Ontario Energy Board

G-2009-0300

Guidelines:

Regulatory and Accounting Treatments for Distributor-Owned Generation Facilities

September 15, 2009

1. Purpose

This document sets out a regulatory framework for the regulatory and accounting requirements for electricity distributors that own and operate renewable energy generation, combined power and thermal (heat) energy generation and energy storage facilities (collectively referred to below as "distributor-owned generation facilities"). This document contains the Board's guidance to electricity distributors in relation to an amendment to the *Ontario Energy Board Act, 1998* (OEB Act) that allows distributors to own and operate such generation facilities. The amendment came into effect when the relevant provisions of the *Green Energy and Green Economy Act, 2009* ("Green Energy Act") came into force.

The purpose of this document is to describe the ownership scenarios potentially available to distributors for generation facilities; and to set out the regulatory and accounting requirements applicable to each scenario.

2. Legal and Regulatory Framework

2.1. The Green Energy Act

On May 14, 2009, the Green Energy Act received Royal Assent. On September 9, 2009, the relevant sections were proclaimed into force and the Green Energy Act amended the OEB Act to address, amongst other things, distributor-owned generation facilities.

The Green Energy Act has amended s. 71 of the OEB Act by adding the following:

(3) Despite subsection (1), a distributor may own and operate,

(a) a renewable energy generation facility that does not exceed 10 megawatts or such other capacity as may be prescribed by regulation and meets the criteria prescribed by regulation;

(b) a generation facility that uses technology that produces power and thermal energy from a single source that meets the criteria prescribed by regulation; or

(c) an energy storage facility that meets the criteria prescribed by regulation.

The Board acknowledges that future regulations and directives may be issued to complement the legislative framework set out in the Green Energy Act. To the extent that such instruments clarify, alter or supplement the subject matter of this document, the Board will reflect these developments in subsequent guidance.

2.2. Legislative Limitation on Rate Regulation

Section 78(3) of the OEB Act only permits the Board to set rates for the transmission and distribution of electricity and for the retailing of electricity. The statutory framework does not currently give the Board the power to include generation assets in rate base, nor to permit rate recovery for any associated operations and maintenance expenses for distributors.

3. Ownership Scenarios for Generation Facilities

This section provides an overview of two potential business scenarios for investment in generation facilities.

The Board recognizes that distributors may not have an immediate need or investment plan to commence projects relating to energy generation facilities given that such projects require analysis, study and planning prior to any decisions being made to undertake such investments. The approach selected will determine the extent of the required regulatory oversight. These optional business scenarios are discussed in sections 3.1 and 3.2.

3.1. Generation Facility Owned by an Affiliate

Affiliates of distributors are currently permitted to own and operate generation facilities; this situation will not be altered by the Green Energy Act. Any new generation facility owned or operated by an affiliate of a distributor would continue to be governed by the current rules, including the requirement for compliance with the Affiliate Relationships Code (ARC) for Electricity Distributor and Transmitters and the requirement to provide notice to the Board under s. 80 of the OEB Act.

3.2. Generation Facility Owned by Distributor and Non-Rate Regulated

A distributor may also choose to own and operate a generation facility directly as part of its utility business. Under this scenario, costs would not be recovered through rates and a regulatory return would not be earned on the investment. The investment project would be debt and/or equity financed. The distributor may enter into a feed-in tariff (FIT) contract with the Ontario Power Authority (OPA). These contracts are long-term in nature and the energy prices vary depending on the type of generation technology and the capacity of the facility.

Like any generator, a distributor that chooses to generate electricity for sale through the IESO administered markets or directly to another person is required to obtain a license from the Board pursuant to s. 57 of the OEB Act. Any distributor that chooses to own or construct generation facilities must also give notice of its proposal to the Board pursuant to s. 80 of the OEB Act.

4. Accounting Requirements

4.1. Generation Facility Owned by a Distributor's Affiliate

Under this ownership scenario, distributors will need only to review its policies, procedures and processes to ensure compliance with the ARC requirements. ARC requirements that the distributor may need to consider include:

- A utility shall ensure accounting and financial separation from all affiliates and shall maintain separate financial records and books of accounts.
- Where a utility shares information services with an affiliate, all confidential information must be protected from access by the affiliate.
- A utility may provide loans, guarantee the indebtedness of, or invest in the securities of an affiliate, but shall not invest or provide guarantees or any other form of financial support if the amount of support or investment, on an aggregated basis over all transactions with all affiliates, would equal an amount greater than 25 percent of the utility's total equity.

The Accounting Procedures Handbook (APH) for Electric Distribution Utilities, Article 340, Allocation of Costs and Transfer Pricing, provides accounting guidance related to the allocation of costs that should be followed by the regulated utility and its affiliates in developing its policies and procedures for allocating the cost of transactions, products or services between the regulated utility and its affiliates[1].

Article 340 also provides that, to the extent possible, all direct and allocable costs between regulated and non-regulated lines of business, services or products shall be traceable on the books of the regulated utility to the Uniform System of Accounts (USoA). Section 2.1.10 of the Electricity Reporting and Record Keeping Requirements ("RRR") contains the current reporting requirements for affiliate arrangements and transactions. In addition, additional documentation shall be retained and made available to the Board upon request regarding transactions between the regulated utility and its affiliates.

4.2. Generation Facility Owned by Distributor and Non-Rate Regulated

Although under this scenario distributor generation activities will not affect the setting of rates for the distributor, the accounting treatment requires a segregation of these activities from the distributor's rate-regulated activities. This segregation of information requires the use of specified accounts to record generation activities. A distributor should follow these accounting procedures to ensure that information reported for rate setting purposes relates only to the distributor's rate-regulated business and does not include the assets, liabilities, revenues and costs associated with its non-rate regulated activities. In this manner, the distributor will continue to provide financial information on a "stand alone" rate-regulated basis in order to support the distribution rate setting and other requirements of the Board.

Appendix A provides a methodology whereby a distributor can allocate direct costs and a proportional share of indirect costs (such as payroll burden) to its non-rate regulated activities including its generation business activities. Adhering to this methodology will ensure that distribution ratepayers are not liable for non-rate regulated costs for which shareholders are responsible.

The distributor should document and maintain records of its fully allocated costing methodology for generation activities, including its application of this methodology to the accounts under the USoA.

For accounting and reporting purposes, the distributor will use the following asset, liability, shareholders' equity, revenue and expense accounts and sub-accounts to record transactions associated with distributor-owned generation facilities.

[1] Although parts of Article 340 of the APH regarding the ARC are currently out of date, the accounting requirements are current.

- Account 2075, Non-Utility Property Owned or Under Capital Leases, Sub-account Generation Facility Assets. Amounts recorded in this account shall include capital assets (property, plant and equipment) and intangible assets. These assets are not included in rate base and the associated amortization expenses are not included in the revenue requirement of the distributor.

- Account 2285, Obligations Under Capital Leases-Current, Sub-account Generation Facility Liabilities. Amounts recorded in this account shall include current liabilities associated with generation. These liabilities shall not be included in the distribution rates.

- Account 2325, Obligations Under Capital Lease-Non-Current, Sub-account Generation Facility Liabilities. Amounts recorded in this account shall include the liability portion not due within one year associated with generation. These liabilities shall not be included in the distribution rates.

- Account 3075, Non-Utility Shareholders' Equity, Sub-account Generation Facilities. This sub-account shall include shares, paid-in capital, appropriated and unappropriated retained earnings, balance transferred from income and dividends associated with distributor-owned generation. Sub-accounts may be used to distinguish the components of non-rate regulated shareholders' equity. Account 3075 is a new account.

- Account 4375, Revenues from Non-Utility Operations, Sub-account Generation Facility Revenues. Amounts recorded in this account shall include revenues for generation from all sources, including Feed-in Tariff contract revenues.

- Account 4380, Expenses from Non-Utility Operations, Sub-account Generation Facility Expenses. Additional accounts shall be used under this sub-account to record the following categories of costs: (1) energy supply expenses (e.g. fuel), (2) operation, (3) maintenance (4) administration, (5) taxes/ payment in lieu (PILs) and (6) amortization expenses.

A distributor may use additional sub-accounts than specified in the above-noted accounts, as necessary to provide full details of the transactions related to distributor-owned generation activities. Accounting information details should be maintained and made readily available to support Board review of these transactions. Further accounting guidance may be provided if necessary.

A distributor is required to file annual audited financial statements under the RRR. The reporting requirements for financial statements in section 2.1.6 of the RRR specify the following:

> "…Where the financial statements of the corporate entity regulated by the Board contain material businesses not regulated by the Board, or where the regulated entity conducts more than one activity regulated by the Board, the distributor shall disclose separately information about each operating segment in accordance with the Segment Disclosure provisions corporate entities are encouraged to adopt by the Canadian Institute of Chartered Accountants Handbook [CICA Handbook]."

Where non-regulated activities including the activities specified in s. 71(3) of the OEB Act are included in the distributor's operations, the distributor should ensure the activities that represent "material businesses" are reported as operating segments consistent with provisions of Section 1701, Segment Disclosures, of CICA Handbook in the distributor's audited financial statements. In addition to the non-regulated activities including the activities specified in s. 71(3) that may require segment disclosure for financial accounting and reporting purposes, for rate setting purposes, a distributor will need to file financial information in rate applications that clearly delineates the distributor's regulated activities from its non-rate regulated activities. The rate applications should provide a description of the procedures and processes that were used to segregate the accounting information.

Appendix A

Fully Allocated Costing Methodology for Non-Rate Regulated Activities

1. DEFINITIONS

In this Appendix:

"Allocable Costs" means indirect costs (i.e., costs that would be incurred regardless of whether or not the Non-Rate Regulated activities were undertaken);

"Cost Driver" means a measure used to allocate, to a Non-Rate Regulated activity, the costs of any functions performed within the distribution company to undertake that Non-Rate Regulated activity;

"Fully Allocated Costs" means the sum of Marginal Costs and Allocable Costs;

"Marginal Costs" means direct costs (i.e., costs that would be eliminated or reduced if the Non-Rate Regulated Activities were no longer undertaken);

“Non-Rate Regulated Activities” means activities that are carried out by a distributor but not rate-regulated by the Board (e.g., global adjustment mechanism funded CDM Programs, billing and collection services for water and sewage, and distributor-owned generation).

2. COST ALLOCATION PROCESS

2.1 Marginal Costs can be directly assigned to the Non-Rate Regulated activity. Allocable Costs must be allocated, using a Cost Driver, to determine the proportional share of the Allocable Costs attributable to the Non-Rate Regulated activities.

2.2 In order to determine the costs associated with the Non-Rate Regulated Activities, distributors shall use an activity analysis to assess the nature and extent of the functions being performed throughout the distribution company to undertake the Non-Rate Regulated Activities. The analysis must include the identification of all activities performed within the distribution company regardless of whether or not these activities directly or indirectly support the Non-Rate Regulated Activities.

2.3 The activity analysis referred to in section 2.2 must include the following Marginal Costs and Allocable Costs, where applicable:

(a) all salaries and labour costs including benefits;
(b) contractor expenses;
(c) billing and collection;
(d) customer care, marketing and advertising;
(e) administration and general expenses;
(f) IT costs;
(g) office equipment; and
(h) any other cost that the distributor can show is relevant and necessary for the program analysis.

2.4 A distributor must determine an appropriate Cost Driver for each Allocable Cost. Cost Drivers must be:

(a) representative of how costs are being incurred;
(b) implemented in a cost effective manner; and
(c) verifiable and justifiable.

The types of Cost Drivers that distributors may use are included below in sections 2.5 to 2.7.

2.5 Distributors may use headcount as a Cost Driver for the allocation of salaries, other labour related costs, administration and general expenses, and IT costs. This Cost Driver is based on the number of full-time equivalents needed to support the Non-Rate Regulated Activities. Distributors shall calculate full time equivalents in accordance with the following examples:

(a) if six employees each devoted 25% of their time to the Non-Rate Regulated activity, the full-time equivalent for those employees would be 1.5; and
(b) if six part-time employees each devoted 25% of their time to the Non-Rate Regulated activities, the part-time positions would first need to be translated into a full-time position (i.e., if an employee works 3 days per week, the full-time position would be 0.6) and then apply the percentage (i.e., 6 X 0.6 = 3.6 and 25% of 3.6 = 0.9) so the full-time equivalent would be 0.9.

2.6 Distributors may use time as a Cost Driver for the allocation of executive and administrative functions, legal services, and financial analysis because these functions are typically project specific. Distributors shall calculate the percentage of time to be allocated to the Non-Rate Regulated Activities by using the base hours per employee. A distributor shall calculate an employee's base hours by determining the hours that the employee can be considered to be available for work for the period being measured. Distributors shall calculate the percentage of time in accordance with the following example:

(a) if an employee's base hours are 40 hours per week and the employee actually worked 40 hours that week, which included four hours of his/her time spent on a Non-Rate Regulated Activities, the percentage of time allocation would be 10 percent; and

(a) If an employee's base hours are 40 hours per week and the employee actually worked 60 hours that week, which included four hours of his/her time spent on a Non-Rate Regulated Activities, the percentage of time allocation would still be 10 percent.

2.7 Distributors may use the frequency of an activity as a Cost Driver for the allocation of call centre costs and accounts payable processing because these activities can be repetitive in nature and consistent over time in terms of the level of effort required to provide the service. Call centre costs shall be allocated based on number of calls received in relation to the Non-Rate Regulated Activities and accounts payable processing costs shall be allocated based on the number of invoices processed for Non-Rate Regulated Activities.