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Exhibit C1-5-2
Attachment 1
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Report to

Hydro One Networks Inc.

Regarding

Review of Overhead Capitalization Rates –2010/2011

June 29, 2009





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SECTION I. OVERVIEW

A. Introduction

Black & Veatch (“B&V” or “we”) is pleased to provide this Report to Hydro One on our *Review of Overhead Capitalization Rates – 2010/2011*. The Overhead Capitalization Rates (“OH Cap Rates”) developed by Hydro One are percentages that are applied to the cost of Distribution business and Transmission business capital projects upon completion; the results are the amounts of Common Corporate Functions and Services (“CCFS”) costs and AM costs that are capitalized to those capital projects for the year.

The methodology was developed for Hydro One by B&V, presented in our report *Distribution Overhead Capitalization Rate Method* report dated May 20, 2005 (“2005 Distribution Report”) and accepted by the Ontario Energy Board (“OEB”).

In 2006, the OEB-accepted methodology was applied to Hydro One’s Transmission business and reported on in our *Transmission Overhead Capitalization Rate Method* report (“2006 OH Cap Report”). In 2008, the OEB-accepted methodology was applied to Hydro One’s Transmission business and reported on in our *Implementation of Transmission Overhead Rate Capitalization Methodology – 2009 / 2010* report (“2008 OH Cap Report”).

The calculation of Distribution OH Cap Rates for 2010-2014 is presented in Appendix A.

Hydro One computed the Distribution OH Cap Rates to be 14% for 2010 and 12% for 2011 (*Attachment A, line 78*). Based on the work we performed, B&V believes that Hydro One’s implementation of the Overhead Capitalization Rate methodology for 2010/2011 and its computation of the 2010/2011 Distribution OH Cap Rates is appropriate and conform to the OEB-accepted methodology.



B. Background

Hydro One's capital spending program is a major focus for the utility in terms of time and cost. Distribution Capital spending is budgeted to be \$730M in 2010 and \$739M in 2011, approximately 16% of Distribution Net utility plant.

Hydro One's capital program requires significant support from all areas of the utility, including engineering, management, administration and infrastructure resources. These resources support Distribution Operations and Maintenance ("OMA") and Distribution Capital Projects work.

C. Criteria for Cost Allocation Methods

The Distribution OH Cap Rate is used to distribute the Distribution business portion of CCFS costs and Asset Management ("AM") costs, between Distribution OMA and Distribution Capital Projects. Following are the criteria that B&V used in selecting and evaluating methods to develop the OH Cap Rates methodology:

- The method should be based on *cost causation*.
- If cost causation can not be used or is determined to be inappropriate in the circumstances, the method usually considered next is *benefits received*.
- The method should be based on data that can be obtained at reasonable cost and are objectively verifiable, in the initial year as well as in subsequent years.
- If the method uses estimates, results should be unbiased and reasonably consistent with the results that would be obtained from using actual data.



D. Description of OH Cap Rate Method

Asset Management and Operators

The AM group is responsible for Hydro One's operating assets, including investment strategy and planning and day-to-day operation of the Ontario Grid Control Centre. Substantially all AM costs are labor and labor-related.

Hydro One performed a time study to determine the portions of AM costs devoted to Distribution capital projects, Distribution OMA, Transmission capital projects and Transmission OMA. The time study was performed for the five -week period ending April 5, 2009. AM personnel are able to determine with reasonable accuracy, on a current basis, the time they spend on each of the four areas.

A properly performed time study measures cost causation, and is widely accepted as a basis for allocating costs. B&V reviewed the Hydro One time study methodology and found it was the same as used in prior years to allocate AM time among these four areas, and was properly conducted, and therefore was a proper basis for determining the portion of AM costs capitalized to Distribution and Transmission capital projects.

Based on the time study, \$23.2 million of 2010 and \$24.8 million of 2011 AM costs are included in the amounts to be capitalized to Distribution capital projects (*Attachment A, line 69*).

Common Corporate Functions and Services Costs

Ideally, the amount of CCFS costs to be capitalized would be based on time studies for labor costs, and special studies for other costs, for each CCFS activity. However, as B&V found in its *Review of Common Corporate Costs Methodology – 2009*, while the CCFS departments can determine with reasonable accuracy the portions of time spent on Distribution, Transmission and the other business units, they are unable to determine with reasonable accuracy the time spent on OMA versus capital projects. Therefore, the



amount of costs to be capitalized must be computed using allocators based on cost causation or benefits received.

In traditional utility cost allocation studies, administrative and general costs are allocated based on one or more factors such as Labor costs, OMA, Investment in Plant or a weighted combination of two or more. B&V considered the following two bases for allocating CCFS costs, which are similar to administrative and general costs, between X) OMA and Y) capital projects:

- Labor Content Method- Labor Content of Distribution OMA versus Distribution capital projects
- Total Spending Method- Total Spending on Distribution OMA versus Distribution capital projects

The CCFS costs to be allocated are causally related to both Labor content and Total spending. Therefore the OH Cap Rate method for CCFS costs recommended by B&V is based on a weighting of 50% Labor Content and 50% Total Spending.

- The formula for Distribution (Dx) Labor Content is:
$$\text{Dx Labor Content} = \text{Dx Labor \$ in Dx Capital Projects} / (\text{Labor \$ in Dx Capital Projects} + \text{Labor \$ in Dx OMA})$$
- The formula for Dx Total Spending is:
$$\text{Dx Total Spending} = \text{Dx Capital Projects} / (\text{Dx Capital Projects} + \text{Dx OMA})$$

The tables below shows the results of the computation for 2010 and 2011.



Percent of Distribution CCFS Costs Capitalized	2010	2011
Labor Content- Capital	44.5%	45.9%
Total Spending- Capital	57.9%	61.0%
50/50 Average	51.2%	53.5%

Common Corporate Functions and Services Costs – Sensitivity Analysis

As a sensitivity analysis, B&V analyzed two sensitivity cases- the highest Labor Content weight considered (75%) and the lowest Labor Content weight considered (25%). The results, shown below, indicate the total OH Cap Rates would not change materially.

CASES	Labor Content / Total Spending	Distribution- 2010	
		% CCFS Costs Capitalized	OH Cap Rate
Recommended	50%/50%	51.2%	13.5%
High Labor Case	75%/25%	47.8%	12.9%
Low Labor Case	25%/75%	54.5%	14.2%
Note- In all cases Labor Content-Capital was 44.5% and Total Spending-Capital was 57.9%.			

B&V also considered the following:

1. The same rate is applied to capitalized assets regardless of their actual usage of CCFS. For example, a transformer that is purchased from a pre-approved vendor requires very little CCFS, but receives the same rate of overhead capitalization as a project requiring substantial CCFS support. In applying the OH Cap Rates, there will



be differences compared to performing a specific analysis for each project. However, the B&V method is appropriate because:

- B&V's recommended Labor / Total Content method correctly computes the total CCFS dollars to be capitalized, and the amount charged to specific projects has virtually no effect on the financial statements or on ratepayers.
- Most assets purchased for stand-alone use are Minor Fixed Assets and the OH Cap Rates are computed without them, and not applied to them. Other assets purchased are usually parts of larger projects, therefore use of the average OH Cap Rates is appropriate, because larger project are more likely to have an average usage of CCFS.
- It is impractical to perform an analysis for each project. To do so is not industry typical practice; use of an average rate is industry typical practice.

2. The OH Cap Rates are developed based on the weighted Labor Content and Total Spending, but are applied to Total Capital Cost.

It is appropriate to compute the total costs to be capitalized based on the weighted Labor Content / Total Spending. Once the amount to be capitalized is computed, it can be applied based on either Total Cost or Labor Content. B&V recommends stating the capitalization rate based on Total cost, and applying it to Total cost dollars, as Hydro One has done, because it is easier to plan and implement based on Total cost than Labor content. In addition, this is the industry typical practice.

B&V believes that allocating CCFS costs to capital projects based on 50% Labor Content / 50% Total Spending is the most appropriate method for Hydro One, and is consistent with industry practice and with the nature of the CCFS costs being capitalized.



SECTION II. COMPUTATION OF DISTRIBUTION OH CAP RATE USING RECOMMENDED METHOD

In this Section we will present the computation of the Distribution OH Cap Rate for 2010. The computation of the Distribution OH Cap Rate for 2011, and of the Transmission OH Cap Rates for 2010 and 2011, use the same method.

A. Formula

The following formula is used by to compute the Distribution OH Cap Rate for 2010:

$$\frac{\text{Distribution OH Cap Rate} = (\text{Distribution CCFS Cap} + \text{Distribution AM Cap})}{\text{Distribution Capital}}$$

Where

Distribution AM Cap = AM costs capitalized to Distribution capital projects

Applicable Distribution CCFS costs = Distribution CCFS costs subject to capitalization

Distribution Capital = Cost of Distribution capital projects supported by CCFS and AM; also, total cost of Distribution capital projects to which the Distribution OH Cap Rate is applied

Distribution CCFS Cap = Distribution CCFS costs capitalized = (Distribution Labor Content X 50% + Distribution Total Spending X 50%) X Applicable Distribution CCFS Costs

Distribution Labor Content = Distribution Labor \$ in Distribution Capital Projects / (Labor \$ in Distribution Capital Projects + Labor \$ in Distribution OMA)



$$\text{Distribution Total Spending} = \text{Distribution Capital Projects} / (\text{Distribution Capital Projects} + \text{Distribution OMA})$$

These terms are further discussed below.

B. Recommended Method

This section discusses the method recommended by B&V to compute the Distribution OH Cap Rate. References below are to Appendix A, using amounts for 2010. The calculation uses projected data. Because the methodology includes a true-up (page 11), any continuing effect of the difference between actual and projected amounts will be not significant.

1) Distribution Capital

(Appendix A, rows 1-8)

Distribution Capital represents the cost of Distribution business Capital Projects that are supported by Distribution business CCFS activities and AM activities, and is the total cost of Distribution business Capital Projects to which the Distribution OH Cap Rate is applied. Distribution Capital equals total spending for Distribution Capital Projects reported for financial accounting, adjusted as follows:

- Minor Fixed Assets (such as vehicles) and Interest Capitalized are removed because they require little CCFS or AM support. Capitalized Overhead is removed to avoid redundancy.
- Capital Contributions by Customers are added because the CCFS or AM effort required is related to gross capital cost, not net capital cost. Removal Costs are added because removal of capital assets requires CCFS or AM effort.

2) Distribution Spending for OMA

(Appendix A, rows 10-16)



Distribution Spending for OMA is used in computing the portion of Total Spending (capital plus OMA) related to capital (rows 37-41). The amounts are based on the BP 2010, with adjustments to remove those costs which are included in Applicable CCFS Costs (row 29).

*3) Applicable Distribution CCFS costs
(Appendix A, rows 18-29)*

Applicable Distribution CCFS represents the Distribution CCFS costs that are subject to capitalization, and equals the amount of CCFS costs distributed to the Distribution unit in the Common Corporate Cost Model Exhibit C1 -6-1 (Row 19), adjusted as follows:

- The Distribution Facilities costs that are removed from the CCFS costs, relating to Operations facilities, are added back.
- The portion of Distribution CCFS costs representing operating-type costs is removed because these departments do not support OMA or capital projects. These activities include Inergi- Customer Support Operations, Inergi- Settlements, Inergi-ETS costs to support CSO Applications and Inergi-ETS costs to support market transition costs.

*4) Distribution Labor Content- Capital
(Appendix A, rows 31-35)*

Distribution Labor Content-Capital is the portion of total Distribution labor costs included in Distribution Capital Projects. The computation uses the formula:

$$\text{Distribution Labor Content} = \frac{\text{Distribution Labor \$ in Distribution Capital Projects}}{(\text{Labor \$ in Distribution Capital Projects} + \text{Labor \$ in Distribution Operations and Maintenance})}$$



The Labor \$ on Rows 32-33 were developed by Hydro One. The Labor \$ are fully burdened labor costs.

*5) Distribution Total Spending- Capital
(Appendix A, rows 37-41)*

Distribution Total Spending-Capital is the portion of Distribution total spending is included in Distribution Capital Projects. The computation uses the formula:

$$\text{Distribution Total Spending} = \text{Distribution Capital Projects} / (\text{Distribution Capital Projects} + \text{Distribution Operations and Maintenance})$$

Distribution spending for OMA (row 38) is from row 16. Distribution spending for capital projects is from row 8.

*6) Distribution CCFS Cap
(Appendix A, rows 37-51)*

The average of the Distribution Labor Content-Capital (from row 35) and the Total Spending- Capital (from row 41), using the appropriate weights (rows 44-45), is the capitalized portion of CCFS costs (row 47). This portion is multiplied by the Applicable CCFS costs (row 49, from row 29) to compute Capitalized CCFS costs (row 51).

*7) Distribution AM Cap
(Appendix A, rows 53-69)*

Distribution AM Cap represents the amount of AM costs capitalized to Distribution business Capital Projects. The time study performed by Hydro One for the five weeks ended April 5, 2009 showed that 26.9% of AM Non-operator time, 4.0% of Operator time and 0.0% of Customer Care time, are related to Distribution Capital Projects. These percentages are applied to the BP 2010 annual budgeted amounts for AM, and the results are the amounts of AM costs to be capitalized (row 69).



8) *E-Factor*

Hydro One trues up the Distribution OH Cap Rate to actual at the end of each fiscal year, therefore an E-factor (to reflect the difference between A) the amount of CCFS and AM costs actually capitalized for a prior year and B) the amount that would have been capitalized for that year using actual data instead of estimates in OH Cap Rate calculation) is no longer needed or used.

9) *Distribution OH Cap Rate*

(Appendix A, rows 71-78)

The Distribution OH Cap Rate equals A) the sum of items 6) and 7) above, divided by B) Capital spending. The Distribution OH Cap Rate for 2010 is **14%** (row 78).

DISTRIBUTION OVERHEAD CAPITALIZATION RATE Appendix A- Page 1 of 2

(\$ millions)	2010	2011	2012	2013	2014
1 Capital Expenditures					
2 Total capexp	730.4	739.4	831.7	853.6	836.0
3 Less: Minor fixed assets	(125.8)	(76.7)	(59.3)	(63.3)	(63.8)
4 Less: Capitalized overhead	(87.5)	(88.7)	(94.6)	(95.8)	(93.9)
5 Less: Capitalized interest	(22.3)	(26.6)	(34.0)	(38.0)	(38.0)
6 Add: Capital contributions	104.1	161.1	106.8	109.2	111.1
7 Add: Removal costs	33.0	35.7	39.9	41.3	42.1
8	631.8	744.2	790.5	807.1	793.4
9					
10 OM&A					
11 Total OM&A	611.6	632.7	639.2	634.3	621.2
12 Less: CCFS costs	(148.0)	(148.2)	(151.2)	(156.7)	(158.9)
13 Less: Facility costs	(28.2)	(29.2)	(28.5)	(29.2)	(29.8)
14 Less: Asset Management costs (excl. facility costs)	(63.3)	(68.0)	(69.2)	(71.7)	(73.7)
15 Add: Capitalized overheads	87.5	88.7	94.6	95.8	93.9
16	459.6	476.0	484.8	472.6	452.8
17					
18 Capitalized CCFS Costs					
19 CCFS Costs	148.0	148.2	151.2	156.7	158.9
20 Add: Facility costs	28.2	29.2	28.5	29.2	29.8
21					
22 Less operating-type CCFS costs:					
23 Inergi - CSO	(38.4)	(37.5)	(38.4)	(39.3)	(40.1)
24 Inergi - ETS CSO Apps	(8.9)	(9.1)	(9.4)	(9.6)	(9.7)
25 Inergi - ETS Market Ready	(4.8)	(5.0)	(5.1)	(5.3)	(5.3)
26 Inergi - Settlements	(2.7)	(2.7)	(2.8)	(2.8)	(2.8)
27	(54.8)	(54.3)	(55.7)	(57.0)	(58.0)
28					
29 Applicable CCFS costs	121.4	123.1	124.1	128.8	130.6
30					
31 Portion capitalized based on labour content:					
32 Labour in OM&A	292.5	353.9	435.4	460.7	448.3
33 Labour in capexp	234.5	300.4	373.8	378.0	371.2
34	527.1	654.3	809.2	838.7	819.5
35 % capexp	44.5%	45.9%	46.2%	45.1%	45.3%
36					
37 Portion capitalized based on total spending:					
38 OM&A	459.6	476.0	484.8	472.6	452.8
39 Capexp	631.8	744.2	790.5	807.1	793.4
40	1091.4	1220.2	1275.3	1279.6	1246.2
41 % capexp	57.9%	61.0%	62.0%	63.1%	63.7%
42					
43 Weighting:					
44 Labour content	50.0%	50.0%	50.0%	50.0%	50.0%
45 Total spending	50.0%	50.0%	50.0%	50.0%	50.0%
46					
47 Capitalized based on weighting of two methods	51.2%	53.5%	54.1%	54.1%	54.5%
48					
49 Applicable CCFS costs	121.4	123.1	124.1	128.8	130.6
50					
51 Capitalized CCFS costs	62.2	65.8	67.1	69.6	71.2
52					

DISTRIBUTION OVERHEAD CAPITALIZATION RATE Appendix A- Page 2 of 2

(\$ millions)	2010	2011	2012	2013	2014
53 Capitalized Asset Management Costs					
54 Network Asset Management Costs (Tx + Dx):					
55 Asset Management (excl. facility costs)	79.8	85.7	86.7	90.0	92.0
56 Operating	44.3	45.6	45.7	47.1	48.5
57 Customer Care Management	11.8	13.3	14.0	14.5	15.1
58	<u>135.9</u>	<u>144.7</u>	<u>146.4</u>	<u>151.5</u>	<u>155.6</u>
59					
60 Portion capitalized (per time study):					
61 Asset Management (excl. facility costs)	26.9%	26.9%	26.9%	26.9%	26.9%
62 Operating	4.0%	4.0%	4.0%	4.0%	4.0%
63 Customer Care Management	0.0%	0.0%	0.0%	0.0%	0.0%
64					
65 Capitalized Asset Management costs:					
66 Asset Management (excl. facility costs)	21.4	23.0	23.3	24.2	24.7
67 Operating	1.8	1.8	1.8	1.9	1.9
68 Customer Care Management	0.0	0.0	0.0	0.0	0.0
69	<u>23.2</u>	<u>24.8</u>	<u>25.1</u>	<u>26.0</u>	<u>26.6</u>
70					
71 Overhead Capitalization Rate					
72 Capitalized CCFS costs	62.2	65.8	67.1	69.6	71.2
73 Capitalized Asset Management costs	23.2	24.8	25.1	26.0	26.6
74	<u>85.4</u>	<u>90.7</u>	<u>92.2</u>	<u>95.7</u>	<u>97.8</u>
75					
76 Capexp	631.8	744.2	790.5	807.1	793.4
77					
78 Calculated overhead capitalization rate	14%	12%	12%	12%	12%