OVERHEAD CAPITALIZATION RATE

This evidence will discuss the methodology used to distribute Common Corporate Functions and Services ("CF&S") and Asset Management costs between Operations and Maintenance and Capital Projects.

Hydro One capitalizes costs that are directly attributable to capital projects, and consistent with Article 410 of the Accounting Procedures Handbook also capitalizes overheads supporting capital projects. The Overhead Capitalization Rate is a calculated percentage representing the amount of common overhead costs that are required to support capital projects in a given year.

As part of the scope of the Request for Proposal (RFP) and evaluation process associated with the Common Corporate Cost Allocation Methodology review, Hydro One retained R.J. Rudden Associates ("Rudden") to recommend a method to derive its Overhead Capitalization Rate for CF&S and Asset Management costs. Rudden's methodology was developed based on the following criteria:

- The method should be based on cost causation
- Where cost causation can not be used, the next method to be considered should be benefits received
- Data used to derive the method should be obtainable at reasonable cost and be objectively verifiable, both in the initial and subsequent years
- Where used, estimates should be unbiased and reasonably consistent with results that would be obtained using actual data
Asset Management costs are substantially all labour or labour-related. Hydro One conducted a time study over a four-week period in 2004, which forms the basis of this allocation method. Rudden reviewed Hydro One’s time study and found it to be appropriate for use in establishing the Overhead Capitalization rate for these costs.

For Common Corporate Functions and Services, it is more difficult to distinguish time spent by these departments on capital and OM&A-related work. Rudden has established a formula based on Labour Content to capitalize these costs. The derivation of the formula and alternatives considered are contained within the study.

Hydro One proposes that the resulting Overhead Capitalization Rate as calculated in the Rudden study is a reasonable method of distributing CF&S and Asset Management costs to OM&A and Capital Projects. Hydro One’s submissions in this application reflect the Overhead Capitalization Rate as developed in the study.

The Rudden study is attached to this evidence as Attachment A. Hydro One’s policy on Classification of Expenditures which guides in the determination of costs being classified as OM&A or Capital, is provided in Attachment B.

Table 1 summarizes the overhead capitalization rates as determined by the Rudden study and the resultant allocation of costs.
Table 1

Overhead Capitalized

2006 Test Year

($ Millions)

<table>
<thead>
<tr>
<th>Overhead Cost Category</th>
<th>Capitalization Rate</th>
<th>Amount Capitalized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Functions and Services</td>
<td>14.2%</td>
<td>41.3</td>
</tr>
<tr>
<td>Asset Management and Operators</td>
<td>2.4%</td>
<td>7.1</td>
</tr>
<tr>
<td>Total</td>
<td>16.6%</td>
<td>48.4</td>
</tr>
</tbody>
</table>

For 2006 business planning, a rounded overhead capitalization rate of 17% was used.
THE RUDDEN REPORT TO HYDRO ONE NETWORKS INC.

DISTRIBUTION OVERHEAD CAPITALIZATION RATE

METHOD

Attachment A
Report to

Hydro One Networks Inc.

Regarding

Distribution Overhead Capitalization Rate Method

May 20, 2005
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I. OVERVIEW

A. Introduction

In this Report, R. J. Rudden Associates (“Rudden” or “we”) recommends a method for Hydro One to compute its Distribution Overhead Capitalization Rate (Dx OH Cap Rate). The Dx OH Cap Rate is used to distribute the Distribution business portion of Common Corporate Functions and Services including Inergi (“CCFS”) costs and Asset Management costs, between Distribution business Operations and Maintenance, and Distribution business Capital Projects. The Dx OH Cap Rate is a percentage that is applied to the cost of Distribution Capital Projects each year; the result is the amount of Distribution business CCFS costs and Distribution business Asset Management costs that are capitalized to capital projects for the year.

Rudden, a unit of Enterprise Management Solutions, Black & Veatch Corporation, is a strategic, economic and management consulting firm specializing in energy matters. We provide assistance in areas such as economic analysis, strategy development, operational assessment, industry restructuring support, litigation and regulatory support and technical analysis. The firm has more than 23 years of experience providing the services necessary to develop regulatory and case-specific strategies, make the decisions about whether or not to file, and execute the work. Rudden has assisted many dozens of electric, gas, water and telecommunications clients in literally hundreds of proceedings.

This Report includes one exhibit, Attachment A.
B. Background

Hydro One’s capital spending program is a major focus for the utility in terms of time and cost. Distribution business Capital spending was $173M in 2001, $240M in 2002, $272M in 2003 and $270M in 2004, and is expected to reach $316M in 2005 and $317M in 2006. Distribution business Capital spending is primarily for the purposes of Sustainment – to improve reliability by replacing and upgrading assets; and Development – to support growth on the system.

Hydro One’s capital program requires significant support from all areas of the utility, including engineering, management, administration and infrastructure resources. These resources support Distribution business Operations and Maintenance (“OMA”) and Distribution business Capital Projects work.

C. Criteria for Cost Allocation Methods

In particular, CCFS and Asset Management activities support Distribution business OMA and Distribution business capital projects. The Dx OH Cap Rate is used to distribute the Distribution business portion of Common Corporate Functions and Services including Inergi (“CCFS”) costs and Asset Management costs, between Distribution business Operations and Maintenance, and Distribution business Capital Projects. The Distribution OH Cap Rate is only used to allocate costs to Capital Expenditures. The following are the criteria that Rudden used in selecting and evaluating methods to distribute Distribution business CCFS and Asset Management costs between Distribution business Operations and Maintenance and Distribution business Capital Projects:

- The method should be based on cost causation.
If cost causation can not be used or is determined to be inappropriate in the circumstances, the method usually considered next is benefits received.

The method should be based on data that can be obtained at reasonable cost and are objectively verifiable, in the initial year as well as in subsequent years.

If the method uses estimates, results should be unbiased and reasonably consistent with the results that would be obtained from using actual data.

D. Description of Recommended Dx OH Cap Rate Method

Asset Management and Operators

The Asset Management group is responsible for the utility’s operating assets, including investment strategy, investment planning and managing daily operations. The Operators group is responsible for the day-today operation of the Ontario Grid Control Centre. Work includes 24 hour/day monitoring of grid system status, coordination of system outages and remote operations/switching of transmission system assets. Substantially all Asset Management costs are labor and labor-related.

Hydro One determined the portion of Asset Management costs devoted to Distribution business capital projects by performing a time study for the four-week period ending December 19, 2004. Asset Management personnel are able to determine with reasonable accuracy, on a current basis, the time they spend on Distribution Operations and Maintenance, Distribution Capital Projects, Transmission Operations and Maintenance and Transmission Capital Projects.

A properly performed time study measures cost causation, and is widely accepted as a basis for allocating costs. Rudden reviewed the time study method used by Hydro One
for Asset Management and found it to be appropriate. It was not practical to perform a full-year study, but any effects of performing the study over four weeks, instead of a full year, are believed to be minimal. To support this judgment, Rudden reviewed the prior Asset Management study performed by Hydro One and found that the results are similar. Therefore Rudden found the time study to be a proper basis for determining the portion of Asset Management costs that should be charged to Distribution business Capital Projects.

Common Corporate Functions and Services Costs

Ideally, the amount of Distribution business CCFS costs to be capitalized to Distribution business Capital Projects would be based on time studies for labor costs, and special studies for other costs, for each CCFS activity, to determine the portions of time and costs related to Distribution business Operations and Maintenance versus Distribution business Capital Projects. However, as Rudden found in the Common Corporate Costs Methodology Review, while the departments that perform the CCFS activities can determine with reasonable accuracy the portions of time they spend on Distribution, Transmission and the other business units, they are unable to determine with reasonable accuracy the time they spend on Operations and Maintenance versus Capital Projects. Therefore, it is necessary to compute the amount of costs to be capitalized to Distribution business Capital Projects using other allocation methods such as cost causation or benefits received.

In traditional utility cost of service studies, administrative and general costs are allocated based on one or more factors including Labor costs, Operating & Maintenance costs, Investment in Plant or a weighted combination of two or more. Rudden considered the following two bases for allocating the Distribution business CCFS costs, which are
similar to administrative and general costs, between X) Operations and Maintenance and Y) Capital Projects:

- Labor Content Method- Labor Content of Distribution business Operations and Maintenance versus Distribution business Capital Projects
- Total Spending Method- Total Spending on Distribution business Operations and Maintenance versus Distribution business Capital Projects

The Distribution business CCFS costs to be allocated are causally related to both potential allocation bases. Therefore the Dx OH Cap Rate method recommended by Rudden with regard to CCFS costs is based on a weighting of 50% Labor Content and 50% Total Spending.

- Using the following formula, the Dx Labor Content for 2006 is 44.8%:
  \[
  \text{Dx Labor Content} = \frac{\text{Dx Labor $ in Dx Capital Projects}}{\text{(Labor $ in Dx Capital Projects + Labor $ in Dx Operations and Maintenance)}}
  \]

- Using the following formula, the Dx Total Spending for 2006 is 50.7%:
  \[
  \text{Dx Total Spending} = \frac{\text{Dx Capital Projects}}{\text{(Dx Capital Projects + Dx Operations and Maintenance)}}
  \]

The weighted average using 50% Labor Content and 50% Total Spending is 47.8%; therefore 47.8% of Dx CCFS costs should be capitalized.

Common Corporate Functions and Services Costs – Sensitivity Analysis

As a sensitivity analysis, Rudden analyzed the results for two sensitivity cases- the highest Labor Content weight that was considered (75%) and the lowest Labor Content
weight that was considered (25%). The results, shown below, indicate that the final Dx OH Cap Rate would not be change materially.

<table>
<thead>
<tr>
<th>CASES</th>
<th>Labor Content Weight</th>
<th>Total Spending Weight</th>
<th>Weighted % of Costs on Capital</th>
<th>Dx OH Cap Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recommended</td>
<td>50%</td>
<td>50%</td>
<td>47.8%</td>
<td>16.6%</td>
</tr>
<tr>
<td>High Labor Sensitivity Case</td>
<td>75%</td>
<td>25%</td>
<td>46.3%</td>
<td>16.2%</td>
</tr>
<tr>
<td>Low Labor Sensitivity Case</td>
<td>25%</td>
<td>75%</td>
<td>49.2%</td>
<td>17.0%</td>
</tr>
</tbody>
</table>

Note- In all cases the % of Labor Attributed to Capital was 44.8% and the % of Total Spending Attributed to Capital was 50.7%.

Rudden also considered the following:

1. The same rate is applied to capitalized assets regardless of their actual usage of CCFS. For example, a transformer that is purchased from a pre-approved vendor requires very little CCFS, but receives the same rate of overhead capitalization as a project requiring substantial CCFS support.

In applying the OH Cap Rate to specific projects, there will be differences compared to performing a specific analysis for each project. However, the Rudden method is appropriate because:

- Rudden’s recommended Labor / Total Content method correctly computes the aggregate portion of CCFS dollars to be capitalized, and the assignment among specific projects has virtually no effect on the financial statements or on the ratepayers.
Report on Distribution Overhead Capitalization Rate Method

- Most assets purchased for stand-alone use are Minor Fixed Assets and the OH Cap Rate is computed without them, and not applied to them. Other assets purchased for stand-alone use are parts of larger projects, therefore use of the average OH Cap Rate is appropriate (because larger project are more likely to have an average usage of CCFS).

- It is impractical to perform a specific analysis for each project and to do so is not the industry standard practice. The use of an average rate is the typical industry practice.

2. The Dx OH Cap Rate is developed based on Labor Content and Total Spending but is applied to Total Capital Cost.

It is appropriate to compute the amount of CCFS costs and Asset Management costs to be capitalized based on the weighted Labor Content / Total Spending developed by Rudden. Once the amount to be capitalized is computed, it can be applied based on Total Cost or Labor Content. Rudden recommends stating the capitalization rate based on Total cost, and applying it to Total cost dollars, because it is easier to plan and implement based on Total cost than Labor content. In addition, this is the typical industry practice.

Rudden believes that allocating Distribution business CCFS costs to Distribution business Capital Projects based on 50% Labor Content / 50% Total Spending is the most appropriate method for Hydro One, and is consistent with industry practice and with the nature of the Distribution business CCFS costs that are being capitalized.
II. COMPUTATION OF DX OH CAP RATE USING RECOMMENDED METHOD

A. Formula

The following formula is used by Rudden to compute the Dx OH Cap Rate:

\[
\text{Dx OH Cap Rate} = \frac{\text{Dx CCFS Cap} + \text{Dx AM Cap}}{\text{Distribution Capital}}
\]

Where

\[
\text{Dx AM Cap} = \text{Amount of Asset Management costs capitalized to Distribution business capital projects}
\]

\[
\text{Applicable Dx CCFS costs} = \text{Distribution business CCFS costs that are subject to capitalization}
\]

\[
\text{Distribution Capital} = \text{Cost of Distribution business capital projects supported by CCFS and Asset Management; also, total cost of Distribution business capital projects to which the Dx OH Cap Rate is applied}
\]

\[
\text{Dx CCFS Cap} = \text{Amount of Distribution business CCFS costs capitalized to Distribution capital projects, where:}
\]

\[
\text{Dx CCFS Cap} = (\text{Dx Labor Content X 50% + Dx Total Spending X 50%}) \times \text{Applicable Dx CCFS Costs}
\]

\[
\text{E Factor} = \text{Difference between A) Amount of Distribution business CCFS and Distribution business Asset Management costs actually capitalized for a prior year and B) Amount that would have been capitalized}
\]
Report on Distribution Overhead Capitalization Rate Method

for that year using actual data instead of estimates in the Dx OH Cap Rate calculation

\[ \text{Dx Labor Content} = \frac{\text{Dx Labor } \text{ in Dx Capital Projects}}{\text{Dx Labor } \text{ in Dx Capital Projects} + \text{Labor } \text{ in Dx Operations and Maintenance}} \]

\[ \text{Dx Total Spending} = \frac{\text{Dx Capital Projects}}{\text{Dx Capital Projects} + \text{Dx Operations and Maintenance}} \]

These terms are further discussed below.

B. Recommended Method

This section discusses the method recommended by Rudden to compute the Dx OH Cap Rate. The recommended method is shown in Appendix A. This example uses projected data for 2006. Due to the timing of this Report, some of the values are 2006 data from Business Plan 2006-2010, and the remaining values are 2006 data from Business Plan 2005-2009. However, because the recommended method includes a true-up (page 13), any continuing effect will be not significant.

Amounts include the Distribution business unit of Hydro One.

1. Distribution Capital
   
   \((\text{Att. A, rows 5-13})\)

Distribution Capital represents the cost of Distribution business Capital Projects that are supported by Distribution business CCFS activities and Asset Management activities, and is the total cost of Distribution business Capital Projects to which the Dx OH Cap Rate is
applied. Distribution Capital equals total spending for Distribution business Capital Projects reported for financial accounting, adjusted as follows:

- Minor Fixed Assets (such as vehicles) and Interest Capitalized are removed because they require little CCFS or Asset Management support. Capitalized Overhead is removed to avoid redundancy.

- Capital Contributions by Customers are added because the CCFS or Asset Management effort required is related to gross capital cost, not net capital cost. Removal Costs are added because removal of capital assets requires CCFS or Asset Management effort.

Distribution Capital for 2006 (that is, capital spending for financial accounting adjusted by the items shown above), based on Business Plan 2005-2009, is $291.4M (Att. A, row 12).

2. Applicable Dx CCFS costs
   (Att. A, rows 14-24)

Applicable Dx CCFS represents those Distribution business CCFS costs that are subject to capitalization, and equals the amount of CCFS costs distributed to the Distribution business unit in the Common Corporate Cost Model Exhibit C1 -6-1 (Att. A, row 15), adjusted as follows:

- The Distribution business LBSS and Facilities costs that are removed from the CCFS costs, relating to Operations facilities, are added back.

- The portion of Distribution business CCFS costs representing operating-type costs is removed because these departments do not support OMA or
capital projects. These activities include Inergi- Customer Support Operations, Inergi- Settlements, Inergi-ETS costs to support CSO Applications and Inergi-ETS costs to support market transition costs.

Applicable Dx CCFS costs for 2006), based on Business Plan 2006-2010, are $86.4 (Att. A, row 23).

3. Dx Labor Content  
(Att. A, rows 25-30)

Dx Labor Content represents the portion of total Distribution business labor costs that is included in Distribution Capital Projects. The computation for 2006), based on Business Plan 2005-2009, is shown below (Att. A, rows 26-29).

Dx Labor Content = Dx Labor $ in Dx Capital Projects / (Labor $ in Dx Capital Projects + Labor $ in Dx Operations and Maintenance)

Labor $ in Dx Operations and Maintenance $ 192.1M 55.2%
Labor $ in Dx Capital 155.9M 44.8%
Total Dx Labor $ 348.0M 100.0%

Labor $ are fully burdened labor.

The Dx Labor Content to Capital for 2006 is 44.8% (Att. A, rows 26-28). The weighted content, using 50% weight, is 22.4% (Att. A, row 30).

4. Dx Total Spending  
(Att. A, rows 31-36)
Dx Total Spending represents the portion of Distribution total spending that is included in Distribution business Capital Projects. The computation for 2006, based on Business Plan 2005-2009, is shown below (Att. A, rows 32-35).

Dx Total Spending = Dx Capital Projects / (Dx Capital Projects + Dx Operations and Maintenance)

<table>
<thead>
<tr>
<th></th>
<th>Amount</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dx Operations and Maintenance</td>
<td>$283.3M</td>
<td>49.3%</td>
</tr>
<tr>
<td>Dx Capital</td>
<td>$291.4M</td>
<td>50.7%</td>
</tr>
<tr>
<td>Dx Total</td>
<td>$574.7M</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

The Dx Total Spending to Capital for 2006 is 50.7% (Att. A, rows 32-34). The weighted content, using 50% weight, is 25.4% (Att. A, row 36).

5. **Dx CCFS Cap**  
   (Att. A, rows 37-41)

Adding the Dx Labor Content weighted rate of 22.4% (Att. A, row 30) and the Dx Total Spending weighted rate of 25.4% (Att. A, row 39), results in 47.8% (Att. A, row 38), representing the portion of Applicable Dx CCFS costs to be capitalized. Multiplying this rate by the Applicable Dx CCFS costs results in the amount of CCFS costs capitalized, or $41.3M (Att. A, row 40).

6. **Dx AM Cap**  
   (Att. A, rows 42-51)

Dx AM Cap represents the amount of Asset Management costs capitalized to Distribution business Capital Projects. The time study performed by Hydro One for the four weeks ended December 19, 2004 showed that 11.7% of Asset Management Non-operator time, and 2.5% of Asset Management Operator time, are related to Distribution business.

7. **E_Factor**

(Att. A, rows 52-56)

Rudden recommends that a true-up procedure be implemented for the Dx OH Cap Rate. The recommended method relies on estimates of future amounts, and a true-up will allow Hydro One to rectify the inevitable differences between actual and estimated amounts. Although it is not expected that differences will be significant, it is appropriate to rectify them because they affect rate-making and financial accounting for years. Prospective true-ups are recommended because the benefit of immediate recognition is outweighed by the disruption of implementing changes in the last quarter of the year.

Rudden recommends that the true-up be implemented by computing an E_Factor for each year, equal to the difference between A) Amount of Distribution business CCFS and Distribution business Asset Management costs actually capitalized for a prior year and B) Amount that would have been capitalized for that year using actual data instead of estimates in the Dx OH Cap Rate calculation.

The E_Factor for any year is included in the Dx OH Cap Rate calculation for a subsequent year. For example, the all of the actual data for 2006 will be available in 2007, so the E_Factor arising in 2006 will be included in the Dx OH Cap Rate for 2008.

The E_Factor for 2006 is zero (Att. A, row 55).
8. *Dx OH Cap Rate*

The Dx OH Cap Rate equals A) the sum of items 5, 6 and 7 above, $48.4M, divided by B) Capital spending, $291.4. The Dx OH Cap Rate for 2006 is **16.6%** *(Att. A, row 61).*

*C. Other Bases Considered*

The Dx OH Cap Rate method recommended by Rudden is based on a weighting of 50% Labor Content and 50% Total Spending. As discussed above, Rudden performed sensitivity analysis to assess the effect of using different weights. The results, presented on page 6, indicate that the final Dx OH Cap Rate would not be change materially if other reasonable weights were used.
| HYDRO ONE |
|-----------------|-----------------|
| CALCULATION OF DISTRIBUTION OVERHEAD CAPITALIZATION RATE |
| ATTACHMENT A - RECOMMENDED METHOD APPLIED TO 2006 (All amounts C$ Millions) |

**DISTRIBUTION CAPITAL**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital, incl. Cap OH</td>
<td>316.6</td>
</tr>
<tr>
<td>Less: Minor Fixed Assets</td>
<td>(32.6)</td>
</tr>
<tr>
<td>Less: Capitalized Overhead</td>
<td>(47.0)</td>
</tr>
<tr>
<td>Less: Capitalized Interest</td>
<td>(2.1)</td>
</tr>
<tr>
<td>Add: Capital Contributions</td>
<td>29.3</td>
</tr>
<tr>
<td>Add: Removal Costs</td>
<td>27.2</td>
</tr>
<tr>
<td><strong>DISTRIBUTION CAPITAL</strong></td>
<td>291.4</td>
</tr>
</tbody>
</table>

**APPLICABLE Dx CCFS COSTS**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dx CCFS Costs from Cost Distribution Model</td>
<td>122.7</td>
</tr>
<tr>
<td>Dx LBSS Facilities costs</td>
<td>12.0</td>
</tr>
<tr>
<td>Operating-Type Dx CCFS costs:</td>
<td></td>
</tr>
<tr>
<td>Inergi-CSO in Dx CCFS</td>
<td>(33.9)</td>
</tr>
<tr>
<td>Inergi-ETS CSO Apps in Dx CCFS</td>
<td>(6.2)</td>
</tr>
<tr>
<td>Inergi-ETS Market Ready in Dx CCFS</td>
<td>(6.2)</td>
</tr>
<tr>
<td>Inergi-Setstlements in Dx CCFS</td>
<td>(2.0)</td>
</tr>
<tr>
<td></td>
<td>(48.3)</td>
</tr>
<tr>
<td><strong>APPLICABLE Dx CCFS COSTS</strong></td>
<td>86.4</td>
</tr>
</tbody>
</table>

**Dx LABOR CONTENT**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor in OM</td>
<td>192.1</td>
</tr>
<tr>
<td>Labor in Capital</td>
<td>155.9</td>
</tr>
<tr>
<td><strong>Dx LABOR CONTENT</strong></td>
<td>348.0</td>
</tr>
</tbody>
</table>

**Dx TOTAL SPENDING**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>OM Spending</td>
<td>283.3</td>
</tr>
<tr>
<td>Capital Spending (excluding Overhead Capitalized)</td>
<td>291.4</td>
</tr>
<tr>
<td><strong>Dx TOTAL SPENDING</strong></td>
<td>574.7</td>
</tr>
</tbody>
</table>

**Dx CCFS Cap = Capitalized Dx CCFS costs**

<table>
<thead>
<tr>
<th>Weighted Average Rate</th>
<th>47.8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable CCFS Costs</td>
<td>86.4</td>
</tr>
<tr>
<td><strong>Dx CCFS Cap = Capitalized Dx CCFS costs</strong></td>
<td>41.3</td>
</tr>
</tbody>
</table>

**Capitalized Asset Management Costs**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-operators</td>
<td>53.0</td>
</tr>
<tr>
<td>Non-operator Costs to Dx Capital</td>
<td>11.7%</td>
</tr>
<tr>
<td>Capitalized Non-operators</td>
<td>6.2</td>
</tr>
<tr>
<td>Operators</td>
<td>36.9</td>
</tr>
<tr>
<td>Operator Costs to Dx Capital</td>
<td>2.5%</td>
</tr>
<tr>
<td>Capitalized Operators</td>
<td>0.9</td>
</tr>
<tr>
<td><strong>Dx AM Cap = Capitalized Asset Management Costs</strong></td>
<td>7.1</td>
</tr>
</tbody>
</table>

**E-Factor**

| Amount capitalized for prior year                                     | 0.0      |
| Amount that would have been capitalized for prior year               |         |
| **E-Factor**                                                         | 0.0      |

**TOTAL OVERHEAD CAPITALIZATION RATE**

<table>
<thead>
<tr>
<th>Item</th>
<th>Total Capitalized</th>
<th>Capitalization Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dx CCFS Cap = Capitalized Dx CCFS costs</td>
<td>41.3</td>
<td>14.2%</td>
</tr>
<tr>
<td>Dx AM Cap = Capitalized Asset Management Costs</td>
<td>7.1</td>
<td>2.4%</td>
</tr>
<tr>
<td>E-Factor</td>
<td>0.0</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>48.4</td>
<td>16.6%</td>
</tr>
<tr>
<td><strong>Capital</strong></td>
<td>291.4</td>
<td></td>
</tr>
</tbody>
</table>
HYDRO ONE NETWORKS INC.

CLASSIFICATION OF EXPENDITURES

POLICY

Attachment B
Classification of Expenditures
October 31, 2000

Policy Statement
Hydro One shall classify its expenditures between capital and OM&A expense so as to allocate costs to specific accounting periods in a manner that appropriately matches those costs with related future economic benefits. Accordingly, expenditures that are material in amount and which meet the definition of an asset shall be capitalized.

Scope
This policy applies to all operations and subsidiaries of Hydro One Inc., whether regulated or unregulated.

Corporate Requirements

GENERAL REQUIREMENTS:

- Expenditures incurred for the following general purposes shall be capitalized, where above established materiality limits:
  
  a) purchase, construction and commissioning of specific assets that will provide future economic benefits;
  b) design and development of specific assets that will provide future economic benefits;
  c) additions to specific assets; and
  d) betterments that result in improvement of capacity, efficiency, useful lifespan, or economy of specific assets.

Exception

Materiality limits shall not apply to plant retirement units.

- Direct expenditures qualifying for capitalization include direct labour, direct materials and supplies, transportation costs, directly attributable external costs and fees, permits, and injuries and damages incurred in construction work (net of insurance recoveries).

  Indirect expenditures qualifying for capitalization include financing costs (i.e. for unregulated subsidiaries – (1) interest costs and for regulated subsidiaries - the regulator's allowance for funds used during construction), (2) attributable shared
service costs (eg. general engineering, administrative salaries and expenses, insurance and taxes), and (3) attributable depreciation of capital tools and transport and work equipment used in the capital project.

- Direct and indirect decommissioning, fixed asset removal and site restoration costs shall be charged to current operations (i.e. depreciation expense) as incurred unless specific accounting provisions have already been made. If a specific accounting provision has been made, such expenditures are to be charged to that accumulated balance sheet provision.

- In unusual cases, generally accepted accounting principles require the deferral and amortization of certain specific costs when future economic benefits can be directly attributed and are reasonably assured. Recognition of such deferred charges requires a high level of accounting judgement and is potentially subject to inconsistent application. As such, deferred charge accounting treatments shall only be used in cases where the business facts are reviewed and approved by Corporate Finance.

- Materials, supplies and capital spares purchased for future usage are not immediately capitalized as in-service assets, nor are they immediately charged to operations. Materials, supplies and spare capital components are treated as inventories of stock for future consumption in Hydro One’s operations, maintenance and construction programs. Materiality limits and business facts will determine the final accounting classification of these items as capital or OM&A.

**SPECIFIC REQUIREMENTS:**

**Assets Not Owned by Hydro One**

Expenditures on assets not owned by Hydro One but providing future economic benefits shall be capitalized, provided there is assurance that Hydro One has the right to use the asset or that the asset’s future economic benefits will continue to be accrue to Hydro One.

**Carrying Charges**

Carrying charges shall be capitalized as asset acquisition costs as long as a project is undergoing design and construction
activities and there is a reasonable expectation of completion and recovery. Carrying charges shall be charged to current operations once a project is either declared in-service or is declared as ready for service.

Carrying charges related to cancelled capital projects and capital facilities with rescheduled in-service dates shall be accounted for in accordance with the Corporate Financial Policy, "Cancelled Capital Projects and Capital Projects with Rescheduled In-service Dates."

**Common Facilities**

A portion of the cost of common facilities in a multiple-asset facility or asset shall be transferred to fixed assets in service at the same time as each of the associated major assets is declared in service and in proportion to the total output or benefit represented by that asset.

**Computer Software Costs**

System software expenditures shall be capitalized. Major applications software projects with total acquisition and enhancement expenditures in excess of established materiality limits, and with an expected future useful life exceeding two years, shall be capitalized. All other software expenditures shall be charged to current operations as incurred.

Software acquisition and enhancement costs shall include:

- software purchase costs (including internal and external customization charges);
- initial and ongoing payments for licensing agreements to use external software packages where the license period exceeds two years;
- attributable development costs where software is internally developed; and
- testing, data purchase and loading costs, commissioning, and documentation.

Software-related expenditures for existing data clean up prior to loading are not capitalized as they represent a repair of existing data. Business process reengineering costs that are directly related to certain computer systems shall be charged to current operations as incurred, as these reengineering costs are
not an integral component of the software.

Major software projects that consist of several related but independent modules should be placed in service as each module meets in-service criteria.

**Contributions in Aid of Construction**

Fixed assets funded in whole or in part by external parties are capitalized at cost. Contributions in Aid of Construction received from external parties should be recorded in capital accounts as a specific asset contra account (i.e. credit account) offsetting the asset cost in whole or in part.

**Land and Land Rights**

Capitalized land costs include direct purchase costs including appraisals, fees, commissions surveys, title search and registration, and net clearance costs of unwanted buildings. Costs for first clearing, grading and damage costs related to construction and installation of plant are ultimately capitalized as part of the cost of fixed assets constructed on the land, rather than as an integral cost of the land.

Capitalized land rights include Hydro One’s cost of acquiring rights, interests and privileges in land owned by others.

Net profits from sales of timber or other resources located on land or rights of way shall be credited to the cost of the land.

**Leases**

Capital and operating leases shall be accounted for in conformance with the requirements of section 3065 of the Handbook of the Canadian Institute of Chartered Accountants.

**Major Infrequent Repairs**

The accounting treatment of unbudgeted infrequent repairs which are material in amount shall be referred to Corporate Finance to determine whether a special regulatory accounting treatment should be sought. All other expenditures for repairs shall be expensed as incurred.
Major Transformation Equipment

The cost of major transformation equipment to be installed at a current construction project shall be transferred to the project capital work order at the time the equipment is delivered to site.

The cost of major transformation equipment for installation at a future construction project shall be transferred to the "Assets Held for Future Use Account" at the time the equipment is delivered to a storage site. While in this account, interest on the equipment will be charged to current operations until the equipment is delivered to a current construction project.

The cost of major transformation equipment purchased as power system operating spares shall be treated as if the equipment is placed in service at the time it is delivered to a storage site.

Mobile Distribution Station Equipment

The costs, including depreciation, rental, connection and disconnection, and moving such mobile distribution equipment, shall be charged to the related capital project in cases where the equipment is used to maintain service to customers during extensive re-arrangements of Hydro One distribution stations. The cost of mobile equipment used for other purposes shall be charged to current operations.

Penalty Payments

Contract penalty payments related to the design and construction of Hydro One fixed assets should be charged to current operations.

Plant Retirement Units (PRU’s)

Expenditures for the creation or replacement of a PRU shall be capitalized.
Expenditures to replace a component of a PRU or for the physical removal or relocation of a PRU, shall be charged to current operations or, where previously provided for, to the appropriate provision account (e.g. asset removal), as incurred.
Premium Labour Costs

Premium labour costs incurred in performing work during an emergency, whether the base work is of a capital, removal or OM&A nature, shall be charged to operations as incurred.

Project Development Costs

Project development and pre-engineering costs shall be capitalized once a preferred alternative has been selected and approved. All general planning and specific project planning costs incurred prior to the approval of a preferred alternative shall be charged to current operations as incurred.

Research and Development Costs

Research and development expenditures shall be accounted for in accordance with the recommendations of the CICA Handbook Section 3450, "Research and Development Costs." Specific capital project development expenditures shall be accounted for under the “project development costs” provision found elsewhere within this policy.

Temporary Facilities Built to Assist Construction

The cost of building and removing such facilities, including material cost less salvage, shall be capitalized as part of the cost of the related capital construction project.

Temporary Operating Plant

The cost of constructing such temporary operating assets shall be capitalized as operating plant if total cost exceeds established materiality levels and if the estimated service life exceeds two years.

Training Costs

Training costs related to assets that are new to Hydro One’s operations or which are otherwise unconventional in nature, and which can be directly associated with those specific tangible assets, shall be capitalized as an integral cost of those assets. All other training costs, including those associated with capitalized computer software projects, shall be charged to current operations as incurred.
Definitions

Many definitions relevant to this policy are provided in the Canadian Institute of Chartered Accountants’ Handbook, in section 1000 (Financial Statement Concepts), section 3060 (Capital Assets), section 3065 (Leases) and section 3450 (Research & Development).

Addition:

An expenditure made to add to an existing capital asset.

Allowance for Funds Used During Construction (AFUDC):

AFUDC represents an allowance for financing costs attributable to the construction or acquisition of a regulated fixed asset. The allowance, which must be approved by the rate regulator, is capitalized as an integral cost of the asset.

Asset:

Economic resources controlled by an enterprise with three essential characteristics: (1) they embody future economic benefits; (2) the enterprise can control access to the benefit, and (3) the transaction giving rise to the future economic benefit has already occurred.

Betterment:

Expenditure made to enhance the service potential of a capital asset over its original specification. This can be accomplished by an increase in service life, increase in output, reduction in operating costs etc.

Capital Asset:

Fixed assets or property, plant & equipment meeting all three of the following criteria: (1) held for the production or supply of goods or services, for rental, for administrative purposes, or for the development, construction, maintenance or repair of other capital assets; (2) acquired, constructed or developed with the intention of being used on a continuing basis, and (3) not intended for resale in the usual course of business.

Carrying Charges:

Carrying charges are recurring costs associated with the
possession or ownership of property. They include such costs as interest, utilities, security, insurance, payments in lieu of property taxes, and storage costs.

**Commissioning (or Testing):**

The need for commissioning or testing work occurs whenever an is constructed or extensively modified. Commissioning work includes pre-start checks and inspections, startup of equipment and systems, functional tests, identification and resolution of problems, running parallel systems in the case of major computer software, and bringing the unit up to full capacity with an acceptable operating reliability. The commissioning or testing period for an asset unit normally starts well prior to the end of construction and continues to the in-service date.

**Expenditure:**

A cash disbursement, liability incurred or transfers of property for the purpose of obtaining goods or services.

**Fixed Asset:**

Generally synonymous with “capital asset.”

**Future economic benefits:**

Future economic benefits are generally evidenced by an increase in net cash inflow. Increased revenues reduced operating costs, or some combination of the two can cause this.

**Future Use Asset:**

An asset is a future use asset when it is acquired for future use in either a capital or OM&A project. Future use assets are not charged with capitalized interest (or AFUDC for regulated assets), nor are they depreciated or amortized.

**In-service Asset:**

An asset is declared in-service when ready for commercial use. Generally this point is evidenced by the commencement of the asset’s contribution of net economic benefits to the enterprise. Capitalization of interest (or in the case of regulated enterprises, capitalization of the allowance for funds used during construction) ceases at the in-service date and depreciation or amortization commences.
**Major Infrequent Repair:**

Occasionally, a significant repair is required to operating plant which does not result in the replacement of a plant retirement unit and does not result in an addition to, or the betterment of, an asset. A repair could be considered unusual if it is non-recurring, has not been budgeted for and is not expected to recur during the service life of the related asset. If the cost of such a repair is large enough to significantly distort net income in the year in which it occurs, it may require special consideration to determine whether an extraordinary regulatory accounting treatment is required.

**Maintenance:**

The ongoing cost of keeping a capital asset in good operating condition.

**Materiality Limit:**

For the purposes of classifying expenditures as capital additions or OM&A, Corporate Finance maintains specific quantitative limits to guide decision-making. Expenditures in excess of these preset limits, and which meet subjective criteria to be considered as capital assets, are capitalized. All other expenditures are charged to current operations as incurred.

**Penalty Payment:**

Any additional payment made to suppliers as a result of canceling or changing the terms of a contract or agreement to purchase which does not result in the acquisition of additional tangible goods, equipment or services of equivalent value. Examples of penalty payments are contract cancellation payments, shop under-absorption charges, loss of profit claims, and interest costs incurred by vendors. Costs arising because of errors in the design and construction process are not considered to be penalty payments. Likewise, storage costs are not considered to be penalty payments - they are treated as carrying charges.

**Plant Retirement Unit (PRU):**

The smallest unit of capital asset that is recorded in the accounts for the purposes of retirement or replacement.
Preferred Alternative:

The preferred alternative is the point at which pre-engineering or capital project development costs begin to be capitalized. A preferred alternative exists when management with sufficient authority provides expenditure approval for a specific capital project.

Project Development Costs (or ‘Pre-engineering Costs’):

Costs incurred during the planning and approval phases of a capital project, prior to detailed design and construction.

Ready for Service Asset:

An asset is ready for service when construction activity has ceased and the asset is capable of providing net economic benefits but is constrained in some manner from making this contribution. Capitalization of interest (or in the case of regulated enterprises, capitalization of the allowance for funds used during construction) ceases when the asset becomes ready for service. Depreciation or amortization does not commence until the asset is actually in-service.

Repair:

The cost of corrective action required to return a capital asset to good operating condition.

Replacement:

The act of replacing one capital asset or PRU with another.

Temporary Operating Plant:

Plant constructed specifically to provide or to maintain service to customers and which will eventually be replaced by permanent facilities. Temporary plant is built to provide immediate relief to the operating system until permanent facilities are warranted or otherwise made available.
Temporary Facility:

A facility built, used, and dismantled during the progress of a Hydro One capital construction project. A temporary facility is required to assist construction or extensive re-arrangements to operating plant. An example is a temporary sub-station.