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July 5, 2006

Mr. Peter O'Dell
Assistant Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, Ontario
M4P 1E4

Dear Mr. O'Dell,

**Re: Multi-year Electricity Distribution Rate Setting Plan
Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism
(EB-2006-0089)**

Hydro One Networks Inc. (Networks) is pleased to provide comments to the Board staff draft report entitled "Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors" distributed on June 20, 2006. Networks will also provide general comments respecting the supporting documents provided, "Calculating the Cost of Capital for LDCs in Ontario" by Dr. Fred Lazar and Dr. Eli Prisman, and "Second-Generation Incentive Regulation for Ontario Power Distributors" by Dr. Mark Lowry.

Networks support the Board's efforts to introduce incentive regulation within the electricity distribution industry and the timely review of the determination of the appropriate capital structures and return on common equity. Due to the overlapping impact upon the future financial viability of Ontario LDCs both topics cannot be considered in isolation.

1.0 Overall Comments on the Board Staff Proposal

According to Board staff, their proposals have been guided by the following objectives:

1. Provide greater regulatory certainty;
2. Provide an incentive for LDC increased efficiency;
3. Stay current with costs and revenues; and
4. Lay a foundation for the 3rd generation incentive rate mechanism.

These objectives are to be achieved through the establishment of code(s) and amendments to LDC licenses.

Networks supports the basic principles the Board wishes to achieve in streamlining the regulatory process in Ontario. The mechanisms proposed by Board staff, if approved by the Board, would certainly smooth the Board's workload over the next three years; however, insufficient attention appears to be given to the ongoing reliability of the electricity system in Ontario.

Over the next several years the electricity industry in Ontario will be undertaking unprecedented levels of capital investment in order to:

1. Replace aging infrastructure;
2. Comply with government initiatives such as the smart meter program;
3. Improve system reliability;
4. Increase system capacity; and
5. Expand the delivery network as new sources of generation come online.

To satisfy these requirements, Ontario LDCs will have to seek 3rd party funding from the capital markets. Networks is very concerned with how the investment community will view the prescriptive nature of the proposed codes for implementation of incentive regulation and the determination of the cost of capital through 2010. Networks believes the current proposal will provide LDCs with limited financial flexibility at a time they need it the most and the legislative nature of the proposed license amendments is unprecedented in Canada.

The interim notion of one flavour for all with respect to capital structure and a common return on equity (ROE) is also without precedence in Canada. All utilities regardless of size, customers served, urban or rural, state of distribution system will have the same capital structure and a very low ROE in relationship to comparable North American returns and common equity levels. For example, Maritime Electric was recently awarded a 10.25 per cent ROE on an equity base of 43 per cent.

Networks is concerned that the rapid regulatory process changes proposed by Board staff (through 2nd Generation IRM, re-basing and 3rd Generation IRM) over a fairly short period of time will create uncertainty for all distributors until 3rd Generation IRM operating parameters are finalized. The perceived lack of regulatory stability will handcuff the distributors in making the right decisions with respect to capital investments and efficiency improvements.

Networks will further elaborate on these concerns as we provide specific comments on the Board staff's proposals for incentive regulation and the cost of capital. Networks hopes that the issues identified and the clarification questions asked will provide staff with sufficient information for consideration in the development of their final paper to be issued on July 20, 2006.

2.0 Review of Board Staff Proposal for Incentive Regulation

2.1 Second-Generation Incentive Regulation

Networks is pleased to provide comments to the Board staff with respect to its proposal for Second-Generation Incentive Regulation for Ontario's Power Distributors. Networks agrees that there is a need to review and determine the mechanisms to establish an appropriate format for incentive regulation for the power distribution sector in the province and that this is also an integral component of the Board's plan to have in place an efficient and streamlined regulatory process to set the rates of the distribution utilities in the Province during the period 2007-2010.

In the following sections Networks provides general comments on the overall perspective of incentive regulation and specific comments that deal with the proposals put forward in the Board staff report and in the discussion paper prepared by the Board staff consultant and issued prior to the workshop on June 20, 2006.

2.2 General Comments

- Networks is supportive of moving toward greater reliance on incentive regulation for the distribution sector in Ontario. However, the success of incentive regulation is premised on there being well established targets. The Regulator must signal its intention to the regulated utilities on what it aims to achieve so that utilities understand the objectives of the incentive regulation plan in terms of moving forward with their business plans and investment projects. Clarity and stability need to be taken into account when embarking on any form of incentive regulation that impacts on the operation and performance of the distributors.

- In its proposal Board staff envisions a two stage incentive regulatory model for the foreseeable future that may entail different constructs and happen within a very short period of each other. The Board staff report indicates that the two stages may be quite distinct and that at this time there is no direction for the 3rd Generation incentive model. The lack of direction and the relatively short period of duration for the 2nd Generation incentive regulatory model (could be one year) creates confusion and uncertainty for LDCs because there is no clear indication as to what is expected from the LDCs at the end of the incentive plan.

- The Board staff's proposal to develop a simple, practical and mechanistic incentive rate adjustment mechanism for the rate plan years 2007-2010 lacks the clarity as to what is the purpose behind the design of the 2nd Generation incentive regulation model. Consequently Networks is uncertain how the adjustment mechanism that is being recommended encourages investments to improve reliability, improve power quality and support the introduction of new generation.

- The Board staff's consultant on incentive regulation prepared a paper that describes in fair detail the theory behind incentive regulation. This paper which described the application of incentive regulation in various jurisdictions throughout North America and elsewhere in the world had little or no evidence to inform the reader as to the degree of success that incentive regulation has achieved in the distribution sector, particularly in North America. In this respect Networks is concerned that Dr. Lowry is proposing to adopt North American data for setting the parameters for incentive regulation in Ontario. Networks suggests that the Board should have available to it all pertinent information on the degree of success attributable to incentive regulation of power distributors in other jurisdictions, particularly in North America. This information is needed to guide the Board in its decisions to adopt a comparable form of incentive regulation in Ontario.

- Dr. Lowry states that incentive regulation can expose utilities to more risk. The distribution utilities differ in their composition and operating practices reflecting their particular circumstances. Dr. Lowry alludes to the importance of having appropriate regional information for the utilities in question. Therefore, it seems to Networks that the Board should weigh carefully its approach to the choice and the setting of parameters for incentive regulation in Ontario to ensure that these reflect the nature of the distribution businesses in Ontario.

- Board staff recognizes the important role that SQIs play in incentive regulation plan design. It is not clear to Networks how a proposal that enshrines SQR indicators and associated performance standards in the Distribution System Code will add either greater weight to the importance of the SQIs or how more frequent SQR reporting will improve the utilities' performance in this respect. There would appear to be little incentive for the utilities to innovate and improve performance.

2.3 Specific Comments on Board Staff's Proposal

The comments provided in this section are in the form of questions to which Networks is seeking answers to provide it with greater clarity as to the Board staff's intent behind the incentive regulation proposal made in the draft paper. Networks will use the responses provided by Board staff to provide more detailed comments as permitted by the review process. The section numbering is the same as in the Board staff's report.

3.1 Theory

What appear to be missing from the theoretical considerations in this section are criteria for the design of 2nd Generation IRM for Ontario and the intent behind the criteria. Therefore it would be helpful if Board staff could clarify the following points:

(a) What is the purpose of introducing a 2nd Generation IRM in Ontario at this time?
(b) What does Board staff envision as the end-state IRM for distribution sector in Ontario?
(c) How does the 2nd and 3rd Generation IRM fit in with that end-state model?
(d) What other information or precedent has Board staff sought to assist it in coming to a decision on the proposal besides Dr. Lowry's report?
(e) What behaviour signals does the Board's staff want to send to the distributors by way of its proposal for incentive regulation?

3.2 Summary of the Formula

Please see following sections for Networks' comments concerning the aspects of the incentive adjustment mechanism.

3.3 Approach & Components

3.3.1 Annual Proxy for Cost of capital – K factor

Please see Networks' commentary on this item under discussion of Cost of Capital.

3.3.2 Term and Starting Base

The Board staff proposal for the 2nd Generation IRM is for a minimum period of 1 year and a maximum period of 3 years. It would be helpful if Board staff could clarify the following:

(a) What criteria did Board staff have in mind that would be used to determine which distributors will be categorized to which of the three tranches to achieve the staggering of utility rate adjustments?
(b) Were there any other options available to Board staff to achieve rate adjustment staggering without recourse to using IRM as an adjustment mechanism and if so on what basis were these dismissed?
(c) What incentives did Board staff have in mind, and what are the expectations of those incentives driving distributor performance when subject to a 1 year IRM, a 2 year IRM or a 3 year IRM?
(d) Has Board staff considered what implications its proposal will have on distributors' operations and on their ability to move forward especially for those distributors who are likely to have significant investments during the incentive plan period? Did Board staff seek any input on this matter from distributors before developing its position on the form and term of its proposal?

3.3.3 Form – Price Cap

Board staff proposes to adopt a price index approach to adjusting rates in its proposal for IRM. It would be helpful if Board staff could clarify the following:

(a) What criteria did Board staff use to arrive at the selection of a price cap index for the proposed IRM for Ontario's power distributors?
(b) What other options did Board staff consider in this respect and what criteria were used to evaluate and dismiss these options?
(c) What supporting material, studies, expert opinion or rationale did Board staff use to convince themselves that revenue caps are not beneficial to consumers as well as distributors in Ontario?
(d) What incentives does the Board staff envision will be provided to those utilities subject to a 1 year IRM?
(e) What are the desired results in terms of adequate service quality, that Board staff seek to achieve with the use of mandatory service quality requirements?
(f) The proposed price cap model suggests a focus on cost management during the incentive plan period. Has Board staff examined the issue of distributor efficiencies and satisfied itself that there is indeed a need to cut distributors costs?

3.3.4. Price escalator – GDP-IPI

Although Networks has some concern about relying on information from other jurisdictions without first testing how that information applies to the Ontario distribution context, nevertheless Networks agrees that using GDP-IPI is a reasonable start to adjust prices for inflation for the purposes intended herein. Is there an expectation that this factor will be updated on an annual basis throughout the incentive plan period?

3.3.5 X Factor – 1%

Board staff proposes to adopt a productivity factor adjustment of 1% as a common adjustment factor for all distributors but there does not seem to be overwhelming evidence provided in the report or the consultant's discussion paper that this approach is reasonable or appropriate for the distribution sector in Ontario. It would be helpful if Board staff could clarify the following:

(a) What studies and relevant information besides Dr. Lowry's paper did Board staff examine to conclude that a common factor of such magnitude was applicable to the power distribution sector in Ontario?
(b) What studies did Board staff perform to validate that Dr. Lowry's proposal is reasonable for applying to Ontario's distributors?
(c) How relevant was the data used in Dr. Lowry's report or other studies used by Board staff to the Ontario distribution sector, what was the time period over which data collected, i.e. recent or older, and were differences identified, their impact assessed and included in Board staff's decision? What criteria did Board staff apply to select the sample of utilities for this purpose?
(d) On what basis did Board staff conclude that a "one X factor fits all" will apply to all distributors in Ontario?
(e) Will the X-factor be adjusted on an annual basis throughout the incentive plan period to ensure consistency?
(f) Has Board staff considered the impact that the choice of a single "X" factor will have on the performance of distributors over the incentive plan period with respect to their ability to maintain, operate and expand the distribution infrastructure to meet the demands placed thereupon and to maintain acceptable reliability and quality of service?
(g) How does the Board staff proposal take into account the practicality of the situation in Ontario where some distributors have made significant efficiency gains over the past few years while others have not?

3.3.6 Contingency and mid-term issues

Board staff's proposal suggests exclusion of Z-factors and off ramps from 2nd generation incentive plan.

What criteria did Board staff use to dismiss the "Z" factor and other adjustment factors that are typically part of the incentive adjustment mechanism and how does that fit with the aim of sending signals to distributors?

(a) The lack of an off-ramp or Z factor may adversely affect distributors which have large infrastructure investments within the 2nd Generation IRM timeframe. What provisions have been made in the Board staff proposal to deal with this matter?

(b) What provisions have been made in the Board staff proposal to assist those distributors whose distribution systems are impacted to a greater extent by weather and geography to assist them in achieving the goals which Board staff hopes to achieve with the 2nd Generation IRM?

3.3.7 Earnings sharing

Networks agrees that until such time as there is sufficient experience with the performance of incentive adjustment mechanisms in Ontario there is little to be gained by setting at the outset an earnings sharing mechanism.

3.3.8 Service Quality

Board staff proposal recognizes the importance of service quality provisions in any incentive regulation plan and Networks agrees. However, it is not clear to Networks what incentives there are for distributors to improve their service quality performance if the indicators and performance standards are implemented through compliance with codes. It would be helpful if Board staff could provide some clarity in respect of the following comments:

(a) What incentives did Board staff have in mind to assist distributors in improving their quality of service by enshrining the SQI requirements and standards in Codes?

(b) How does monthly reporting of SQIs increase the incentive to improve or maintain performance?

(c) What additional work, e.g. collection of data and information, does Board staff envision is required in support of its proposal for reviewing SQIs?

(d) In support of its proposal what provisions does Board staff envision would have to be made to ensure consistent measurement of SQI across all of the distributors in Ontario?

3.3.9 CDM/(Smart Meters)

Networks is concerned that exclusion of CDM costs from the 2nd Generation IRM may lead to a similar situation to that concerning Market Ready costs, i.e. cost tracking through deferral accounts for future recovery. This approach leads to potentially large impacts on customers' bills.

(a) Has Board Staff given consideration to how escalation in CDM costs due to OPA directives during the plan period might be handled under its proposal? Do Board Staff envision separate treatment involving deferral accounts?

(b) If there were to be a separate process for CDM expenditures, has Board staff given any thought to the potential confusion that may result from multiple rate changes to LDC customers?

(c) Given the significant capital expense awaiting distributors in respect of smart meter implementation should there not be some allowance for additional revenue recovery in the 2nd Generation IRM to assist distributors, especially given the timing of smart meter implementation being identical to the plan period? Board staff should consider the use of an "m" factor to facilitate annual revenue increases to cover smart meter costs. Networks suggest the Board staff consider a simple adjustment such as an annual increment of $1.00 per year in its 2nd Generation IRM formula.

3.3.10 Reporting and Data Requirements

It would seem prudent that Board staff might consider recommending the gathering of information that is pertinent to setting incentive adjustment measures and performance so that the Board can build up experience that would help it to make adjustments to improve the efficiency of the regulatory model and the incentive signals that are sent to distributors.

3.4 Looking Forward to 3rd Generation IRM

Networks would suggest that the development of 3rd Generation IRM principles or approach should be a part of the development of the 2nd Generation IRM. In other words the two stages are not separate but should be treated as a whole. The development of a longer-term and enduring IRM will provide more certainty and stability to the distribution sector in Ontario. Therefore, Networks encourages Board staff to consider the development of incentive regulation as a whole that could include first and second stages.

3.0 Review of Board Staff Proposal for Cost of Capital Determination

As with Networks' discussion on Incentive Regulation, the section numbering below corresponds to numbering in the Board staff report.

2.2.1 Capital Structure
3.3.1 Annual Proxy for Cost of capital – K factor

It is Networks understanding from a review of the Board staff's proposal and subsequent meetings with Board staff, that under their proposal, the following steps will be used to determine the cost of capital:

1. In 2007, all LDCs will have an adjustment to their ROE levels through the "k" factor adjustment with no adjustment to debt costs.
2. In 2008 and 2009, LDCs who are not before the Board for a cost of service review, will have their capital structures adjusted as applicable through the "k" factor with no change to ROE levels or the cost of debt.
3. When LDCs are before the Board for their future test year cost of service resets, they will be able to file for LDC specific ROE's and that the proposed code will reflect this opportunity.

Networks would appreciate confirmation of our interpretation in the staff's final paper. We would also appreciate confirmation that the "k" factor will include a full ROE adjustment including the impact of income taxes. An illustrative example of the application of the "k" factor would be a helpful inclusion in the final paper.

Networks would also ask the Board staff to clarify whether the capital structures of the LDCs would be subject to review and potential adjustment as part of each LDCs cost of service review. How does Board staff plan to reflect the issuance of preference shares by utilities within the "k" factor?

Given one of the objectives according to Board staff is to stay current with costs and revenues, is it inconsistent to not provide an update for ROE using the "k" factor for those LDCs who are not rebased in 2008 or 2009 similar to the adjustment for inflation? Networks would be interested in Board staff's rationale for the distinction.

2.2.1 Return on Equity (ROE)

Board staff is proposing a ROE in the range of 7.52 to 8.36 per cent. This range is extremely low in comparison to Networks' current Board approved level of 9.0 per cent, but also in comparison to LDC returns in other North America jurisdictions. As indicated above, at a time when Networks must access the capital markets to finance an unprecedented level of capital investment, Board staff is proposing a mechanism which can result in potential credit rating downgrades and the resultant increase in financing costs to the long-term detriment of our customers.

On June 23, 2006 with limited opportunity to assess Board staff's recent proposal on incentive regulation or changes to capital structure and returns, the Dominion Bond Rating Agency (DBRS) upgraded the rating of Hydro One Inc.'s Senior Unsecured Debentures to A (high) with a Stable trend from "A" with a Positive trend Noting among other factors, improvements to the regulatory framework in Ontario in recent years, and that the OEB was mindful of the fact that heavy handed regulation is not good for investor confidence.

DBRS further noted that this upgrade was premised on the Company's reduced business risk profile associated with improvements to the regulatory framework. They go on to comment that the Board staff's recommended ROE range of 7.52 to 8.36 per cent would:

1. have a material negative impact on cash flow-to-debt and interest coverage ratios;
2. be lower than any other jurisdiction in Canada, placing additional pressure on credit metrics; and
3. make access to capital more challenging in the future, given the elimination of foreign content limits by the Canadian government.

BMO Capital Markets (BMO) in their June 27, 2006 Pipeline/Gas & Electric Research Comment also expressed concern with the direction of the Board staff report. In their report BMO considers the 7.52 to 8.36 per cent ROE range suggested by Board staff to be confiscatory and that it likely violates the fair return standard.

Networks would like to know what, if any, discussions Board staff or its consultants had with members of the financial community prior to finalizing its initial ROE recommendations. Networks recommends Board staff review these reports and any other investment reports that may become available prior to the issuance of their final report on July 20, 2006 and give serious consideration to the thoughts and concerns of the financial community and to the Board's recent Networks decisions in this regard.

4.0 Networks Specific Comments with Board's Cost of Capital Proposal

4.1 ROE Components

It appears that Board staff is using different risk-free rates to establish the ROE range. The 7.52 per cent appears to be based on the consultants' forward rate of 5.0%; and the 8.36 per cent appears to be based on the 4.56% forecast yield from the consensus forecast that was applicable at the time of the RP-2005-0020/EB-2005-0378 proceeding. If Board staff is proposing to use forward rates, rather than the Consensus Forecast, Networks believes that staff's "upper end of the range" should reflect the current Board guidelines for measuring the risk premium, but use the forward rate of 5.0%. This would result in a ROE of 9.0 per cent.

Networks strongly recommend that Board staff provide additional support for its derivation of its range in its final paper. Networks recommend an exhibit similar to Exhibit K1.6 filed in RP-2005-0020/EB-2005-0378 be included in the final report. This table should clearly show the derivation of each component for both the low and high end of staff's recommended ROE range. The components requested include the risk-free rate, the market risk premium, beta and flotation costs. A table of this nature will provide transparency and allow a more focused assessment of the various elements of Board staff's proposals.

4.2 Capital Asset Pricing Model

Board staff is suggesting the adoption of the Capital Asset Pricing Model (CAPM) as the sole determinant of utility return. While the formula is simple, the determination of the appropriate inputs is not. For example, is it Board staff's opinion that the sample companies selected by their consultants are good proxies for regulated LDCs?

Networks would like to know on what basis Board staff dismissed other approaches? Further, is it not good regulatory practice to use a combination of approaches in arriving at ROE decisions? Without looking at the results of other tests, how can Board staff have confidence that their proposed ROEs meet the test of fair and reasonable returns?

Networks notes that the BMO report referenced earlier also has concerns with sole reliance on the CAPM for determining the cost of equity capital. In their words, the CAPM, "is fraught with difficulty". How will the revised Board staff paper respond to the concerns being raised by the BMO report to ensure investor confidence is maintained?

4.3 Market Risk Premium

Networks believes it would be helpful if Board staff could outline the rationale followed in the selection of 10-year time period selected to develop the market risk premiums and was any consideration given to the potential volatility of the data and the resulting estimate of the market risk premium? What changes in the methodology would staff propose if actual market returns over the selection period were negative or close to zero?

Is Board staff aware of any other cost of capital expert recommending that the expected market risk premium be determined using relatively short-term actual historic returns for the equity market?

4.4 Risk Adjustment

With regard to the risk adjustment, based on the presentation of the consultants, the indicated beta for the LDCs is in the range of 0.50 to 0.90, or an average of approximately 0.70. However, Board staff's recommendations include a beta of 0.357. Why has Board staff not adjusted this beta for financial risk as it would appear their consultants did, to arrive at their beta range of 0.50 to 0.90 (mid-point of 0.70)?

Networks would also like Board staff to confirm that the consultants' betas of 0.50 to 0.90 assumed a common equity ratio of 40%. If this is the case, would there not be less financial risk assumed in the consultants' estimated betas than in the Board staff's recommended common equity ratio of only 36%, and thus the need for an upward adjustment to Board staff's proposed range of ROEs?

4.5 Financing Flexibility

Networks agrees with Board staff's recommendation to add 50 basis points for financing flexibility, as has been this Board's and other Canadian regulators' practice.

4.6 Maintenance of an A Rating

The consultants' report indicates that the average Standard and Poors (S&P) financial metrics for A ratings (Table 7) include a debt ratio of 53.8 per cent (implied equity ratio of 46.2 per cent), and ROE of 10.8 per cent, EBIT coverage of 3.1 times and FFO to debt of 18.2 per cent. These are in line with S&P guidelines for an A rating and a "business profile" score of 3 (the scores that S&P initially applied to various larger Ontario distributors and to Networks). How are the S&P financial metrics used to assist in developing the ROE and capital structure for LDCs?

Is it Board staff's opinion that if Networks maintained a capital structure with the 36 per cent equity ratio and earned a return in the 7.52 to 8.36 per cent range recommended by staff, that Networks would be able to maintain ratios in the S&P ranges and continue to have access to the long-term debt markets at reasonable rates? Has Board staff taken into consideration that electric LDCs in Ontario, unlike their gas counterparts, do not have access to equity markets?

4.7 Use of Forward Rates

Networks would like to have a better understanding of what Board staff is proposing, as per their report at page 10 with respect to the use of forward rates. Is Board staff going to estimate the forward rates at the same time they would have normally used the Consensus Forecast? Some utilities track the consensus forecast results monthly. Are they going to provide some kind of formula to allow utilities to make their own calculations of the forward rates? Even with a formula are the data required to calculate these rates readily available? The explanation at pages 42 to 43 of the consultants' report looks fairly daunting.

4.8 Relative Risk

At page 18, the consultants' refer to Alberta distributors, and opine that the Alberta market differs from Ontario. Networks would like Board staff to clarify in what way and whether those differences pointed to higher or lower risk than in Ontario and why.

5.0 Concluding Remarks

In order to ensure a successful and smooth transition to an incentive regulation environment, Networks encourages Board staff to run a few scenarios using selected LDC data, to test what impact its proposals may have on the financial viability of the electric LDCs in Ontario.

Networks appreciate this opportunity to comment on the Board proposal and hopes that its comments and questions will be helpful to Board staff in the preparation of their final report in July. Networks will continue to study the reports and we will be providing further comments once we have had a chance to review the July 20, 2006 report. Networks also will be providing expert evidence as part of our August 14, 2006 submission. We would also be pleased to meet with you or Board staff to discuss our comments in further detail or to participate in any additional informational sessions that might be planned to help expedite this process.

Thank you.

Sincerely,

Susan Frank

Susan Frank