 per month per customer that was discussed in the July 25<sup>th</sup> Staff paper. Hydro One communicated this point as part of the evidence in this proceeding that it submitted to the Board on August 14, 2006.

Our understanding of the current plan is that the amount of smart meter funding will increase over time. In addition, the amount of costs over and above funding is held in a deferral account to be decided upon by the OEB at some future date.

Hydro One believes that the amount of this deferral account may grow to large levels if the funding is not adjusted upward to a level that more closely approximates the cost of this program. Disposition of this deferral account may be difficult if the amounts are material. For example, Hydro One estimates that smart meter costs will be approximately \$2/month in 2007.

- (d) Please see response to part c above

## RESPONSE TO SCHOOL ENERGY COALITION QUESTIONS

1. Many parties have raised the issue of whether the proposed changes to cost of capital and to rates will have a negative impact on the financial health of LDCs. Please file your most recent annual audited or unaudited, as the case may be, financial statements. If your LDC represents more than 50% of the assets of a holding company, please file the holding company's most recent annual audited or unaudited, as the case may be, financial statements.

### Response

Please see Hydro One's Distribution filing RP 2005-0020/ EB-2005-0378, at Exhibit A, Tab 10, and Schedule 1. Hydro One's audited financial statements can also be found on Sedar ([www.sedar.com](http://www.sedar.com)). Hydro One Distribution's 2005 financial statements are attached.



Networks Dx 2005  
Fin Statement...

2. A number of LDCs have, in their submissions, raised the question of whether the proposed changes in cost of capital are a surprise to LDCs and for that or other reasons will erode the foundation of their current business plans. The PWU has also relied on this proposition in its submissions. Please file your most recent multi-year business plan, if such a document exists and has been reviewed and/or approved by any of your shareholders or your board of directors. If the business plan includes unregulated business activities, please redact all parts of the plan that relate to an unregulated business and don't relate to the regulated utility business. If the business plan includes other confidential information, please file the document in confidence so that the Board's protections for confidential filings can be engaged.

### Response

The ROE underlying Hydro One's business plan document for distribution is the last Board approved amount of 9.00%. Any pertinent information from the Hydro One business plan applicable to the Distribution business is contained in our recent Distribution Rate Filing. In addition, the detailed description of our Business Planning and Prioritization process is also contained in Hydro One's Distribution proceeding RP 2005-0020/EB-2005-0378 at Exhibit A, Tab 14, Schedule 1.

3. If your LDC has carried out a merger or acquisition of an LDC since 1999, or has prepared an investment analysis of a proposed merger or acquisition of another LDC, or has prepared an analysis of a potential sale of your LDC to another LDC, please provide that investment analysis, business case, or similar document showing the financial parameters of the deal or proposed deal, including in particular any calculations of expected overall return or return on equity, and advise of the eventual result of the proposed transaction. If any such document contains confidential

information, please file the document in confidence so that the Board's protections for confidential filings can be engaged.

**Response**

Please response to Board Staff question #2

4. Dr. Yatchew posits, at page 16 of his report, that mergers or acquisitions of LDCs may have been cancelled, repriced, or otherwise materially affected by uncertainty about whether the acquiror would be able to receive the benefit of savings generated by the transaction. If your utility has any documents showing that this was a consideration in any transaction, please file those documents. If any such document contains confidential information, please file the document in confidence so that the Board's protections for confidential filings can be engaged.

**Response**

Please see response to Board Staff question #2

5. Several parties have suggested that the proposed changes in the ROE and capital structure may cause LDCs to be offside on their debt covenants. Please advise whether such changes may cause your utility to be offside on your debt covenants, and if so file the text of such covenants, the amounts of borrowing to which they relate, and whether the lender is an affiliate/shareholder or an arm's length third party.

**Response**

The proposed changes in the ROE and capital structure will not cause Hydro One to be offside on its debt covenants.

6. An important issue in this proceeding is maintaining the creditworthiness of the LDC. If your LDC has been rated by Standard & Poors, DBRS, Moody's, or Dun and Bradstreet within the last 18 months, please file the last full rating from each rating agency, plus any updates since that full rating. If your LDC is rated and you have a public sector shareholder, please also advise the shareholder's debt rating(s) if any.

**Response**

Please refer to Hydro One's distribution proceeding RP 2005-0020/EB-2005-0378, at Exhibit A, Tab 11, Schedule 1 and Hydro One's responses to Information Requests that arose during the Technical Conference posted Sep 28, 2006 on the Ontario Energy Board website.

7. The ability of utilities to attract equity investment has been raised as a critical issue by many parties. Please provide the date, amount, investor identity and terms of the last common equity investment in your utility. If there was an offering or disclosure document, please file that document.

**Response**

Hydro One has not had a common equity offering.

8. Mr. Camfield believes that inadequate returns will result in lower than required investment in capital assets. Please provide for your utility the opening rate base, capital expenditures, and closing rate base for each year from 2000 to 2005 inclusive, and your current projected numbers for 2006.

**Response**

Hydro One filed information on capital expenditures for 2002-2006 in proceeding RP 2005-0020/EB-2005-0378 at Exhibit D1, Tab 3, Schedules 1 - 6. Rate base is a regulatory concept that only exists in rate years. As such Hydro One only has rate base information for 2006. Fixed asset information was also filed in the same proceeding.

9. Please provide a chart showing your fixed asset age distribution measured by dollar amount (e.g. \$120 million at 25-30 years old).

**Response**

The distribution business, rate base, and assets are discussed in Exhibit A, Tab 3, Schedule 1 and Exhibit D1, Tab1, Schedule 1, 2 and 3 of proceeding RP 2005-0020/EB-2005-0378. In addition, specific information on the age of the Distribution asset is filed in Exhibit D1, Tab 2, Schedule 1, Attachment A of the same proceeding.

10. For each LDC that has debt traded in the public markets, either directly or indirectly, please provide a chart for the period 2003 to date showing the average yield of your debt (broken down by issue if you had more than one outstanding) each month in the market, and for the same month the average yield of 10 year Canadas.

**Response**

Historic credit spreads for the years 2002, 2003, and 2004 were provided as part of the Hydro One's proceeding RP 2005-0020/EB 2005-0378 at Exhibit H, Tab 3, Schedule 24.

Credit spreads for 2005 and 2006 have been added as per the chart below.

Hydro One Historic Credit Spreads as at year ended					
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>September 2006</u>
5 year	0.58%	0.32%	0.34%	0.32%	0.35%
10 Year	0.84%	0.51%	0.55%	0.52%	0.51%
30 Year	1.10%	0.78%	0.81%	0.83%	0.85%

Note: The above indicative secondary trading spreads were provided by a member of Hydro One Inc.'s medium term note dealer group.

Actual Government of Canada bond yields can be obtained from the Bank of Canada's website (<http://www.bankofcanada.ca/en/rates/bond-look.html>)

11. At pages 11 and 17 of his report, Dr. Yatchew notes that utilities already have an "informal yardstick competition" currently going on. Please file any efficiency comparisons between Ontario LDCs in the possession of your utility, including any line item or similar benchmarking, any estimates of "best practices" standards, any formal or informal studies, etc.

**Response**

Hydro One's distribution business is a unique service provider due to the large geographic area that is covered by its service territory, the diverse customer mix and low customer density, and the integrated nature of its service provision. For these reasons Hydro One is not easily benchmarked with other LDCs. Hydro One does make efforts, through conferences, courses and other arrangements, to study best practices and incorporate them into our work methods as appropriate.

12. At page 12 of his report, Dr. Yatchew discusses the importance of aligning performance compensation plans to incentive regulation plans. Please provide the performance based compensation plan of your utility, if any, together with a list of any changes to that plan between 2000 and today.

**Response**

Please refer to Hydro One's evidence at Exhibit C1, Tab 4, Schedule 2 of proceeding RP 2005-0020/EB-2005-0378 which describes the incentive plans for the Society, PWU, and MCP, and also indicates when the plans were both introduced and discontinued. The relevant references are: page 4, lines 10 through 20, page 5 line 19, page 6 lines 17 through 21, page 7 line 14, page 9 lines 12 through 27.

13. Please describe any attempts your utility has made in the past to borrow in the market in common or in tandem with other LDCs. If you have proceeded with or proposed any such transaction, please describe the structure, the impact on cost of capital, and the result.

**Response**

Hydro One has not borrowed in the market in common or in tandem with other LDCs.

14. If your utility has a holding company of which at least 50% of its consolidated assets are assets of the LDC, please advise whether the debt rating of the holding company is different from the debt rating of the LDC, and if so advise the two ratings.

**Response**

Less than 50% of Hydro One Inc.'s (i.e. the holding company) consolidated assets are assets of Hydro One's distribution business.

15. Please provide the “Bill Impacts” pages of the 2006 EDR Model for your utility, and comparable calculations using the year 2000 and 2003 approved distribution rates.

**Response**

Hydro One did not use the 2006 EDR model in its 2006 rate application. Nevertheless it did file with the OEB bill impacts for Core Legacy customer classes and each Acquired LDC customer classes consistent with the guidelines in the 2006 EDR model. The relevant information can be found in the Draft Rate Order filed by Hydro One on April 18<sup>th</sup>, 2006 with the OEB and Intervenors as part of the RP-2005-0020/EB-2005-0378 proceeding. Appendix A to this draft rate Order includes the bill impacts for Hydro One’s Core Legacy customer classes of the change in Distribution rates on total bill and the impact of the Distribution rate changes and Commodity price increase on total bill. Appendix B to the said document includes similar information for each of the Acquired LDCs customer classes.

16. Please provide a list of the Tier 1 adjustments sought by your utility in your 2006 rate application, the dollar amount of each, and the total revenue requirement applied for.

**Response**

Hydro One did not use the EDR handbook model in its 2006 rate application.



**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**FINANCIAL STATEMENTS**  
**FOR THE YEAR ENDED**  
**DECEMBER 31, 2005**

**HYDRO ONE NETWORKS INC.  
DISTRIBUTION BUSINESS  
AUDITORS' REPORT**

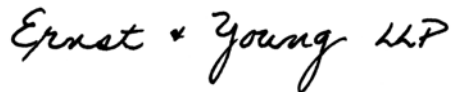
To the Directors of Hydro One Networks Inc.

We have audited the balance sheets of the Distribution Business (a business of Hydro One Networks Inc.), as at December 31, 2005 and December 31, 2004 and the statements of operations, and cash flow of the Distribution Business for the year then ended. These financial statements are the responsibility of the management of the Distribution Business. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Distribution Business of Hydro One Networks Inc. as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended, in accordance with Canadian generally accepted accounting principles.

The Distribution Business has no separate legal status or existence (See Note 1).

A handwritten signature in black ink that reads "Ernst & Young LLP". The signature is written in a cursive, flowing style.

Ernst & Young LLP  
Chartered Accountants  
Toronto, Canada  
April 5, 2006

**HYDRO ONE NETWORKS INC.  
DISTRIBUTION BUSINESS  
STATEMENTS OF OPERATIONS**

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b> <i>(restated- Notes 1 and 18)</i>
<b>Revenues</b>		
Energy sales <i>(Note 3)</i>	2,536	2,375
Rural rate protection <i>(Note 14)</i>	125	125
Other	45	55
	<u>2,706</u>	<u>2,555</u>
<b>Costs</b>		
Purchased power <i>(Notes 3 and 14)</i>	1,845	1,752
Operation, maintenance and administration <i>(Note 14)</i>	373	358
Depreciation and amortization <i>(Note 5)</i>	219	217
	<u>2,437</u>	<u>2,327</u>
Regulatory recovery <i>(Note 4)</i>	-	102
<b>Income before financing charges and provision for payments in lieu of corporate income taxes</b>	269	330
Financing charges <i>(Notes 6 and 14)</i>	117	125
<b>Income before provision for payments in lieu of corporate income taxes</b>	152	205
Provision for payments in lieu of corporate income taxes <i>(Note 7)</i>	56	40
<b>Net income</b>	<u>96</u>	<u>165</u>

*See accompanying notes to financial statements.*

**HYDRO ONE NETWORKS INC.  
DISTRIBUTION BUSINESS  
BALANCE SHEETS**

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b> <i>(restated- Notes 1 and 18)</i>
<b>Assets</b>		
Current assets		
Inter-company demand facility <i>(Note 14)</i>	58	-
Accounts receivable (net of allowance for doubtful accounts - \$9 million; 2004 - \$8 million) <i>(Note 14)</i>	439	499
Materials and supplies	22	16
	<u>519</u>	<u>515</u>
Fixed assets <i>(Note 8)</i>		
Fixed assets in service	5,493	5,224
Less: accumulated depreciation	2,176	2,047
	<u>3,317</u>	<u>3,177</u>
Construction in progress	80	53
	<u>3,397</u>	<u>3,230</u>
Other long-term assets		
Regulatory assets <i>(Note 9)</i>	344	330
Goodwill	73	73
Deferred debt costs	8	8
Long-term accounts receivable and other assets	8	8
	<u>433</u>	<u>419</u>
<b>Total assets</b>	<u>4,349</u>	<u>4,164</u>

*See accompanying notes to financial statements.*

**HYDRO ONE NETWORKS INC.  
DISTRIBUTION BUSINESS  
BALANCE SHEETS (continued)**

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b> <i>(restated- Notes 1 and 18)</i>
<b>Liabilities</b>		
Current liabilities		
Inter-company demand facility <i>(Note 14)</i>	-	102
Accounts payable and accrued charges <i>(Note 14)</i>	438	388
Accrued interest	23	22
Long-term debt payable within one year <i>(Notes 10, 11 and 14)</i>	179	192
	640	704
Long-term debt <i>(Notes 10, 11 and 14)</i>	1,809	1,701
Other long-term liabilities		
Employee future benefits other than pension <i>(Note 12)</i>	396	360
Environmental liabilities <i>(Note 13)</i>	43	41
Regulatory liability <i>(Note 9)</i>	41	25
Long-term accounts payable and accrued charges	3	4
	483	430
<b>Total liabilities</b>	<b>2,932</b>	<b>2,835</b>
Contingencies and commitments <i>(Notes 16 and 17)</i>		
Excess of assets over liabilities	1,417	1,329
<b>Total liabilities and excess of assets over liabilities</b>	<b>4,349</b>	<b>4,164</b>

*See accompanying notes to financial statements.*

On behalf of the Board:



Tom Parkinson  
Chair



Beth Summers  
Director

**HYDRO ONE NETWORKS INC.  
DISTRIBUTION BUSINESS  
STATEMENTS OF CASH FLOWS**

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b> <i>(restated- Notes 1 and 18)</i>
<b>Operating activities</b>		
Net income	96	165
Adjustments for non-cash items:		
Depreciation and amortization (net of removal costs)	195	195
Regulatory recovery	-	(102)
Low voltage services	(24)	-
Retail settlements variance accounts	13	29
	280	287
Changes in non-cash balances related to operations <i>(Note 15)</i>	114	(54)
<b>Net cash from operating activities</b>	<b>394</b>	<b>233</b>
<b>Investing activities</b>		
Capital expenditures	(317)	(270)
Other assets	(1)	-
<b>Net cash used in investing activities</b>	<b>(318)</b>	<b>(270)</b>
<b>Financing activities</b>		
Change in allocated long-term debt	95	68
Payments to Hydro One Inc. to finance dividends	(46)	(5)
Issuance of preferred shares by Hydro One Networks	38	-
Termination of interest rate swap	(3)	-
<b>Net cash from financing activities</b>	<b>84</b>	<b>63</b>
<b>Net change in intercompany demand facility</b>	<b>160</b>	<b>26</b>
Inter-company demand facility, January 1	(102)	(128)
<b>Inter-company demand facility, December 31</b>	<b>58</b>	<b>(102)</b>

*See accompanying notes to financial statements.*

# **HYDRO ONE NETWORKS INC.**

## **DISTRIBUTION BUSINESS**

### **NOTES TO FINANCIAL STATEMENTS**

#### **1. DESCRIPTION OF THE DISTRIBUTION BUSINESS**

Hydro One Inc. (Hydro One) was incorporated on December 1, 1998, under the *Business Corporations Act* (Ontario) and is wholly owned by the Province of Ontario (the Province). The principal businesses of Hydro One are the transmission and distribution of electricity to customers within Ontario. These businesses are regulated by the Ontario Energy Board (OEB).

Hydro One Networks Inc. (Hydro One Networks or the Company) was incorporated on March 4, 1999 under the *Business Corporations Act* (Ontario) and is a wholly owned subsidiary of Hydro One. The Company owns and operates Hydro One's regulated transmission and distribution businesses. The regulated distribution business (Distribution Business) operates a low-voltage electrical distribution network that distributes electricity from the transmission system, or directly from generators, to customers within Ontario. Distribution customers include small local distribution companies and large industrial customers with loads of less than 5 MW.

In prior years, the results of the Company's Sentinel Light operations had not been included in the Distribution Business financial statements as these assets were considered to be unregulated. In August 2005, the Company filed its distribution rate application on a basis that included sentinel lights within the definition of the regulated Distribution Business. While the OEB has not rendered a decision as at the date of the financial statements, OEB approval of the inclusion of sentinel lights as part of the regulated Distribution Business is considered probable. As a result, the Balance Sheets, Statements of Operations and Statements of Cash Flows of the Distribution Business now reflect Sentinel Lights. The prior year comparative figures have been restated to reflect this change in business definition. The impact of the restatement on the financial position and results of operations of the Distribution Business was not significant.

#### **2. SIGNIFICANT ACCOUNTING POLICIES**

##### ***Basis of Accounting***

The financial statements have been prepared in accordance with accounting principles generally accepted in Canada (Canadian GAAP). The financial statements have been prepared for the specific use of the OEB. Consolidated financial statements of Hydro One for the year ended December 31, 2005 have been prepared and are publicly available.

The financial statements have been prepared primarily through specific identification of assets, liabilities (other than debt), revenues and expenses that relate to the Distribution Business. The Company's long-term debt is allocated based on the respective borrowing requirements of the Company's Transmission Business and Distribution Business. A portion of the Company's shared functions and services costs are allocated to the Distribution Business on a fully allocated cost basis.

##### ***Rate-setting***

The rates of the Distribution Business are subject to regulation by the OEB. The OEB has the general power to include or exclude costs, revenues, losses or gains in the rates of a specific period, resulting in a change in the timing of accounting recognition from that which would have applied in an unregulated company. Such change in timing gives rise to the recognition of regulatory assets and liabilities. The Distribution Business's regulatory assets represent certain amounts receivable from future customers and costs that have been deferred for accounting purposes because it is probable that they will be recovered in future rates. In addition, the Company has recorded a regulatory liability for a variance account balance expected to be disposed of in the favour of Distribution Business customers. The specific regulatory assets and liabilities recognized at December 31, 2005 are disclosed in Note 9.

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

The Company's distribution rates are based on a revenue requirement that includes a rate of return. Current distribution rates are based on a cost of service rate regulation model, which also includes a targeted return of 9.88% on deemed common equity. In August 2005, the Company filed a distribution rate application seeking approval for a \$160 million increase in the 2006 revenue requirement for its Distribution Business. This revenue requirement is based on achieving a 9.00% return on equity, consistent with the OEB's guidance for setting 2006 rates. An oral hearing occurred in January 2006 and the OEB decision is expected to render its decision in the second quarter of 2006.

On December 9, 2004, the OEB issued its decision on the prudence of various regulatory deferral accounts incurred prior to December 31, 2003, including related interest. As a result of the OEB's December 9, 2004 decision, the proportion of the Company's regulatory assets subject to potential future OEB disallowance has been significantly reduced. The Company continually assesses the likelihood of recovery of each of its regulatory assets and continues to believe that it is probable that the OEB will factor its regulatory assets and liability into the setting of future rates. If, at some future date, the Company judges that it is no longer probable that the OEB will include a regulatory asset or liability in future rates, the appropriate carrying amount will be reflected in results of operations in the period that the assessment is made.

***Revenue Recognition***

Revenues attributable to the delivery of electricity are based on OEB-approved distribution tariff rates and are recognized as electricity is delivered to customers. The Company estimates the monthly revenue for the period based on wholesale power purchases because customer meters are not generally read at the end of each month. Unbilled revenue included within accounts receivable as at December 31, 2005 amounted to \$344 million (2004 - \$318 million).

Revenue also includes an amount relating to rate protection for rural residential customers, which is received from the Independent Electricity System Operator (IESO) based on a standardized customer rate that is approved by the OEB. The current legislation provides rate protection for prescribed classes of rural residential customers by reducing the electricity rates that would otherwise apply.

Revenues also include revenue related to sales of other services and equipment. Such revenue is recognized as services are rendered or as equipment is delivered.

***Corporate Income and Capital Taxes***

Under the *Electricity Act, 1998*, the Company is required to make payments in lieu of corporate income taxes to the Ontario Electricity Financial Corporation (OEFC). These payments are calculated in accordance with the rules for computing income and taxable capital and other relevant amounts contained in the *Income Tax Act* (Canada) and the *Corporations Tax Act* (Ontario) as modified by the *Electricity Act, 1998*, and related regulations.

The Distribution Business provides for its share of the Company's payments in lieu of corporate income taxes using the taxes payable method, as directed by the OEB. Under the taxes payable method, no provisions are made for future income taxes as a result of temporary differences between the tax basis of assets and liabilities and their carrying amounts for accounting purposes. When unrecorded future income taxes become payable, it is expected that they will be included in the rates approved by the OEB and recovered from Distribution Business customers at that time.



**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

*Inter-Company Demand Facility*

Hydro One maintains pooled bank accounts for its use and for the use of its subsidiaries and, implicitly, by the regulated businesses of these subsidiaries. The inter-company demand facility represents the cumulative net effect of all deposits and withdrawals made by the Distribution Business to and from the pooled cash accounts. Interest is earned on positive inter-company balances based on the average of the bankers' acceptance rate at the beginning and end of the month, less 0.02%. Interest is charged on overdraft inter-company balances based on the same bankers' acceptance rate, plus 0.15%.

*Materials and Supplies*

Materials and supplies represent spare parts and construction material held for internal construction and maintenance of fixed assets. These assets are carried at lower of average cost or net realizable value.

*Fixed Assets*

Fixed assets are capitalized at cost, which comprises materials, labour, engineering costs, overheads, depreciation on service equipment and the approved allowance for funds used during construction applicable to capital construction activities. Fixed assets in service consist of: distribution assets; communication, administration and service assets; and easements.

Some distribution assets, particularly those located on unowned easements and rights-of-way, may have asset retirement obligations. The majority of the Company's easements and rights-of-way are either of perpetual duration or are automatically renewed annually. Land rights with finite terms are generally subject to extension or renewal. As the Company expects to use the majority of its installed assets for an indefinite period, no removal date can be determined and consequently a reasonable estimate of the fair value of any related asset retirement obligations cannot be made at this time. If, at some future date, it becomes possible to estimate the fair value cost of removing assets that the Company is legally required to remove, an asset retirement obligation will be recognized at that time.

*Distribution*

Distribution assets comprise assets related to the distribution of low-voltage electricity, including lines, poles, switches, transformers, protective devices and metering systems.

*Communication, Administration and Service*

Communication, administration and service assets include telecommunications equipment, towers, associated buildings, administrative buildings, major computer systems, personal computers, transport and work equipment, and tools, vehicles and minor fixed assets.

*Easements*

Easements include amounts incurred for easements and other access rights.

*Construction in Progress*

Overhead costs, including corporate functions and services costs, are capitalized on a fully allocated basis. Financing costs are capitalized on fixed assets under construction based on the allowance for funds used during construction (2005 – 6.8%; 2004 – 7.0%).

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

***Depreciation***

The capital costs of fixed assets are depreciated on a straight-line basis, except for transport and work equipment and personal computers, which are depreciated on a declining balance basis.

Depreciation rates for the various classes of assets are based on their estimated service lives. The average estimated remaining service lives and service life ranges of fixed assets are:

	Estimated service lives (years)	
	Range	Average
Distribution	15 - 75	41
Communication, administration and service	5 - 50	30

Depreciation rates for easements are based on their contract life. The majority of easements are held in perpetuity and are not depreciated.

In accordance with group depreciation practices, the original cost of normal fixed asset retirements is charged to accumulated depreciation, with no gain or loss reflected in results of operations. Gains and losses on sales of fixed assets and losses on premature retirements are charged to results of operations as adjustments to depreciation expense. Depreciation expense also includes the costs incurred to remove fixed assets where an asset retirement obligation has been recognized.

The estimated service lives of fixed assets are subject to periodic review. Any changes arising out of such a review are implemented on a remaining service life basis from the year the changes can first be reflected in distribution rates.

***Goodwill***

Goodwill represents the cost of acquired local distribution companies (LDCs) in excess of fair value of the net identifiable assets purchased and is evaluated for impairment on an annual basis, or more frequently if circumstances require. Under Canadian Institute of Chartered Accountants Handbook Section 3062, *Goodwill and Other Intangible Assets*, goodwill impairment is assessed based on a comparison of the fair value of the reporting unit to the underlying carrying value of the reporting unit's net assets, including goodwill, with any write-down of the carrying value of goodwill being charged against the results of operations.

The Company has determined that the Distribution Business' goodwill is not impaired.

***Deferred Debt Costs***

Deferred debt costs include the unamortized amounts of debt issuance costs incurred by Hydro One and allocated to its subsidiaries and their regulated businesses based on the Company's share of Hydro One's debt issue amount. Deferred debt costs are amortized on an annuity basis over the period to maturity of the debt.

***Derivative Financial Instruments***

Hydro One periodically uses interest rate swap contracts to manage interest rate risks. Payments and receipts under interest rate swap contracts are recognized as adjustments to interest expense on an accrual basis and are allocated to Hydro One subsidiaries and their regulated businesses. Hydro One formally designates its hedges, documents all hedging relationships and formally assesses hedge effectiveness. In the event a hedging relationship is extinguished or the relationship is found to be ineffective, realized or unrealized gains or losses are recognized in results of operations. Hydro One does not engage in derivative trading or speculative activities.

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

*Discounts, Premiums and Hedging*

The Distribution Business share of the Company's allocated discounts, premiums and hedging gains and losses are amortized over the period of the related debt and are presented net with long-term debt.

*Employee Future Benefits*

Employee future benefits provided by Hydro One and its subsidiaries include pension, group life insurance, health care and long-term disability.

In accordance with the OEB's rate orders, pension costs are recorded when employer contributions are paid to the pension fund in accordance with the *Pension Benefits Act* (Ontario). Actuarial valuations are conducted at least every three years. Pension costs are also calculated on an accrual basis. Pension costs are actuarially determined using the projected benefit method prorated on service and based on assumptions that reflect management's best estimate of the effect of future events, including future compensation increases, on the actuarial present value of accrued pension benefits. Pension plan assets, consisting primarily of listed equity securities as well as corporate and government debt securities, are valued using fair values. Past service costs from plan amendments and all actuarial gains or losses are amortized on a straight-line basis over the expected average remaining service life of the employees covered.

Employee future benefits other than pension are recorded on an accrual basis. Costs are determined by independent actuaries using the projected benefit method prorated on service and based on assumptions that reflect management's best estimates. Past service costs from plan amendments and actuarial gains or losses are amortized on a straight-line basis over the expected average remaining service life of the employees covered.

Employee future benefit costs are attributed to labour and charged to operations or capitalized as part of the cost of fixed assets.

*Environmental Costs*

The Distribution Business recognizes a liability for estimated future expenditures associated with the assessment and remediation of contaminated lands and for the phase-out and destruction of polychlorinated biphenyl (PCB) contaminated mineral oil from electrical equipment, based on the net present value of these estimated future expenditures. As the Company anticipates that the related expenditures will continue to be recoverable in future rates, a regulatory asset has been recognized to reflect the future recovery of these costs from customers. The Distribution Business reviews its estimates of future environmental expenditures on an ongoing basis.

*Use of Estimates*

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses for the year. Actual results could differ from estimates, including changes as a result of future decisions made by the OEB or the Province.

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

**3. ELECTRICITY CREDITS**

Under a new regulation issued in October 2005, Regulated Price Plan customers received a one-time credit reflecting a lower cost of power than the fixed commodity price between April 1, 2004 and March 31, 2005. In the fourth quarter of 2005, revenue and purchased power costs were each reduced by \$129 million. The application of the one-time credit did not result in any adjustment to net income in the current or previously reported periods.

**4. REGULATORY RECOVERY**

The *Electricity Pricing, Conservation and Supply Act, 2002*, suspended a previously approved rate increase related to annual low-voltage services costs for embedded LDCs and direct customers. The associated costs are charged annually to the Distribution Business' results of operations. Subject to future OEB approval, the *Electricity Pricing, Conservation and Supply Act, 2002* also allowed for establishment of a regulatory deferral account to record suspended low voltage services amounts to be recovered from future customers. Due to uncertainty of recovery, amounts recorded in this regulatory deferral account between May 1, 2002 and December 9, 2004 were not previously recognized as regulatory assets. Similarly, the Company did not reflect certain other costs, such as interest, as regulatory assets in prior years' financial statements.

On May 31, 2004, Hydro One applied for recovery of approximately \$156 million included within various regulatory deferral accounts prior to December 31, 2003. The requested recovery primarily included the low voltage amounts not previously recognized as regulatory assets, as well as interest on all of the requested balances. As a result of the oral and written evidence submitted by the Company, the OEB issued a decision on December 9, 2004 regarding the prudence of the distribution-related deferral account balances included in the application. The OEB approved all but approximately \$12 million of the requested amount for recovery over the period ending April 30, 2008. As a result of this successful regulatory recovery, the Distribution Business recorded an increase in its regulatory asset balance, which primarily reflects future recovery of costs that had been previously charged to results of operations without recognition of corresponding revenue.

The 2004 regulatory recovery attributable to the Distribution Business consisted of the following components:

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2004</b>
Low voltage services – 2002	17
Low voltage services – 2003	25
Low voltage services – 2004	23
Interest accretion	18
Other	19
	<b>102</b>

**5. DEPRECIATION AND AMORTIZATION**

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Depreciation of fixed assets in service	144	144
Fixed asset removal costs	24	22
Amortization of regulatory and other assets	51	51
	<b>219</b>	<b>217</b>

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

**6. FINANCING CHARGES**

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Interest on long-term debt payable	130	127
Interest on inter-company demand facility	2	2
Less: Interest capitalized on regulatory assets	(11)	-
Interest capitalized on construction in progress	(4)	(4)
	<b>117</b>	<b>125</b>

**7. PROVISION FOR PAYMENTS IN LIEU OF CORPORATE INCOME TAXES**

The provision for payments in lieu of corporate income taxes (PILs) differs from the amount that would have been recorded using the combined Canadian Federal and Ontario statutory income tax rate. A reconciliation between the statutory and effective tax rate is provided as follows:

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Income before provision for PILs	152	205
Federal and Ontario statutory income tax rate	36.12%	36.12%
Provision for PILs at statutory rate	55	74
 (Decrease) increase resulting from:		
Net temporary differences:		
Regulatory recovery	-	(37)
Pension contribution in excess of pension expense	(21)	(19)
Depreciation and amortization in excess of capital cost allowance	20	14
Retail settlements variance accounts	6	11
Interest capitalized for accounting purposes but deducted for tax purposes	(6)	(2)
Employee future benefits other than pension expense in excess of cash payments	5	5
Environmental expenditures	(3)	(3)
Other	(6)	(10)
Net temporary differences	(5)	(41)
Net permanent differences:		
Large corporations tax	5	6
Other	1	1
Net permanent differences	6	7
Provision for PILs	56	40
Effective income tax rate	36.84%	19.51%

Future income taxes have not been recorded in the accounts as they are expected to be recovered through future revenues. As at December 31, 2005, future income tax liabilities of \$64 million (2004 - \$59 million), based on substantively enacted income tax rates, have not been recorded. In the absence of rate regulated accounting, the Company's provision for PILs would have been recognized on an accrual basis rather than under the taxes payable method. As a result, the provision for PILs would have been higher by approximately \$5 million.

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

**8. FIXED ASSETS**

<i>December 31 (Canadian dollars in millions)</i>	Fixed Assets in Service	Accumulated Depreciation	Construction in Progress	Total
<b>2005</b>				
Distribution	4,934	1,828	80	3,186
Communication, administration and service	551	345	-	206
Easements	8	3	-	5
	<u>5,493</u>	<u>2,176</u>	<u>80</u>	<u>3,397</u>
<b>2004</b>				
Distribution	4,710	1,742	53	3,021
Communication, administration and service	506	302	-	204
Easements	8	3	-	5
	<u>5,224</u>	<u>2,047</u>	<u>53</u>	<u>3,230</u>

Financing costs capitalized on fixed assets under construction using the allowance for funds used during construction were \$4 million in 2005 (2004 - \$4 million).

**9. REGULATORY ASSETS AND LIABILITIES**

Regulatory assets and liabilities arise as a result of the ratemaking process. The Distribution Business has recorded the following regulatory assets and liabilities (see Notes 2 and 4):

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
<b>Regulatory assets:</b>		
Regulatory asset recovery account	88	121
Pension	76	34
Employee future benefits other than pension	71	94
Low voltage services	53	26
Environmental	52	50
Other	4	5
	<u>344</u>	<u>330</u>
<b>Regulatory liability:</b>		
Retail settlement variance accounts	41	25
	<u>41</u>	<u>25</u>

***Regulatory assets***

***Regulatory asset recovery account (RARA)***

On December 9, 2004, the OEB issued a decision on the prudence of the distribution-related deferral account balances sought by the Company in its May 31, 2004 application (see Note 4). Recoverable amounts represent balances incurred prior to December 31, 2003, plus associated interest. The OEB ordered that the approved balances be aggregated into a single regulatory account to be recovered on a straight-line basis over the period ending April 30, 2008. The RARA includes distribution business low-voltage services amounts, deferred environmental expenditures incurred in 2001 and 2002, deferred market ready expenditures, retail settlement

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

variance amounts, and other amounts primarily consisting of accrued interest. In the absence of rate regulated accounting, amortization expense in 2005 would have been lower by approximately \$20 million. In addition, related financing charges would have been higher by \$7 million.

*Pension*

In a July 14, 2004 decision, the OEB approved the Company's establishment of a regulatory deferral account to record distribution-related pension contributions that would otherwise have been charged to 2004 results of operations. The regulatory asset also includes amounts payable to Inergi LP commencing 2005 in respect of a risk sharing agreement related to the imbalance between pension fund assets and liabilities in respect of transferred staff. In its decision, the OEB concluded that prudently incurred expenditures of this type are generally recoverable as part of a general rate application. The Company has included its request for recovery as part of its distribution rate application currently under review by the OEB. In the absence of rate regulated accounting, the Company's pension expense would have been recognized on an accrual basis rather than on a cash basis. As a result, operation, maintenance and administration expense would have been higher by approximately \$38 million, assuming no regulatory deferral of distribution and Inergi pension-related amounts. In addition, related financing charges would have been higher by \$4 million.

*Employee future benefits other than pension*

Employee future benefits other than pension are recorded using the accrual method as required by Canadian GAAP. The OEB has allowed for the recovery of past service costs, which arose on the adoption of the accrual method, in the revenue requirement on a straight-line basis over a 10-year period. As a result, in 1999 the Distribution Business recorded a regulatory asset, with an original balance of \$226 million, to reflect this regulatory treatment. This regulatory asset has a remaining recovery period of 3 years (2003 - 4 years) and does not earn a return. In the absence of rate regulated accounting, amortization expense in 2005 would have been lower by approximately \$23 million.

*Low voltage services*

The OEB's December 9, 2004 decision allows for delayed recovery of previously approved low voltage services amounts, within the RARA, for the period up to December 31, 2003. Given this decision, the Company has determined that it was highly probable that, at some future date, the OEB will also approve recovery of the low voltage amount attributable to 2004 and 2005, plus interest. As a result, the Company has recognized a regulatory asset reflecting this probable future recovery.

*Environmental*

The Company provides for estimated future expenditures required to remediate past environmental contamination. Because such expenditures are expected to be recoverable in future rates, the Company has recognized the net present value of these estimated future environmental expenditures as a regulatory asset. This regulatory asset is expected to be amortized to results of operations on a basis consistent with the pattern of actual expenditures expected to be incurred up to the year 2030. During 2005, the Company increased its estimated long-term liability and offsetting regulatory asset in respect of future estimated land assessment and remediation costs by \$6 million. In the absence of rate regulated accounting, amortization expense in 2005 would have been lower and operation, maintenance and administration expense would have been higher by \$7 million. The OEB has the discretion to examine the prudence and the timing of the Company's future environmental expenditures.

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*Regulatory liability*

*Retail settlement variance accounts*

The Company has deferred certain retail settlement variance amounts under the provisions of Article 490 of the OEB's *Accounting Procedures Handbook*. The OEB's December 9, 2004 decision allows for recovery of retail settlement variance amounts accumulated prior to December 31, 2003, inclusive of interest, within the RARA. The Company anticipates that the OEB will include the net balance of this regulatory account in future rates.

**10. DEBT**

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Long-term debt payable within one year	179	192
Long-term debt	1,804	1,694
	1,983	1,886
Net unamortized premiums	10	10
Unamortized hedging losses	(5)	(3)
	1,988	1,893

Debt represents the Distribution Business share of various notes payable by Hydro One Networks to Hydro One. This allocated debt is summarized by the number of years to maturity in the following table:

Years to Maturity	Principal Outstanding <i>(Canadian dollars in millions)</i>	Weighted Average Interest Rate <i>(percent)</i>
1 year	179	10.3
2 years	105	8.6
3 years	210	4.0
4 years	133	4.0
5 years	122	7.2
	749	6.7
6 – 10 years	546	5.6
Over 10 years	688	6.7
	1,983	6.4

**11. FAIR VALUE OF FINANCIAL INSTRUMENTS AND RISK MANAGEMENT**

The carrying amounts of all financial instruments, except long-term debt, approximate fair value. The fair value of derivative financial instruments reflects the estimated amount that the Company, if required to settle an outstanding contract, would have been required to pay or would be entitled to receive at year end. The fair value of long-term debt, based on year end quoted market prices for the same or similar debt of the same remaining maturities, is provided in the following table:

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>		<b>2004</b>	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Long-term debt <sup>1</sup>	1,983	2,222	1,886	2,009

<sup>1</sup> The carrying value of long-term debt represents the par value of the notes.



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Financial assets create a risk that a counter-party will fail to discharge an obligation, causing a financial loss. As at December 31, 2005, there were no significant concentrations of credit risk with respect to any class of financial assets. The revenue of the Distribution Business is earned from a broad base of customers. The Distribution Business did not earn a significant amount of its revenue from any single customer. As at December 31, 2005, there were no significant balances of accounts receivable due from any single customer.

**12. EMPLOYEE FUTURE BENEFITS**

*Pension*

Hydro One has a contributory defined benefit pension plan covering all regular employees of Hydro One and its subsidiaries, except Hydro One Brampton. The Hydro One Pension Plan does not segregate assets in a separate account for individual subsidiaries, nor is the cost of the benefit plans allocated to, or funded separately by, entities within the consolidated group. Accordingly, for purposes of these financial statements, the pension plan is accounted for as a defined contribution plan and no deferred pension asset or liability is recorded.

Hydro One's pension plan provides benefits based on highest three-year average pensionable earnings. For new management employees who commenced employment on or after January 1, 2004, and for Society of Energy Professionals' represented staff hired after November 17, 2005, benefits are based on highest five-year average pensionable earnings. After retirement, pensions are indexed to inflation. The measurement date used to determine plan assets and the accrued benefit obligation is December 31. Based on the actuarial valuation filed on September 22, 2004, effective for December 31, 2003, Hydro One contributed \$83 million to its pension plan in respect of 2005 (2004 - \$74 million), all of which will satisfy minimum funding requirements. Contributions are payable one month in arrears. A significant portion of these contributions are attributed to the Distribution Business. All of the contributions are expected to be in the form of cash. Prior to 2004, Hydro One was not required to contribute to the pension plan because the last actuarial valuation at December 31, 2000 indicated that the plan had a surplus. Contributions after 2006 will be based on an actuarial valuation no later than December 31, 2006 and will depend on future investment returns, and changes in benefits or actuarial assumptions.

For Hydro One, the actuarial present value at December 31, 2005 of the accrued pension benefits was estimated to be \$5,355 million (2004 - \$4,862 million). Pension plan assets available for these benefits were \$4,713 million (2004 - \$4,243 million).

*Employee Future Benefits other than Pension*

During the year ended December 31, 2005, \$33 million of employee future benefits other than pension costs was charged to the results of operations of the Distribution Business (2004 - \$32 million), and \$23 million was capitalized as part of the cost of fixed assets (2004 - \$22 million). Benefits paid were \$20 million (2004 - \$19 million). The liability associated with employee future benefits other than pension for the Distribution Business at December 31, 2005 was \$414 million (2004 - \$378 million), including the current portion.

A detailed description of employee future benefits is provided in Note 12 of the Consolidated Financial Statements of Hydro One for the year ended December 31, 2005.

**HYDRO ONE NETWORKS INC.**  
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**13. ENVIRONMENTAL LIABILITIES**

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Environmental liabilities, January 1	50	57
Interest accretion	3	3
Expenditures	(7)	(10)
Revaluation adjustment (Note 9)	6	-
Environmental liabilities, December 31	52	50
Less: current portion	(9)	(9)
	43	41

Estimated future environmental expenditures for each of the five years subsequent to December 31, 2005 and in total thereafter are as follows: 2006 - \$9 million; 2007 - \$8 million; 2008 - \$7 million; 2009 - \$7 million; 2010 - \$6 million and thereafter - \$31 million.

There are uncertainties in estimating future environmental costs due to potential external events such as changing regulations and advances in remediation technologies. The Company continuously reviews factors affecting its cost estimates as well as the environmental condition of the various properties. The actual cost of investigation or remediation may differ from current estimates.

**14. RELATED PARTY TRANSACTIONS**

***The Province and Successor Corporations of Ontario Hydro***

The Province, OEFC, Ontario Power Generation Inc. (OPG) and the IESO are related parties of Hydro One Networks' Distribution Business. In addition, the OEB is related to the Company by virtue of its status as a Provincial Crown Corporation. Transactions between these parties and the Distribution Business were as follows:

The Distribution Business received amounts for rural rate protection from the IESO. Revenues for 2005 include \$125 million (2004 - \$125 million) related to this program.

In 2005, the Distribution Business purchased power in the amount of \$1,809 million (2004 - \$1,716 million) from the IESO-administered electricity market and \$36 million (2004 - \$36 million) from OPG.

The Company has service level agreements with Ontario Hydro's successor corporations, primarily OPG. These services include field and engineering, logistics, corporate, telecommunications and information technology services. Operation, maintenance and administration costs related to the purchase of services from these successor corporations were less than \$1 million in 2005 and 2004.

Under the Ontario Energy Board Act, 1998, the OEB is required to recover all of its annual operating costs from gas and electricity distributors and electricity transmitters. In 2005, the Distribution Business incurred \$5 million (2004 - \$3 million) in OEB fees.

The provision for payments in lieu of corporate income taxes was paid or payable to the OEFC.

***Subsidiaries of Hydro One Inc.***

The Company provides services to, and receives services from, Hydro One and its other subsidiaries. Amounts due to and from Hydro One and its subsidiaries are settled through the inter-company demand facility.

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The Company has entered into various agreements with Hydro One and its subsidiaries related to the provision of corporate functions and services, supply management, computer support and operational services such as environmental, forestry and line services. Revenues include \$1 million (2004 - \$1 million) related to the provision of services to Hydro One and its subsidiaries and operation, maintenance and administration costs include \$2 million (2004 - \$1 million) related to the purchase of services from Hydro One and its subsidiaries.

The Company's debt, including the portion allocated to the Distribution Business, is due to Hydro One. Financing charges include interest expense on this debt in the amount of \$130 million (2004 - \$127 million). In addition, balances payable or receivable under the inter-company demand facility are due to or from Hydro One. Financing charges of the Distribution Business include interest expense on this facility in the amount of \$2 million (2004 - \$2 million).

The amounts due to and from related parties as a result of the transactions referred to above are as follows:

<i>December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Accounts receivable	1	3
Accounts payable and accrued charges	211	179

Included in accounts payable and accrued charges are amounts owing to the IESO in respect of power purchases of \$183 million (2004 - \$179 million).

**15. STATEMENTS OF CASH FLOWS**

The changes in non-cash balances related to operations consist of the following:

<i>Year ended December 31 (Canadian dollars in millions)</i>	<b>2005</b>	<b>2004</b>
Accounts receivable decrease (increase)	60	(50)
Materials and supplies increase	(6)	(1)
Accounts payable and accrued charges increase	50	4
Accrued interest increase	1	2
Employee future benefits other than pension increase	36	33
Long-term accounts payable and accrued charges decrease	(1)	(13)
Other	(26)	(29)
	114	(54)

**16. CONTINGENCIES**

The Company is a wholly owned subsidiary of Hydro One. As such, the assets of the Company's Distribution Business are available for the satisfaction of the debts, contingent liabilities and commitments of the Company and Hydro One.

**17. COMMITMENTS**

The Company and Hydro One have numerous commitments. These commitments have not been specifically allocated to the Distribution Business. However, the net assets of the Distribution Business are available to satisfy these commitments.

**HYDRO ONE NETWORKS INC.**  
**DISTRIBUTION BUSINESS**  
**NOTES TO FINANCIAL STATEMENTS** (continued)

**18. COMPARATIVE FIGURES**

The comparative financial statements have been reclassified from statements previously presented to conform to the presentation of the December 31, 2005 financial statements. More specifically, the 2004 statements have been restated to reflect the inclusion of the Sentinel Lights operation of the Distribution Business (see Note 1).