

**Toronto Hydro**

**Conditions of Service**

**Section 6, Reference #1**

**Economic Evaluation Model for Distribution System Expansion**

**Dated: November 7, 2011**

## APPENDIX B

# Methodology and Assumptions for An Economic Evaluation

Last Revised October 21, 2009

**APPENDIX B -  
METHODOLOGY AND ASSUMPTIONS FOR AN OFFER TO CONNECT ECONOMIC  
EVALUATION**

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**B.1 COMMON ELEMENTS OF THE  
DISCOUNTED CASH FLOW MODEL**

To achieve consistent business principles for the development of the elements of an economic evaluation model, the following parameters for the approach are to be followed by all distributors.

The discounted cash flow (DCF) calculation for individual projects will be based on a set of common elements and related assumptions listed below.

**Revenue Forecasting**

The common elements for any project will be as follows:

- (a) Total forecasted customer additions over the Customer Connection Horizon, by class as specified below;
- (b) Customer Revenue Horizon as specified below;
- (c) Estimate of average energy and demand per added customer (by project) which reflects the mix of customers to be added – for various classes of customers, this should be carried out by class;
- (d) Customer additions, as reflected in the model for each year of the Customer Connection Horizon; and
- (e) Rates from the approved rate schedules for the particular distributor reflecting the distribution (wires only) rates.

**Capital Costs**

Common elements will be as follows:

- (a) An estimate of all capital costs directly associated with the expansion to allow forecast customer additions.
- (b) For expansions to the distribution system, costs of the following elements, where applicable, should be included:
  - distribution stations;
  - distribution lines;
  - distribution transformers;

**APPENDIX B -  
METHODOLOGY AND ASSUMPTIONS FOR AN OFFER TO CONNECT ECONOMIC  
EVALUATION**

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- secondary busses;
- services; and
- land and land rights.

Note that the “Ownership Demarcation Point” as specified in the distributor’s Condition of Service would define the point of separation between a customers’ facilities and distributor’s facilities.

- (c) Estimate of incremental overheads applicable to distribution system expansion.
- (d) A per kilowatt enhancement cost estimate – the per kilowatt enhancement cost estimate shall be set annually and shall be based on a historical three to five year rolling average of actual enhancement costs incurred in system expansions.
- (d.1) paragraph (d) shall cease to apply to a distributor as of the date on which the distributor’s rates are set based on a cost of service application for the first time following the 2010 rate year.
- (e) For residential customers, the amount the cost of the basic connection referred to in section 3.1.4 of the Code.
- (f) For non-residential customers, if the distributor has chosen to recover the non-residential basic connection charge as part of its revenue requirement, a description of, and the amount for, the connection charges referred to in section 3.1.5 of the Code that have been factored into the economic evaluation.

**Expense Forecasting**

Common elements will be as follows:

- (a) Attributable incremental operating and maintenance expenditures - any incremental attributable costs directly associated with the addition of new customers to the system would be included in the operating and maintenance expenditures.
- (b) Income and capital taxes based on tax rates underpinning the existing rate schedules.
- (c) Municipal property taxes based on projected levels.

**Specific Parameters/Assumptions**

## APPENDIX B - METHODOLOGY AND ASSUMPTIONS FOR AN OFFER TO CONNECT ECONOMIC EVALUATION

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Specific parameters of the common elements include the following:

- (a) A maximum customer connection horizon of five (5) years, calculated from the energization date of the facilities.<sup>1</sup>
- (b) A maximum customer revenue horizon of twenty five (25) years, calculated from the in service date of the new customers.<sup>2</sup>
- (c) A discount rate equal to the incremental after-tax cost of capital, based on the prospective capital mix, debt and preference share cost rates, and the latest approved rate of return on common equity.
- (d) Discounting to reflect the true timing of expenditures. Up-front capital expenditures will be discounted at the beginning of the project year and capital expended throughout the year will be mid-year discounted. The same approach to discounting will be used for revenues and operating and maintenance expenditures.<sup>3</sup>

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<sup>1</sup> For customer connection periods of greater than 5 years an explanation of the extension of the period will be provided to the Board

<sup>2</sup> For example, that the revenue horizon for customers connected in year 1, is 25 years while for those connected in year 3, the revenue horizon is 22 years.

<sup>3</sup> For certain projects Capital Expenditures may be staged and can occur in any year of the five year Connection Horizon.

# APPENDIX B - METHODOLOGY AND ASSUMPTIONS FOR AN OFFER TO CONNECT ECONOMIC EVALUATION

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## B.2 DISCOUNTED CASH FLOW (DCF) METHODOLOGY

<b><u>Net Present Value ("NPV")</u></b>	=	Present Value ("PV") of Operating Cash Flow + PV of CCA Tax Shield - PV of Capital
1. <u>PV of Operating Cash Flow</u>	=	P V of Net Operating Cash (before taxes) - P V of Taxes
a) PV of Net Operating Cash	=	PV of Net Operating Cash Discounted at the Company's discount rate for the customer revenue horizon. Mid-year discounting is applied. Incremental after tax weighted average cost of capital will be used in discounting.
Net (Wires) Operating Cash	=	(Annual(Wires) Revenues - Annual (Wires) O&M)
Annual (Wires) Revenue	=	Customer Additions * [Appropriate (Wires) Rates * Rate Determinant]
Annual (Wires) O&M	=	Customer Additions * Annual Marginal (Wires) O&M Cost/customer
b) PV of Taxes	=	PV of Municipal Taxes + PV of Capital Taxes + PV of Income Taxes (before Interest tax shield)
Annual Municipal Tax	=	Municipal Tax Rate * (Total Capital Cost)
Total Capital Cost	=	Distribution Capital Investment + Customer Related Investment + overheads at the project level
Annual Capital Taxes	=	(Capital Tax Rate) * (Closing Undepreciated Capital Cost Balance)
Annual Capital Tax	=	(Capital Tax Rate) * (Net Operating Cash - Annual Municipal Tax B Annual Capital Tax)

The Capital Tax Rate is a combination of the Provincial Capital Tax Rate and the Large Corporation Tax (Grossed up for income tax effect where appropriate).

**Note: Above is discounted, using mid-year discounting, over the customer revenue horizon.**

2. <u>PV of Capital</u>	=	P V of Total Annual Capital Expenditures
a) PV of Total Annual Capital Expenditures		
Total Annual Capital Expenditures over the customer's revenue horizon discounted to time zero		
Total Annual Capital Expenditure	=	(for New Facilities and/or Reinforcement Investments + Customer Specific Capital + Overheads at the project level). This applies for implicated system elements at the utility side of the "Ownership Demarcation Line".

**Note: Above is discounted to the beginning of year one over the customer addition horizon**

**APPENDIX B -  
METHODOLOGY AND ASSUMPTIONS FOR AN OFFER TO CONNECT ECONOMIC  
EVALUATION**

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3. PV of CCA Tax Shield

P V of the CCA Tax Shield on [Total Annual Capital]

The PV of the perpetual tax shield may be calculated as:

PV at time zero of: 
$$\frac{[(\text{Income tax Rate}) * (\text{CCA Rate}) * \text{Annual Total Capital}]}{(\text{CCA Rate} + \text{Discount Rate})}$$

or,

Calculated annually and present valued in the PV of Taxes calculation.

**Note: An adjustment is added to account for the ½ year CCA rule.**

4. Discount Rate

PV is calculated with an incremental, after-tax discount rate.