

**2006 ELECTRICITY DISTRIBUTION RATES
RATE BASE - SECTION 3.3
STAKEHOLDER REPORT**

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Summary of Work to Date

- Reviewed the definition of distribution rate base and rate base components as to be defined in the 2006 Distribution Rate Handbook (DRH).
- Worked to develop filing guidelines and definitions for all rate base components that have been identified as 'issues'.
- Reviewed the relevancy of these identified issues to the Ontario electric distribution sector.
- Identified where these issues impact or cross over to other revenue requirement or rate design issues for the 2006 EDR process.
- Identified where the Accounting Procedures Handbook (APH) lacks guidelines or prescriptive treatment for these issues and have recommended treatment for these issues post 2006.
- The group's work and recommendations are based on the premise that a historic test year of 2004, with approved adjustments, will be the basis for the cost of service and revenue requirements for setting 2006 distribution rates.

Questions of Scope (assumptions)

- A subsequent cost of service process (re-basing) will occur, no later than 2008 to update revenue requirements.
- The OEB will undertake a comprehensive review and full study of the asset categories and amortization rates listed in Appendix E of the DRH, to be

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completed no later than 2008 distribution rate implementation. This study to include the consideration of stranded assets as a result of implementing smart meters.

There are a number of items or “hot buttons” which may need to be dealt with on an expedited basis. These include:

- C&DM capital assets that will not be approved in the C&DM variance accounts
- Depreciation rate for new smart meters and accelerated depreciation for existing meter assets needs to be defined.

Should these issues be dealt with in 2006 EDR?

Is clarification of the application of 2005 MBRR funds to C & DM assets part of the 2006 process?.

Issues List, Summary of Discussions, Resolutions or Alternatives

Issue 9 – Depreciation Rates

Summary of Discussion

- A) The current definitions and amortization schedules were from the former regulator and may not be reflective of the current useful life of the assets and categories.
- B) There is currently no time to do a comprehensive study on depreciation rates for 2004 to be implemented by 2006.
- C) That since individual electricity distributor may not have the time or resources to do their own depreciation studies, a working group could define a generic process with rates and categories for the industry as a whole.
- D) Distribution companies that do not want to file using this generic process could file their own amortization schedule with their own methodology and defend this to the OEB.
- E) This working group or study could define rates, which would be in place for 2007.
- F) There are a number of items or “hot buttons” which may need to be dealt with on an expedited basis. These include:

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- ❑ Add a new category for computer software.
 - ❑ New rates for computer software and hardware. Since most electricity distributors are on a three-year hardware replacement program, the subgroup recommended that both hardware and software purchase made on or after January 1, 2006 be amortized over three years.
 - ❑ C&DM capital assets that will not be approved in the C&DM variance accounts
 - ❑ Depreciation rate for new smart meters and accelerated depreciation for existing meter assets needs to be defined.
- G) Minor discussion on best way to depreciate franchises and land rights.
- H) Salvage value.

Proposed Consensus

- ❑ That the current asset categories and amortization rates as listed in Appendix E of the current Distribution Rate Handbook will be used for the purpose of the 2006 Revenue Requirement. The Ontario Energy Board should convene a working group to examine, reevaluate and adjust if necessary the amortization rates and asset categories, to be completed for no later than the implementation of 2008 rates.
- ❑ Organizations that do not follow the amortization rates as listed in the current Appendix E of the Distribution Rate Handbook be allowed to file their own amortization schedule based on their own depreciation study to be evaluated by the Ontario Energy Board. This filing would be supported by explanations and evidence for Board evaluation and be applicable only to organizations that are filing a forward test year.

Unresolved issues

Depreciation rates for hardware and software and proposed effective date of those rates.

Proposed path:

Likely to call evidence on reasonable life of software and hardware.

Cross Over

- ❑ Conservation & Demand Management (C&DM)

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- Smart Metering

Issue 13 – Definition of Distribution Rate Base

Summary of Discussion

- A) Considered whether customer deposits should be deducted from the rate base. As this is function of assets, liabilities and working capital it has been passed along to the group looking after working capital allowance.
- B) Definition of net fixed assets plus working capital is accepted. However, changes to what is included in fixed assets have to be made.
- C) Discussion about smart meters and C&DM – Items not included in deferral accounts and of a capital nature should be included in rate base. (This item forwarded to the group considering test year adjustments)
- D) The following should be considered in rate base:
 - Contributions made to Hydro One for transmission upgrades
 - Wholesale metering costs should be included in metering assets
 - Interval meters
 - Shared assets that utility pays should be included in their rate base. The objective is to ensure the item is included in the rate base only once.
- E) The past practice has been to include joint use assets (i.e. utility poles) in the rate base for revenue requirement. It was debated whether the revenue from the joint use asset should be removed from the revenue requirement.
- F) Discussion around the capital leases and whether they should be included in the rate base. In some United States jurisdictions, even though leases were capital for accounting purposes they are not allowed in rates. Consensus of the group was that if a lease met the stringent Canadian GAAP standards for classification as a capital lease then it should be included in the rate base.

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- G) Distribution companies that have separated assets to shareholder or affiliate service should remove those assets from the rate base.

Proposed Consensus

- The current definition of rate base and calculation there of, shall be maintained for the 2006 EDR process with the following inclusions:
 - Expenditures for smart meters and C&DM capital projects not recovered through the next phase of MBRR or otherwise funded are to be included in the definition of fixed assets.
 - Amounts paid to other LDCs for capital projects, namely Hydro One, for contributions for transformer stations and transformer assets >50 kV (LDC owned Transformer Stations) to be included in the definition of fixed assets.
 - The definition of metering assets to include wholesale metering upgrade assets.
 - Capital leases as defined by Canadian GAAP would be included as fixed assets.

Work to be done:

- The joint use assets included in rate base should have the revenue that these assets generate be applied consistently with other revenues in determining the revenue requirement.

Unresolved issues

- If within scope, the application of 2005 MBRR funds to C & DM assets.

Cross Over

- Conservation and Demand Management (C&DM)
- Smart meter initiative
- Test Year

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Issue 14 – Rate Base Measurement Date

Summary of Discussion

- A) In valuing the assets, discussion ensued about the three different approaches. Assuming that we are filing in 2005 and based on a historical test year, the three approaches to use are either:
- The balance at the end of the year
 - An average of the balances from the beginning of the year and end of the year
 - Average monthly balance

It was discussed that some distribution companies could not produce the average monthly balances total so this method would be discarded.

The rational behind using the average for the year was that since the assets where not in full production and in rate base for the whole year, why a full rate of return should be allowed.

The rational for using year end balances was that is was easier and simpler to use, there is no standard out there and the fact that since rates will not be in effect until 2006, distribution companies will have these assets for a full year in their rate base and therefore should earn a full rate of return.

- B) Timing difference between calendar year and rate year is a non-issue.
- C) LDCs may file evidence on a prospective year basis providing they are willing to defend the underlying forecast details before the Board.
- D) If 2004 were to be established as the historic test year, it should be done so only if there is sufficient scope of the prudential review to determine if the year is reflective of actual costs that may be faced in 2006. To that end, 2002 and 2003 numbers and details should also be filed, in order that appropriate deductions or averaging be considered. 2004 numbers should not be accepted on their face without determining the actual revenue requirement that was necessary in that year, and which of those requirements were base, which were one time, and which will be continuing.

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Unresolved Issue

- What date should be used to determine the 2004 historical balances?

Alternatives

- Historical year end balances

As rates will not be implemented until 2006, the assets purchased or constructed in 2004 will be in full use and in rate base for over a year from the close of fiscal 2004. Therefore the LDC should be allowed to calculate the 2006 rates using the full amount of the 2004 year-end balances.

Using year-end amounts would be easier to calculate and more transparent in an audit function and is also consistent with the original Rate Handbook.

Using a yearly average may not be reflective of when the asset was placed in service, which in some cases, benefits some and hinders others. Therefore consistency and fairness would dictate that year balances would be used.

- Yearly Average balances

The argument for using average balance is that when rates are based on a year when the asset is placed in service, the LDC should not receive rates based on assets that have not been in use for the full year.

Proposed Path for this Issue

- Calling of evidence

Cross Over

- Test Year

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Issue 16 – Capitalizing Expenses

Summary of Discussion

- A) The definitions of direct and indirect costs, and full cost versus incremental costs. Agreed upon the fact that there is a lack of consistency in the industry.

Some electricity distributors capitalize administrative and overhead costs and allocate them based upon a number of drivers, for example material, direct labour hours, percentages of costs, etc.

Overall there was a wide range of practices noted, ranging from some organizations allocating only direct costs, to others allocating a percentage of administration labour to capital overhead, to others allocating full costs including all corporate overhead.

- B) Discussed that current definition in the APH is vague but implies full cost accounting.

Most favored full cost accounting but the group had a hard time agreeing on a very prescriptive approach. It was brought to the groups attention that a number of years ago the MEA tired to perform this function and went the slippery slope into a back hole. The EDA was contacted to find if a study was ever done. Their answer was there was no consistency and nothing was ever done after that was determined.

Consensus was that it would be hard to find a detailed prescriptive approach that all would adhere to.

- C) There needs to be a consistent and more prescriptive approach because comparisons among distribution companies cannot be made until all LDCs are using similar capital policies. You cannot compare utilities with different capital policies. This point to be forwarded to the Comparatives & Cohorts group.
- D) Some expressed the timeline is too tight to go back and recalculate prior years.
- E) The definition of full cost accounting in the APH should be redone to be more detailed.

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- F) One suggestion was to include the organization's capitalization policy when filing rate applications (similar to Hydro One practice).

- G) Discussion moved towards the accounting of interest cost to be applied to capital projects. Some points of view were that since these capital projects are short term in nature, the financing obtained to finance them should be at the short-term rate. GAAP would argue that only the actual costs of debt interest incurred should be attributed to the project. Another point of view was debt cost should be incurred at the long-term debt-financing rate because the organization needed to secure a significant amount of capital and had to go to the markets for a long-term debt issue.

- H) Asset retirement cost should be considered in the cost of the asset, especially with respect to the new C.I.C.A. handbook section 3110, which came into effect on January 1, 2004. Although this was raised in the depreciation section, it belongs to the capital asset debate.

- I) The capitalization policy should be outlined in the Manager's summary.

Proposed Consensus

- No change for 2006, but electricity distributors should implement full cost accounting; including interest cost allocation method, as indicated by the APH, by no later than 2008.

- The definition should be redefined and a companion guide produced to provide more guidance and consistency in allocating overhead.

- The APH should also be amended to include reference to the new CICA section 3110 on Asset Retirement Obligations.

- Disclosure of how the LDC has applied their capitalization policy 2002 – 2004 should be included with their 2006 rate filing.

Unresolved issues

What interest rate should be used for interest capitalization?

Cross Over

- Distribution expenses

- Test year, particularly restatement of financial statements

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- Financial parameters, regarding the weighted average cost of capital
- Since the basis of allocating overhead is not consistent, the Comparative & Cohort working group take this into account when trying to compare similar electricity distributors. Filing guidelines with respect to disclosure of capitalization policies will be provided in sufficient detail for input to any review based on comparators and cohorts.

Issue 17 – Capital Projects

Summary of Discussion

- A) The practicality regarding an in-depth review of capital projects was discussed and thought to be too broad due to resource constraints and the number of electricity distributors (90+).
- B) Capital project review could be approached by way of filing rules. File a trend line and brief analysis of line items. Ability to question trend line needs to be in place.
- C) Trend line should be at a minimum of three years.
- D) Should a materiality limit or level be imposed? This could be used to flag where an LDC would have to provide further analysis and summaries. For example, if 2004 figures greater than 25% compared to past, an explanation would be required.
- E) Discussion about merged utilities and how a trend line would affect them. Add the merged capital programs and use that as a point of reference.
- F) The subgroup suggested that 1 to 2 paragraphs of explanation, i.e. summary of business case, would be sufficient. Otherwise the paperwork could get overwhelming.
- G) If greater than the variance level, a more detailed level of explanation would be required.

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- H) Dips in the trend line were mentioned as a point regarding under-investing but the consensus was that it was not really a concern.
- I) If 2004 were to be established as the historical test year, it should be done so only if there is sufficient scope of the prudential review to determine if the year is reflective of actual costs that may be faced in 2006.

To that end, 2002 and 2003 numbers and details should also be filed. This will ensure that appropriate deductions or averaging be considered.

The 2004 numbers should not be accepted without determining the actual revenue requirement that was necessary in that year, and which of those requirements were base, which were one time, and which will be continuing.

Proposed Consensus

- Three years of historical data on capital expenditures is filed.

Unresolved issue

Level of detail in filing requirements for 2002, 2003 and 2004 capital projects data, including what explanation must be provided for variances.

Definition of the materiality threshold.

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Issue 18 – Contributed Capital

Summary of Discussion

- A) Discussion ensued around the fact that the post 2000 contributed capital was not allowed to earn a rate of return.
- B) Other comments were that these contributions should be allowed to earn a rate of return because funds are required for the maintenance and the replacement of these assets in the next twenty years.
- C) The Ontario Energy Board has decided this issue in the past.

Proposed Consensus

- The Status Quo should remain in effect.

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Issue 19 – No Cost Capital

Summary of Discussion

- A) Discussion was centered on the following definition of no cost capital and should it be included in the definition of rate base:

“No-cost items are the opposite of rate-base items. They represent amounts collected from customers to cover future expenditures. Including these items in the capital structure at zero cost has the same effect as deducting them from the rate base in arriving at the net investment the regulated entity must finance.”

and

“Contributions in aid of construction, reserve for injuries and damages, provision for self-insurance, deferred taxes (for investor-owned utilities), and any other future liability that the ratepayer has funded in advance of the liability becoming payable.”

The group came to conclusion that although no cost capital may be applicable in other jurisdictions, it is not really applicable to Ontario.

- B) Some of the costs, which may fit in the second definition listed above (i.e. costs related to self insurance policies, future employee benefits or costs associated with Operations, Maintenance & Administration), will be included in the OM&A costs of working capital allowance.

Proposed Consensus

- No Cost Capital is a non-issue in Ontario.

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Issue 20 - Treatment of Capital Gains & Losses

Summary of Discussion

- A) Should the profits on sales of assets financed by ratepayers be shared by ratepayers and shareholders?
- B) The gain or loss on sale should only apply to readily identifiable assets such as land, buildings, vehicles, customer information systems, etc.
- C) The suggested 50/50 split of gain or loss is based upon a past decision by the Board with respect to Enbridge Gas.
- D) Alternatives discussed included shareholder keeping 100% of gain or loss, ratepayer keeping 100% of gain or loss, or a sharing of gains or losses between ratepayers and shareholders.
- E) Concept of materiality was discussed. In the past the Board did have a materiality limit and insisted the whole amount be refunded.
- F) Amount should be put into a deferral account and true up at some consistent point in the future.
- G) This whole process was to be revisited once a sharing of net earnings mechanism was put in place.
- H) Materiality level should be considered and tied to a percentage of value such as fixed assets or a straight dollar value.
- I) Tax treatment of gain or loss in calculation should be considered.
- J) In prior decision the Board had allowed the shareholder to keep 100 percent of the gain. Also the 50/50 split decision was with a gas utility not electricity utility.

Unresolved Issue

- How should capital gains and losses be shared between the ratepayers, and the shareholder, if at all?

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- ❑ Materiality threshold

Proposed Path for this Issue

- ❑ Likely calling of evidence