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COST ALLOCATION OF REVENUE REQUIREMENT

This exhibit presents an overview of the process to allocate Hydro One Distribution related revenue requirement costs to Legacy, Acquired, and Sub-Transmission customer groups (including current Embedded LV customers).

1.0 INTRODUCTION

The 2008 revenue requirement of \$1,067 million for Hydro One Distribution was derived in Exhibit E1, Tab 1, Schedule 1, and is attributed to the Retail, (Legacy and Acquired), and Sub-Transmission customers.

This revenue requirement is allocated to the proposed customer groups using the Cost Allocation methodology issued by the OEB on September 29, 2006 in the RP-2005-0317 proceeding. Hydro One modified the OEB methodology to reflect its unique circumstances related to the provision of an LV system and a very large number of rates. The modifications are detailed in Exhibit G2, Tab 1, Schedule 1, and are similar to the modifications applied in Hydro One's Cost Allocation Information Filing of January 15, 2007 as part of Proceeding RP-2007-0001.

2.0 APPORTIONMENT OF REVENUE REQUIREMENT

Hydro One used the OEB Cost Allocation Methodology to allocate the proposed \$1,067 million revenue requirement to customer classes. The allocated revenue requirement was compared to the revenues that would be collected from customers at adjusted 2007 Distribution rates. The adjustment consisted of increasing the 2007 approved rates proportionally to recover the 2008 Revenue Requirement of \$1,067 million. Revenue to cost ratios were then calculated. Revenue to cost ratios above 1 mean that the customer class is over-contributing and revenue to cost ratios below 1 mean that the customer class

1 is under-contributing. The results of the cost allocation study are summarized in the
 2 Table below.

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Table 1
Hydro One Cost Allocation Study Results

	UR	R1	R2	Seasonal	UGSe	UGSd	GS e	GS d	ST	DG	Street Light	Sent. Light	Total
Rev Req \$M	66.0	240.2	390.3	83.6	9.3	16.8	111.1	105.4	27.4	0.4	8.1	8.0	1,066.6
Revenue at current rates \$M	57.7	197.1	404.6	77.0	12.1	16.0	119.6	107.9	64.2	0.6	4.9	4.9	1,066.6
Rev/cost ratio	0.87	0.82	1.04	0.92	1.29	0.95	1.08	1.02	2.35	1.63	0.60	0.62	1.00

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More details on the results of the cost allocation study can be found in Exhibit G2, Tab 1,
 Schedule 1.

11 **3.0 TARGET REVENUE TO COST RATIO**

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Hydro One is proposing to use the revenue to cost ratio ranges recommended in the Board's report issued November 28, 2007 under proceeding EB-2007-0667, "Application of Cost Allocation for Electricity Distributors". The Board recommended revenue to cost ratios range from 0.7 for street lights to 1.8 for large commercial customers. Given that this is the first time that the OEB's cost allocation methodology is being used as a basis for determining distribution rates, the wider range of revenue to cost ratios proposed by the Board will reduce the potential bill impacts on customers whose distribution rates have to increase to closer reflect cost causality. The proposed range of revenue to cost ratios will result in those customer classes with a revenue to cost ratio above 1 continuing to cross-subsidize those customer classes with a revenue to cost ratio below 1.

1 Hydro One is proposing the following revenue to cost ratios for the various new proposed
2 customer classes.

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4 For the R2 Residential, General Service energy billed, and General Service demand billed
5 customer classes, the current revenue to cost ratio is proposed to be maintained:

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7 For the Distributed Generation customer class, the revenue to cost ratio is proposed to be
8 set at 1.0 rather than the current 1.63 in support of Government policy to promote
9 Distributed Generation in Ontario.

10
11 For Street Light and Sentinel Light classes it is proposed to increase the revenue to cost
12 ratio from about 0.6 to 0.7. This is the lower end of the revenue to cost ratio proposed by
13 the Board for this class of customers.

14
15 For the Urban General Service energy billed class it is proposed to reduce the revenue to
16 cost ratio from 1.29 to 1.2. This is the higher end of the revenue to cost ratio proposed by
17 the Board for small commercial customers.

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19 For the Sub-Transmission class it is proposed to reduce the revenue to cost ratio from
20 2.35 to 1.15. This is the higher end of the revenue to cost ratio proposed by the Board for
21 large users.

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23 In order to recover almost all of the 2008 Revenue Requirement based on the revenue to
24 cost ratios described above, the revenue to cost ratio for Urban Residential, R1
25 Residential, Seasonal Residential and Urban General Service demand billed customer
26 classes will have to increase. The revenue to cost ratios for the Urban Residential,
27 Seasonal Residential, and Urban General Service demand billed customer classes are
28 proposed to be set to 1.0. For the R1 Residential customer class, the proposed revenue to

1 cost ratio is 0.88, which results in bill impacts that are considered to be the maximum that
 2 Acquired residential customers being harmonized to this customer class can sustain.

3
 4 The proposed revenue to cost ratios result in Hydro One not being able to fully recover its
 5 2008 proposed Revenue Requirement. The shortfall is estimated to be \$2.5 million per
 6 year, which is the difference in the total proposed revenue requirement shown in Table 2
 7 as compared to Table 1. Hydro One proposes to establish a variance account, as described
 8 in Exhibit F1, Tab 3, Schedule 1 to record this revenue shortfall for recovery at a future
 9 date from all customers.

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 11 **Table 2**
 12 **Proposed Revenue/Cost Ratio by Customer Class**

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	UR	R1	R2	Seasonal	UGSe	UGSd	GS e	GS d	ST	DG	Street Light	Sent. Light	Total
Proposed Revenue Requirement \$M	66.0	211.4	404.6	83.6	11.2	16.8	119.6	107.9	31.5	0.4	5.7	5.6	1,064.1
Proposed revenue to cost ratio	1.0	0.88	1.04	1.0	1.2	1.0	1.08	1.02	1.15	1.00	0.7	0.7	1.0

14 *Revenue to cost ratios in bold show the proposed change

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 16 **4.0 REVENUE TO COST RATIO EQUAL TO ONE**

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 18 In response to feedback received during the stakeholdering process, Hydro One explored
 19 the impact of moving all customer classes to a revenue to cost ratio of 1. Table 3 shows
 20 the average impacts that would result from making this change. As shown in Table 3, the
 21 resulting average total bill impacts under a revenue to cost ratio of 1 is generally greater
 22 and could be as much as three times the impact under the proposed revenue to cost ratios.
 23 As a result, using a revenue to cost ratio of 1 for all customer classes would result in
 24 either unacceptable bill impacts or the need for an excessively long impact mitigation
 25 period.

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Table 3
Impact to Customer Classes of Revenue/Cost Ratios

	Proposed R/C	Average impact %	R/C = 1	Average impact %
UR	1.0	3.4	1	3.4
R1	0.88	3.0	1	8.3
R2	1.04	1.0	1	(0.8)
Seasonal	1.0	9.7	1	9.7
UGe	1..2	(2.3)	1	(6.3)
UGd	1.0	0.3	1	0.3
GSe	1.08	0.5	1	(2.2)
GSd	1.02	(2.1)	1	(2.7)
DG	1	(29.0)	1	(29.0)
Street Light	0.7	5.0	1	21.7
Sentinel Light	0.7	25.0	1	118.1
ST	1.15	(4.7)	1	(5.0)

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