



August 14, 2006

Ontario Energy Board  
P.O. Box 2319, Suite 2601  
Toronto, ON M4P 1E4

Attention: Board Secretary

Dear Sir:

**Re: EB-2006-0088 (Cost of Capital) and EB-2006-0089 (2<sup>nd</sup> Generation IRM)**

London Hydro would like to address two specific elements contained in the OEB Staff's Proposal (the "Proposal") that we believe are fundamentally flawed, being:

- 1) The universal 60/40 debt/equity structure;
- 2) The undue focus on the "*optimum*" capital structure, in isolation of other significant and necessary regulation.

Additionally, London Hydro remains concerned with the timeframe in which this proceeding is occurring given the significant implications for distributors, ratepayers and shareholders. We consider that significant changes, such as a change to capital structure, should only occur after a careful, thoughtful analysis and deliberation of the consequences of such changes.

We urge Staff and the Board to proceed cautiously.

### **The Universal 60/40 Debt/Equity Structure and Total Entity Risk**

The Proposal states that all distribution utilities are more the same than they are different, and that therefore it is expedient to assess the same capital structure to all. This is highlighted on page 13 of the current proposal where Board Staff state that:

*" while there are several dimensions of risk that vary across utilities, such as load concentration, total load, etc., staff finds that there is no reasonable way to differentiate them. In other words, distributors are more alike than they are different with respect to the risks that they face, and therefore proposes a common structure for all distributors."*

The comment indicates that because Staff can't neatly group specific utilities that the obvious result is they are all the same. Rather than develop a different analytic technique or accept that distributors may be individuals and unique, Staff conclude that the differences are either irrelevant or must cancel each other out without providing an evidentiary basis for such a conclusion.

London Hydro disagrees with this approach and conclusion. To refute this approach and claim we have revisited and outlined below the fundamentals that impact the ability of an entity to attract debt capital.

### ***Assessing Risk***

It is evident that in a world without risk an entity would have all (100%) of its capital requirements in the form of debt as the cost of capital on an after tax basis would be the most efficient. Clearly, this is never achieved as there is risk to capital providers. The assessment of entity risk is not limited to a macro assessment of the regulatory environment and the industry, as the Proposal seems to suggest. While those are worthy considerations, capital providers will also look to the risk of the individual entity. More specifically, capital providers will be concerned with the cashflows that the particular entity generates and the risk to those cashflows, both within that macro industry and regulatory environment and specific to the unique circumstances of the entity.

- To suggest that those individual entity cashflows and risk attributes are the same throughout all regulated distribution companies is erroneous.
- To suggest that all individuals will be impacted in the same manner to future changes such as a downturn in a specific industry is clearly not the case.
- To suggest that one capital structure can be accommodated by all companies suggests that in addition to the macro regulatory and industry risks, that all companies have principally the same specific entity risks that impact their individual cashflows and that is also erroneous.

The ability of an entity to attract and sustain debt capital is based on the overall assessment of risk by the debt capital providers. Total entity risk can be defined as the uncertainty of income and cash inflows to the entity and ultimately to the individual suppliers of capital – both debt and equity.

Total entity risk can further be segregated into two principal elements being:

***Business Risk:*** uncertainty of operating income due to industry, sales variability, customer demographic, production process and inherent operating leverage etc.

***Financial Risk:*** uncertainty of returns to capital providers which is influenced by debt levels, with allowable debt capacity measured by debt/equity ratios and the amount of earnings/cash generated to cover recurring financing charges.

While there appears to have been considerable review of the macro factors affecting the electricity distribution industry in Ontario, there has been no proper consideration of the specific entity level risks that impact the total business risk assessment.

In our submission of June 30, 2006 in response to the initial draft of the Proposal, we indicated that there are separate and distinct impacts to individual companies due to the variability of distribution revenue resulting from customer demographics, rate design, commodity pricing and territory served. We have derived Table 1 from the published annual reports of the utilities listed for the year ended December 31, 2005 to demonstrate the variability of revenue per customer (an indicator of the separate and distinct impacts/risks across utilities):

<b>TABLE 1</b>		<b>Net Revenue</b>	
	<b>Customers</b>	<b>/Customer</b>	
London	135,000	313.3	
Hamilton	230,000	333.9	
Veridian	104,000	417.3	
Ottawa	278,000	352.5	
Oakville	55,000	560.0	
Enersource	178,000	581.5	
Toronto	677,000	813.9	

The above analysis, while simple, underscores that revenues and therefore cash inflows are varying substantially across the above noted entities. Additionally, there are different risks associated with the customer demographic producing those cashflows. On this simple basis it is clearly evident that the business risk is not universal, and that the individual entity risk assessment would not be uniform and therefore could not lead to a universal acceptance by capital providers of a 60/40 debt/equity structure for each of those companies.

Using a different source of information and a broader sample, we reviewed the regulatory financial data submitted to the Board by utilities in their 2006 rate applications. This data further emphasizes that there is a substantial degree of variation between distributors with respect to load concentration, total load, customer mix, operating costs, revenue per customer, etc. that would indicate distributors are not more alike than they are different.

In this sample the revenue per customer varies from \$233 to \$713, controllable costs per customer ranges from \$124 to \$418, net fixed assets per customer vary from \$311 to \$2,447 and there is wide range of variance in other financial and statistical data. This data indicates a wide range of variance in the factors influencing business risk such as, quality of operations, management, customer density, customer mix, geographic impacts, size of service territory and age and condition of infrastructure.

There is no indication that Board staff have considered the impact of this information in arriving at their conclusion that “distributors are more alike than they are different with respect to the risks they face”. However, these will be critically important factors

impacting the *actual* financial performance of a company and the risk assessment by its capital providers.

### ***Size of Operations Matter***

Does size and scale of operation impact the debt capacity of an entity? Yes. Yet, the Proposal suggests that the capital structure (while completely ignoring the aforementioned entity risk assessment elements) should be based upon the gas industry where the size differential is sixteen times that of London Hydro and many times larger than that for other distributors. Comparisons to the gas industry where assets are exponentially larger is like comparing the corner variety store to a national grocer and suggesting that like those conglomerates, the variety store should and can sustain an equivalent debt carrying capacity. It clearly doesn't work that way. Yes, size and scale matter.

London Hydro suggests that operating leverage may be a relevant factor. Given relatively similar fixed/variable production cost structures – or in the case of a regulated utility the amount of capital investment for a given fixed and variable distribution revenue returned, the more variable throughput that can be attained for that given level of fixed investment the greater the cashflow and the greater the capacity for debt.

It is unclear and unproven whether the production process and rate design of the gas industry is similar enough to that of the electricity industry to suggest that the risk profile for equivalent sized electrical utilities can be considered the same as gas. Simply put, the comparisons and reference point to the gas industry are erroneous. While the regulatory environment may on its face be similar, recent history would suggest that the electricity industry continues to face more regulatory uncertainty than the gas industry.<sup>1</sup> In addition, the specific entity risks, cashflow risks, overall entity size and operating leverage impact the possible capital structures that can be employed. Those have been ignored in the Proposal and the supporting analysis.

On page 13 of the current proposal, Staff provides the following rationale for revising the fixed debt equity to a proposed structure of 60/40:

*“The natural gas distribution industry has been regulated by the Board for decades and the risks have been examined thoroughly through the regulatory process, unlike the electricity distribution industry. As a result of this history of regulation before the Board, staff is more confident about the current state of infrastructure of the gas distributors. Staff believes that there is a need for significant expansion of investment in electricity distribution infrastructure for maintaining, enhancing and expanding the infrastructure and that this poses additional risks as compared to natural gas distributors. This is reflected in staff’s recommendation for a higher proposed equity.”*

Board staff acknowledges that a thorough understanding of the risks for the electricity distribution industry does not exist, yet the current proposal continues to recommend a

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<sup>1</sup> Since May 1, 2002, there have been significant legislative amendments to the OEB Act and the Electricity Act, 1998 that have impacted the electricity distributors. The role of LDCs in CDM delivery is but one example. In addition, ROE for utilities has decreased while the formula used by the gas industry has remained unchanged.

uniform debt equity structure of 60/40 for all electricity distributors. Staff’s proposals are not supported by a full analysis of the risks inherent in the electricity distribution industry of Ontario. This statement further confirms the fact that no analysis has been made of the risk factors that vary across utilities to determine if the existing debt equity structures as approved in the 2006 EDR process are justified. Additionally, it further supports the observation that no analysis has been performed to support the conclusion that current structures are not justified, and that a 60/40 fixed structure is more appropriate.

### Actual Return on Equity (“ROE”) and Missing Regulation

As a principal second area of concern, London Hydro believes that there has been undue emphasis on the optimum capital structure in isolation of other critical and necessary considerations and regulatory changes. In its original submission, London Hydro stated that the notional capital structure and capital rates suggested in the Proposal will not necessarily be attainable by all LDCs. That is a serious issue as it creates an uneven result across the industry. While for some utilities poor operating cost management may contribute to sub-par financial performance and the ability to financially support that capital structure, in the case of London Hydro, we are comfortable that our operating cost structure is efficient in that we rank quite favorably in relation to our peers. However, given that London Hydro has relatively low distribution rates, and low customer load growth, distribution revenue per customer (Table 1) is quite low. These factors severely restrict London Hydro’s ability to sustain the capital structure that is implied in the Proposal.

We have summarized certain select financial information from published annual reports for fiscal 2005 for certain companies in the industry:

TABLE 2	Net						ROE (%)
	Distribution Revenue	Total Assets	Net Plant (millions)	Earnings	Equity		
London	42.3	257.6	167.2	5.2	120.7	4.3%	
Ottawa	98.0	633.8	470.2	22.6	253.8	8.9%	
Toronto	551.0	2,819.2	1,624.7	92.5	845.9	10.9%	
Enersource	103.5	652.9	394.2	13.4	201.2	6.7%	
Hamilton	76.8	450.3	287.5	12.4	169.9	7.3%	
Veridian	43.4	227.4	124.0	7.9	67.3	11.7%	
Oakville	30.8	200.3	99.9	7.1	69.8	10.2%	

As outlined in Table 2, while the above ROE is impacted by various capital structures, there is a wide range of reported returns. Clearly, the ability to sustain proper capital reinvestment<sup>2</sup> is impacted by these actual returns being achieved. For those that have already attained the proposed capital structure, the impact will be minimal. For those who have not but can, the impact will be a realignment of their capital structure. For those who have not and cannot sustain that structure, the impact will be punitive as

<sup>2</sup> At this time significant investment in electricity infrastructure is required. The Proposal acknowledges the need for capital but does not create an atmosphere that is conducive to the investment of the required capital.

distribution tariffs will be reduced by a notional structure that cannot be attained in reality or at a cost that is higher than anticipated. London Hydro submits that in such circumstances, rates would not be just and reasonable.

***The Dupont Theory***

It should be noted that actual ROE and the ability to provide adequate returns to capital providers is impacted by more than just the capital structure outlined in the Proposal. Capital structure must be considered in context, not in isolation, and it is important that the other elements be equally addressed to ensure a relative playing field in attracting and sustaining capital. To illustrate these considerations we refer to the Dupont System of Return on Equity (“ROE”) analysis which is outlined as follows:

$$\text{ROE} = \text{Profit Margin} \times \text{Total Asset Turnover} \times \text{Financial Leverage}$$

The above relationship outlines that a company’s actual ROE is not only a function of how the capital structure is aligned (Financial Leverage), but also its Net Earnings to Distribution Revenue (Profit Margin) and the efficiency of its asset base in generating revenue (Total Asset Turnover). The Proposal has only addressed the Financial Leverage element of the equation and that in fact has received undue attention.

The equation can be further described as follows:

$$\text{ROE} = \text{Net Earnings/Net Sales} \times \text{Net Sales/Total Assets} \times \text{Total Assets/Equity}$$

Based on the same audited 2005 financial results used in Tables 1 and 2, the derivation of the reported ROE can be analyzed as follows:

<b>Dupont Analysis</b>					
<b>TABLE 3</b>	<b>Net Earnings /Revenue</b>	<b>Revenue /Assets</b>	<b>Assets /Equity</b>	<b>ROE Computed</b>	
London	12.29%	16.42%	213.42%	4.3%	
Ottawa	23.11%	15.46%	249.72%	8.9%	
Toronto	16.79%	19.54%	333.28%	10.9%	
Enersource	12.95%	15.85%	324.50%	6.7%	
Hamilton	16.15%	17.06%	265.04%	7.3%	
Veridian	18.20%	19.09%	337.89%	11.7%	
Oakville	23.05%	15.38%	286.96%	10.2%	

Table 3 was an additional focus of our preliminary comments in our June 30, 2006 submission. London Hydro’s position was that if one compared the net distribution revenue to the rate base of utilities across the industry one would find there are significant differences and that these differences would impact on the company’s ability to earn. Actual ROE and the ability to sustain and attract capital are impacted by much more than the Financial Leverage structure solely focused on by the Proposal. The relationship of distribution revenue to assets or rate base (Total Asset Turnover) and Net Earnings/Distribution Revenue are equally important considerations. For London Hydro we find that despite being a low cost operator, distribution revenue per customer

(Table 1) translates into both lower than average Profit Margin (Table 3) and Total Asset Turnover (Table 3) components of ROE.

The analysis illustrates that there currently is a disconnect between rate base and distribution revenue which has been impacted by the inadequate review of cost to serve studies and possibly rate design through the arbitrary evolution of fixed and variable rate elements in the distribution tariff. These other elements along with Financial Leverage all must be assessed at some level to ensure that rates are at levels necessary to achieve actual ROE and financial performance that will attract and sustain capital. The sole focus of the Proposal is Financial Leverage and that focus is incomplete and unfair to companies.

To further illustrate the impact of the other Dupont elements to the equation and again using the data from 2005 annual reports, we have added Net Revenue to Net Plant which is a better proxy for Rate base and eliminates the impact of non regulatory data included in consolidated statements.

<b>TABLE 4</b>	<b>Net Revenue / Total Assets</b>	<b>Net Revenue / Net Plant</b>	<b>ROE Computed</b>	<b>Adjusted ROE</b>	<b>Delta</b>
London	16.42%	25.30%	4.3%	6.9%	2.6%
Ottawa	15.46%	20.84%	8.9%	17.1%	8.2%
Toronto	19.54%	33.91%	10.9%	11.5%	0.6%
Enersource	15.85%	26.26%	6.7%	10.3%	3.6%
Hamilton	17.06%	26.71%	7.3%	10.8%	3.5%
Veridian	19.09%	35.00%	11.7%	11.7%	0.0%
Oakville	15.38%	30.83%	10.2%	12.9%	2.7%
Maximum		35.00%			
Minimum		20.84%			
Delta		14.16%			

We have adjusted the reported ROE using the Dupont system and assuming that each company was able to attain the same Net Revenue to Net Plant return as the highest in the sample. The results show that for many there would be a significant increase in returns and the ability to attain capital, by addressing the distribution tariff to rate base issue, while holding the capital structure constant. The conclusion being that the Proposal, by only addressing Financial Leverage is imposing a capital structure that may not be attainable for some and is inequitable. There needs to be equal attention to other elements of rate making and a more holistic approach other than tweaking capital structures and rates.

Although the primary concerns of London Hydro are discussed above, London Hydro has some specific comments on the statutory framework for the decisions and other select observations and commentary on other issues of consequence contained in the Proposal.

## **Statutory Framework for Decisions**

Section 78(3) of the *Ontario Energy Board Act, 1998*<sup>3</sup> statutorily limits the Ontario Energy Board (the “OEB” or the “Board”) to set “just and reasonable” rates. Furthermore, the OEB can’t exceed its statutory jurisdiction in its orders to distributors. Orders beyond its jurisdiction and for rates that would not be just and reasonable are simply not lawful. If the Staff recommendation of a mandatory 60/40 debt-equity split was the ultimate outcome of this proceeding then two potential scenarios may occur.

Under the first scenario, the utility does not proceed with the corporate restructuring. At this time, the previous deemed structure would be a significant departure from the previously deemed capital structure and may be even a further departure from actual capital structure of the utility. As the ratemaking structure departs from actual structure of the utility, the ability to assert the resulting rate is just and reasonable becomes more tenuous. The return that would be earned would be diminished to such an extent that the “fair return” standard would not be met.

Under the second scenario, the utility decides to alter its capital structure because the economic reality of not changing the structure is completely unacceptable. There are a number of illustrations of the potential harm that would result from Staff’s proposal if the deemed structure was not adopted. Such financial hardship from the Proposal would effectively have the utility acting under compulsion. The Board does not have the authority to order a capital restructuring of the utility and therefore Board would not have the authority to establish a code that indirectly requires what the Board cannot do directly.

### **Proposed X-factor adjustment of 1%**

The largest operating expenditure for most electric utilities is labour, which can comprise up to 2/3rds of current operating expenditures. In an industry where unionized labour agreements with annual increments of 3% is the standard, and employing a forecasted inflation rate of 2 % overall, utilities would be required to achieve a 10% annual reduction in all non-labour operating costs, in order to meet the target of a 1% total reduction. With many of the remaining costs beyond the control of the utility (e.g. municipal taxes, OEB fees, insurance) and significantly increasing in recent years, it is unrealistic to expect such a reduction in costs.

We believe that the 1% X-factor adjustment is not appropriate for this industry in Ontario. The cumulative negative impact on earnings of the X-factor adjustments over a three-year period will be substantial for most utilities, and in fact the utilities who currently have the lowest rates and lowest cost structures are the ones mostly likely to be penalized by this proposed X-factor adjustment.

Our recommendation would be that an X-factor adjustment should be a variable factor applied across the industry based upon a comprehensive comparator and cohort study,

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<sup>3</sup> S.O. 1998, c.15, Sched. B.

to ensure that it is targeted where it is most needed and that it does not impose financial penalties on those utilities with the lowest costs and lowest rates.

### **Proposed Z-Factor**

The Proposal provides an exhaustive list of situations in which the Z factor may be utilized.

London Hydro supports the inclusion of a Z factor in any formulaic approach to ratemaking to address significant events that are not captured in the existing rates. However, London Hydro remains concerned with attempting to exhaustively define when a factor would be available to a utility. Therefore, any list should be illustrative only.

### **Equity Risk Premium**

In the Proposal, Board staff proposes that only CAPM should be used to set ERP. Board staff has been informed of the viewpoints and expert opinions provided by BMO Capital Markets who have stated that “CAPM is not widely used by the capital markets to determine the relevant cost of equity.”

On page 15 of the current proposal, Board staff advise that “It would be helpful to staff and the Board to understand the arguments and principles that parties believe support an alternative method for setting ERP.” Board staff has been provided with this information by Toronto Hydro through the BMO report in the initial round of comments and input. The current proposals do not adequately address the considerable list of issues, concerns and recommendations offered by the expert opinions received.

Board Staff continues to propose a methodology that is known to have minimal application by those parties making the investment decisions that will impact the utilities. Furthermore, the recommendations by Board Staff would permit a return on equity that is significantly below the natural gas industry’s benchmark utility. Given the shortcomings of the comparison between the electricity and natural gas noted herein and by other distributors, such a conclusion is illogical.

### **Conclusions and Recommendations**

#### *Conclusions*

It is evident that the proposed changes in capital structure and capital rates will significantly reduce the distribution tariffs of some, if not all, distribution companies. To make such adjustments using a uniform capital structure, as it is convenient to do so, while ignoring the uneven consequence to some companies, is incorrect and violates principles of fairness and reasonableness. As we have previously noted the application of one capital structure to all sized utilities dramatically oversimplifies the impact to utilities that do not have equivalent size or scope and therefore the financial capacity to entertain or sustain such a capital structure.

We suggest that the Proposal and supporting analysis is unduly focused on capital structure in isolation of other factors that must be addressed to ensure that rates produce acceptable levels of ROE and cashflows to attract and sustain capital. Without addressing those factors, customers and municipal shareholders will be inequitably treated and an uneven playing field will exist. The companies affected will not have the same ability to attract capital and the distribution rates and capital reinvestment will not be consistent for a given level of customer, despite a uniform obligation to serve customers across the Province.

With respect to the stated objectives of the Proposal, based on our observations herein, London Hydro contends that the following objectives are not achieved:

- ***Ability to raise the financing necessary to invest in distribution infrastructure to enhance service quality and reliability.***

As we have outlined, we believe that an uneven and undesirable result will be achieved due to the imposition of a capital structure that cannot be universally accommodated based on a risk assessment methodology that does not apply or take into account the individual risk profiles of the entity.

- ***Predictability and stability. To provide an environment where distributors and consumers are better able to plan and make decisions.***

The Proposal produces more confusion and leaves more issues unaddressed and creates more uncertainty.

- ***Establishing a common capital structure and incentive framework for all distributors. The objective is to avoid imposing barriers to consolidation within the electricity distribution sector.***

As noted, a common capital structure cannot be universally applied or accommodated and even if it could it would not serve to remove any barriers. We contend that distinct and different capital structures do not present barriers to consolidation.

### *Recommendations*

Given the observations made by London Hydro and the numerous submissions to the Board on the Staff's first draft of the Proposal that were largely unaddressed, that:

- 1) The Proposal be deferred until full and proper analysis of the implications and the related issues, including a detailed a plan to address related issues of rate base and cost to serve and other issues ( all of which impact corporate financial sustainability and just and reasonable rates) are examined and properly discussed with adequate and appropriate levels of stakeholder input;

- 2) In the interim and in the absence of an appropriate risk analysis of the electricity distribution industry in Ontario, the Board should continue to employ the existing debt equity structures that applied to the 2006 EDR methodology by using the existing stratified capital structure related to size of rate base, acknowledging that while also imperfect, it accords with the expectations of the investor/lender community and is much closer to fairness than the current Proposal.

Those are London Hydro's submissions. London Hydro will be participating in the Technical Conference.

Yours truly,  
LONDON HYDRO INC

John Stephenson  
VP, CFO