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VIA E-MAIL AND WEB POSTING

December 20, 2006

To: All Participants in Proceedings EB-2006-0087, EB-2006-0088 and EB-2006-0089
All Licensed Electricity Distributors

**Re: Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089)
Issuance of Report of the Board and Instructions for Filing 2007 Rate Applications**

Today, the Board issued its final "Report of the Board on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors". A copy of the Report is attached and is available from the Board's website at www.oeb.gov.on.ca.

The Report details the Board's policies on the cost of capital and 2nd generation incentive regulation (2nd Generation IRM) and includes guidelines to help parties understand how the policies will be implemented and filing requirements to guide distributors in the preparation of their rate applications for the 2007 rate year. The target date for filing those applications is January 26, 2007. Details are outlined below.

On November 30, 2006, the Board issued a draft of its report for comment. That report built upon the work of Board staff and the input of interested parties since this consultation was initiated in April of this year. The Board received 11 submissions in response to its November 30, 2006 draft report. In light of comments received from interested parties on the draft report, the Board revised the report in order to improve the clarity of the policies.

The Revisions

Some distributors objected to the Board's policy of a common capital structure for all distributors, regardless of size, on the basis that size is a proxy for risk. Although the Board continues to believe a common structure is appropriate, the Board recognizes that some distributors may face materially different risks. The Board's final Report clarifies that distributors that believe that their risk profile is materially different from that of other distributors may raise this issue at rebasing.

Some parties asked for clarification on the treatment of variable-rate debt. In the Board's draft report, the Board indicated that it would use the deemed long-term debt rate. However, in the final Report the Board now clarifies that this debt rate will be adjusted at the time of the distributor's rebasing, regardless of whether the distributor makes the request for the change.

Distributors sought clarity on the return on equity (ROE) updating process with regard to the 50 basis point premium for floatation and transaction costs. As stated in its Report, the Board's ROE update method will continue to include an implicit premium of 50 basis points (0.5%) for floatation and transaction costs. The Board wishes to clarify that this premium is included in, and not an addition to, the equity risk premium. This has been the case ever since the Board first introduced the premium in the early 1990s, and is similar to the policies of other Canadian regulators.

Comments received from several interested parties assumed that the Board's cost of capital policies are transitional in nature. In addition, many interested parties sought clarification on cost of capital implementation. The final Report confirms that the Board does not anticipate reviewing this issue again in the context of third generation incentive regulation. Also, to help parties understand how the cost of capital policies will be implemented, the Board has added a section to its Report to outline further details (see sub-section 2.3.3 in the Report). Specifically, a distributor's transition to the common deemed capital structure will start in 2008 regardless of whether the distributor rebases in that year or continues to be subject to 2nd Generation IRM. Other cost of capital parameters – updating of the ROE and long term debt rate, incorporating the deemed short-term debt rate, and implementing the short term debt component in the capital structure – will be implemented when a distributor files a cost-of-service rebasing application.

One interested party noted that it would be clearer if the Board provided the specific series for all of the assumptions (e.g., price escalator) referenced in the Board's report. This has been reflected in the Report.

One interested party's comments on Z-factors brought to light other considerations that the Board believed needed to be reflected in its final Report. First, for 2nd Generation IRM, Z-factors should be limited to changes in tax rules and to natural disasters. The Board believes that for 2nd Generation IRM, Z factors should be limited to events genuinely external to the regulatory regime and beyond the control of management and the Board – changes in Board policy should not be included. The Board can always assess the implications of such changes and make provision for them at the relevant time. Further, given the potential flexibility around the application of accounting rules changes, the Board concludes that Z-factor treatment in this area is not required for the relatively brief duration of 2nd Generation IRM. Therefore, accounting rule changes should not be a Z-factor for 2nd Generation IRM. The Board has therefore decided to modify the eligibility criteria for Z-factor amounts. The "inability for management to control" criterion and the 75% qualifier in the "causation" criterion have been deleted. The Board does not believe these are necessary because of the Board's limitation on Z-factors for 2nd Generation IRM to two specific events – tax rule changes and natural disasters. Further, the "prudence" criterion effectively addresses management's control over Z-factor amounts.

Additional Comments Received

Consumer groups reiterated their concerns over the potential for distributors to over- or under-earn under the Board's cost of capital and 2nd Generation IRM policies. In response, the Board advises interested parties that on December 19, 2006 the Board issued for comment a letter and discussion paper regarding the mapping of distributors into the three

tranches for rebasing. In that paper, earnings level and self-nomination requests are included amongst other criteria to be considered.

Comments received from two interested parties suggest that the Board should re-iterate that its cost of capital policy to deem 4% of short-term debt in the debt component of a distributor's capital structure is not linked to or reflective of the Board's views on an appropriate level of working capital. The Board confirms that, throughout this consultation, there has never been an intention to have short-term debt and working capital necessarily aligned.

One group of distributors commented that the Board's proposed short-term debt rate is too low, and recommended an alternative method of assigning a rate. The Board's approach uses a method consistent with what the Board's Chief Regulatory Auditor has developed – a method that has been accepted by the Board for calculating carrying costs on deferral and variance accounts. Alternate approaches may be available that could be developed with some work, but they would be inconsistent with that used for short-term carrying costs.

Many interested parties commented that they generally accept the simplified approach that the Board has adopted for 2nd Generation IRM and provided suggestions as to what issues and options should be considered in the third generation incentive regulation regime. The Board has taken note of these comments and will consider them once work has started on that initiative in the first quarter of 2007.

One interested party expressed concern that a revitalized service quality regulation (SQR) regime will not be in place for the 2nd Generation IRM. The Board advises that, as indicated in its draft 2007 – 2010 Business Plan, it will have the SQR regime in place for 2nd Generation IRM.

One distributor sought clarification on how the Board will use benchmarking data at rebasing. The Board reminds interested parties that it is currently consulting on these matters in a separate benchmarking study (EB-2006-0268) on the comparison of Ontario electricity distributors' costs.

One group of distributors provided comment on how the Board might provide the allowance for smart meter implementation with the 2nd Generation IRM rate adjustment. The Board has communicated separately to distributors that the process for approval of additional requirements for funds related to smart meters is under review, and will be dealt with shortly. The Board will advise parties of how changes will be implemented.

All documents related to this consultation are available for public inspection on the Board's web site at www.oeb.gov.on.ca and at the office of the Board during normal business hours.

Process and Requirements for 2007 Distribution Rate Applications

The 2007 electricity distribution rate application model (the "2007 IRM Model") has been developed to be used by distributors in applying for their 2007 rate adjustments based on the policies set out in the attached Board Report. Distributors will be required to make a number of data entries from their approved 2006 EDR Model, including the complete approved 2006 EDR tariff schedule. The steps are described in the attached Report.

The target date for filing applications is January 26, 2007. The Board asks applicants to have all filings to the Board by 4:45 pm that day.

The application, identified with the distributor's assigned Board file number, is to be received by the Board Secretary in the following form:

- (a) by e-mail to boardsec@oeb.gov.on.ca, one (1) electronic version of the manager's summary and the 2007 IRM Model as a single PDF document in the prescribed file naming format to be released in early January, 2007;
- (b) eight (8) paper copies of the manager's summary and the 2007 IRM Model (note the date of paper copy application is the date of receipt by the Board); and
- (c) with (b) above, on a CD, an electronic copy of the PDF document e-mailed to the Board and a completed copy of the MSExcel 2007 IRM Model in the prescribed naming format outlined on Sheet 14 of the model.

Board file number assignments will be issued shortly.

Distributors are reminded that applications based on alternative principles or mechanisms for setting rates will not be able to be processed as expeditiously as applications that are consistent with the final report, and may require a significant length of time to process.

The 2007 IRM Model has been posted on the Board's web site for downloading by the distributors. A distributor that encounters difficulty in downloading the material should contact the Market Operations hotline at 416-440-7604 or by e-mail at market.operations@oeb.gov.on.ca.

Yours truly,

Original Signed By

Kirsten Walli
Board Secretary

Attachments: Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors