Ontario Energy Board

Commission de l'Énergie de l'Ontario

Ontario

EB-2009-0387

IN THE MATTER OF the *Ontario Energy Board Act 1998*, S.O.1998, c.15, (Schedule B);

AND IN THE MATTER OF an application by Five Nations Energy Inc. for an Order or Orders pursuant to section 78 of the *Ontario Energy Board Act, 1998* for 2010 transmission rates and related matters.

BEFORE: Paul Sommerville
Presiding Member

Paula Conboy
Member

DECISION AND ORDER

November 1, 2010

Background

Five Nations Energy Inc. (“FNEI”, the “Company”) filed an application with the Ontario Energy Board (the “Board”) dated February 26, 2010 under section 78 of the *Ontario Energy Board Act*, *1998*, S.O. c.15, (Schedule B) (the “Act”). The Board assigned the application file number EB-2009-0387.

FNEI is a non-profit, non-share capital, federally-incorporated corporation with its head office in Moose Factory, Ontario, and main operational office located in Timmins, Ontario. FNEI is a licensed transmitter of electricity in Ontario (ET-2003-0074), owning and operating transmission facilities along the western coast of James Bay. FNEI currently serves four customers, which include three local distribution companies and one commercial customer.

This Board last reviewed FNEI’s rates in 2001 (RP-2001-0036). In this application, FNEI is seeking Board approval for a forecasted revenue requirement of $6,466,100 for 2010. The application is based on a future test-year cost of service methodology.

FNEI’s revenue requirement represents a small portion of the total provincial transmission revenue requirement used to establish the uniform transmission rates (UTR). Therefore, the increase in revenue requirement sought in this application is not large enough to trigger a change to the current UTRs. However, due to the change in revenue requirement, there is a slight increase in FNEI’s revenue allocators to the UTR.

FNEI submitted an application for 2010 revenue requirement on February 26, 2010. Energy Probe Research Foundation (“Energy Probe”) and the Independent Electricity System Operator (“IESO”) applied for intervenor status. Both parties were granted intervenor status, while only Energy Probe was found eligible for an award of costs. In addition, the Board received and reviewed one letter of comment from a Mr. Geltman.

By Decision and Order dated April 27, 2010, the Board declared FNEI’s current rates interim as of March 1, 2010. In this Order the Board also set the dates for filing interrogatories and responses to interrogatories. Board staff and Energy Probe filed interrogatories. The Company’s responses to interrogatories were filed on June 4, 2010.

FNEI requested that its responses to Board staff interrogatories 21(a), 22(b), 22(c) and 23 (a, b and c) be treated as confidential. The Board approved FNEI’s request and issued its decision in Procedural Order No. 3. Further, also in Procedural Order No. 3, the Board decided to proceed by way of a written hearing and set out the dates for arguments. Pursuant to Procedural Order No. 3, FNEI filed its Argument-in-Chief on July 5, 2010 and its final reply on July 30, 2010. The Board received submissions from Energy Probe on July 19, 2010 and submissions from Board staff on July 16, 2010.

Board staff filed a redacted and an un-redacted version of its submissions. The redacted sections of the submission related only to the submissions on charge determinants. Board staff subsequently contacted Counsel for the Applicant to determine if certain sections of the redacted submission could be placed on the public record. After reviewing the submissions, Counsel for the Applicant informed staff that the entire submission on charge determinants could be placed on the public record as it did not refer to customer specific load data.

Summary of the Application

FNEI in its original filing requested Board approval for a revenue requirement of $6,474,700. In an updated application, filed on March 29, 2010, FNEI revised its revenue requirement to $6,466,100. The main components of revenue requirement are summarized below:

	2001 Board Approved ($ 000s)	**2010 Applied ($ 000s)**
Operations, Maintenance & Administration	1,898.5	3,386.1
Depreciation & Amortization	1,100.6	1,187.4
Interest on Debt	922.2	762.3
Internally Generated Funds (ROE)	1,256.7	1,130.3
Revenue Requirement	**5,178.0**	**6,466.1**

Issues

In reviewing the evidence, the Board has identified the following issues:

- Rate Base and Capital Expenditures
- Operating Revenue

- Operations, Maintenance and Administration (including Depreciation Expense and Harmonized Sales Tax)
- Cost of Capital
- Charge Determinants
- Implementation Matters

FNEI is a non-profit and non-share capital utility. Given its non-profit status, one of the key issues in this proceeding dealt with FNEI's request for a return on equity. Both Energy Probe and Board staff made significant submissions on the issue. The Board has addressed this issue and the related issue of how FNEI's revenue requirement should be determined under the Cost of Capital section.

Rate Base and Capital Expenditures

FNEI's rate base for 2010 is forecasted to be $28.688 million. This is the sum of the net book value of $28.180 million and working capital allowance of $0.508 million. The total test year rate base represents a 13% increase from the last Board approved rate base of $25.439 million, in RP-2001-0036.

Consistent with previous practice, the working capital allowance was estimated as 15% of total Operations, Maintenance and Administration expenses.

FNEI is proposing to spend $275,000 on capital expenditures in the test year. FNEI provided detailed evidence on historical capital expenditures and the test year capital budget. The main areas of spending in the test year are:

- $150,000 for station equipment, as well as the removal of old relay panels and wiring;
- $35,000 for poles and fixtures;
- $60,000 for overhead conductors and devices;
- $20,000 for building and fixtures; and
- $10,000 for miscellaneous expenditures.

No party objected to FNEI's test year rate base or the proposed level of capital expenditures.

Board Findings

The Board accepts FNEI's proposed test year rate base and working capital allowance. The Board also accepts FNEI's 2010 capital expenditure forecast of $275,000.

Operating Revenue

FNEI is seeking Board approval for a test year Operating revenue forecast of $5.078 million.[1] The Operating revenue forecast is comprised of Transmission Service revenue and Other revenue. FNEI's test year forecast of Transmission Service revenue is $4.978 million and the forecast of Other revenue is $0.1 million.

Board staff argued that FNEI's forecast of test year Transmission Service revenue is understated. Board staff submitted that a test-year forecast of $5.280 million is a more reasonable level and is consistent with the average of the last three years and the historic trend. Energy Probe supported Board staff's submission. No party objected to FNEI's Other revenue forecast.

FNEI argued that the as-filed Transmission Service revenue forecast of $4.978 million is appropriate. FNEI argued that the reliance on historical revenues is of limited value. FNEI further argued that its test year Transmission Service revenue forecast is consistent with the IESO's 18-month Outlook, which forecasts a decline in peak demand. FNEI also noted that its revenues do not fluctuate based on the transmission demand of its customers and are tied to the overall provincial demand. Therefore, any increases in revenue, such as those generated by DeBeers will be shared by all four transmitters and will not have a significant impact on FNEI's revenues. FNEI also noted that on a month-to-date basis, the actual 2010 revenues for the period January to April are 2% lower than 2009 revenues during the same period.

Board Findings

The Board notes that FNEI's forecast of Transmission Service revenue of $4.978 million is significantly lower than the historical average and is the lowest in its history. In fact, FNEI had forecasted the same revenues in 2009 as well. As noted by Board staff, that forecast was also low and the actual revenues in 2009 were in fact $5.023 million or approximately $45,982 higher than FNEI's forecast. Despite the increase in actual 2009

[1] FNEI Argument-in-Chief, p.16

revenues compared to forecast, FNEI maintained that its test year estimate of $4.978 was reasonable.

The Board disagrees. In the Board's view, FNEI's forecast of test year Transmission Service revenue of $4.978 million is unreasonably low.

FNEI argued that the test year estimate is consistent with the IESO's 18-Month Outlook, which forecasts an increase in load but a decline in peak demand. However, the IESO's analysis has been used to simply justify FNEI's "no growth" outlook and does not appear to have been actually used in the derivation of the test year forecast. Therefore, the Board is not persuaded by the evidence presented by FNEI. In the absence of relevant empirical analysis, the Board is guided by the observed historical trend in revenues.

Board staff submitted that the Transmission Service revenue forecast should be increased to $5.280 million. This estimate is based on a historical average and in the Board's view is a more reasonable level. However, the Board notes that the actual 2010 Transmission Service revenue for the period January to April shows a decline of 2% compared to the same period in 2009. Given this decline in actual 2010 revenues, the Board will reduce the Board staff estimate by 2% and directs FNEI to use $5.1744 million as the test year Transmission Service revenue forecast.

The Board accepts FNEI's 2010 forecast of Other Revenue.

Operations, Maintenance and Administration

FNEI proposed Operations, Maintenance and Administration ("OM&A") costs of $3,386,100 for 2010. This represents an increase of 78% over the previously Board-approved amount of $1,898,500 for 2001.[2] This is an average yearly increase of approximately 6.6% over that period.

FNEI employs a 'bottom-up' approach to OM&A budgeting. FNEI indicated in evidence that it is often more cost-effective to hire certain operations and administration expertise on a part-time or contractual basis, rather than to create a full-time employee position. FNEI has only three employees, with one currently on long-term disability. FNEI's

[2] Board-approved, RP-2001-0036.

OM&A costs have varied significantly from year to year, with a significant number of external consultants retained, as opposed to the use of full-time staff.

Board staff submitted that, in general, the level of OM&A expenditures appeared reasonable and that it appeared that FNEI did not foresee significant escalation of OM&A costs in future years. Board staff submitted that it would expect FNEI's OM&A budget to be reasonably static or decreasing over the coming years due to the fact that the significant build-out of the system is now largely complete. Among these significant additions were: transmission lines, including the De Beers system additions, the fibre-optic communications "sky wire" and connection of back-up transformers.

Board staff filed specific submissions with respect to OM&A on International Financial Reporting Standards ("IFRS") transition costs, Tendering and Service Agreements, and Fibre Optic line operating and maintenance. The Board is satisfied with the record on Fibre Optic line operating and maintenance, and provides its findings below with respect to the other issues. Energy Probe supported the submissions of Board staff and made an additional submission regarding Tendering and Service Agreements.

Board Findings

The Board finds that a general OM&A envelope of $3,386,100 is appropriate, but notes specific adjustments through the findings that follow. The overall level of OM&A expenditures appears reasonable, and the Board notes that FNEI does not foresee significant escalation of OM&A costs in future years.

IFRS Transition Costs

FNEI applied for total one-time IFRS transition costs of $100,000 to be amortized over 2010, 2011, and 2012. In a response to an interrogatory from Board staff[3], FNEI explained why, as a non-profit utility, it requested to transition to IFRS, claiming the associated amounts. FNEI indicated that it operates in the commercial mainstream, and its operations are like any other rate-regulated utility. In general, FNEI's overall position was that IFRS is likely the most suitable choice since it would provide reporting consistent with other rate-regulated utilities, particularly with respect to disclosures regarding capital assets.

[3] Response to Board staff interrogatory #57

FNEI indicated that the majority of the $100,000 requested is to complete a depreciation study, with the balance of the funds being primarily used to do a componentization of capital assets.

Board Findings

The Board accepts FNEI's budget with respect to total one-time IFRS transition costs of $100,000 to be reflected in equal three slices in 2010, 2011, and 2012. However, the Board notes that it is possible there will be a general delay to the adoption of IFRS for Canadian companies. The Board advises FNEI to track its spending on IFRS transition costs, and the applicant should be aware that any amounts awarded by this Board for IFRS transition costs, but not incurred in the period, will be subject to review and possible recapture.

Charitable Donations

FNEI stated in response to Board staff interrogatory #40 that amounts totaling $31,225 included in Account 5410 do not provide assistance to customers in paying their bills and assistance to low income consumers, as stipulated in the definition of that account. The $31,225 is made up of $10,000 for sponsorship of *Creefest*, $12,000 in scholarships for local students, and $9,224 for other sponsorship of educational events. FNEI stated that the remainder of the $86,000 recorded in Account 5410 contributes to providing assistance to customers in paying their bills and assistance to low income consumers.

Board staff submitted that the Board should deny the inclusion of $31,225 in Account 5410 related to sponsorship and events which do not further the purpose for which this account was established.

FNEI suggested that the Board's Filing Requirements are overly narrow, and submitted that the Board should have the flexibility to consider whether any expense in Account 5410 is a legitimate cost of doing business and therefore recoverable in rates.[4]

FNEI further submitted that maintaining a positive corporate reputation and profile in these communities makes good business sense and ought to be viewed as a legitimate business cost.

[4] Reply argument, para. 50

Board Findings

The costs totaling $31,225 shall be excluded from Account 5410, and as a consequence the approved OM&A envelope is reduced by $31,225. FNEI clearly indicated in its response to interrogatory #40 that the amounts totaling $31,225 do not fit the description of amounts that should be recorded in this account. The remaining $86,000 forecast to assist customers in paying their bills and assistance to low income consumers will be allowed in rates.

As noted in Board staff's submission, the Board clearly indicates in its Filing Requirements that:

> "The recovery of charitable donations will not be allowed for the purpose of setting rates, except for contributions to programs that provide assistance to the distributor's customers in paying their electricity bills and assistance to low income consumers. If the applicant wishes to recover such contributions, it must provide detailed information for such claims. <u>The applicant must review the amounts filed to ensure that all other non-recoverable contributions are identified disclosed and removed</u>." [5]
> (Emphasis added)

While the disallowed donations may be contributed towards laudable goals, the Board does not find that they are appropriately recovered through electricity rates. The Board notes in making its finding that FNEI is like any other transmission or distribution company with regard to qualification of charitable donations and is subject to the same conditions.

Tendering and Service Agreements

FNEI does not have service agreements with any of its member LDC distributors. In response to a letter from the Board regarding a compliance matter, FNEI filed a letter on May 17, 2010[6], which discussed at length the status of FNEI's relationship with its member distributors. That letter stated that they are not affiliates within the framework

[5] *Filing Requirements for Transmitters and Distributors*, Section 2.5.2, p.14
[6] Also filed as part of response to Board staff interrogatory #1(a)

described by the *Affiliate Relationships Code* (*ARC*). Board staff responded[7] confirming that FNEI and its member distributors are not affiliates as contemplated by the *ARC*.

The three First Nation communities of Attawapiskat, Fort Albany and Kashechewan are remote, and travel between them is via plane only. For practical purposes, FNEI has indicated in evidence that this remoteness limits the number of businesses that would likely submit competitive tender to provide services to FNEI. FNEI stated that the only practical parties to take on such work are the neighboring LDCs. Since January 1, 2006, the amount paid to the three member LDCs for these services totals to approximately $480,000[8], and the work has been completed and billed without any service agreements governing the work.

FNEI noted that it utilizes power line maintainers of the LDCs when doing maintenance on transmission lines, and also uses LDC staff to perform routine maintenance checks. FNEI does not have any full time power line maintainers located in the three communities. FNEI has further argued that, given the remote location and costly travel in the region, use of LDC staff is by far the most economical way for FNEI to have this work completed.

FNEI also indicated that it does not put out to tender the maintenance services provided by the LDCs claiming that there is no purpose in doing so[9], and that the work involved can be done far more economically by LDC lineworkers than anyone else.

FNEI noted that at present the work by LDCs is done on an "as needed" basis. FNEI submitted that it agrees with submissions of Board Staff that service agreements between FNEI and the three LDCs are required. FNEI submitted that it plans to put in place service agreements with the LDCs, and believes this can be done by the end of calendar year 2010.

FNEI indicated in reply argument that it has always procured maintenance services from its three member LDCs on a “cost plus 15%” basis.[10] When combined with zero travel costs, FNEI submitted that it makes these arrangements with the LDCs far better than anything FNEI could achieve through a competitive tendering process. However, FNEI

[7] Letter from the Board, Re: Compliance with Electricity Reporting and Record Keeping Requirements (“RRR”), dated June 22, 2010
[8] See FNEI letter dated May 17, 2010.
[9] Response to Board staff interrogatory #56(c)
[10] Where “cost” is comprised of: (a) non-unionized labour costs of $28 to $36 per hour; (b) equipment rental costs; and (c) minimal materials costs, since FNEI usually supplies these materials.

indicated in reply that having service agreements in place with the LDCs will make pricing of services transparent and provide a basis to assess the prudence of such costs in the future.[11]

Board staff submitted that FNEI should have formal agreements with each of the LDCs given that there appears to be frequent and ongoing work from LDCs. Board staff submitted that without agreements between FNEI and the LDCs, disputes could arise as to pricing, accusations of non-performance, liability, or other terms which could otherwise be more appropriately understood at the outset of any work via service agreement.

Board staff further submitted that the need for service agreements is made more necessary since FNEI does little in the way of competitive tendering to complete the necessary work.

Energy Probe expanded upon Board staff's concerns surrounding a general lack of a competitive tendering process. Energy Probe submitted that FNEI's tendering practices are lacking in the sort of customary controls used to ensure that fair value is received from contractors. Energy Probe cited a number of interrogatories[12] which suggest that significant amounts of consulting and construction work have been awarded by FNEI without competitive tendering. Energy Probe submitted that without competitive tendering it is difficult to determine whether the price quotations FNEI received for the work were reasonable and raises questions of prudence.

FNEI responded that it would not object to competitive tendering "when it makes sense" but wished to retain discretion to determine when it should single-source and when it should run a competitive tendering process. FNEI cited that in certain instances it has awarded work in a sole-source fashion to companies that had previously worked in the region due to experience working in its unique environment.

Board Findings

The record in this proceeding with respect to service agreements and tendering arrangements clearly demonstrates that there are important matters to address in this area. The Board has closely examined the commercial relationships between related

[11] Reply argument, para. 42
[12] Response to Energy Probe IRs 10, 11, 12, and 15

entities on previous occasions and in some instances has imposed a methodology to govern pricing for goods and services between such related entities.[13]

The Board finds that it is important that all work arrangements between the transmitter and its member LDCs should be governed by well-defined, commercial, competitively priced service agreements. The Board sees the applicant's proposal to secure such service agreements by the end of calendar year 2010 as satisfactory. Accordingly, the Board directs FNEI to file with the Board service agreements between FNEI and the three LDCs on or before December 31, 2010. The service agreements shall be based on, and shall conform to the format required under section 2.2 of the ARC, and shall contain the information mandated by that Code. The Board expects that the provision of the service agreement(s) will be supplemented by a dated letter from the FNEI's CEO, confirming that the service agreements are in place, and disclosing their effective dates.

With respect to tendering, the Board finds that FNEI should be required to put all requests for work out to competitive tender where the value of the contract exceeds $25,000. This requirement would not apply where the need to have the work done is one of pressing emergency in which delay would be injurious to the public or in genuinely special circumstances where FNEI believes competitive tendering is not appropriate.

On the question of discretion to single-source, the Board finds that it would be inappropriate to allow FNEI, or any other utility, unconditional discretion. Despite the unique geographic circumstances faced by FNEI, competitive tendering should be the rule rather than the exception. Without the evidence provided through the competitive tender process, this Board is in the position of not having the best kind of evidence respecting the prudence of expenditures. There is also a risk that potential competitors to the single source supplier will be once and forever frozen out of access to this work, to their detriment, and the detriment of ratepayers.

In those circumstances, where FNEI specifically intends to award work without conducting a competitive tender process FNEI should document the specific instances where it believes that awarding the work through a competitive tender is not appropriate. Such documentation must include a description of the specific reasons

[13] See FNEI letter dated May 17, 2010 which refers to the transcript of EB-2005-0544, Enbridge Gas Distribution, p. 80-82, July 24, 2006.

relied upon for this deviation from Board direction. In these circumstances the Board would expect the work to be carried out at a price no greater than cost plus 5%.

Depreciation Expense

FNEI requested 2010 Depreciation and Amortization expense of $1,187,427, up approximately 53% from reported 2009 level of $775,600, and 84% from reported 2008 level of $645,200.[14] FNEI uses straight-line depreciation calculations based on the depreciable gross book value of each asset class. FNEI has applied the same depreciation rates historically, consistent with those applied by other Ontario utilities. One exception is for Account 1908, where FNEI uses 4.00% rather than the 2.00% rate used in the *Electricity Distribution Rate Handbook*. FNEI noted that, due to conditions and building methods in remote Northern Ontario communities the expected life of buildings is 25-years, rather than the more typical 50-year life. FNEI noted that concrete or brick structures are extremely rare in their communities.

The methodology used for calculating rate base is based on the average of the monthly closing balances. This differs from the typical method applied by other transmitters and distributors, who generally use the average of the opening and closing balances.

FNEI indicated that in the early years of FNEI's existence (from 2002 through 2004), the use of the average opening and closing balances substantially overestimated rate base.[15] This is due to both the change in the monthly fixed assets and also due to the timing of the addition and removal of assets from rate base in these early years. For instance, in 2009, use of the opening and closing balance methodology again overestimates rate base significantly since most of the capital expenditures placed into service were done so in the final month of that year. The differences in other years (2005-2008, 2010) are much smaller, reflecting the low level of capital expenditures and the timing of when the assets were put into service.

Board Findings

The Board accepts FNEI's argument that the conventional method for calculating depreciation expense produces an overestimation of rate base in its particular circumstances. The Board accepts FNEI's total Depreciation and Amortization expense

[14] The increase over the Board approved level in RP-2001-0036 of $1,100,600 is approximately 8%.
[15] Board staff interrogatory 12

of $1,187,427, subject to any minor adjustments consequential to other findings in this Decision. The Board notes that the method used by FNEI to calculate depreciation expense is similar to the approach used by natural gas distributors in Ontario to calculate the property, plant and equipment component of rate base.

Harmonized Sales Tax

The provincial sales tax ("PST") and goods and services tax ("GST") were harmonized effective July 1, 2010 into the Harmonized Sales Tax ("HST"). PST is typically included as an OM&A expense for transmission and distribution companies. When the GST and PST are harmonized, it is expected that corporations will realize a reduction in OM&A expenses and capital expenditures. FNEI will pay the HST on purchased goods and service but will claim an input tax credit for the PST portion.

Board staff submitted that the Board may wish to consider establishing a deferral account to track any savings in OM&A expenses and capital expenditures that might arise as a result of harmonizing the provincial sales tax and goods and services tax.

FNEI submitted that its OM&A expenses do not typically attract PST, and although PST is paid on capital expenditures, FNEI does not foresee significant capital expenditures in future years. While FNEI did not oppose the establishment of a deferral account for this purpose[16], *per se*, FNEI submitted that establishment of such an account may cause unnecessary administrative burden in light of what FNEI contends will be miniscule amounts that will be recorded in the account. If such an account were approved, FNEI suggested that it would work in a fashion similar to the Hydro One Networks Inc. "Tax Rate Changes Account".

Board Findings

The Board directs that, beginning July 1, 2010, FNEI shall record in a deferral account, the incremental input tax credit it receives on revenue requirement items that were previously subject to PST and which become subject to HST. Tracking of these amounts will continue in the deferral account until the effective date of FNEI's next rate application. While the actual amounts recorded in such an account may well be small as FNEI contends, there is insufficient evidence at this point to determine whether the

[16] Reply argument, para. 79. FNEI indicated that it had no issue with the establishment of such an account if the "administrative issue" associated with the account could be overcome.

administrative costs outweigh the benefits. As a result the Board finds that in order to ensure consistency across regulated utilities, a deferral account is appropriate.

The Board may issue more detailed accounting guidance in the future. In that event, FNEI should make the appropriate accounting entries, if and as applicable.

Cost of Capital

This section of the Decision addresses issues related to FNEI’s proposal to transition to a 60/40 debt-to-equity split, cost of debt and return on equity. FNEI’s proposed test year cost of capital is $1.8926 million – of this total, $0.762 million is related to the cost of debt and the remainder, $1.1303 million is related to FNEI’s request for a return on equity of 9.85%.

Transition to deemed 60/40 capital structure

Beginning in 2008, the Board adopted a deemed capital structure of 60% debt (56% long-term debt and 4% short-term debt) and 40% equity, and provided for a transition to this structure of up to three years. Most electricity transmitters and distributers had transitioned to the 60/40 deemed capital structure by the beginning of 2010, but FNEI has not. In the *Cost of Capital Report of December 2009*, the Board indicated that for utilities still transitioning to the deemed capital structure, the matter would be dealt with in their respective cost of service applications. FNEI has applied for a 60/40 debt-to-equity split in 2010, without transition.

Board staff submitted that FNEI appears to be capable of making the transition directly to a 60/40 debt-to-equity split without undue hardship.

Board Findings

The Board accepts FNEI’s proposal to move to a deemed 60/40 debt-to-equity split in 2010.

Cost of Debt

With respect to debt, FNEI has a Credit Agreement with Manulife and Pacific & Western Bank ("PWB") which provides FNEI with a term credit facility from Manulife and PWB of up to $11 million (at 5.5%), and an operating facility from PWB of up to $500,000 (at prime plus 2.5%). FNEI also has a $500,000 operating line of credit with its bank, the Bank of Montreal ("BMO"). In addition, FNEI has an interest-free loan from the Northern Ontario Heritage Fund Corporation ("NOHFC") which dates back to the initial development stage of the FNEI project. The NOHFC loan is interest-free until October 2010, at which point FNEI has indicated that interest at 4% will begin to accrue.

Staff submitted that no compelling reason has been provided by FNEI why short-term unfunded debt should attract a rate higher than the Board's deemed rate of 2.07%, as arrived at using the methodology contained in the Board's *Cost of Capital Report of December 2009.* Staff submitted that the Board clearly contemplated that utilities should apply the deemed short term debt rate to short-term debt capitalization, whether funded or unfunded. Board staff submitted that FNEI's argument that it should receive treatment similar to natural gas distributors does not comply with the *Cost of Capital Report of December 2009*, and FNEI has not adequately supported its proposal for different treatment.

FNEI submitted that 4.75% is its actual short-term debt rate. However, FNEI indicated in reply that, at a minimum, the amount of short-term debt with the fixed 4.75% interest rate, i.e. the $500,000 BMO Operating Facility, should be included in costs. The remaining unfunded debt would be calculated at the deemed rate to ensure that FNEI is allowed to recover its actual costs. This approach would result in a weighted cost of short-term debt of 3.24%.[17]

In FNEI's view, it should be permitted to recover its actual costs.[18]

Board Findings

First, it is important to note that the Board's *Cost of Capital Report of December 2009*, does not really fit the circumstances of this Applicant in a number of aspects. As will be discussed more fully below, insofar as this company has no equity *per se* as a not for-profit corporation without share capital, the simple application of the Board's Report is problematic.

[17] This calculation was carried out by FNEI in response to Board Staff IR #60(b).
[18] Reply argument, para. 64.

The Board agrees with FNEI's position that it should be permitted to reflect the actual interest rate governing the BMO Operating Facility in its cost of short term debt. However, this treatment will not be afforded to any other portion of its short term debt, all of which should be deemed to be at a 2.07% rate, consistent with that arrived at using the consensus methodology reflected in the Board Report.

The Board cautions the Applicant that, in future, care should be taken when negotiating short-term debt-financing arrangements. Financings that are significantly out of line with prevailing market interest rates or the Board's deemed rates may not be viewed in a similar light in future applications. The Board also requires that FNEI provide better support for its proposed actual short-term debt rate in its next cost of service rebasing application. In the absence of sufficient and compelling evidence, this panel would recommend that, in future rate applications, the Board's applicable deemed rate be applied to all unsupported tranches of short-term debt financing.

Accordingly, FNEI's approved short-term debt rate shall be 4.75% for the $500,000 BMO Operating Facility, and 2.07% for the remainder of the short term debt component, resulting in a weighted cost of short-term debt of 3.24%, as calculated in response to Board staff interrogatory #60(b). This treatment results in a short term debt cost recoverable by the company of $1.875 million.

Return on Equity

In FNEI's last rate case the Board approved FNEI's request for a return on equity of 9.88%.

In that case, the Board dealt with the issue of a non-profit, non-share capital utility earning a return on equity and the appropriateness of FNEI earning an income in excess of expenditures. In approving FNEI's request, the Board referred to the Canada Revenue Agency ("CRA") position that a non-profit organization may earn income in excess of its expenditures under specific circumstances, without jeopardizing its non-profit status.[19] The Board used the existing return on equity amount of 9.88%, which it called "internally generated funds" to calculate the revenue sufficiency that it would allow FNEI to collect.

[19] Decision RP-2001-0036, paragraph 3.3.8

The Board noted that its approval of the internally generated funds, driven by a notional Rate of Return on Equity of 9.88% was intended to create reserves respecting unplanned future Capital requirements, unplanned future Operating requirements, and insurance. In this proceeding, FNEI is requesting a return on equity of 9.85%, which is derived from the Board's *Cost of Capital Report of December 2009* and has proposed a design for the Operating and Capital reserves.

In determining the appropriate "cost of capital" to be included in FNEI's revenue requirement, the Board must decide the following issues - Is FNEI's request for a return on equity appropriate, given that it is non-profit non-share capital utility? And, given that the return on equity is to be used to fund the reserves, the related issue is - Is the proposed design of the reserves appropriate?

Is FNEI's request for a return on equity appropriate, given that it is non-profit non-share capital utility?

FNEI is requesting Board approval for a return on equity of 9.85%. Now that the Insurance reserve is fully funded, FNEI proposes to use the excess revenue generated by this rate of return to build up the Operating and Capital reserves. Unlike the Insurance reserve, which is at a capped amount of $4,000,000, FNEI argued that the Operating and Capital reserves should not be capped and should not be subject to restrictive rules respecting withdrawals. FNEI argued that regardless of its non-profit, non-share capital structure, it can earn revenues in excess of costs, provided such excess revenues are not paid out as dividends, but rather are spent on activities that promote the social, economic and civic welfare and development of the Attawapiskat, Fort Albany and Kashechewan First Nations. FNEI stated it had received professional advice on this point and was not concerned about losing its non-profit status merely by continuing to earn revenues in excess of costs. In the submissions of Board staff and Energy Probe, FNEI's proposal is referred to as "the ROE approach".

Energy Probe submitted that the Board should deny FNEI's request. Energy Probe argued that if FNEI wants to earn a return on equity, in the same manner as other for-profit utilities, then it must reconsider its non-profit status and operate as a for-profit utility. Energy Probe argued that a request for a return on equity assumes investor equity and FNEI as a non-profit utility without share capital does not have investors and should therefore not earn a return on equity. Energy Probe also argued that for-profit utilities that earn a return on equity are subject to taxes or payments in lieu on their earnings. FNEI does not pay taxes and therefore allowing it to earn a return on equity creates an inequity and is not appropriate.

Energy Probe proposed the Times Interest Earned Ratio (“TIER”) mechanism to establish FNEI’s revenue requirement. The TIER estimates the excess earnings that non-profit utilities in U.S. jurisdictions can earn. Energy Probe submitted that FNEI had not adequately explained why the TIER method is not appropriate and given FNEI’s non-share capital structure, the TIER method is more appropriate.

In its Decision in RP-2001-0036 the Board directed FNEI to file a report that would discuss the design of the reserves as the basis for a transition to an alternate approach to using the ROE approach.[20] FNEI did not file such a report and proposed to continue with the ROE approach. Energy Probe and Board staff submitted that FNEI had not complied with the Board’s directive in this regard.

Board staff argued that it is not appropriate for a non-profit, non-share capital utility to earn a return on equity. Board staff noted that the Board’s approval for a rate of return in its previous rate case was to allow FNEI to build the reserves. Board staff also noted that FNEI had stated that it would be appropriate to move to the Reserve approach after gaining sufficient experience.[21] Board staff therefore proposed the Reserve approach. Under the Reserve approach, FNEI would not earn a return on equity. The annual revenue requirement would be the sum of all costs and the annual increment needed to fund reserves. The excess revenues to build up reserves are determined based on an assessment of operating and capital needs and supported by evidence.

Is the design of the Capital and Operating reserves appropriate?
With respect to the design of reserves, FNEI argued that unlike the Insurance reserve, the Operating and Capital reserves should not have a cap. A cap assumes that the reserves will have a set amount (i.e. upper limit) and that the funds in the reserve cannot be used for any other purposes other than those that the reserves are designed for. FNEI also proposed to link the Operating and Capital reserves – specifically proposing that current earnings in the first three quarters of any calendar year be appropriated to the Operating fund and at year-end, the funds transferred to the Capital reserve. FNEI also proposed to use the funds in the reserves for social, economic and civic welfare and development activities in the three First Nations communities.

[20] Oral Hearing Transcript, RP-2001-0036, paragraph 251 - 253
[21] Oral Hearing Transcript, Rp-2001-0036, paragraph 244

Board staff submitted that the reserves should have a cap and that it was not appropriate to use the funds in the reserves for any other purpose. Board staff also noted that FNEI had used the term “Operating reserve” and “Operating fund” interchangeably and that the Operating fund as designed is not a reserve. Board staff also noted that the proposal to link the Operating fund to the Capital reserve is not appropriate. In this regard, Energy Probe supported the submissions of Board staff.

Board Findings

The appropriateness of FNEI earning a return on equity was addressed by the Board in RP-2001-0036, FNEI’s previous rate case. In that case, the Board approved amounts in the revenue requirement that were in excess of costs. However the Board also found that it was not appropriate for a non-profit, non-share capital utility to earn a return on equity *per se*. The Board is not convinced it needs to vary its findings in RP-2001-0036 in this regard.

The Board notes that FNEI was directed to use the TIER mechanism in its next rate case and file a report on the design of reserves. The Board also stressed that the excess revenue provided for by the use of a rate of return was intended to fund reserves directly related to the sustainable operation of the utility, and for no other purpose. Further, owing to FNEI’s non-share capital structure, the Board stated it was “inappropriate to describe amounts included in revenue requirement that are in excess of costs as a return on equity” and directed that they be described as “Internally Generated Funds”.

The Board dealt with a similar issue in a subsequent rate application by Attawapiskat Power Corporation (“APC”) (EB-2005-0233). APC, a non-profit, non-share capital utility, sought Board approval to earn and retain revenues in excess of its expenditures in order to establish reserves. APC used the Board’s return on equity methodology (referred to as Internally Generated Funds) as a proxy to estimate the excess revenues needed to provide for reserves directly related to the reliable and sustainable operation of the utility. Owing to APC’s non-profit status, the Board noted that the cost of capital parameters relied on were really only appropriate for ‘for-profit’ utilities and are “not directly applicable and are surrogates at best".[22] The Board stressed that once the reserves are fully funded, "the methodology must be reconsidered".[23]

In this proceeding, FNEI is proposing a return on equity of 9.85%, consistent with the Board's *Cost of Capital report of December 2009*. The excess amounts in revenue requirement are to build up the Operating and Capital reserves.[24]

The need for Operating and Capital reserves was established in FNEI's last rate case. The Board believes it is critical for FNEI to have sufficient Operating and Capital reserves. Only in this way can its ratepayers be reasonably satisfied that it will continue to be able supply electricity in a safe and reliable manner regardless of contingencies. The reserves, properly structured, prescribed and implemented are the only genuine security the ratepayers, and the ratepayers of its ratepayers, have that the supply of electricity will be reliably and safely delivered in their communities.

In this regard, the Board is very concerned that FNEI's current Operating fund and Capital reserve remain unfunded. In the Board's view, reserves provide a cushion against unplanned expenses and therefore FNEI must maintain sufficient operating and capital reserves.

Having determined that it is not appropriate for FNEI to earn a return on equity *per se*, but also that it is crucial that the reserves be appropriately funded the issue is – How should the amounts in revenue requirement in excess of costs be determined?

In FNEI's last rate case the Board directed FNEI to use the TIER mechanism and to file a report on the design of the reserves in its next rate case. Energy Probe argued that FNEI had not complied with the Board's directive and should use the TIER approach. Board staff proposed the Reserve approach. Board staff submitted that in the RP-2001-0036, FNEI's witness had indicated that it was appropriate to earn a return on equity on an interim basis, but as the company gained experience, it would move to the Reserve approach.[25]

[22] Decision and Oder, EB-2005-0233, p. 8
[23] *Ibid., p. 7*
[24] Pre-filed evidence, Ex 1/t1/S13/p.5
[25] Oral Hearing Transcript, RP-2001-0036, paragraph 243 to 246

In the Board's view, the appropriate methodology to manage excess revenues is the Reserve approach. The Board will therefore not require FNEI to follow the TIER approach at this time.

The TIER mechanism, similar to the return on equity mechanism, is formulaic. As such, there is no link between the TIER or the return on equity and the genuinely required level of the reserves, other than that the excess earnings are used to fund the reserves. Under the Reserve approach, the excess revenue needed to fund the reserves is determined based on a demonstrated need and the resultant rates therefore recover only the revenue needed to fund the reserves. In comparison, under a formulaic approach, the resultant rates may recover more or less revenue than is actually needed to fund the reserves and can lead to rates that are either higher or lower than they need to be. To prevent any over-collection, once the reserves are fully funded the rates are adjusted to eliminate any revenue sufficiency.

Further, the Board's Decision to adopt the TIER mechanism was made at a time when FNEI had little operational experience. Today, FNEI has over eight years of operational experience. This gives FNEI the necessary experience to manage the amounts in the reserves, according to the rules established by the Board for their use.

Under the Reserve approach, FNEI will not receive a return on equity *per se*. The amounts in the reserves shall be determined based on an assessment of operating and capital needs supported by evidence, similar to the approach approved by the Board in the APC case and as the Board had directed FNEI to provide in this case. The period over which the reserves are to be built up is also established. Therefore, the revenue requirement is the sum of all costs (such as OMA, Depreciation, Interest Expense etc.) and the annual increment needed to fund the reserves. Once the reserves are fully funded, the excess revenue ceases, until such time as the company brings a new application for rates.

Design of the Reserves

The Board accepts the design of the Insurance reserve as it is currently configured. This reserve has effectively been mandated by the financial institution providing some funding to the utility, and is serving its purpose effectively. However, the Board does not accept FNEI's proposal with respect to the design of the so-called "Operating fund" and the Capital reserve.

FNEI proposed to link the Operating fund and Capital reserves and argued that the reserves should not have any upper limits or caps. The Board disagrees with FNEI's proposal. Under the Reserve approach, the amounts directed to the respective reserves are to be determined based on an assessment of operating and capital needs, supported by evidence. This is no different from the approach used to establish the Insurance reserve. The Board notes that currently the Insurance reserve has a cap of $4 million and which is based on an assessment of exposure to loss due to weather and other incidents. Similarly, in the APC case, the amount set for the Operating reserve is the sum of: (a) the three months with the highest cost of power and transmission costs; and (b) three months of average OM&A costs. The three month period was chosen to address the historical cash flow problems associated with the largest customers of APC. In APC, as in this case, under the Reserve approach the rates are to be reset once the reserves are fully funded. For that to take place, the reserves must have a cap.

The Board does not approve FNEI's proposal to link the "Operating fund" and Capital reserve. Appropriating funds from the "Operating fund" to the Capital reserve will make it impossible to build up the "Operating fund" to its upper limit. The Board also finds that the "Operating fund" as designed and proposed by FNEI is not a reserve in form or function. In order for a Reserve to operate as a Reserve it must be subject to specific, prescriptive rules governing withdrawals from the Reserve.

It is important to address at this point FNEI's proposal to use the Reserves or "excess earning" to support the social, economic and civic welfare and development activities in the three First Nations communities. The Board rejects this proposal. The Board stresses that amounts included in revenue requirement in excess of costs are for building reserves necessary to ensure the sustainable operation of the utility in its role as a transmitter of electricity pursuant to its license and for no other purpose. The Company is specifically prohibited from using any funds to support the social, economic, and civic welfare and development activities in the First Nations communities. As laudable as these activities may be, they are not the responsibility of the utility as a licensed electricity transmitter and the ratepayers of the utility should not be funding them. There are certain Board-approved charitable programs and the utility should inquire as to how they may be accommodated by the utility going forward.

The Board approves the recovery of revenue in excess of costs amounting to 9.50%, instead of the requested 9.85%, to be included in revenue requirement. This amount is to be used to fund the Operating and Capital Reserves, respectively. FNEI will refer to these amounts as Internally Generated Funds.

The Operating Reserve shall be funded until it reaches its cap which is established at an amount equal to the sum of the highest six months Operating, Maintenance, and Administration expenses experienced by the utility over the last two years of operation.

The Capital Reserve shall be funded until it reaches $275,000, which has been derived from the Company's projected capital spending requirement for the test year.

The operation of the Reserves shall be subject to the rules appearing in Appendix "A" to this Decision, and any deviation there from shall be strictly on consent of the Board, acquired in advance.

Once the Reserves have been fully funded according to this Decision, the Company shall make application for revised rates, but under no circumstances shall the Company collect any funds in excess of revenue requirement once the Reserves are fully funded.

The Board directs FNEI to file a reserves policy within three months of the date of this Decision including the calculations, underlying policies, and methodologies for building up the Operating and Capital Reserves. The policy shall include the following information:

1. Identification and definitions for the types of operating and capital reserves.
2. The purpose, goals, and intended use of the capital and operating reserves.
3. Target amounts for the reserves and methodology used to derive the target amounts.
4. The mechanism and the process to use, build, and maintain reserves.
5. The responsibilities of FNEI's Board of Directors and management with regards to the reserve funds.
6. The authorization and approval process for access and use of reserves.
7. Investment objectives and policies.
8. Requirements for reporting and monitoring.

Regulatory Audit shall review and monitor FNEI's operation and funding mechanism of the Reserves. Regulatory Audit shall advise the Board when transactions and matters related to the Reserves do not comply within the intent of this Decision and regulatory practice in general.

Charge Determinant Forecast

FNEI's test year charge determinant forecast for the three pools is: 148.12 MW for Network, 169.98 MW for Line Connection and 62.899 MW for Transformation Connection.[26]

The charge determinant forecast for the three asset pools was determined by averaging the load for the last three years (2007-2009) in each pool. Board staff argued that the 3-year average method ignores the underlying trend in the data, and can result in forecasts that vary significantly from actual experience. Board staff proposed a forecast based on the linear trend method. The forecast based on the trend method is higher that the test year forecast. Energy Probe supported the submissions of Board staff.

FNEI submitted that it took no issue with submissions of Board Staff and Energy Probe as to the most appropriate method for estimating FNEI's 2010 charge determinant forecast.

Board Findings

The Board notes that the proposed 2010 charge determinant forecast for the three pools is significantly lower than actual 2009 load. FNEI is forecasting a 20% decline in the Network and Line Connection pools and a 7% decline in the Transformation Connection pool. In the Board's view, these are significant year over year declines that have not been adequately explained or supported.

The Board is not convinced that the 3-year average method is an appropriate method to forecast charge determinants. As demonstrated in the ex-post analysis presented in Board staff interrogatory no. 23(a) the 3-year average method tends to produce forecasts that are consistently low and which result in large forecast errors (i.e. difference between actual and forecast). The forecast errors ranged from 44% to 64% for the Network and Line Connection pools respectively and 11% to 15% for the Transformation Connection pool.

In comparison, ex-post forecasts prepared using a linear trend method produced forecasts that were higher and resulted in lower forecast errors.

[26] Ex 8/T1/S1. The as-filed Transformation Connection estimate was corrected in Board staff interrogatory no. 21(a), Footnote 1.

In the Board's view, the linear trend method appears to be a superior method in this instance. While both the 3-year average method and the linear trend method are quite simplistic, the ex-post analysis suggests that the linear trend method produces forecasts that are more accurate. The linear trend method also uses the entire historical load data rather than relying only on 3-years of data. In Board staff interrogatory no. 22(c) FNEI prepared a test year charge determinant forecast based on the linear trend method. The Board directs FNEI to use this forecast for the test year. Therefore, the forecast for the three pools in the test year shall be: 187.12 MW for the Network pool, 213.46 MW for Line Connection pool and 76.19 MW for Transformation Connection pool.

Implementation

The Board ordered FNEI's current rates interim as of March 1, 2010. The Board finds that an effective date for FNEI's 2010 rates shall be March 1, 2010. The Board addresses the preferred approach to implement the new rates below.

The Board sees benefit to minimizing the number of changes to UTRs where it is appropriate to do so. The Board directs FNEI to establish a deferral account (account 1574, Deferred Rate Impact Amounts Account) to capture any lost revenue with respect to the increase to its revenue requirement from the effective date (March 1, 2010) until such time as the new UTR rates are implemented in Hydro One's 2011 transmission rates proceeding (EB-2010-0002), which is currently before the Board. The Board notes that, in this manner, changes to existing UTRs established in EB-2008-0272 can be avoided at this time. The Board approved a similar approach in the Great Lakes Power Transmission proceeding (EB-2009-0408). A process to set new UTRs will accompany Hydro One's 2011 transmission rates application and will provide opportunity to more appropriately align and reflect FNEI's 2010 Board approved transmission revenue requirement and charge determinants.

The Board directs FNEI to file an implementation proposal that provides a month by month methodology of adjustment to the revenue requirement commencing from March 1, 2010 being the effective date of the approved 2010 revenue requirement until the implementation of the new UTRs i.e., the date when FNEI's approved 2010 revenue requirements implemented through changes to UTRs (this date will be determined by the Board).

THE BOARD ORDERS THAT:

1. FNEI shall file its implementation proposal with the Board and all intervenors within 14 calendar days from the date of this Decision.
2. Intervenors and Board staff shall have 7 calendar days to respond to FNEI's implementation proposal.
3. FNEI should respond as soon as possible to any comments by intervenors, but not later than 5 calendar days after the deadline for comments from intervenors.
4. Energy Probe shall submit its cost claims within 33 calendar days from the date of this Decision. The cost claim must be filed with the Board and one copy is to be served on FNEI. The cost claims must conform to the Board's *Practice Direction on Cost Awards*.
5. FNEI should review the cost claims. Any objections must be filed with the Board and one copy must be served on Energy Probe, within 40 calendar days from the date of this Decision.
6. Energy Probe shall file with the Board and forward to FNEI any responses to any objections for cost claims within 47 days of the date of this Decision.
7. FNEI shall pay the Board's costs upon receipt of the Board's invoice.

DATED at Toronto on November 1, 2010

ONTARIO ENERGY BOARD

Original signed by

Kirsten Walli
Board Secretary

APPENDIX "A"

TO

DECISION AND ORDER

ACCOUNTING FOR THE RESERVES

FIVE NATIONS ENERGY INC.

BOARD FILE NO. EB-2009-0387

DATE: NOVEMBER 1, 2010

Accounting for the Reserves

The Board directs FNEI to create three appropriations to retained earnings called "Earnings Retained for Operating Reserve", "Earnings Retained for Capital Reserve", and "Earnings Retained for General Reserve". These reserves shall be recorded in account 3047, Appropriations of Retained Earnings – Current Period, of the USoA in the three separate sub-accounts in accordance with the requirements below.

1. At the end of each year before the net income or loss is closed to retained earnings, the amount of "net income" that first arises shall be appropriated to the Retained Earnings for Operating Reserve and to Retained Earnings for Capital Reserve.
2. Excess amounts of "net income" over and above the amounts approved by the Board should be closed to the Retained Earnings for General Reserve.
3. In the case that a loss arises in a year, the loss would draw down the retained earnings sub-accounts in the reverse priority to how they are built up, i.e., general first, capital second, and operating last.
4. Once the limits for both Operating and Capital reserves are reached, the excess revenues shall no longer be required and will cease by way of an application for new rates. FNEI is expected to promptly file such an application and may include revisions to its reserves, if applicable.
5. FNEI should report to the Board the balances of the account 3047, Appropriations of Retained Earnings – Current Period, and its sub-accounts on a quarterly and annual basis.
6. The Board's Regulatory Audit group should monitor activities of account 3047 and its subaccounts to ensure FNEI is building the required reserves and report to the Board, if required.