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ONE Nicholas Street, Suite 1204, Ottawa, Ontario, Canada K1N 7B7

August 14, 2006

VIA EMAIL AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto, ON
M4P 1E4

Dear Ms. Walli:

Re: EB-2006-0088 (Cost of Capital) and
EB-2006-0089 2nd Generation IRM
Vulnerable Energy Consumers Coalition (VECC) Comments

As Counsel to the Vulnerable Energy Consumer's Coalition (VECC), I am writing, per the Board's letter of July 25th, 2006, to provide our comments on the OEB Staff's Discussion Paper on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. The comments contained in this memorandum are in two parts.

Part A deals specifically with the OEB Staff proposals regarding Cost of Capital in Section 2 of the Staff Discussion Paper and **Part B** deals with OEB staff proposals regarding the design and implementation of a 2nd Generation Incentive Regulation Mechanism (IRM) as set out in Sections 3 and 4 of the Staff Paper.

The comments are generally organized according to the various sections of the Staff Paper. In each case, a brief summary is provided of the Staff proposals and followed by VECC's comments.

I also note that with respect to the Cost of Capital, VECC, together with the Consumers Council of Canada, the Industrial Gas Users Association and the London Property Management Association, have sponsored Expert Commentary from Dr. Laurence Booth, Professor of Finance at the Rotman School of Business.

These comments on Cost of Capital are supplementary comments on behalf of VECC only.

VECC appreciates the opportunity to comment and looks forward to participating in the Technical Conference scheduled for September.

If you have any questions regarding the preceding comments on the Cost of Capital please contact Roger Higgin (416 348-9391) rhiggin@econalysis.ca and on the IRM Bill Harper (416-348-0193) bharper@econalysis.ca or VECC Counsel Michael Buonaguro (416-767-1666), mbuonaguro@piac.ca.
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As requested we have provided our comments in a PDF and Word format. We have also sent by courier 3 hard copies.

Thank you.

Yours truly,

Michael Janigan
Counsel for VECC

Part A: VECC Comments on Cost of Capital Proposals

2.1 Theory

The Board Staff Paper summarizes the approach adopted in the 2006 EDR Handbook and makes the following comment:

The cost of capital is very important for distributors since it represents about half of the revenue requirement. In any business, capital is required to acquire assets that will produce income in the future. There is always some risk that the assets will not generate enough income to recover the operating expenses, cost of assets, debt costs, as well as yielding an acceptable return to shareholders.

Comments

Cost of Capital is equally important to ratepayers for the same reason that it comprises about 50% of the distribution revenue requirement.

Dr Cannon's Cost of Equity formulation on which the 2006 Cost of Capital Section is based, is based on Equity Risk Premium (ERP) with an implicit ERP of 380 basis points.

Distribution versus other investment opportunities

Board Staff poses two questions

What return on investment is required to invest in distribution utilities versus other investment opportunities?

Over what period should investors seek a return?

Comment

The Board Staff discussion is most relevant to investor-owned utilities whose common equity is traded in equity markets. There is only one true investor- owned electricity distribution utility in Ontario. The regulatory issue is what return on equity do the current equity holders that are predominantly either the province or municipal corporations. require relative to their alternatives of holding or selling their shares in distribution utilities?

2.2 Ontario Market Conditions and Risks to Electricity Distributors

Government policy objectives rely on distributor sector involvement

Looking to the future, distributors may face challenges arising from government policy respecting the "culture of conservation" and "smart" metering. This is in addition to the continuous need for distributors to invest capital for maintaining, replacing and expanding their electricity distribution infrastructure.

Board staff addresses these issues and challenges in its proposals.

Comments

Government policy objectives are broader than just conservation culture and Smart Meters. The role of LDCs in "conservation culture" is a matter that has yet to be determined between the government, the OEB, the OPA and the distribution utilities. The successful adaption of natural gas LDCs to going conservation programs should be noted as a factor that mitigates potential risk.

2.3 Approach and Components

Staff proposes ERP approach

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Comment

Risk underlies the cost of Capital (Debt and Equity). Risk is commonly accepted as comprised of business risk, financial risk and market risk.

Currently the Ontario Electricity Distribution Sector is dominated by narrowly held licenced/franchised non-publicly traded Companies, so there is no commonly accepted basis to assess the overall financial risk for the majority of utilities. The exception to this type of holding is Veridian Networks Corporation.

Accordingly Board Staff and others must of necessity resort to proxies for determining risk and the appropriate cost of Capital.

Dr Booth in his evidence, sponsored inter-alia by VECC, addresses the issue of risk and concludes that the regulated Ontario electricity distribution sector is less risky than average in North America

Staff proposes to use revealed preference of financial markets

New tools have become available in recent years to allow for the latter approach and one of them is recommended by Lazar and Prisman. This method takes advantage of new data which began to be provided by the Bank of Canada in 2004.

Staff proposes riskless rate = zero-coupon bonds

The new data are estimates of the zero-coupon yield curves that may be inferred from the traded prices of Government of Canada bonds.

Staff proposes inputs be updated annually

Another matter that requires discussion is the issue of updating the cost of capital. A distinction needs to be made between updating: (1) the formula itself; (2) the parameters of the formula; and (3) the inputs to the formula. Staff currently proposes that only the inputs to the formula be updated annually to minimize uncertainty about changing formulae or parameters.

Comment

Dr. Booth addresses the proposed approach in has evidence. VECC commends his analysis and conclusions on determination of the appropriate risk-free return.

2.3.1 Capital structure

Staff proposes a common structure for all distributors and recommends 60% debt and 40% equity

This is a thicker common equity than for Ontario natural gas distribution utilities (which are at a debt–equity ratio of 65/35 and 64/36) but staff believes that this is justified for several reasons. 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.

Is 40% equity sufficient?

Staff is open to hearing other views on all aspects of capital structure. In particular, what would be helpful would be justification and supporting arguments for a higher equity thickness and the principles which underpin differing proposals

Comments

1. Current Equity thickness is based on Dr. Cannon's Study and ranges from 35% to 50% depending on the size of Rate Base Assets. Dr. Cannon indicated that Times Interest coverage Ratio was a factor in his proposal. Board Staff should conduct a check of Times Interest coverage ratios for the current and proposed Debt/Equity ratio for a sample of utilities.

2. The treatment of Preference shares is problematic for two reasons.

First a rate needs to be set and there is no market for Electric LDC preference shares except for the few investor-owned traded utilities.

Second the issue of additional financial flexibility needs to be addressed first.

VECC suggests that allowing preference shares is a just a way to compensate utility shareholders in the general move to higher debt/equity (less equity) ratios than currently allowed.

Dr Booth also concludes that 36% equity is reasonable.

2.3.2 Equity Risk Premium (ERP)

Staff has described above the approach proposed for the riskless rate. This section concentrates on the determination of the ERP.

Is CAPM appropriate?

Staff suggests using only the CAPM to set ERP. 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.

Comment

The problems of the CAPM approach to non-traded utility securities are well known, including the need to select a sample of proxy utilities in order to determine a Beta Coefficient. It has not been demonstrated by either Lazar and Prism or Board Staff that a simple, somewhat more arbitrary approach to determining an ERP, such as that adopted by Dr Cannon, is any less fair or robust.

2.3.3 Return on Equity (ROE) Scenarios

Staff list three factors related to determination of the ERP:

- the sample of firms from which to estimate the average market return;
- the sample of firms from which to estimate the beta; and
- the relevant time frames for each.

Four ERP scenarios based on proxy group membership and short- long-term perspectives

Staff proposes long-term view of rate regulated utiliies

50 bps premium

The ROEs in Table 3 include 50 basis points (bps) because the Board has included this in previous orders as an implicit premium for flotation and transaction costs.

Incentive for investment?

The necessity to raise significantly higher levels of capital for infrastructure upgrading and expansion may justify an additional premium to the ROE for electricity distributors. Staff invites comments as to whether a premium in the range of 50 to 150 bps would be required to provide an incentive for new infrastructure investment. If this were the case, and using the long-term, rate regulated scenario result from Table 3 above, the existing rate base as of 2006 would earn a return of 8.37% while new distribution infrastructure added to rate base in 2007 and beyond would be at an ROE of between 8.87% to 9.87%.

Comments on all aspects of return on equity are invited.

Comments

The purposes of allowing a fair return on equity include providing security to utility bondholders and compensation to utility shareholders for holding the common stock. In the latter case the risk/return balance for Municipal Corporations or the provincial Electricity Financial Corporation is different than the choices facing the average stock market investor in traded securities.

VECCs position is that the focus on market proxies is bogus. The reality of the sector (except for Veridian) is essentially one of publicly held , as opposed to investor owned utilities. The task is to replicate as best as possible a market return for investments of comparable risk.

Even if financial market proxies are appropriate, then the low risk profile of the distribution utilities translates to lower ERP than market.

[See also Comments on incremental capital for Smart Meter Investment]

2.3.4 Debt Rate

Staff makes a distinction between affiliated debt and third party debt. Staff also makes a distinction between new and existing debt.

New affiliate debt at riskless rate plus bond spread

New 3rd party debt at actual

For new third party debt the actual debt rate would be used.

Existing at Board approved

All existing affiliate and third-party debt would be at the previous Board-approved rate.

Staff suggests ST debt be deemed at 8% rate base

As a general principle, staff believes that the term of debt should try to match the life of the assets that are to be acquired with that debt. Thus, for an industry with long-lived assets, the majority of debt should be long term. Nevertheless, some short term debt is needed to provide cashflow stability. There are no general rules that provide guidance. Staff offers as an option that short-term debt, needed to finance working capital, be deemed to be 8% of rate base. This is based on staff's review of Hydro One Distribution's lead-lag study filed in its 2006 EDR rate case (Table 1 on Hydro One's RP-2005-0020/EB-0378, Exhibit D1, Tab 1, Schedule 1, Page 2 of 5).

Comments

VECC agrees that the allowance for Working Capital should be either a percentage of rate base or the requirement indicated by a lead-lag study whichever is less.

The evidence is that the 15% Working Capital allowance is too generous for most utilities and VECC believes that a reduction is warranted.
VECC cannot comment on whether 8% v.s some other number is fair just that a reduction is warranted. [SEE also below VECC Comments on Short term debt rate]

Access to capital

Concerns have been expressed by distributors about access to capital. However, to date, very few Ontario electricity distributors have attempted to issue debt in financial markets. Those that have do not appear to have had difficulty in doing so; nor does there appear to be difficulty in attracting bank financing for capital investments. Staff invites parties to demonstrate if this has not been the case. This will be helpful to the Board in determining whether staff's suggestions on the capital structure and risk premium are appropriate or require adjustment.

Comment

See Dr. Booth's Conclusion on Access to Capital

Incremental smart meter funding

Staff is sensitive to the likelihood of substantial financing needs for the introduction of smart metering. Staff is therefore proposing an adjustment to all distributors' fixed distribution rates (see section 4.3.1 entitled "Allowance for Smart Meter Implementation") to ensure financing does not impose constraints to the smart metering program.

Staff invites comments on alternate proposals on the issue of debt rate and supporting rationale for these.

Comments
Ontario's Utilities are geographically distributed and growth rates (customers and capital) vary across the province. For example the GTA and Golden Horseshoe areas are subject to high rates of growth.

Growth is the most significant factor in determining the financing needs of a utility. The addition of smart meter replacement programs spread out over 5 years does not materially increase capital requirements, except for some smaller utilities. It is not appropriate to increase the equity component of the capital structure, or as Staff seem to imply, increase the return on equity, unless there is clear evidence of financial difficulty as evidenced either by low times interest coverage and/or reductions in bond ratings (for those utilities with rated bonds). No such evidence in the form of financial projections with/without the addition of Smart Meter replacement has been provided.

<u>Other ISSUES</u>

<u>Short term debt rate</u>
The Staff paper seems to disagree with the recommendations of Lazar and Prisman that the average commercial paper rate of the Beta sample utilities be used for short- term debt included in the capital structure.

The discussion paper seems to indicate that the Board-approved rate on deferral accounts of one year be used. This may be distinction without a difference, but the issue is more significant for forward test year rate filing utilities. Under the 2nd Generation IRM a common universal rate such as the average 30-90 day rate for commercial paper, should be used for Capital Structure purposes. For deferral accounts, then the Board would then have the discretion to authorize a different rate, depending on the circumstances related to specific deferral accounts. This dual approach is fair to both ratepayers and to the utilities.

Part B: VECC Comments on 2nd Generation IRM Proposals

Theory and Objectives of 2nd Generation IRM (Section 3.2)

Staff Proposal

- The Staff Paper sets out the following objectives for the 2nd Generation IRM:
    - Provide regulatory certainty while various rate related studies are being carried out,
    - Drive efficiency improvements in the distribution sector
    - Lay the foundation for the third generation IRM
- The Paper also notes that:
    - The 2nd Generation IRM "is a transitional methodology and not an end-state in itself", and
    - The Board needs to put in place a formulaic rate adjustment mechanism that will return distributors to incentive regulation
- Overall, "Staff believes that its current proposal is an effective transitional methodology that balances short-term efficiency, simplicity and time management to allow the Board to approve just and reasonable rates".

VECC's Comments

Goals for 2nd Generation IRM

- **Although not mentioned by Board Staff, in VECC's view any proposed IRM must first satisfy the Board's statutory objectives[1] of:**
    - **Protecting the interests of consumers with respect to prices and the adequacy of reliability and quality of electric service,**
    - **Promoting economic efficiency and cost effectiveness in the distribution of electricity, and**
    - **Facilitating the maintenance of a financially viable electricity industry**
- **Given this prerequisite, VECC agrees that the purpose (or objective) of the 2nd IRM is to act as a transitional methodology until various studies have been completed, full COS reviews have been undertaken for all distributors and a 3rd Generation IRM developed.**
- **However, VECC disagrees with the proposition that one of the goals should be to "drive efficiency improvements". VECC considers this to be an unreasonable objective. The scheme is too short-lived (i.e., one to three years depending upon when an LDC is rebased) and the timing of rebasing too uncertain to truly drive**

[1] *Ontario Energy Board Act, 1998*, Section 1

efficiency improvements. Also, there is insufficient information available to properly design and calibrate an IRM scheme for the Ontario electricity distribution sector. Indeed, this should be one of the objectives of the 3rd Generation IRM.

- **In VECC's view, the primary emphasis should be on developing an IRM mechanism that is both workable and ensures "just and reasonable rates" during the transitional period.**

Relationship to 3rd Generation IRM

- **In VECC's view, the 2nd Generation IRM will not provide a "foundation" for the 3rd Generation IRM but rather just buys the Board and other Parties the time required to develop the next generation IRM. As result, the approach used in the 2nd Generation IRM should, in no way, be taken as a precedent as to how the 3rd Generation IRM is to be structured. The 2nd Generation IRM is a transitional model based on available information. In contrast, the 3rd Generation IRM should be developed from first principles and be supported by research and data analysis as required, with a view to establishing a scheme that will have some longevity to it and satisfy long-term objectives such as encouraging efficiency and supporting industry rationalization.**
- **It is essential that the OEB start working on the 3rd Generation IRM first thing in 2007, if not sooner – in order that sufficient time is available for its development.**

Annual Proxy for Cost of Capital (Section 3.3.1)

Staff Proposal

- There will be two K-factor adjustments – one in 2007 and a second in 2008. There would be no K-factor adjustment for 2009.
- The 2007 adjustment would "numerically approximate" the impact on revenue requirement of the change in ROE arising from the application of the new cost capital approach and updated data. The adjustment would only be applied if the newly calculated ROE differed from the 2006 Board approved 9.0% by more than 10 basis points. The 2007 adjustment would not address changes in embedded debt cost or changes in capital structure. There would be no additional adjustments after 2007 for changes in ROE.
- The 2008 adjustment would numerically approximate the impact of the change in capital structure (for those utilities that are not rebased in 2008). Utilities that are re-based would have the "new" cost of capital method applied in the determination of their revenue requirement.
- Distributors that adopted either a zero ROE or an ROE of less than 9% for 2006 would be exempt from the K-factor adjustment in 2007 (i.e., their K-Factor would be zero).

VECC's Comments

No Subsequent Adjustments to ROE (i.e., in 2008 or 2009)

- **The Staff Paper notes that its proposed proxy inflation rate tracks some changes in market returns and therefore, the K-factor adjustment for ROE is not needed other than to capture the one-time change in methodology. VECC notes that for IRMs that use an economy-wide measure of inflation (such as GDP-IPI) the inflation index will reflect changes in the cost of capital in the economy and will be weighted by the importance of capital in determining the overall inflation index. As the Board noted[2] in its RP-1999-0017 Decision regarding Union Gas Limited's PBR Application, a properly constituted price cap index must include an input price differential to capture difference between the input usage of the regulated entity and the input usage in the Canadian economy overall. This input price differential is typically one of the components that goes into the derivation of the X-Factor in the IRM formula.**
- **The X-factor proposed[3] by Staff is meant to include (among other things) an allowance for input price differentials. However, given that the derivation of the X-Factor is simply based on a survey of precedents from Canada and other jurisdictions it can - at best - be considered to reflect the average input price differential provided for in the IRM plans surveyed. Furthermore, this average input price differential is relative to economy-wide inflation indexes for economies other than just Canada and for industries other than just electricity distribution.**
- **This means that, in reality, the ability of the Staff's proposed inflation adjustment and X-Factor to track changes in market returns will be tenuous at best. In a long-term IRM plan this would be unacceptable. Ideally electric distribution utility data would be gathered and analyzed (similar to the process undertaken for the 1st Generation PBR Plan). However, there is insufficient time to complete such an exercise for purposes of the 2nd Generation IRM. On the other hand, incorporating a specific adjustment for 2008 and 2009 changes in ROE into the IRM formula would likely result in some double counting (as the X-factor does have some provision for input price differentials) and add a significant degree of complexity to the overall scheme. As a result, the Staff proposal may be the only workable solution for the 2nd Generation IRM.**
- **However, in VECC's view, it is essential that the necessary analyses be undertaken to determine input price differentials for the 3rd Generation IRM. It is critical that the OEB defines as soon as possible the data required to support the development of a comprehensive IRM and advises the electricity distributors in the Province accordingly.**

No adjustment for Changes in Debt Costs

- **The Staff proposal does not allow for any changes in the cost of debt to be flowed through as K-factor adjustments. In theory, the inflation and X-factor adjustments**

[2] Decision With Reasons, RP-1999-0017, pages 87-88.
[3] See Staff Paper, page 26.

would track the changes in debt costs as well as ROE. However, the previous comments with respect to ROE adjustments also apply for the cost of debt.

- In the case of debt costs there is an additional issue that VECC believes requires clarification. Under the revised July 25th Staff Proposal, distributors would be permitted to apply for Z-factor adjustments to recover costs that satisfy the four eligibility criteria. Conceivably increases in debt expense (i.e., the average cost debt) due to refinancing or the need to finance new investments could be considered as meeting the eligibility criteria since actual cost of debt is beyond management's control as is the need to re-finance or respond to customer growth.
- A question therefore arises as to whether changes in the embedded cost debt would be eligible for consideration as a potential Z-factor. If the answer is yes, then consumers will require some assurance that the reverse situation will trigger similar consideration- namely that the necessary Z-factor applications will be made where a reduction in distribution rates is warranted due to a change in the average cost of debt.
- A related issue is whether changes in the embedded cost of debt should be a consideration in the selection of distributors for rebasing. Again, if the answer is yes, then fairness requires that it be consideration be equally applied to both reductions and increases in the embedded cost of debt. This would require that distributors be held accountable for reporting both anticipated and actual debt cost changes to the OEB.

No adjustment for Distributors with ROE < 9%

- VECC is concerned that when these Distributors made the decision not to apply for a 9% ROE for 2006, there was no indication that this decision could impact returns for the following years as well, Not allowing any adjustment for ROE for these utilities could prove to be problematic, particularly if the distributors concerned are not rebased until 2010. There are only a handful of such utilities and they should be given the option of early rebasing (i.e., 2008) and/or incorporating the allowed ROE into their 2007 K-Factor, if desired.

10 Basis Point Trigger for ROE Change

- VECC does not agree with the 10 Basis Point trigger for ROE change. Depending upon when the distributor is re-based, the new ROE could be in place for up to three years.

Mechanics of the K-Factor Adjustment (Appendix C)

Staff Proposal

- In response to comments received on their first Draft, OEB Staff has provided additional details (see Appendix C) as to how the K-Factor would be calculated and applied.
- The Proposal calls for the 2007 adjustment to be developed using a large sample of distributors – excluding those with 2006 ROEs of less than 9% or with complex 2006 rate models.
- For each distributor in the sample the change in Base Revenue Requirement for 2006 would be calculated (using the distributors' approved 2006 EDR model) assuming the updated 2007 ROE along with the change in PILs/taxes due to the change in net income. A percentage change in Base Revenue Requirement would be determined for each distributor and the results would be grouped by the four capital structures currently in effect. A (simple) average adjustment factor would then be determined for each capital structure grouping and applied to each distributor in capital structure category.
- For the 2008 capital structure adjustment, the same sample would be used as for the 2007 adjustment. For each distributor, the impact on the 2006 Base Revenue requirement (re-estimated using the 2007 ROE) of now also changing the capital structure would be determined. Then, similar to 2007, an average adjustment factor would be determined for each capital structure category and applied to all distributors in that category.

VECC's Comments

Use of an Average K-Factor by Capital Structure Category

- **Analysis of the 2006 Rate Application data posted on the Board's web-site indicates that the return on equity component of the base revenue requirement can range from less than 7% to over 20% of total distribution expense for distributors that fall within the same capital structure category (even after excluding those distributors requesting an ROE of less than 9%). This suggests that the individual K-Factors could vary widely, with the value for some being more than three times the values for others in 2007.**
- **Similarly, based on the 2006 Rate Application data, the total return varies from less than 20% to almost 60% of distribution expense for distributors with the same deemed capital structure (even after excluding those distributors with ROEs of less than 9%). This fact combined with the observation that the average cost of debt varies across distributors suggests that the individual K-Factors will also vary widely in 2008 for distributors with the same deemed capital structure in 2006.**
- **Given this wide variation, VECC believes that specific K-Factors should be determined for each distributor for 2007 and 2008, in order to ensure that the**

resulting rates are "just and reasonable". Also, given that Staff's Proposal was to use a "large" sample of distributors, VECC does not believe the additional work required would be that significant.

K-Factor Calculation

- **VECC considers the proposed methodology for determining the actual K-Factor values for an LDC to be reasonable provided the income and capital tax rates used are updated to 2007 and 2008 values as applicable.**

Term and Starting Base (Section 3.3.2)

Staff Proposal

- Staff proposes that the starting point be the 2006 approved rates.
- Staff has disagreed with various parties who suggested that, where 2006 rates were based on 2004 costs, the values for 2007 should be adjusted to reflect three years' of escalation as opposed to just one.
- Staff has proposed a term of up to three years, depending upon when the rebasing for each distributor takes place (i.e., 2008, 2009 or 2010).

VECC's Comments

Term

- **VECC notes that there is an inconsistency between the currently proposed term of three years which results in all distributors being rebased by 2010 and the commitment made by the Board Panel[4] overseeing the 2006 EDR Process that all distributors would be rebased in 2008. However, in VECC's view, the experience of the 2006 EDR approval process has clearly demonstrated that it would impractical to try to fully rebase all distributors by 2008. Particularly, if the resulting rates are expected to form the "base" for an extended IRM period.**
- **In VECC's view, the Board and other parties will be sufficiently challenged by the 2010 target date for full rebasing of all distributors. As result, VECC accepts the 3-year term as a practical necessity. Having said this, VECC is also of the view that the term should be no longer than is necessary to complete the rebasing of all distributors.**

Starting Point

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[4] EDR Issues Day, Volume 1 (November 1, 2004), paragraph 579

- **VECC agrees with OEB staff about there being no need to adjust for the fact 2006 rates were generally developed based on 2004 costs. VECC notes that the 2006 EDR process permitted distributors to include both Tier 1 and Tier 2 adjustments to their 2004 costs in order to help normalize and update them. Furthermore, OEB Staff has indicated that distributors that are facing significant cost pressures can petition the Board and request early selection for rebasing.**

Form (Section 3.3.3)

Staff Proposal

- The Board Staff proposal calls for a price cap form of IRM, as opposed to a revenue cap or a yardstick/benchmarking framework.

VECC's Comments

- **VECC agrees with Board Staff that modeling and data requirements likely preclude the use of a yardstick/benchmark framework. Having said this, VECC recommends that work be initiated to support such an approach for possible use in the 3rd Generation IRM as soon as possible.**
- **VECC also agrees with use of price cap over revenue cap. Use of a price cap is consistent with past application of IRM in Ontario for both gas and electricity distributors. Also, adoption of a revenue cap uses somewhat the same formula but then requires that the results be translated into "rates". VECC considers the price cap approach to be a more straightforward approach. It also maintains the relationships among the various customer classes rates until the Cost Allocation Informational Filings are completed, diagnosed and any necessary changes implemented.**

Price Escalator

Staff Proposal

- Staff recommends using the Canada GDP-IPI for final domestic demand as the inflation escalator.
- The suggestion to use the Canada value as opposed to the Ontario value is based on the fact that the Canada value for the previous year is "published" by the end of February (whereas the provincial value is not available until late April). Given the May 1st date for rate changes, with the provincial value there would not be sufficient time for rate approvals and implementation. Furthermore, Staff proposes to use the change in the index from 4th quarter of two years ago to the fourth quarter of last year.

- Finally, the Proposal recognizes that the index can be subject to future revision and suggests that any revisions be captured in the next year's rate adjustment. However, they propose to limit the provision for such adjustments to only the prior year.

VECC's Comments

Use of a Macroeconomic Measure

- **VECC agrees with the Staff proposal to use of a macroeconomic index (such as GDP-IPI) as the price escalator. The strongest point in favour of using a macroeconomic measure is that it is readily available. Indeed, there is no "available" industry-specific index even if Board wanted to consider one. Under the current Electricity Reporting and Record Keeping Requirements distributors annually file statistics on performance based regulation related information. However, this data is not available publicly and, to VECC's understanding, has not been analyzed by the Board. As a practical matter, the 2nd Generation IRM must rely on a macroeconomic index.**
- **However, for purposes of the 3rd Generation IRM it is important that industry specific escalator be developed. Even if industry specific index is not used as the escalator in the 3rd Generation IRM formulation, it will be necessary to develop historical data for such an index in order to determine the input price differential between the electricity distribution industry and the economy overall for inclusion in the X-Factor determination.**

Use of GDP-IPI

- **VECC also agrees with the Staff proposal to use the GDP-IPI (final domestic demand) for the same reasons as noted in the Staff Paper.**
- **While the use of the 4th Quarter over 4th Quarter change represents the most current "annual change", VECC notes that the Quarter over Quarter changes have typically been more volatile than the changes in the annual values. However, over a number of years the volatility averages out to roughly the same result[5]. Given this result and the short-term for the 2nd Generation IRM VECC believes the year over year change in the annual GDP-IPI value should be used.**

[5] Please see the LPMA Comments for details

X-Factor (3.3.5)

Staff Proposal

- The Staff proposal calls for an X-Factor of 1% - based on an "average" of the X-Factor precedents reported by their consultant Dr. Lowry for companies that employed a macroeconomic inflation measure.

VECC's Comments

- **The X-Factor captures more than just expectations regarding productivity/efficiency improvements. Given that a macroeconomic inflation index will be used, the X-Factor must also capture:**
    - **The Input Price Differential (i.e., the difference between price changes in the economy and price changes for the electricity distribution sector), and**
    - **The Productivity Differential (i.e., the difference between productivity improvements in the electricity distribution industry and the economy overall).**

  As a result, in VECC's view, arguments by distributors that they are unable to attain a level of productivity improvement commensurate with the proposed X-Factor are comparing "apples and oranges".
- **A review of the PEG results indicates that for the 10 companies where a macro economic inflation measure (GDPPI or CPI) was used the simple average for the various X-factors is 1.16 and not 1.01. Similarly, restricting the average to those utilities using GDPPI yields an average of 1.13**
- **During the stakeholder session, Board Staff indicated that LDCs would be able to petition the Board for early rebasing (i.e., in 2008 as opposed to 2009 or 2010). On this basis, it is reasonable to conclude that the LDCs who will be in the plan for 2-3 years are those that are best able to manage their costs and achieve efficiency improvements under the plan. VECC therefore believes that it would be reasonable to use a value which is slightly higher than average and suggests that an X-Factor of 1.2% would be reasonable.**
- **In VECC's view the foregoing discussion also highlights the types of analyses that will be needed to support a comprehensive 3rd Generation IRM. To this end, VECC reiterates its earlier comments about the need to start defining and gather the necessary data to support the development of the 3rd Generation IRM as soon as practical.**

Contingencies and Mid-Term Issues (Section 3.3.6)

Staff Proposal

- The original June 2006 Staff Proposal did not include a provision for Z-Factors or Off-Ramps. However, the current Proposal includes a provision for Z-Factor adjustments that are beyond the control of the distributor's management and meet a materiality threshold test.
- The materiality tests for Z-factors are the same as those used in the 2006 EDR process: 0.2% of total distribution expense before taxes in the case of "expenses" and 0.2% of net fixed assets in the case of capital cost recovery.
- The Proposal continues to call for no Off-Ramps.

VECC's Comments

- **The Staff Paper proposes that Z-Factor adjustments be limited to the examples listed which are changes in regulation, changes in accounting or tax-rules and natural disasters. However, in VECC's view, a reasonable application of the proposed criteria could trigger Z-Factor adjustments for a number of other reasons. As indicated previously, a cogent argument could be developed that a material increase in embedded debt costs due to refinancing was eligible for a Z-factor adjustment if market debt rates where higher the original cost of debt. Similarly, under the Distribution System Code, distributors are required to follow "good utility practice" in operating, maintaining and expanding their systems. Thus distributors experiencing increased equipment failures and/or maintenance needs could legitimately argue that the need to respond is "beyond their control".**
- **Given this wide potential scope for Z-Factors, VECC is concerned that the provision for Z-factors is one-sided. In VECC's view, distributors are unlikely to apply for Z-factors that would result in "refunds" to consumers. There is a need for mechanisms to help address this and create a level playing field for consumers. A number of options are available to the Board:**
    - **First, distributors experiencing extraordinary over-earnings should be targeted for early rebasing. However, this measure has limited use since the financial results used for such matter will be two years outdate relative to the rebasing year. (e.g. When determining who to rebase for 2008, at best 2006 financial results will be available).**
    - **Second, the OEB must make public the detailed annual financial results (per the RRR filings) of Distributors and make them readily accessible to interested parties. These filings must be prepared and submitted in a format that permits all parties to readily determine the ROE that has actually been earned. Unfortunately, the filing date for such materials (April 30th of the next year) is such that it can not be factored into the rate determination process[6].**

  In VECC's view the Board should implement both of these suggestions. However, this will not be sufficient to address the asymmetry of the allowing Z-Factors.

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[6] Please also refer to VECC's comments on Section 4.1 - Implementation

- **In order to fully address the problem, there would have to be the capability for parties to pursue and seek "refunds" (perhaps at the time of rebasing) for favourable Z-factors that occurred during the 2nd IRM period. An alternative and simpler approach would be to introduce an earnings sharing mechanism for over-earnings. See the discussion in the next section for more details.**
- **VECC also notes that even if Z-Factors are not allowed for under the 2nd Generation IRM Code, distributors would still be able to apply for an exemption from the Code and seek a Z-Factor "type" adjustment from the Board. Given this reality and Staff's perspective that "an incentive regulation scheme should limit reliance on Z-Factors", VECC believes that the Code should not include a provision for Z-Factors. Rather, individual distributors seeking to obtain a company-specific Z-factor should be required to apply for an exemption from the Code.**
- **In VECC's view this would ensure that Z-factor applications were only made when truly warranted and that the applications received full scrutiny by all interested parties. VECC notes that for generic issues such as tax or accounting changes the Board could initiate (on its own motion) a change to the Code to implement the necessary Z-Factor for <u>all</u> distributors. However, VECC would emphasize that exclusion of Z-Factors from the Code does not obviate the need for an earnings sharing mechanism as distributors are unlikely to seek Z-Factor Code exemptions in order to reduce rates.**

Earnings Sharing Mechanism (Section 3.3.7)

<u>Staff Proposal</u>

- Staff recommends that there be no earning sharing mechanism on the grounds that "it is thought to reduce the distributor's efficiency incentive".

<u>VECC's Comments</u>

- **VECC disagrees with the Board Staff proposal for the following reasons:**
    - **The 2nd Generation IRM is meant to be a transitional methodology, only lasting a limited number of years. It is unlikely that it will generate much in terms of efficiency given the short-term and uncertainty on the part of individual distributors as to when they will be rebased. In VECC's view there is little to be lost in terms of efficiency gains by implementing an earnings sharing mechanism,**
    - **There are opportunities for LDCs to address unfavourable earnings through Z-factors (whether included or excluded from the Code) and self-nomination for early rebasing. There is a need for counterbalancing protection for consumers in the event that there are over-earnings.**

- **Board Staff has suggested that over earnings could be one of the "factors" considered in determining which distributors will be re-based. While a useful factor in making such decisions, this will only protect consumers with respect to future rates. It does not "protect" consumers who have already paid too much. Furthermore, Board Staff is suggesting that the decision on who should be rebased in 2008 should be made in March of 2007. This is well before utilities are required to report their 2006 financial results, therefore the decision will have to rely on 2005 financial data. Over earnings in 2006 will at best trigger rebasing in 2009. Also, if the decision is made in March 2007 as to which distributors will be rebased in 2009, then any financial data indicating potential over earnings will be 4 years out of date.**
- **While this statement may be directionally correct, the benefits associated with excluding an earnings-sharing mechanism must be weighed against the costs to other stakeholders in the event of over-earning.**
- **Overall, as an interim/transitional methodology, a key focus of the 2nd Generation IRM should be on just and reasonable rates. Earnings sharing is required to "protect consumers".**

- **In VECC's view, the earnings sharing mechanism should apply to earnings in excess of 100 BP above the approved ROE and the sharing should be on a 50/50 basis. The 100 BP is reasonable as it represents a value that is significantly higher[7] than the materiality limit suggested for Z-Factors. For 2007, the approved ROE would be the value adopted by the Board for the 2007 IRM adjustment. For 2008 and 2009, the approved ROE would be the ROE adopted for distributors that were being rebased in the respective years.**

Service Quality

Staff Proposal

- Staff proposes that the OEB resume its SQR review to finalize further appropriate refinements to the SQR regime. They call for the results to be implemented by means of an amendment to the Board's DSC and be mandatory.

VECC's Comments

- **VECC generally agrees with the Staff proposal on this issue. Furthermore, VECC believes it is critical that the SQR review and the resulting Code amendments must**

[7] For those distributors whose 2006 EDR Application information is posted on the Board's web-site, 100 Basis Points is more than 10 times the materiality limit proposed for Z-Factors for over half the distributors and over four times for all such distributors.

be completed prior to the commencement of the 2nd Generation IRM – i.e., by April 31st, 2007.

- **VECC notes that the initial draft of the Staff Proposal included provisions for quarterly reporting of SQI's and publishing of the results on the Board's web-site – both of which have been dropped in the July 25th draft. This is the one area where VECC disagrees with the Staff Proposal. In VECC's view frequent and, more importantly, public reporting of SQIs is a critical element of any IRM. There is significant risk of Board exposure in the event that disclosure is not timely.**
- **In the absence of full rate proceedings, the <u>public reporting</u> of SQIs is needed to ensuring transparency and accountability for performance. It will help to ensure that utilities do put forward the effort to meet and perhaps even exceed the standards. Also, the Board's web-site should include not only the most recent SQI results for each distributor but also historical values to provide perspective. With respect to frequency of reporting, VECC suggests that it should be at least semi-annually – for the same reasons as noted in the initial Staff draft.**

Reporting and Data Requirements (Section 3.3.9)

<u>Staff Proposal</u>

- Staff does not propose any additional reporting requirements for the 2nd Generation IRM beyond that contemplated in the Service Quality Indicator proposals.

<u>VECC's Comments</u>

SQIs

- **As noted above, VECC believes that the frequency of reporting of SQI's should be increased to semi-annually and the SQI reports (along with comparable historic data) should be published on the Board's web-site.**

Financial Data

- **Currently much of the financial information filed with the Board by distributors as part of the Electricity Reporting and Record Keeping Requirements is considered confidential. Furthermore, even information which is not confidential is not readily accessible.**
- **VECC believes that distributors should be required to file and the Board should <u>post on its web site</u> annual financial results (i.e., the trial balances) at the same level of USoA detail as was presented in the 2006 EDR applications.**

Implementation – Determination of Rate Plan Groupings (Section 4.1)

Staff Proposal

- Staff indicates that it will commence a study to design a process to select the distributors for rebasing in each of 2008, 2009 and 2010. Possible criteria that could be used include:
  - Comparator and cohort information screening (e.g. costs and rates),
  - Urgency of cost allocation issues,
  - Prior direction in a Board Decision,
  - Need and ability to implement new rate design, and
  - Financial viability and realized earnings (e.g., significant over/under).
- Staff also indicates that it will hold stakeholder consultations on this design process with an aim to announcing in March 2007 (at a minimum) the first grouping of distributors to be rebased in 2008.

VECC's Comments

Decision Date for Selection of Distributors for Rebasing

- **VECC agrees that realized earnings should be a key factor in selecting distributors for rebasing. However, if the decision is to be made by March 31st, 2007 the most recent data available will be that for 2005 as the previous year's financial results will not be available. Also, the final tranche of Cost Allocation informational filings will not be submitted until February 28, 2007. It is difficult to see how the Staff review of these filings can be completed, Staff recommendations developed and stakeholder input received in time to decide which cost allocation issues should be addressed in the 2008 rebasing before the end of March 2007. Overall, VECC does not see March 2007 as a realistic deadline for establishing which distributors will be rebased in 2008.**
- **VECC considers mid-June to be a more realistic and useful date. This would allow the process to consider the previous year's:**
  - **Financial Results as distributors are required[8] to file their audited financial results (and trial balance in the USoA) by April 30th the next year, and**
  - **SQI results which are also reported to the Board by April 30th.**

  It would also allow more time to assess the results of the cost allocation filings, although there may still not be sufficient time to formulate the required input to the rebasing decision process.

Selection of Candidates for 2009 Rebasing

[8] Under the RRR, distributors are required to file financial data and audited statements by April 30th of the next year.

- **The Staff paper suggests that the decision as to which utilities will be rebased in 2009 could be made in March of 2007. While it would be simpler to identify the timing of the rebasing for all distributors at the start of 2nd generation IRM, in VECC's view, this may not be practical. Circumstances could change and more current data on financial or service quality performance should be taken into account when determining who should file for rebasing in 2009. VECC believes the decision regarding which distributors to rebase in 2009 should be made in the second Quarter of 2008.**

Determination of the Rate Adjustment

<u>Staff Proposal</u>

- For purposes of applying the 2nd Generation IRM Board Staff proposes that the following items (which are included in the 2006 approved distribution rates) be excluded from the "rates" to which the escalation factor would be applied
    - Allowance for Smart Meters. Instead, for selected distributors the monthly service charge for all customers would be increased by $1. while for the balance the charge would be increased by $0.30 in 2007
    - C&DM. Instead these amounts would be dealt with separately.
    - Regulatory asset recovery.
    - Any distributor specific rate riders.
- Contrary to the initial draft, Staff is now proposing that the distributors' allowance for taxes (PILs etc.) be adjusted by the proposed price cap index. Changes in tax rules would be dealt with as a Z-factor.
- Staff proposes that, to the extent possible, an incentive regulation scheme should limit reliance on the creation of new deferral accounts to well defined and well justified cases only. The disposition of deferral and variance accounts would be dealt with at rebasing.
- Finally, Staff proposes that the price cap index be applied uniformly across all customer classes and to both the monthly fixed rate and the volumetric rate. The index would not be applied to the specific service charges.

<u>VECC's Comments</u>

Allowance for Smart Meters

- **While not specifically stated in the Staff Paper, VECC assumes (and supports) the following:**

- **Funds collected under the Smart Meter adders will be credited to the variance accounts that have been established for each LDC – per the Generic Issues decision issued as part of the 2006 EDR process.**
  - **Provisions for any increase in the Smart Meter adder after 2007 would be made through an amendment to the Code which would be subject to public review and input.**
- **VECC is unsure as to the basis for selecting the nine distributors eligible for the $1.00 increase in fixed customer charges. The Staff Proposal makes reference to "distributors currently working to achieve the government's target of smart meter installations for the end of 2007". However, VECC notes that only 6 of the 9 distributors referenced in Paper are included in the Ministry's proposed Regulation – Smart Meters: Discretionary Metering Activity and Procurement Principles.**

C&DM

- **Again, while not specifically stated, VECC assumes that the C&DM amounts under discussion are any post-3rd tranche spending included in the 2006 rates. In VECC's view, this is the appropriate C&DM spending to be excluded from the price cap index.**
- **The Staff Paper does not offer any details as to how C&DM will be dealt with outside of the price cap index. In VECC's view, C&DM could be addressed as follows:**
  - **For those distributors with no post-third tranche spending, there could be a deferral account where such spending would be recorded. This account could be "cleared" at some point in the future (e.g., at re-basing) and at that time the merits of the programs reviewed and a determination made as to whether they were appropriate). Alternatively, distributors could apply for a C&DM rate rider supported by proposed C&DM programs and costs and an associated variance account. However, this approach would increase the level of regulatory activity/oversight required during the 2nd Generation IRM term.**
  - **For those with some post 3rd tranche spending their 2006 rates, the 2006 C&DM spending would have to be back out of the 2006 rates prior to escalation[9]. This would require "re-running" the 2006 EDR models for a limited number of distributors. In VECC's view such a step is necessary. Otherwise, distributors will continue, in 2007 and possibly beyond, charging customers for programs whose costs were fully recovered in their 2006 rates. Again, post-2006 expenditures could be posted to a deferral account.**

Taxes

[9] Note: As an alternative, the incremental 2006 C&DM spending could be left in the rates subject to escalation. However, in this event, the incremental revenues should be tracked in a deferral account. In order to identify these incremental revenues it would be necessary to re-run the 2006 EDR model.

- **The initial Staff proposal called for taxes to be calculated outside the IRM scheme whereas the current proposal includes taxes in the rates subject to adjustment by the price cap index. Changes in tax rates etc. would be dealt with as a Z-factor.**
- **VECC notes that the current proposal is easier to implement. However, VECC also notes that there are currently a number of proposals for further changes in capital and income tax rates over the 2nd generation IRM period at both the Federal and Provincial levels. These proposed changes are likely to trigger the materiality criteria for a Z-factor adjustment for many distributors. VECC suggests that tax changes for 2007 and 2008 should be captured in the K-Factor adjustments for the corresponding years and, for 2009, a generic Z-Factor adjustment be incorporated into the Code by the OEB to address any tax changes.**

Deferral and Variance Accounts

- **VECC believes that new variance and deferral accounts should not be permitted under the Code. Instead they should be positioned as requiring an exemption to the Code. This would ensure that they are only requested under well-defined and well-justified cases. It would also ensure that the merits of such accounts were subject to full discovery and review.**

Conclusions

- **VECC generally supports the 2nd Generation IRM proposal put forward by Board Staff – with the specific changes outlined below. However, this support is not based on the view that the proposal represents a comprehensive and effective performance regulation plan. Rather VECC's support is based on the pragmatic recognition that neither the time nor the data is currently available to develop a more refined approach and that (with the amendments suggested) the proposal should provide just and reasonable rates for the duration of the transition to a more robust 3rd Generation IRM.**
- **VECC is concerned that there is an asymmetry of information and opportunity under the Staff proposal that needs to be addressed if the OEB is to protect the interests of consumers with respect to price. The financial and service quality information available to the Board and other parties when selecting distributors could be dated by more than a year. Only the distributors have more recent data. Furthermore, it is left to the discretion of the distributors to:**
  - **Petition for early rebasing consideration,**
  - **Request Z-factor adjustments, and**
  - **Seek exemptions from the IRM code.**
- **To address this regulatory imbalance VECC believes the Staff Proposal must be altered as follows:**
  - **Individual distributor financial and SQI data must be publicly reported and readily accessible through a medium such as the Board's web-site.**

- **The selection of candidates for rebasing should be delayed until the financial and SQI data from the previous year can be considered**
    - **The X-Factor should be increased to 1.2%**
    - **Requests for Z-Factors and Deferral/Variance Accounts should be considered as outside the IRM scheme.**
    - **An earnings sharing mechanism should be introduced for earnings in excess of 100 Basis Points above the approve ROE and the sharing should be on a 50/50 basis.**
- **To be fair to both consumers and distributors, the K-Factor adjustments for 2007 and 2008 should be determined on distributor specific basis.**
- **Other refinements recommended by VECC include:**
    - **There should be no 10 Basis Point trigger for ROE changes.**
    - **The inflation escalator should be based on the annual change in GDP-IPI (as opposed to the 4th Quarter over 4th Quarter change)**
- **It is critical that the development of the 3rd Generation IRM start as soon as possible. Otherwise, the data shortcomings associated with the current proposal will continue to exist and confound the Board's ability to develop a more comprehensive and robust IRM next time around.**