Hydro One Networks Discussion Paper
Process for Establishing 2006 Electricity Distribution Rates

1.0 Introduction

Hydro One Networks has an active interest in the issues and discussions related to establishing 2006 electricity distribution rates. In addition to expanding on the presentation made to OEB staff and various stakeholders on July 6, 2004, this discussion paper provides Hydro One Networks' perspective on the specific issues outlined in the Board's "Potential Issues for Generic Methodology Review". This paper also identifies and discusses other relevant issues that should be considered under the scope of this initiative in order to address the interests and concerns of distribution customers, the industry and Hydro One Networks.

Establishing a rate setting process for LDCs is a significant undertaking. Setting a common process for all LDCs, while potentially more efficient from a preparation and review perspective, needs to recognize the inherent differences across LDCs. Differences in customer base, customer density, geographical location, system configuration and age as well as legacy financial structure and practices make establishing a common approach a difficult task. There should be a common set of principles for all LDCs to follow, with the flexibility for each LDC to use specific practices in the calculation of its revenue requirement.

We believe that, once implemented, any proposed methodology and guidelines will need to be sufficiently flexible to allow for specific LDC circumstances and also for changes in industry legislation and operating conditions.

There is a need to establish a process for input and consultation beyond the presentations made and issues papers submitted. It is very important that stakeholders continue to be involved in this process. As Board staff consider the feedback received from LDCs and other interested parties, changes and refinements to the proposed approach should be discussed with all parties and opportunity be given for comment and changing proposals where warranted.

2.0 Review Process

An LDC should be allowed to choose between two methods:

- ***a generic formula based approach developed by the OEB with allowances for adjustments, or***
- ***a fuller Cost of Service review based on detailed information filed by the utility.***

Hydro One Networks is concerned about the scope/expanse of the proposed process. The number of issues identified by Board staff, along with those raised by LDCs and intervenors will make it difficult to arrive at a common template for submissions in May 2005.

Hydro One Networks would prefer to limit the number of issues addressed, and have the review focus on key issues.

A comprehensive review and establishment of the proposed "formulaic" methodology for a 2005 rate submission will be difficult to complete in a timely manner in view of the implementation schedule. As an alternate approach, the OEB should consider limiting the focus of the review to key issues and develop a simplified approach to implementation. A focussed review would:
(a) ensure that high priority issues are dealt with thoroughly,
(b) avoid diluting it into a catch-all hearing, and
(c) keep regulatory and LDC costs reasonable

A formal public review for all utilities applications would be not be manageable for May 2006 implementation of rates. Alternatively, a process that utilizes benchmarks and audits to review compliance for the majority of utilities would result in a more manageable process.

3.0 Discussion of Board Staff Identified Issues

Comments on the more significant issues raised in the OEB's letter of June 16, 2004 are provided in this section. More detailed comments on all Board staff identified issues and our recommendations on each are provided in Appendix A.

3.1 Comparators and Cohorts

Cohorts should be used only where suitable comparators exist, and cohort groups should be established with care and allow for adjustments where needed to derive meaningful comparisons.

For both our Distribution and Remotes utility businesses, Hydro One Networks' unique characteristics, such as customer density, types of customers, broad geographic service territory, weather patterns and system condition and configuration make it difficult to find a comparable cohort.

The establishment of any cohort groups needs to be done with care and consideration for adjustments where needed to derive meaningful comparisons. Comparisons could be used as a screening tool to enable the OEB to identify portions of an LDCs' submission for additional scrutiny.

It should be noted that the Service Quality Regulation (SQR) committee of the OEB, has attempted to address the subject of cohorts and has concluded that there is a need to spend more time on the subject due to the uniqueness and different size/type of utilities in Ontario.

As an alternative to cohorts, historical improvement in measurable performance indices within a distribution utility may provide a more effective regulatory tool. An individual utility's financial and operating performance over time is likely to be the best indicator of performance for the foreseeable future.

3.2 Test Year for Establishing Rate Base / Revenue Requirement

The test year should be the same as the year of rate implementation. Ideally, the test year should be 2006 in order to be representative of financial requirements in the year rates are to be implemented.

It is important to have a "test" year that is reflective of expected future operating environment for the year rates will be implemented. This is especially important given the rapid pace of industry change in Ontario. The best available information should be used and this would typically be the prospective year, which is 2006 in the current rate submission scenario. Planned expenditures for 2006 would be supported by actual (historical) expenditure levels and would also reflect current financial conditions and operating plans.

If a historic test year must be used, it should be as current as possible to better reflect the going-forward cost structure. Under the Board's proposed process, this would be 2004. The timing of the hearing should be adjusted as appropriate to allow for use of 2004 actual results. A more recent year would minimize the number of required adjustments.

Whenever a historic test year is used, adjustments would be required in order to accommodate updates such as:

- Changes in government policy
- Changes in codes
- Accounting policy changes
- Utility specific adjustments (eg LV, depreciation)
- Uniform industry trending adjustments (eg. inflation, etc.)
- LDC cost efficiencies and work program changes

By better matching the revenues and costs for a rate period, the utility can avoid issues of retroactivity which has been an issue of customer concern in the past.

3.3 Debt/Equity Structure

We do not support standard structures if they do not reflect actual, established capital structures of LDCs.

The Debt/Equity structure varies across LDCs as a result of utility specific capitalization decisions. LDCs have been financed based on consideration of their capital structure and the investment community has expectations with respect to LDC net income levels and interest coverage. As a result, we are not supportive of any changes to, or standardization of, LDC Debt/Equity structure unless they clearly improve the financability of the utility (e.g. higher common equity ratio or higher common equity return).

3.4 Capital Projects/Programs

Review and justification of capital expenditures must be based on the merits of each project.

The use of historical trends is helpful for setting revenue requirement. However, consideration must also be given to several evolving factors such as forecasted needs, changing technology, asset condition, and customer expectations.

Capital project expenditures should be consistent with the best forecast that reflects system needs in the rate year. Each LDC should be expected to provide justification for future capital expenditures, using an appropriate level of detail necessary to support the program work and expenditure level. In between formal rate review periods, any material increase in capital project or program expenditures should be accommodated as part of a rate re-set process (e.g. Z factor adjustment).

3.5 Post-Retirement Benefits and Pensions

We support further study of the accounting treatment for post-retirement benefits and pension costs. The financial impact of any change in methodology should be recovered through rates.

Hydro One currently follows the accrual method of accounting for post-retirement benefits for both rate setting purposes and external financial reporting purposes. Consistent with the OEB transitional rate orders for the Company, pension costs are included in the Company's revenue requirement based on the cash (funding) basis, rather than the accrual basis.

Hydro One Networks supports maintaining the “accrual” basis for post-retirement benefits and the “cash” basis for pension costs due to the significant impact a change would have on customer rates. We do however support further study of the accounting treatment if desired by the Board. If a change in accounting treatment is deemed desirable based on further study, we believe the utility should not have to absorb the financial impact of the change.

The prudent management of the pension assets should be considered. However, due regard should be given to external market factors, investment strategies, and the nature or legacy nature of the pension plan and member benefits.

3.6 Employee Compensation and Staffing

Compensation and staffing need to be considered based on each LDC’s specific circumstances.

Utilities have legacy labour agreements that prescribe rates of pay and benefits for their employees. These negotiated agreements are “locked in” for the duration of the contract period and would be difficult to change even in future negotiations. These agreements are unique to a particular utility reflecting utility specific size, location and organizational complexity. These considerations are embedded in contracts and are difficult to change

quickly. As a result compensation and staffing needs to be considered based on each LDC's specific circumstances.

3.7 Low Voltage and Wheeling Costs

We strongly support any mechanism to allow Hydro One Networks and other LDCs to recover these costs through rates.

Hydro One Networks has valid and approved LV costs that must be recovered. The approved LV rates cover the cost of owning and operating the Low Voltage assets necessary for the operation of the distribution network. A mechanism is required for all utilities to recover these valid and approved costs.

4.0 Discussion of Other Important Issues

In addition to the issues raised in the OEB staff discussion paper, there are other areas with the potential to impact LDC costs. For these issues and others that are subsequently identified, Hydro One Networks believes that LDCs should be held neutral from a net income perspective. These issues are summarized below, and more detailed comments and recommendations are contained in Appendix B:

1. Impact of TSC decision on Distribution (e.g. OEB support for new embedded generation would necessitate additional Distribution rate options)
2. Rate Harmonization
3. Bill 100 implementation (eg. commodity pricing and new SSS requirement)
4. DSM load reductions

The OEB staff discussion paper recommended that the following issues be deferred and not dealt with in the scope of this review:

- Recovery of DSM Costs (need to have recovery in 2006 rates).
  - We believe that it is important to address DSM cost recovery on a timely basis and this issue should not be deferred. Expenditures on these initiatives will be significant. The programs that are ultimately implemented, including metering changes, will be significant. Establishing a mechanism for recovery will provide incentive to utilities to spend DSM designated funds

- Revisions in loss factors that will impact 2006.
  - We confirm our support for the Board's proposal to consider line loss factors as part of the next rate setting exercise.

5.0 Summary

It is important that Board staff and other stakeholders in this process not underestimate the scope and complexity of this initiative if meaningful results are to be achieved.

There is great diversity across LDCs, and a "one size fits all" approach will be difficult. It is impossible to anticipate all circumstances that will need to be addressed so it is important that any guidelines provide for sufficient flexibility to accommodate new conditions. LDCs should have the opportunity to submit and defend costs when a formulaic approach will result in rates that are not "just and reasonable" for the LDC and/or the rate payer.

The OEB needs to provide a more detailed schedule of "process" steps so that LDCs can integrate 2005 rate submission requirements into overall work plans and business planning/financial reporting processes.

Hydro One Networks supports the consultative process that the Board has initiated. Going forward, the Board should continue to engage LDCs and other stakeholders in the development of guidelines for 2006 rates even if this impacts the timing of the hearing process. We would expect to be further involved prior to any direction being issued by the Board. A consultative approach is essential if a meaningful rate setting mechanism is to be developed. The sessions held on July 6 and 7 were a good start to this consultative process and such communication should continue throughout the development of the process to establish 2006 rates.

Appendix A
Process for Establishing 2006 Electricity Distribution Rates

Use of Comparators to assist prudency review of OEB costs:

1. **Comparators and Cohorts**

- *The Board is interested in using comparators to assist in the review of LDC's individual rate applications. Board staff would compare various operational and financial statistics between LDCs as a means of identifying outliers and anomalies.*
- *What would be useful comparators to assist in expeditious processing of individual rate applications? For example: costs per customer, billing and collection expenses per customer, growth rates in certain capital and expense categories, etc.*
- *To further aid in the use of comparators as part of the rate application review process, can the various Ontario LDCs be grouped into a smaller number of cohorts or peers (for example, based on size, operating characteristics, structure, or operational and management processes)?*
- *What would stakeholders suggest be a practical segmentation of Ontario LDCs into cohorts or peer groups for reviewing 2006 rate applications?*

Comments:

- We are supportive of relevant benchmarking process.
- The Service Quality Regulation (SQR) study group is working to develop appropriate cohort groups; further work in this area is still required.
- Other large Ontario LDCs do not have similar operating system/customer base/service territory.
- Should compare "like to like". Need to establish appropriate comparator for Hydro One. (ie. large rural, not urban like most other large LDCs).
- Need to have basis of comparison that will provide meaningful results.
- Will be difficult to establish a comparable cohort for Hydro One Networks.
- Hydro One Networks has fully integrated the acquired LDCs, except Hydro One Brampton, into its overall operations, and as such, the costs and performance of these former utilities cannot be benchmarked separately from the rest of Hydro One Networks' distribution business.
- LDCs need to have input on the measures used for comparison (has to be a valid/consistent measure for each type of LDC - and yield meaningful comparisons to others).
- Comparisons can be used as a screening tool to enable the OEB to identify portions of an LDCs' submission for additional scrutiny.

Recommendations:

- Where there is no comparable cohort (e.g. Hydro One Networks and Remotes), there should be a separate process such as a review of historical performance over time for a specific LDC.
- For smaller LDCs, continue efforts to create comparator groups in Ontario with similar characteristics based on criteria such as geographical dispersion, customer density, system age and configuration.

Revenue Requirement – General Issues:

2. Test Year for establishing Rate Base / Revenue Requirement

- ***Merits of historical versus forward/future test year (or combination thereof).***
- ***Should one approach apply to all LDCs?***
- ***Preferred choice for a specific past test year****.*

Comments:

- Important to have a "test" year that is reflective of expected future operating environment for the year the rate will be implemented.
- Should use best available information (ie. 2005 projection for 2006, at time of submission).
- Historical year (e.g. 2003) is not reflective of future funding requirements.
- Use of a historic year would require adjustments to make costs more reflective of the year in which revenues are being collected and to avoid the need for deferred accounts and retroactive rate setting.

Recommendations:

- Test year should be 2006 in order to be representative of financial requirements in the year rates are to be implemented.
- If historical year is used, timing of hearing should be adjusted to allow for use of 2004 actual results and adjustments for changes in operating condition allowed for items such as:
    - Changes in government policy
    - Changes in codes
    - Accounting policy changes
    - Utility specific adjustments (eg LV, depreciation)
    - Uniform industry trending adjustments (eg. inflation, etc.)
    - LDC cost efficiencies and work program changes

3. Load Forecast

- *If using a forward test year, acceptable methodologies to be used for the load forecast employed for determining the revenue requirement.*

Comments:

- LDCs should be able to develop their own load forecasts.
- Forecasts should be comprehensive and take into account factors such as economic conditions, customer surveys, demographics, weather normalization, customer growth, DSM impact, etc…

Recommendation:

- Forecasts should be prepared based on accepted methodology and LDCs defend based on merits.

4. Test Year Adjustments

- *What types of adjustments in historical or future test year data might be allowable (for example, for anomalies or for known and measurable changes that are expected to persist)? What should be provided in support of proposed adjustments?*

Comments:

- Valid adjustments should be allowed (eg. required program increases – would need to be justified based on merits).
- Possible adjust for unforeseen conditions through Z factor.
- Should allow for externalities (ie. costs/events outside of management control, e.g. weather).
- There should be further consultation with utilities to identify and consider a broad range of potential adjustments. In some cases, especially if a historical test year is used, we would expect that these adjustments could be quite numerous.

Recommendation:

- Valid test year adjustments should be allowed.

5. Weather Normalization

- *Is there a need for weather normalization, of future test year data, in the electricity sector?*
- *If yes, then what methodology or methodologies would be appropriate for weather normalization in Ontario?*
- *Should the allowed ROE be reduced if utilities no longer face weather related risks?*

Comments:

- Methodology should take into consideration factors such as temperature, wind speed, humidity, cloud cover.
- A reasonable normalization time period needs to be selected (we use 30 year average).

Recommendation:

- Hydro One Networks supports the use of weather normalized forecasts.

6. (Maximum) Return on Equity for 2006 Electricity Distribution Rates

- *The current formula is based on the same approach as used in the natural gas sector, but with a separate multi-year forecast of interest rates.*
- *Results of application of current formula in light of current interest rates.*
- *Bearing in mind the Board's recent decision on the generic ROE for Ontario gas distributors (RP-2002-0158), are there any adjustments to the electricity distribution ROE formula that warrant serious consideration?*
- *What economic estimates should be used in the ROE formula (e.g. annual vs. multi-year forecasts of long-term Canadian bond interest rates)?*

Comments:

- Need to have multi-year stability in ROE.

- Possible adjustments to the electricity distribution ROE formula based on LDC risk.
- LDCs should be allowed to defend their approach to Cost of Capital on its merits (with help of special studies and expert witnesses).
- Agree that adjustments to cost of capital should be linked to changes in long-term Canadian bond rates and linked to utility size.
- ROE should relate to a specific LDC given that the investment community has expectations regarding financial performance (ie. net income level, interest coverage) and has already provided capital on the basis of a certain financial structure and returns.

Recommendation:
- Expectation is that ROE will be established based on standard practice/methodology and result in utilities earning a full market adjusted rate of return.
- Further study on ROE methodology is appropriate at a later date.

7. Debt/Equity Structure
- *Are the current deemed D/E structure(s) still appropriate? If not, what other common approach may be more suitable?*
- *Merits of using actual utility-specific D/E, in lieu of a deemed D/E, when setting rates.*

Comments:
- Hydro One Networks has a specific OEB-approved capital structure.
- Debt/Equity structure should relate to a specific LDC given that the investment community has expectations regarding financial performance (ie. net income level, interest coverage) and has already provided capital on the basis of a certain financial structure and returns.
- Must maintain confidence of capital markets in providing financing to utilities.

Recommendation:
- Debt/equity structure varies across LDCs as a result of capitalization decisions; differences should be respected.

8. Debt Rate / Cost of Capital
- *The current deemed Debt Rates were based on a forecast of long-term Canadian bond rates, and were adjusted based on utility size.*
- *Update of Debt Rate(s) to reflect current economic conditions and interest rates.*
- *Debt Rate(s) to be uniform, size-related, based on ability to borrow, or other?*

Comments:
- Public issuers like Hydro One have a portfolio of actual, outstanding debt with assigned interest rate and duration. Debt rate is a weighted average composite of actual outstanding debt.
- Establishing debt rate on this basis will closely match actual interest expense.
- Cost of debt needs to be directly linked to outstanding debt portfolio.

Recommendation:

- Embedded cost of issued debt should be used to establish debt rate.

9. Depreciation Rates

- *Depreciation rates set out in Distribution Rates Handbook were carried over from the former regulator.*
- *Appropriate time to undertake a full-scale review of depreciation rates?*
- *Stakeholder views on a limited review of depreciation in 2006, such as: amortization of select assets, salvage valuation, asset verification studies, or updating technical inputs (e.g. composite service life statistics).*
- *Merits of true-up provision requiring differences between theoretical depreciation and booked depreciation in excess of a specific percentage to be amortized over the remaining life of the asset.*

Comments:

- There are variety of depreciation methods that could be used.
- Migration from current practice may require "one time" adjustment to LDC revenue requirement.

Recommendations:

- Two approaches should be allowed:
  a) OEB direction that outlines an industry wide approach to depreciation calculation, or
  b) LDCs that choose not to follow OEB guidelines defend their own methodology
- LDCs should use consistent approach to depreciation (e.g. straight line, vintage group procedure using IOWA curves for remaining service life estimation).

10. Transfer Pricing and Shared Corporate Services

- *What method(s) will be acceptable for rate purposes when allocating the cost of shared corporate services to the regulated utility?*
- *How to review prudency of expenses paid for services outsourced to affiliates (or non-affiliates)?*

Comments:

- Hydro One Networks supports the use of shared services as this helps to lower overall costs.
- Hydro One Networks business model is more complex than most LDCs (ie. need to apportion common costs between TX and DX, regulated and un-regulated businesses).
- The OEB directed at our last hearing that Hydro One conduct our own study.
- Need to establish consistent principles across LDCs (e.g. causality/benefit).
- Approach needs to recognize different LDC organization structures (e.g. holding company model, multiple affiliates).

Recommendations:

- Approach should have generic drivers that could then be "fine-tuned" to enable LDCs to apply in their specific circumstance. Each LDC should defend its own approach.
- Transfer pricing and shared services should follow the principle of fully allocated costs.

- It's difficult for smaller LDC to conduct its own shared services study, and the regulatory burden of reviewing these studies would be significant. It would be helpful for the OEB to provide its view on appropriate cost drivers for small LDCs.

11. Low Voltage and Wheeling Costs

- *Host distributors are presently providing low voltage and wheeling services, but without recovery in rates.*
- *Treatment in 2006 revenue requirement of Low Voltage charges embedded distributors incur and will pass through to their customers.*

Comments:

- Hydro One Networks has valid and approved LV costs that should be recovered, as they reflect the cost of owning and operating the associated assets.

Recommendations:

- Strongly support mechanisms to allow us and other LDCs to recover these costs through rates.

12. 2006 Taxes / PILs

- *A fair and practical methodology for calculating an allowance for taxes/PILs in 2006 rates.*
- *Merits of the use of actual versus deemed figures in regulatory tax calculation.*
- *How to confirm whether LDCs are maximizing tax deductions?*
- *Impact of any expected changes in 2006 tax rates or rules.*
- *Relevance of discussions in other Canadian jurisdictions on approaches to tax calculation (e.g. use of "flow through" method).- "True-up" of historical PILs (2005 or before) will be addressed separately.*
- *Whether taxes should be inside or outside a future PBR envelope, as well as appropriate sharing of benefits of tax planning, will be addressed later.*

Comments:

- Supportive of a fair and appropriate methodology for calculation of taxes/PILs. Hydro One Networks current methodology is appropriate.
- Onus is on LDCs to claim the maximum deductions that in the judgment of the LDC and its advisors are available under the Federal and Ontario tax statutes. However, tax legislation by its very nature quite often lacks clarity and accordingly, it may be difficult to determine whether deductions have been maximized. We suggest a "prudent tax professional" approach in considering whether tax deductions have been maximized. We suggest that LDCs seek tax advice when appropriate.
- We are interested in monitoring tax approach discussions in other jurisdictions regarding the "taxes payable" and "tax liability" methods.
- Non-routine tax adjustments should be considered on their merits.
- Need clarification of definition of "deemed" taxes (i.e. Does this question relate solely to partnerships and other flow-through entities or is it of more general application?)
- Deferred tax accounting may have merit in levelizing rates over time. Consideration should be given to further study.

Recommendation:

- We are supportive of further study in this area.

Distribution Rate Base Issues

13. Definition of Distribution Rate Base

- *The Distribution Rate Handbook lists what assets and accounts should be included in the distribution rate base, but there have been some changes to the Uniform System of Accounts over time.*
- *Are there assets for which the classification should be clarified or changed (e.g. treatment of >50 kW transformer assets)?*
- *For assets that are shared between distributors, or assets shared between distribution and non-utility functions, should specific methods be approved for apportioning the appropriate amount to the distribution rate base?*

Comments:

- Hydro One Networks assets include a number of HVDS and power system assets operated at below 50kV outside the TS station fence.
- We consider HVDSs, which provide step down transformation from above 50 kV to below 50 kV, as distribution function assets. HVDSs have more significant. commonality with a DS than a TS (i.e. HVDS and DS share; similar design, level of capacity, level of service, cost).
- Other LDCs own power system assets operated at greater than 50 kV (i.e. transformation connection stations) and include them in their distribution rate base. Hydro One Networks Tx/Dx boundary is essentially at the LV egress at the TS station fence.
- Hydro One Networks owns assets that are shared between Transmission and Distribution businesses - primarily buildings and telecom assets. We believe that each LDC is in the best position to allocate its shared facility costs and to justify its approach as needed.
- Revenue requirement would have to be adjusted for financial impact of any change.

Recommendations:

- For those LDCs that own power system assets (and specifically connection assets) that operate at voltages above 50 kV, Hydro One Networks supports including these in the LDCs' Distribution rate base subject to OEB approvals.
- We prefer that each LDC perform its own allocation of shared asset costs; however, Hydro One Networks would not object to as prescribed allocation using suitable common principles.

14. Rate Base Measurement Date(s)

- *Electricity distributors have historically reported data for RRR and rate application filings for the calendar year, while the "rate year" for 2006 is presumed to be May 1, 2006 to April 30, 2007.*
- *What approach should be adopted for dealing with the timing difference between the calendar (report) year and the rate year?*

- *What approach should be take towards valuing the rate base over a 12 month period (average of monthly values, averaging of start and end dates values, end of period value)?*

Comments:
- While proration for partial year implementation is possible, rate implementation needs to be kept simple.
- Need to consider possible billing/timing implications.
- Need to have rate adjustments that can stay fixed until next rate setting period (ie. stability in rates).
- Should continue to stay on calendar year for calculation of revenue requirement even though implementation period may be different.

Recommendation:
- Calculate rate base on calendar year

15. Working Capital Component of Rate Base
- *The previous working capital allowance (WCA) was based on a formula originating when Ontario Hydro regulated the industry and consisted of 15% of controllable costs plus the Cost of Power.*
- *Should a common WCA formula continue to be used? How should it be updated in light of subsequent industry restructuring and rate unbundling?*
- *Should some LDCs be required to conduct lead-lag studies to empirically establish their working capital requirements? Could the results of these studies be extended to other LDCs? Should any LDC requesting a WCA greater than that provided by the new formula be required to file a lead-lag study?*

Comments:
- There have been no recent studies to confirm the validity of using a 15% Working Capital Allowance.

Recommendations:
- A standard WCA of 15% (or an amount confirmed through further study) would be appropriate for smaller LDCs.
- For larger LDCs, a lead/lag study would be more appropriate (reflecting their own specific cash flows).

16. Capitalizing Expenses
- *Reasonableness of a LDC's policy regarding capitalization of expenses.*
- *Consistency between utilities.*
- *Significance of accounting debates over the merits of incremental vs. full cost approaches towards capitalizing overhead or indirect costs.*

Comments:

- This is an important issue for Hydro One Networks as our capital programs are relatively large and we have an established cost allocation methodology. Options for such a review include:
    (i) a generic review with standards set for all LDCs
    (ii) LDC-specific reviews to ensure that the treatment of capital is consistent with GAAP and regulatory principles.
- We strongly prefer a *specific* review of our treatment of capital, as we have been using an established approach that is integral to our overall financial management system.
- Once that standard is set it should remain in effect until the next rate setting period.

Recommendations:
- That utilities maintain a "full costing" approach to capital costing (direct costs plus corporate capital overhead rate) consistent with methodology currently approved by the OEB.

17. Capital Projects
- *How should the prudency of capital expenditures be reviewed?*
- *Merits of project-by-project review versus use of trendlines.*
- *What level of review is appropriate for major projects? Are there filing requirements that can assist review?*
- *Establishing a fair trendline in light of historical trends and planned new investments.*

Comments:
- Hydro One Networks maintains that the level of scrutiny afforded to capital expenditures should be commensurate with the materiality, the nature of the expenditure, and the impact on the customer.
- Any review of capital expenditures should reflect the decision-making process that the LDC would be expected to follow in establishing the expenditure internally. For example, the decision might be based on cost minimization for system and infrastructure investments; on policy for certain demand work; and on cost/benefit assessments for reliability investments.
- Options for review of capital expenditures include:
    1. Project-by-project review
    2. Program level review
    3. Policy level review
    4. Use of trendlines and historical data
- Review of capital projects and their justification must be based on project *merit,* as other approaches could lead to inappropriate regulatory decisions. The use of historical trends, while helpful, does not take into consideration forecasted needs, changing technology, asset condition and customer expectations.
- Hydro One Networks and many other LDCs have mature decision making and investment prioritization processes which we expect to describe in our rate review submission. The risk of subjecting LDCs to more simplistic or cursory reviews is that prudent capital expenditures may be disallowed in the absence of a full review.
- We are in favour of a project or program specific review, based on merit, not a formulaic approach.

- We agree with mid-term formulaic adjustments to adjust approved capital expenditures to changing needs.
- We want to defend significant program changes and not just a historically trended formula.

Recommendations:
- Each LDC should be expected to provide justification for future capital expenditures, using an appropriate level of granularity (policy, program, or project level) as it deems adequate. Historical trend lines are a relevant consideration and should be used as support but should not be the primary basis for setting capital expenditure approval.
- Materiality should be taken into account when determining the evidence that is provided and the hearing time that is devoted to the investigation of an issue.

18. Contributed Capital
- *Distributors are presently allowed to earn a return only on pre-2000 contributed capital, and until such assets are fully depreciated.*
- *Prudency review to check that the appropriate amount of contributed capital is allowed to earn a return.*

Comments:
- Contributed Capital. Hydro One DX does not earn a return on contributed capital (unlike other LDCs).

Recommendations:
- Utilities should be allowed to earn a return on contributed capital and there should be consistency in treatment across LDCs.

19. No-Cost Capital
- *Extent of application of "no-cost" capital concept to Ontario electricity distributors. What specific items should be included (e.g. pension assets)?*

Comments:
- LDCs should be entitle to earn a return on capital that required financing.

Recommendation:
- If an asset did not require financing (e.g. deferred pension asset), it should not be entitled to earn a return on that asset.

20. Rate-Setting Treatment of Capital Gains
- *Should a uniform approach be followed for distributing gains from sale of utility assets between shareholders and ratepayers?*
- *Would the same approach apply to sale of shares?*

Comments:
- It is important to keep pool/rates and net income whole
- Depreciation expense is budgeted and submitted for rate treatment with an embedded assumption as to normalized levels of gains and losses. Variances between actual

experience and budgeted assumption can go in either direction (i.e. excess net gains or excess net losses). Whatever mechanism is adopted, the utility should have symmetry to deal with gains and losses.

- For divestiture of transmission assets the OEB has already ruled that *"… assets should be removed from the utility rate base at accounting net book value"* regardless of whether or not a sale results in a gain or loss, and *"… any gain or loss from the sale is to the account of the shareholder"* (ref: RP-1999-0044, section 2.3.7, page 21).

Recommendation:

- Asset sales should be removed from the rate base at accounting Net Book Value and any gain or loss from the sale should be to the account of the shareholder.

Operating Expense Issues:

21. Distribution "Wires Only" Expenses

- *The Distribution Rate Handbook lists various utility and non-utility expenses (and revenues), but there have been subsequent changes to the Uniform System of Accounts. Does the classification of any item(s) need to be clarified or changed?*

Comments:

- Need to have up to date USofA.

Recommendation:

- USofA should be updated and aligned with current practice.

22. Post-Retirement Benefits and Pensions

- *Review of economic assumptions used in plan calculations.*
- *What pension costs are allowed into the distribution revenue requirement (e.g. treatment of a pension surplus, shortfall or contribution holiday; valuation measures to reduce volatility)?*
- *Must an LDC move to the accrual method of accounting for post retirement benefits for rate setting purposes, in light of CICA s. 3461?*
- *If an LDC changes from the cash to the accrual method, regulatory amortization of one-time expense as a result of the change-over.*
- *Prudency of management of pension assets.*

Comments:

- Consistent with the OEB transitional rate orders for the Company, pension costs are to be included in rates, based on the cash (funding) basis, rather than the accrual basis.
- Hydro One currently follows the accrual method of accounting for post-retirement benefits for both rate setting purposes and external financial reporting purposes.
- The prudent management of the pension assets should be considered. However, due regard should be given to external market factors, investment strategies, and the nature or legacy nature of the pension plan and member benefits.

Recommendation:

- Hydro One Networks supports maintaining its' "accrual" basis for post-retirement benefits and the "cash" basis for pension costs due to the significant impact a change would have on customer rates.
- We support further study of the accounting treatment for post-retirement benefits and pension costs if desired by the OEB.
- If a change in accounting treatment is deemed desirable based on further study, we believe that the financial impact of any change should be recovered through rates.

23. Site Restoration and Removal Costs

- *For any LDCs to which this applies, what are the rate-setting impacts of compliance with new CICA s. 3110 (effective 2004).*

Comments**:**

- Currently, with the exception of Land Assessment and Remediation (LAR) and PCBs, Hydro One Networks accounts for its site restoration and removal costs by charging them to OM&A as incurred. CICA 3110 says to recognize a liability for future removal (NPV) and capitalize it as part of the cost of the related asset.
- We adopted CICA 3110 effective Dec. 31, 2003 and did not recognize any obligations due to inability to estimate a fair value (due to uncertainty as to the date of ultimate removal) or immateriality.
- PCBs and LAR are accounted for on an analogous basis.
- There is already significant U.S. regulatory discussion on this topic as SFAS 143 was effective in the U.S. on Jan. 1, 2003.

Recommendation:

- Continue to treat these expenditures on a cash basis due to the uncertainty of future liabilities.

24. Insurance Expense

- *Determination of appropriate reserves for distributors that self-insure, or appropriate insurance expenses for distributors that use insurers.*

Comments:

- Organizations should seek a proper balance between risk retention (e.g. financed internally) and risk transfer (e.g. purchase insurance).
- Risk transfer is the process of paying a premium to pass on the uncertainty of loss. This provides cost stability to the organization.
- Risk retention involves a more complex set of variables such as i) historical losses; ii) the organization's net cash flow; and iii) borrowing power.
- Risk retention falls into two broad categories: i)self insurance, which involves budgeting for losses or ii) large deductible.
- The advantages of risk retention to a business are: i) better control of claims handling; ii) maximum control over claims negotiation and settlement; iii) exercise substantial discretion in selecting defense counsel and deciding whether to settle or litigate.
- In the long run, it could cost less to retain risk then it does to transfer it. The savings come from removal of the insurer's profit, agent/brokers compensation, and premium taxes.

Recommendation:

- For utilities who elect to self insure to reduce insurance premiums, allow higher reserves in rate base or some other form of recognition.

25. Bad Debt Expense

- *What is an appropriate amount for uncollectables, especially considering interaction with other policies (such as the LDC's Security Deposit policy)?*
- *Should a single method be used to calculate the amount? If so, how should it be determined?*

Comments:

- Goal is to minimize unpaid charges and maximize the probability of recovery, utilizing expertise of the 3rd party collection vendor(s) and other collections practices as deemed appropriate by the LDC.
- Collection experience will vary geographically and for differences in the local economies
- Hydro One Networks' customer base is unique relative to other LDCs in size of service territory and customer demographic, making industry-standardized collection efforts ineffective and ultimately increasing the cost of collection activity. We need to establish our own collection practices accommodating these factors rather than a standardized method/practice and/or timeline across the industry.
- Collection-related costs charged to customers should reflect actual costs and cost causality.

Recommendation:

- The bad debts allowance should be based on a utility's specific circumstances with appropriate demonstration of controls.

26. Employee Compensation and Staffing

- *Review of reasonableness of total executive compensation (base, incentive plans, and supplemental income and benefits). Review of the distribution of the costs of the incentive plans and supplemental income between shareholders and ratepayers (for example, based on who receives the benefits from achievement of corporate targets). Review of allocation of executive salaries within a corporate group.*
- *Merits of a uniform approach in respect of regulatory review of bonuses (such as dividing costs 50/50 between shareholders and ratepayers) versus a case-by-case review of the terms of each incentive plan.*
- *Review of reasonableness of non-management labour costs.*

Comments:

- Utilities have legacy labour agreements that prescribe rates of pay and benefits for their employees.
- These negotiated agreements are "locked in" for the duration of the contract period and would be difficult to change even in future negotiations.
- These agreements are unique to that particular utility. As such, compensation and staffing needs to be considered based on each LDC's specific circumstances.

Recommendation:

- Employee compensation and staffing should be considered on a utility specific basis.

27. IT Costs

- *Review of prudency of IT costs, including treatment of IT outsourcing costs and of IT project cost overruns.*

Comments:

- We have legacy IT systems costs.
- We are unsure if relevant comparators (ie. energy industry) exist for Hydro One Networks.
- Outsourcing agreement with third-party service provider prescribes service costs and service levels.

Recommendation:

- IT costs should be considered on a utility specific basis.

28. Advertising, Entertainment, Charitable/Political Contributions, Employee Dues, Research & Development

- *What is an appropriate regulatory treatment of expenditures that may benefit the ratepayers only partially?*

Comments:

- Process needs to be fair and also simple.

Recommendation:

- Where common type costs provide some benefit to the ratepayer they should be allocated to the ratepayer based on appropriate cost drivers (ie. causality, usage).

2006 Rate Design Matters:

Board staff propose that certain rate design issues, discussed below, be addressed as part of setting 2006 distribution rates. Hence, these issues would be examined as part of the fall 2004 generic process. Stakeholder views on inclusions or deletions from this list are sought.

It is proposed that further rate design issues be addressed after the updated cost allocations results become available, as part of the process for establishing 2007 distribution rates.

While the treatment of Demand-Side Management / demand response initiatives is recognized as potentially impacting on the setting of 2006 distribution rates, it may be expected that the treatment is better dealt with outside of this generic process. The same approach is also expected with respect to any new treatment of the distribution loss factor.

Rate treatment of smart metering initiatives for large consumers may be addressed in the generic process. The need for and design of Time-of-Use distribution rates and their

effectiveness in encouraging load shifting are also of interest to the Board. Stakeholders' perspectives on these possible inclusions or exclusions are sought at the July consultation.

The future commodity pricing mechanism under development may have an impact upon 2006 rates, and it is expected this will be dealt with when the applications are filed in mid-2005.

29. Specific Service Charges

- *Specific Service Charges are to be considered as part of establishing the 2006 revenue requirement.*
- *Will also address variability in types and charges for Specific Service Charges across all distributors, with an aim of exploring consistency in definition and application. For example, should there be a single charge for each service across Ontario?*

Comments:

- These charges are also known as "Miscellaneous Charges".
- Hydro One Networks recognizes that the potential for each Ontario LDC to have its own unique set of charges introduces customer confusion and regulatory challenges.
- Hydro One Networks supports the existence of these charges for special services, as they help attribute costs to customers who cause them, and help mitigate rates for those customers who do not benefit from the services. Service charges also provide appropriate drivers for the LDC and the customer, by incenting and deterring certain behaviours (e.g. late payment charges).
- Hydro One Networks can accept a province wide fee schedule if our own costs are covered by these charges. In many cases, our geography and customer density result in higher costs than other LDCs.

Recommendations:

- Hydro One Networks strongly believes that miscellaneous charges should be cost-based, usually using the LDC's *average* costs for each service, reflecting the costs of labour, materials, and equipment used to provide the service.
- In cases where non-cost considerations dominate (eg late payment charges), standard industry practices and benchmarks should be used to set fees. We would accept standard province-wide fees for these types of services where costs are not the dominating factor.
- The OEB should set a single "menu" of services for which miscellaneous charges can be charged, with definitions, and agree upon standard principles and methodology for establishing each charge. Allow each LDC to set its own charge, providing it abides by the standard definition and methodology.

30. Unmetered Scattered Load

- *Definition and rate treatment of Unmetered Scattered Load (cable TV, payphones, advertising, etc.).*

Comments:

- This is an issue raised by Cable companies who are concerned about most distributors not having a different rate for unmetered load. Customers would also like to be able to aggregate their multiple locations.
- Another issue is the profile assumed for the load, since it is not metered.
- A possible solution would be to do a cost allocation study and create a separate rate class for those customers with unmetered loads. The load profile for these customers needs to be developed and agreed to. An interim solution could be to take the current fixed service charge that the distributor applies to these customers and give a credit to reflect that no meter or meter-reading costs are incurred on behalf of these customers.

Recommendations:
- HON does have separate rates for unmetered load customers and recommends that no metering or meter reading costs be included for these type of customers.
- To determine the load profile, meters should be installed in a few locations to develop a default load profile. Such a study could be conducted prior to a rate reset period.

31. Time-of-Use Rates

Even prior to completing new cost allocation studies, the merits of integrating the former TOU distribution rate classes that appear in the tariffs for various LDCs into more appropriate rate classes.

- *Design of Time-of-Use rates for large consumers to encourage loadshifting*

Comments:
- The consideration of ToU in respect of the application of distribution rates appears to be timely given the Government's recent legislation that promotes demand side management and efficient use of the electricity commodity.
- There are system and customer benefits arising from use of ToU particularly in light of demand/supply situations, as experienced in Ontario.
- The application of ToU rates in respect of distribution charges would avoid penalizing those customers who make changes to their consumption patterns that avoid consumption during peak demand periods.
- ToU rates are not cost based and so other than cost causality principles need to be factored into the decision making to include ToU rates in the portfolio of charges.
- The application of ToU rates could be restricted only to those customers who meet certain criteria, e.g. demonstrate that their off-peak load is at least twice their peak load.
- The application of ToU rates will result in some revenue loss to participating LDC and consequently a mechanism needs to be put in place to allow recovery of that revenue loss at a future date, e.g. a true-up at the time of rate setting.

Recommenation:
- Hydro One Networks generally supports the concept of ToU distribution rates for certain customers.

32. Fixed/Variable

- *In advance of new cost allocation studies, it may be desirable to start addressing some of the variability in the fixed (Monthly Service Charge) and variable (demand/energy-related) tariffs across the province.*
- *Should there be partial movement towards a uniform fixed charge for each rate class across Ontario in 2006?*

Comments:

- Hydro One Networks generally supports an initial approach to addressing some of the variability in the fixed (Monthly Service Charge) and variable (demand/energy-related) tariffs.
- However, it cautions that this matter is best resolved through a full cost allocation and rate design process which the OEB intends to use for setting 2007 rates.
- The variability currently experienced in the tariffs of the various LDCs across Ontario is not readily resolvable because it is not clear whether the current rates are truly cost reflective.
- Subsidies between utilities (e.g. LV costs not paid by beneficiaries) exacerbate the situation.
- The unbundling process used to establish initial distribution rates at the outset of market opening (as directed by the Rate Handbook) did not address the matter of cost allocation per se. Consequently the starting point for the LDCs' unbundled rates may be different and thus the variability.
- To that extent, Hydro One Networks suggests that an approach towards harmonization of fixed charges might be addressed through examining what constitutes common costs that essentially make up the fixed costs. A dialogue on this issue at this time might provide valuable input to the subsequent cost allocation and rate design process.
- It is a known fact that distribution rates prior to market opening entailed different levels of cross-subsidies, and these need to be addressed before one can make any judgment regarding the nature of fixed charges.

Recommendations:

- Costs of providing services should generally be paid by those that benefit from the service. LV costs should be charged to benefiting utilities and customers.
- Hydro One Networks would not support a move towards harmonization of fixed rates on a provincial or regional basis or rate class basis at this time. This would be premature and is best left to the next stage of the Board process that entails a full examination of cost allocation principles.

33. 2006 Rate Mitigation

- *Rate mitigation may be used, as it has been historically, to reduce significant rate impacts. Should a common rate mitigation test or methodology be adopted? What test(s) or methodology for mitigating rate impacts are appropriate?*

Comments:

- Hydro One Networks generally supports the concept of using a mitigation process to reduce the impact of significant rate increases.

- The tolerance level that would be acceptable to customers needs to be determined.
- The current 10% test for mitigating impacts to small consumers is a good starting point.

Recommendation:

- A move towards a common rate mitigation test would be preferable since that removes any potential for preferential treatment.
- It is important that consideration be given to the potential impact of a 2006 rate re-set. Rate mitigation will likely be required similar to the three year phase-in that was implemented for Hydro One Networks under Phase 1 PBR.

Appendix B

Additional Issues for Consideration

In addition to the issues identified in the Board discussion document, there are a number of other issues that require clarification/resolution in the determination of revenue requirement. These issues from Hydro One Networks perspective include:

1. Impact of TSC decision on Distribution.
   - *Different rates would have to be established for different scenarios*
   - *Costing detail would be required to support rates*
   - *Issues include Transmission flow-through rates, connections for new generation*

Recommendation: LDC's should be compensated for all incremental costs associated with the impact of TSC changes

2. Rate Harmonization.
   - *Establish more uniform rate classes across industry (consistency/rationalization)*
   - *Rate design and customer bill standardization*
   - *Reduce cross subsidization between customer classes*

Recommendation: We support establishing a transparent process that will equitably reflect the costs that specific customer groups should pay for the service benefits received.

3. Bill 100 implementation (eg. commodity pricing and new SSS requirement).
   - *The full scope and impact of Bill 100 could be quite broad, but it is difficult to establish the full impact at this time (eg. potential for new bill format, expanded default supply responsibilities, additional complexities in retailer supply and load billing, billing system changes required for interfaces with IMO and the new OPA*
   - *These changes could be quite complex and have a high cost*
   - *Will need to respond to these requirements in a short time period*

Recommendation: LDCs should be fully compensated for any incremental costs associated with implementation of Bill 100. Consideration should be given to establishing requirements that are clear and straightforward for utilities to implement. The design of new rules should not be overly complex and should provide sufficient time for LDCs to implement.

4. DSM load reductions.
   - *As a result of Demand Side Management initiatives, load and hence revenue will be reduced.*
   - *A significant portion of LDC costs are fixed (ie. depreciation and interest) and will still need to be funded despite reduced use of the assets.*
   - *The level of load reduction is uncertain.*

Recommendation: LDCs should be compensated for any reduction in revenue and increase in cost as a result of DSM initiatives.