Distribution Expenses

Section: 3.4

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1. Summary of work to date:

The Distribution Expenses Sub-group completed the following tasks:

- Reviewed the definition of distribution expenses for the 2006 Distribution Rate Handbook ("DRH").
- Considered and in some cases developed filing guidelines and definitions for expense items identified as "issues" in the Board Staff's strawman document that require unique or specific treatment.
- Determined relevance of these "issues" to the Ontario electricity LDCs.
- Worked to strike a balance in prescribing filing guidelines which will expedite the review of the 2006 cost-based rate applications and provide the required level of detail for the regulatory review while allowing for flexibility in reporting requirements that addresses the variation in the reporting capabilities of 90+ utilities of various sizes and resources.
- Identified distribution expenses issues that impact or cross over to other revenue requirement or rate design issues as applicable for the 2006 EDR process and 2006 DRH.
- Identified where the Accounting Procedures Handbook ("APH") and Uniform System of Accounts ("USoA") lacks guidelines or prescriptive treatment for particular distribution expenses and provided suggestions on the treatment of these expenses post-2006.
- A historic test year of 2004, with approved adjustments, will be the basis for the 2006 cost of service and rate setting process.

2. Questions of scope:

The Distribution Expenses Sub-group's work is based on the following assumptions:

- Will the Board confirm that Local Distribution Companies will be permitted to re-base in 2008?
- A prescriptive accounting treatment should be developed for use for expenses incurred in 2006 and beyond for implementation into 2008 rates.

3. Issue List, Discussion Summary, Alternatives and Resolutions

Issue #21 – Definition of Distribution Expenses

Major Points of Discussion/Background:

- Identified the need to update the current DRH definitions of distribution activities and list of distribution expenses as related to the USoA.
- Impacts on distribution expense definitions resulting from changes in rate base definitions.
- Level of detail and number of years of historical data to be filed for distribution expenses not identified as "issues" versus those identified as "issues" in the Board Staff strawman.

Proposed Consensus:

- Definition of distribution activities as outlined in Appendix "D", Part I of the current DRH ("Guidelines For Determining Distribution Or "Wires Only" Activities And Assets") is satisfactory for use in the 2006 DRH.
- Appendix "D", Part II of the current DRH ("Rate Base Calculation – Initial Filing") is no longer valid and should not be included in the 2006 DRH.
- Appendix "D", Part III, Table B.2 should be updated to include accounts 5014 and 5015 to address proposed changes to rate base for the inclusion of transformer station equipment.

The following filing guideline is recommended for distribution expenses generally. Further filing requirements may be imposed by the Board for specific items

1. Utilities should file 3 years of historical data (i.e. 2004, 2003 and 2002) for high level groupings of distribution expenses.

Unresolved issues:

Level of filing detail for each group of distribution expenses not otherwise described in this paper.

Proposed path:

Further discussion in working group, with possible argument.

Crossovers

A sub-group other than the Distribution Expenses Sub-group is addressing adjustments to the 2004 costs.
Filing requirements developed in test year section 3.1
The filing guidelines developed in section 3.4 of the 2006 DRH will provide sufficient level of detail for any review of distribution expenses conducted, in part, on the basis of comparators and cohorts.

Issue #24 – Review of Insurance Expense

Major points of Discussion/Background:

- Most LDCs pay 3rd party premiums for insurance purchased.
- Where permitted by law some utilities self-insure and concern was expressed on the accounting treatment of reserves related to self-insurance.

Proposed Consensus:

The following filling requirements are recommended for Insurance Expenses:

1. LDCs using 3rd party insurance should provide: 3 years of historical costs; high level information on number of insurers; types of insurance purchased; and, premium costs by insurer.
2. LDCs that self-insure should provide high level information on their: evaluation plan for self-insurance; and, the accounting treatment of their reserves related to self-insurance, if they have any.

Unresolved Issue

Whether a reserve for self-insurance can be treated as an expense for revenue requirement purposes.

Proposed Path

Further discussion in working group

Issue #25 – Bad Debt Expense

Major points of Discussion/Background:

- Bankruptcies vary from year to year and are an ongoing component of bad debt expense.
- The validity of removing bankruptcies based on a dollar or customer class impact threshold was questioned because of the difficulty of setting a threshold that could be fairly applied to 90+ LDC's of varying size and customer mix.

Proposed Consensus:

The following filing guidelines are recommended for Bad Dept Expenses:

1. All bad debt recorded in 2004, including bankruptcies, is to be reported and segregated by customer class.
2. Single bankruptcies exceeding the current materiality level for Z-factors (i.e. 0.25% of net assets) should be disclosed separately with explanation.
3. Provide 3 years of historical data (2004, 2003, and 2002) on bad debt expenses subject to the same disclosure levels as indicated in item 1 (i.e. include bankruptcies

and segregate bad debt information by customer class).

Cross Over or Other Considerations:

- There may be future material impacts related to: (1) new pricing plan (i.e. Regulated Pricing Plan); (2) changes in deposit policy; and (3) Bill 100. These future changes point to the need for rate rebasing in 2008.
- Can bad debt be used as a comparator across utilities given the variation in customer mix and economic conditions amongst the service areas?

Issue #27 – IT Expenses

Major points of Discussion/Background:

- IT expenses have been highlighted as an issue as a result of IT project cost overruns in the gas industry.
- Discussions on IT expenses suggested a wide variety of treatment by utilities with respect to IT expenses with some utilities recording portions of IT expenses within engineering or billing expense accounts.
- There is currently a lack of prescribed accounting treatment guidelines and provision of accounts to track IT expenses.
- Discussion on the relevance of the review of IT expenses versus the review of IT capital investments suggests that IT capital investments are more material than IT expenses and would involve a review at the IT project level.

Proposed Consensus:

- The most useful review of IT expenditures would be on the capital investments, rather than IT expenses.
- Given that there is a lack of formal account definition for IT expenses in the USoA, separate filings of such expenses would prove difficult and would likely have little or no comparative value across LDCs.
- A prescriptive accounting treatment should be developed for future years.

Cross Over or Other Considerations:

- It is suggested that the review of major IT capital expenditures be undertaken as part of the consideration of Rate Base.

Issue #28 – Advertising, Entertainment/Travel, Charitable and Political Contributions, Employee Dues, Research & Development

Major points of Discussion/Background:

- Issue of appropriate allocation of costs between ratepayers and shareholders.
- Each of the cost categories identified under Issue #28 is unique, and therefore there is

no generic treatment that can apply to all categories.

- Discussion on the value of charitable contributions to the ratepayers and the view of public utilities as “community” supporters through these contributions.
- Quantifying entertainment/travel expenses may be difficult because they are often recorded across many expense accounts, with varying treatment across utilities. The issue therefore is how prudency might be determined in the absence of filings of specific dollar values.
- General principles for LDCs to follow in allocating these expenses between the ratepayers and shareholders

Proposed Consensus:

The implementation of the following policies are recommended for Advertising, Entertainment/Travel, Charitable and Political Contributions, Employee Dues, Research & Development Expenses

- Advertising: Advertising expenses, incurred for the sole purpose of promoting corporate branding or image, are not recoverable in distribution rates and are a cost to be borne by the shareholder.
- Entertainment/Travel: Staff entertainment and travel expenses, more aptly called employee business expenses, must be approved by LDC management and must be based on a documented and consistently applied corporate policy.
- Political Contributions: Political contributions are cash donations to political parties, and are a cost to be borne by the shareholder and are not recoverable in distribution rates.
- Employee Dues: Fees or dues for annual recreational or social club memberships are not recoverable in distribution rates (examples: golfing, tennis, sailing).
- R & D: Prudently incurred distribution related R & D expenditures, intended to benefit the ratepayers, are recoverable in distribution rates.

Unresolved Issues:

The issue of whether Charitable Contributions should be recoverable in distribution rates remains unresolved. While gas distributors do not recover charitable contributions through rates, the LDCs indicated that there is public expectation of public utilities’ support through these contributions.

Whether the disallowed portion of entertainment expenses that would be filed on the LDCs’ tax returns could be used as a proxy for ½ of the value of these expenses in the LDCs’ rate filings.

Whether utilities should file their corporate policy for entertainment and travel, including staff development and training, with their 2006 rate filings.

Filing requirements, if any, for excluded items (eg. Statement in Manager’s summary).

Proposed Path for these Issue:

The working group will continue working on these issue.

Issue #10 – Affiliate Transactions and Shared Services

Major points of Discussion/Background:

- Discussion on level of information to be filed for regulatory review while maintaining confidentiality of affiliate's competitive information.
- Impacts of including affiliate's confidential information in publicly filed documents that would disclose service agreements.
- Discussion on Affiliate Relationship Code ("ARC") compliance versus review of prudent expenses.
- Wide range in nature and amount of affiliate transactions and shared services across utilities, including "virtual utilities" with 100% outsourcing to affiliates.
- Discussion of recent contentious issues related to affiliate transactions in the gas sector.

Proposed Consensus:

The following is the proposed consensus reached in the Sub-group:

- The following minimum filing requirements are recommended for Affiliate Transactions:

    1. Disclosure of the identity of each of the LDCs' affiliates.
    2. High-level summary of the nature of activities provided by each affiliate.
    3. Annual dollar value in aggregate of services provided by each affiliate.
    4. Summary of process used to determine the basis for the transfer pricing (e.g. cost based versus fair market pricing).
    5. Description of general methodology followed in determining prices (e.g. cost based, cost allocation basis, market based, tendering process followed)

- The following minimum filing requirements are recommended for Shared Services:

    1. Types of services (examples: finance services; IT; office space).
    2. Total annual dollar value by service.
    3. Rationale and summary of cost allocators used for shared costs for each type of service (examples: square footage; computers; headcount).
    4. Utilities should reference APH Article 340 on cost allocators for shared services.

Unresolved Issue:

To what extent must ARC compliance be determined as part of the 2006 rate setting process (i.e. to determine reasonableness of expenses)?

What should the additional filing requirements be for review of affiliate transactions and shared services (eg. Whether service agreements and contracts between utilities and affiliates need to be filed).

Proposed Path:

Submissions / argument before the Board

Cross Over or Other Considerations:

- Cross over to 3.1: Review of revenue from services to affiliates should be addressed in the DRH under the same general principles as proposed for the LDCs' expenses for affiliate transactions.

Issue #11 - Low Voltage and Wheeling Costs

Major points of Discussion/Background:

- This issue is a cross over issue from the "Other Regulated Charges Sub-group".
- Given that Hydro One has an approved Shared Distribution Station rate, the Other Regulated Charges Sub-group suggested that the Distribution Expenses Sub-group draft a paragraph that informs the embedded distributors to include billed amounts under Shared DS (e.g. USoA Account 5017).
- Similar wording is suggested for expenses related to future Hydro One's Specific DS charge and Specific Line Charge, and for comparable future charges from host distributors than HO.
- The costs pertain to:
    - those that flow to embedded LDCs related to the recouping of the regulatory assets of the host LDC by the embedded LDC; and,
    - going forward charges that host distributors will levy in 2006 and beyond.

Unresolved issue:

- The following filing requirements are those recommended by the Other Regulated Charges Sub-group:

    1. Amounts billed to an embedded LDC by its host LDC for Shared DS, Specific DS, Shared Line and Specific Line charges should be included in Account 5017.
    2. Such amounts shall include amounts for:
        a. recouping regulatory assets from the host LDC; and
        b. amounts for rates to be charged by a host LDC in 2006 and beyond for Shared DS, Specific DS, Shared Line and Specific Line services.

Proposed path:

Group will have to consider rules resulting from Regulatory Assets proceeding and further government directives.

Crossover to rates group:

Development of wheeling rates

Issue #22 – Benefits and Pension Matters

Major points of Discussion/Background:

- Most utilities are member of OMERS and their pension expenses are period costs only for premiums.
- It was considered that as many utilities do not have a choice of pension provider, a review of OMERs amounts would not be useful in the 2006 EDR process.
- Discussion of whether any review should be on period expenses only or on choice and performance of pension plans.
- Some utilities administer their own pension plans and may have unique expenses or associated risks.

Proposed Consensus:

- The following filing requirements are recommended for Pensions:

  1. Provide three years of historical information (i.e. 2004, 2003 and 2002) on amounts paid in period expense for pension premiums and adjustments.
  2. LDCs who do not use OMERS (including utility-owned and administered pensions) must provide key policy information such as cash versus accrual valuation, "smoothing" methods, and summary of performance.

- The following filing guidelines are recommended for Post Retirement Benefits:

  1. Provide information on current accounting treatment (e.g. cash versus accrual, review period frequencies) of post retirement benefits, as well as on treatment of one-time expenses and on past changes in accounting policies (example: movement from cash to accrual; amortization issues of one-time expenses).
  2. Provide information on treatment of changes in actuarial value in post retirement benefits.

Unresolved issue

Filing requirements for non-OMERs utilities who have plans that are not available to all employees.

Issue #26 – Total Compensation

Major points of Discussion/Background:

- Discussion on what level of disclosure would be meaningful for regulatory review while being sensitive to privacy of disclosure of individual wages.
- Difficulty of establishing filing requirements to "fit" utilities of all sizes with varying levels of employees.
- Value of using a disclosure threshold for individual wages, such as disclosing all individuals earning amounts over $100,000.

- Should review be limited to management and executive wages or include all categories?
- Review of filing requirements in recent gas sector rate proceedings.

Proposed Consensus:

- Compensation issues related to affiliate transactions are adequately reviewed under the filing requirements for affiliate transactions.

- Utilities need to confirm existence of and adherence to a documented compensation policy.

The following filing guidelines are recommended for Total Compensation:

Provide the following for 4 broad categories of utility employees – Executive, Management, Non-Unionized and Unionized:

1. Average Yearly Wage
2. Average Yearly Incentive
3. Average Yearly Benefits
4. Number of FTEs

    - Where “Wage” is defined as all earnings paid including overtime but excluding incentives and benefits.
    - Where “Incentive” is those amounts paid on a prescribed corporate incentive or bonus plan.
    - Where “Benefits” are those amounts the utility deems as employee benefits related to compensation.
    - Where “Executive” is generally accepted to include positions such as CEO, COO, VP’s and Directors.
    - Where “Management” is generally accepted to include positions such as operational, middle and supervisory managers.
    - Where “Non-Unionized” is generally accepted to include positions not included in union bargaining units and having no supervisory or management responsibilities.
    - Where “Unionized” is generally accepted to include all positions included in a union bargaining unit.
    - Where there are 3 or less FTE’s in any one category, the utility may aggregate this category with the category it is most closely related to . This higher level of aggregation may be continued if required to ensure that no category contains 3 or less FTEs.

Unresolved issues

Should overtime amounts be included (as may be outside of utility control)?

Filing requirements for utilities with less than three employees

Should “unionized” category be broken down into bargaining units?

Should compensation of employees who earn more than $100,000 be disclosed?

Disclosure / eligibility for recovery of performance incentive plans.

Need to file information regarding contract staff.

Need for filing of three year historical data for compensation.

Proposed Path

Continue discussion in the work group, possible argument before the Board.