2006 Distribution Rates
Discussion Paper for Issues Conference

INTRODUCTION

The goal of this process is to prepare a Handbook (including all the filing requirements and a set of spreadsheets) to assist distributors in the preparation of their applications for 2006 rates. If consistent filings are made, the Board will be able to review each distributor's application in a timely and efficient manner.

Each distributor is unique and has its own set of conditions and circumstances. If a distributor concludes that there are individual issues and circumstances that are not incorporated in the Handbook and that are truly material to its application, these facts should be reflected in its rate application. However, deviations from the standard approach as outlined in the Handbook will add complexity and time to the process of reviewing an application. The distributor will be required to justify its proposal through separate and additional material in its application or in answer to interrogatories.

The following discussion paper has been prepared in order to provide a starting point for discussions of those items that will be included in the Handbook and the filing requirements.

For the sake of continuity, the previously identified list of issues has been maintained in this paper rather than regroup the discussion according to the potential sections of the Handbook and filing requirements. In an attempt to show where each issue fits in, a draft Table of Contents for the Handbook has been prepared and is attached as an appendix to this paper. As noted in that Table of Contents, an attempt has been made to identify where each of the following issues has been "slotted" into one or more of the sections.

Issue 1) Comparators and Cohorts

<u>Framework for Filing Requirements</u>

It is suggested that distributors will be required to file their balance sheet and operating statement data in considerable detail for 2004, and for three years prior to that if possible, based on the Uniform System of Accounts. The Board will have to determine which individual accounts in the USoA will be required, and which may be filed as sub-totals For example some similar accounts might be grouped together as they are found in the Accounting Procedures Handbook. For other accounts, sub-account detail may be required where applicable or available, for example as it applies to purchase of consultant services.

Distributors who are unable to provide a full history, due to merger of utilities that kept records in an incompatible format for example, will be required to file as much historical data as possible.

As a starting point, the Board plans to retain an expert who will advise the Board on possible comparators and cohorts for use in 2006, and on a strategy for making greater use of this approach in subsequent years. The report of the expert will be made available to interested parties, who will be able to question the expert and provide their own expert reports or information to the Board.

REVENUE REQUIREMENT

General

Issue 2) Test Year (Historical or Forecast)

It is suggested that the Test Year for the 2006 distribution rate setting process should be based on the historical 2004 results of the distributor.

Advantages of a historical test year:

1. Provides a consistent reference point (2004 audited financial statements) for the rate application, and reduces the resources needed for both the distributor in preparing an application and for the Board in the analysis and decision making regarding the application.

2. Eliminates the need for the preparation of costly and sometimes subjective load forecasts for the 100 distributors, and addresses the issue of inequity for the smaller distributors who may not have the resources to prepare a unique load forecast.

3. Eliminates the need for costly and often subjective weather normalization exercises for 100 distributors spread out across the province.

4. Is consistent with the rate setting methodology used in 2001.

Issue 3) Load Forecast

If historical test year is used, the filing guidelines will not require a load forecast.

Issue 4) Test Year Adjustments

If a historical test year is used, the filing guidelines should limit test year adjustments by individual distributors as these are often subjective, and can cause difficulty as they may only address adjustments that are of benefit to the distributor. The larger number of test year adjustments, the more intensive and time consuming will be the adjudication of the application. However, it may be necessary to make specific adjustments to the test year for:

(a) revenue erosion due to distributor conservation and demand management activities which reduce load. Adjustments would need to be based on the distributor's projected incremental load reductions.
(b) other material adjustments to the 2004 load, eg. a gain or loss of major customers - a materiality threshold would have to be determined
(c) conservation and demand management funding beyond 3rd tranche allowance. Adjustments would need to be based on the distributor's projected incremental capital and operating costs.
(d) Deployment of smart meters as per the Government's implementation plan. Adjustments would need to be based on the distributor's projected incremental capital and operating costs.
(e) LV adjustments
(f) other adjustments to revenue and costs related to rate design matters.

Issue 5) Weather Normalization

If a historical test year is used, the filing guidelines will not require weather normalization.

Issue 6) 2006 Maximum Return on Equity

It is suggested that a formula for Market-based Rate of Return be adopted, consisting of the yield on long-term Canada government bonds plus an equity risk premium. The value of the risk premium would be retained at the existing level, while the bond yield would be determined by the value prevailing at the time of the application. It is proposed that for 2006 the rate of return would apply to the one year only (i.e. an adjustment mechanism is not required), and that a single value will apply to all electricity distributors.

An illustration of the mechanism may be useful. The existing risk premium formula for the gas distributors is based on the market risk premium as a whole, an adjustment factor to reflect the (lower) riskiness of the utility industry, and a cushion of 50 basis points. In 2003, the risk premiums ranged from about 3.7 to 3.9%. The equity risk premium for electricity distributors was calculated at 385 basis points, broadly consistent with the existing approved values for the gas distributors. Adding this value for the risk premium to the yield on 30-year Government of Canada bonds prevailing currently gives a calculated maximum ROE of approximately 9.6%.

The advantages of this approach are its relative simplicity and consistency with the guideline formula applied to gas distributors. The Board found in RP-2003-0158 that the approach had not harmed the ability of the gas distributors to attract capital investment.

Issue 7) Debt / Equity Structure

The proposal is to retain the groupings for the debt rates that are in the Distribution Rate Handbook, section 3.4.1. In particular, the structure of higher debt rate, to reflect higher risk allowed to distributors with smaller rate bases, would be retained.

The long-term rates will be updated to reflect actual rates at the time of the application in 2005.

If the utility has issued debt to third parties other than to its affiliates, its actual cost of debt will be incorporated into its total embedded cost of debt. Debt obligations issued to its parent or affiliates will be included at the actual rate expressed in the debt agreements or the Board-approved deemed debt rate, whichever is lower.

The weighted-average cost of debt resulting from the inclusion of third party and affiliate/ parent debt will be used in the return calculations.

Issue 8) Debt Rate / Cost of Capital

If the utility has issued debt to third parties other than its affiliates, its actual cost of debt may be used. Where debt has been issued to affiliates the deemed rate will be used.

The Distribution Rate Handbook, section 3.4.1, will need to be updated for reflect current economic conditions existing at the time of the application. In particular, the structure of higher debt rate, to reflect higher risk, allowed to distributors with smaller rate bases would be retained.

Issue 9) Depreciation Rates

It is suggested that the amortization rates listed in Appendix E of the current Distribution Rate Handbook will be used for the purpose of 2006 Revenue Requirement.

Issue 10) Transfer Pricing and Shared Corporate Services

LDCs may acquire services from affiliated and non-affiliated firms. Transactions between the regulated utility and affiliated firms must be compliant with the Affiliate Relationships Code for Electricity Distributors and Transmitters.

When the utility applies for rate changes, the Board will require the utility to provide evidence with respect to affiliate transactions, contracts, service level agreements, etc. The level of detail will be as follows:

-Type of charge or cost and annualized dollar amounts. The terms of each contract should be summarized.
-Type of asset transfer/ sale/ purchase and annualized dollar amounts. Any special arrangements, lack of tendering, and valuation issues should be disclosed.
-Identity of the transferor and transferee**.**

Issue 11) Low Voltage and Wheeling Costs

<u>Pass-through of Wheeling Costs by Embedded Distributors</u>

Embedded distributors should add Hydro One Shared Line charges (or a similar charge from another host distributor if applicable) to the IMO charge to obtain Retail Transmission Service Costs (Connection). No change to the Handbook (section 11.3.2.3) is necessary concerning how to allocate this cost to classes.

Any applicable charges for Specific Lines should be added to an appropriate income statement account (e.g., 5030 Overhead Sub-transmission Feeders - Operation). Charges for Shared DS should also be added to an appropriate account (e.g. 5017 Distribution Station Equipment - Operating Supplies and Expenses)

<u>Revenue from LV Rates</u>

Host distributors should treat revenue from LV rates in the same way as Specific Service Charges, i.e. as a deduction from the Distribution Revenue Requirement.

<u>2006 LV Rates</u>

For the 2006 rate application, a host distributor may adopt the previously approved Hydro One rate for Shared Lines

Alternatively, a host distributor may propose an allocation of its relevant rate base and operating statement costs, distinguishing between the load of the embedded distributor and the aggregate load of the host distributor's own customers that are served at LV voltage or lower. The wheeling rate should be calculated as the monthly charge that will recover the allocated cost, at a rate per kW of the embedded distributor load.

Issue 12) 2006 PILs and Corporate Taxes

The guiding principle in calculating the proxy to be included in 2006 rates is that the OEFC/ Ministry of Finance should receive the taxes "collected" from ratepayers to pay down the stranded debt. Taxes are not meant to finance the distributor's business. Taxes on the income before tax gross-up, and on the tax gross-up, is defined as "collected from ratepayers".

It is proposed that the evidence in the proceeding will be used to calculate PILs and taxes. The historical test year data will be considered to equate to or apply to the rate year; no pro-ration will be required. i.e. January to December 2004 is viewed to be the same as March 1, 2005 to February 28, 2006, or May 1, 2006 to April 30, 2007. A rate year of more or less than 12 months may be required to deal with government legislation at the time. PILs/ taxes will be treated as a rate adder and will be treated in a manner similar to Z-factors.

<u>Methodology:</u>

Revenue from power "sales"
Less: cost of power
Margin should be zero since any imbalance should be posted to the RSVAs

<u>Distribution Revenue:</u>

Gross distribution revenue = approved rates multiplied by applicable billing determinants

All other income is obtained from specific service charges, etc. If the utility has additional proposed rates to charge customers, these should be identified and approved by the Board. All rates and charges will be used in determining distribution revenue or other income since the maximum revenue requirement will be determined through this process. The 2004 actual other income will be used for the PILs/ tax calculation.

Less: Board-approved tested expenses:

- Operating
- Maintenance
- Administration
- Depreciation and amortization
- Interest
- Ontario capital tax

Other expenses and charges
Net income for accounting purposes

Additions and deductions to determine net income for tax purposes, and taxable income, will relate to material types of items and amounts. Values for book adjustments will be based on the tested evidence, for example, depreciation.

The 2004 actual tax return data will be used for the tax adjustments to determine income for tax purposes and taxable income. Taxable capital for both provincial and federal purposes will be the amount from the 2004 tax returns. Should the 2004 tax returns not have been prepared by the application filing date, pro-forma tax return data, as expected to be filed with the Ministry of Finance (and CRA where applicable), should be used.

Tax rates will be those enacted at the time of the application in 2005 and will be communicated in the filing guidelines in the spring of 2005.

A variance account could be established to record the difference between tax expenses derived in the rate-setting exercise and the actual tax expenses or taxes paid and payable from tax returns (and applicable assessments/ amendments) for the 2006 tax year.

Benefits of this approach:

- It is consistent with the historic test year proposed.
- It is simpler than the existing Board methodology.
- It will be easier for the distributor and its tax advisors to prepare evidence since it is based on historical data.
- It will be more efficient for Board staff to review 100 applications.
- The utility achieves its after-tax return as determined in the rate-setting process.
- It is only for the 2006 year. 2007 PILs / taxes will be based on new calculations.
- The utilities have gained experience from 4 years of tax planning and assistance from tax advisors. Tax advisors have learned how to deal with the Board's regulatory methodologies. This knowledge should produce a result that does not affect the utility's bottom line in earning its after-tax return.

Rate Base

Issue 13) Definition of Rate Base

It is proposed to use the 2001 RUD methodology after ensuring that all APH accounts are properly identified and included, and wires and non-wires assets are segregated. Rate base will be comprised of net fixed assets plus a working capital allowance.

The 2004 historic balance sheet will be the source. The 12 month whole year historic data, and year end balances, represent the rate year's activities irrespective of start and end dates of the rate year.

Distributors will have to identify adjustments to historical values to identify and to segregate for Board review, wires and non-wires assets as allowed under the exemptions to s. 71 of the Act. Examples are: 1) components of a billing system for sewer and water activities, and 2) assets used for conservation and demand management activities.

Issue 14) Rate Base Measurement Date(s)

Distributors should use the historic 2004 closing balance sheet date.

Issue 15) Working Capital Component of Rate Base

It is proposed that distributors use the 2004 year end data consistent with the historic test year approach. The RUD methodology should be used.

Issue 16) Capitalizing Expenses

There appears to be a lack of consistency in the method of expense capitalization within the electricity industry.

Should there be consistency in the form of a uniform percentage applied to a similar group of costs?

For example, capitalizing direct costs incurred in the project can be more easily tested and supported. Including capitalized indirect costs, or percentages of pools of non-direct project costs, allows executive bonuses, meals, travel costs, head office rent, etc. to be hidden on the balance sheet.

Issue 17) Capital Projects

A historic test year is proposed for the application. A review of capital expenditures from 1999 through 2004 is not required. The review of future capital expenditures is not needed because the 2004 year end asset balances will be used for rate base and depreciation purposes.

Should the applicant be able to justify the use of a future test year, the Board will review capital projects for the bridge year and the future test year.

Distributors will have to identify adjustments to historical values to identify and to segregate for Board review, wires and non-wires capital items related to smart metering and other conservation and demand management activities as allowed under the exemptions to s. 71 of the Act.

Issue 18) Contributed Capital

Funds received from customers for utility projects should be netted against the asset for rate base purposes.

Capital contributed by distributors to Hydro One for transmission-related projects may not be disclosed currently in fixed assets and may be recorded in short-term and long-term deferred charges. Both these balance sheet categories are currently excluded from the rate base definition.

Should a working group examine and recommend the accounting and regulatory treatment for these items?

Issue 19) No-cost Capital

The definition of rate base above does not allow for inclusion of no-cost capital.

Issue 20) Rate-Setting Treatment of Capital Gains

Historical revenue and expenses related to the sales of fixed assets should be adjusted in establishing the 2006 revenue requirement.

Profits on sales of assets financed by ratepayers should be shared by ratepayers and shareholders. A 50/50 sharing of such profits is suggested, as it has been used by applicants in the past.

However, the Board requires a MAAD application before disposal of most distribution assets can take place. The specific proportions for sharing capital gains may be dealt with in that forum.

Operating Expenses

Issue 21) Distribution Wires Only Expenses

It is proposed that the definition from the RUD exercise be used. The 2004 historic year data is proposed to be the basis for the 2006 rate setting process.

Distributors will have to identify adjustments to historical values to identify and to segregate for Board review, wires and non-wires revenues and expenses as allowed under the exemptions to s. 71 of the Act.

Issue 22) Post-retirement Benefits and Pensions

For distributors that use OMERS for pensions, it is suggested that the amounts paid or payable to OMERS as included in the 2004 cost of service will be allowed for rate setting.

For those LDCs that do not use OMERS but may have defined benefit pension plans, the evidence for inclusion in rates will have to be submitted.

If the pension plans are defined contribution plans, the company contributions to the employees' plans are period expenses and will be included in cost of service. Evidence will have to be provided of these contributions.

Excess pension payments are made for employees where the pension entitlement exceeds that permitted by CRA. These costs are legitimate business expenses and will be allowed in cost of service for rate setting, subject to Board approval in specific applications.

Post-retirement benefits other than pensions are covered by the CICA Handbook. The distributors adopted the requirements of the Handbook section in 2000 or in 2001. The amounts included in the 2004 historic cost of service will be used for rate setting.

Issue 23) Site Restoration and Removal Costs

Any expenses in this category of cost should be separately disclosed in the evidence.

Issue 24) Insurance Expense

Insurance exposures are being managed through the purchase of insurance policies and self-insurance programs. Evidence should be submitted explaining any self-insurance program used by the utility. The dollar split between purchased and self-funded expense should be provided to disclose the degree of financial exposure and potential risk assumed by the utility.

Issue 25) Bad Debts Expense

Bad debt expense related to normal and customary business activities, as recorded in the 2004 income statement, will be considered as representative of the distributor's exposure for 2006 rates. These bad debts result from amounts billed that have not been collected and are not considered to be collectible.

Bankruptcies and the related amounts will be identified separately in the utility's evidence. These incidents may not recur and may not be representative of the utility's exposure. Distributors may apply for a Z-factor in future years if extraordinary expenses occur.

Un-billed theft of power is not included in the bad debt category for rate setting purposes. For 2006, all such incidents should be identified and quantified as a separate category of expense. Distributors may apply for a Z-factor in future years if extraordinary expenses occur.

Issue 26) Employee Compensation and Staffing

Evidence should be submitted showing total compensation in the 2004 cost of service for the top 10 people in the expense categories of the utility. e.g. operating, maintenance, administration. These amounts will be disclosed separately from all other total compensation paid to other employees.

If support is provided under a service-level agreement from an affiliate, the total employee compensation component of the costs under these contracts or agreements should be disclosed separately from the other charge components in each of the expense areas.

Issue 27) IT Costs

Evidence should be submitted by the distributor which analyzes the IT department's costs for 2004. Details of regular recurring costs should be separated from project costs. The purpose is to identify those costs that recur in supporting the business as opposed to one-time costs incurred only in 2004.

If services are provided by an affiliate, a summary of the service level agreement and the associated costs should be provided in the evidence.

Issue 28) Advertising, Entertainment, Charitable and Political Contributions,

Employee Dues, Research and Development Costs

Evidence of these types of charges and costs should be submitted with the application. The intent is to identify those recurring, necessary costs required for prudent business operations. Research and development costs are generally allowed, subject to a prudency review. Advertising, entertainment, charitable and political contributions and some employee dues are generally a shareholder cost unless a benefit to ratepayers can be demonstrated.

RATE DESIGN

Issue 29) Specific Service Charges

Other than charges made to customers based on actual costs (unique to each occasion) or the straight pass-through of third party charges, all specific service charges (including charges included in a distributor's Conditions of Service) must be part of a distributor's application for an approved rate schedule.

The determination of the levels of the charges must ensure that the costs associated with the provision of these services are not recovered through both the specific service charge and the distribution rates.

A distributor will be allowed to make a cost justified application for specific service charges unique to its operation that is not included in the standard set identified above.

Following preliminary consultations with distributors, some analysis have been done by Board staff on these charges. This work will form the basis of the rate design working group discussions.

Issue 30) Un-metered Scattered Load

Despite the lack of currently available cost data, it appears that the use of a modified three-part rate structure (fixed account charge, fixed per connection charge and a volumetric charge based on accepted energy consumption estimates) should be examined.

There may be an opportunity to include cost-justified different sets of rates within this group to reflect specific applications, such as bus shelters, telephone booths, cable TV amplifiers, etc.

Until updated cost allocation results become available, any "loss" in revenue to the distributor as a result of modifications to the un-metered scattered load rates should be "reallocated" to the General Service <50 kW class.

Issue 31) Time-of-Use Distribution (i.e non-commodity) Rates

As part of announced government policy on conservation and demand management, parties should study the introduction/continuation/redefinition of TOU distribution rates.

The application of such rates would be complementary to and in conjunction with time differentiated commodity rates.

There is need for a standard set of terminology and application to be used by all distributors for this sub-classification (e.g. a uniform load threshold, mandatory verus voluntary application, etc.).

In the absence of cost data, for those distributors currently with an approved TOU distribution rate classification, the distribution revenues received through the application of these rates will be combined with the appropriate non-TOU General Service class and a "combined" set of distribution rates will be determined. This will allow for the maintenance of a unique TOU sub-classification but at the same time permit the distributor to recover its required distribution revenue.

Issue 32) Fixed/Variable Split of the Recovery of Distribution Revenue

Based on previous government -commissioned studies, there is a desire to examine the variability among the distributors regarding their levels of the fixed (Monthly Service Charge) versus the variable (Distribution Volumetric Rate) components of their distribution rates for residential and low-volume classes of customers.

Until updated cost allocation results become available and subject to bill impact mitigation, an attempt should be made to significantly reduce the range of Monthly Service Charges (currently $1.85 to $26.70) either by changing the fixed charges on both ends of the spectrum, or by a "ceiling cap level". Class distribution revenue recovery will need to be maintained.

Issue 33) Mitigation as a Result of 2006 Rates

There is a need to include a bill impact mitigation threshold. It is proposed that the maximum monthly bill impact shall be set at the lesser of 5% of the total customer's bill (assuming a constant commodity price and other rates, despite potential changes as a result of the Regulated Price Plan and possibly other rate changes) or $3.00, unless specifically justified.

Issue 34) Rate Harmonization

Section 5.6 of the current Electricity Distribution Rate Handbook (EDRH) allows for a bill impact as a result of rate harmonization of not more than ± 5% (on an annualized basis).

Until updated cost allocation results become available and subject to any Board direction on the need for rate harmonization of similar customers within a distributor's service territory, the general process as outlined in the EDRH should continue, unless specifically justified.

Issue 35) SSS Administration Charge

Chapter 10 of the EDRH addresses the concept of Standard Supply Service (SSS). Section 10.7 of the EDRH addresses the level of the SSS Administrative Charge.

Given the evolution of the electricity industry since the EDRH was written and the market opened, there is a need to re-examine the SSS concept. However, until updated cost allocation results become available, the general process and level as outlined in Chapter 10 of the EDRH should continue, unless specifically justified.

Issue 36) Cost Allocation

Until updated cost allocation results become available, the general methodology for allocation among customer classes as outlined in the Electricity Distribution Rate Handbook and as used for the 2002 and 2004 adjustments should continue, unless variations from that methodology are justified by the distributor.

Possible additional issues:

Retail Transmission Service Rates

Adjustment for Line Losses

Appendix to 2006 Distribution Rates Discussion Paper

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