

Ontario Energy Board
PO Box 2319
27th Floor
2300 Yonge Street
Toronto ON M4P 1E4

30 June 2006

Re: Draft Staff Report dated 19 June 2006
Multi-year Electricity Distribution Rate Setting Plan
Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism
(EB-2006-0089)

To: Peter H. O'Dell, Assistant Board Secretary

Newmarket Hydro is pleased to provide the following written comments on the Board staff's draft report dated 19 June 2006. Newmarket Hydro finds the majority of staff's recommendations to be reasonable within the context of the six guiding objectives that staff employed to guide the proposals contained in the draft report. Newmarket Hydro is therefore including comments only on those recommendations that we believe will have a detrimental impact on one or more of the guiding objectives.

As Board staff has noted, the cost of capital is very important for distributors since it represents about half of the revenue requirement. Through the cost of capital return component of rates, distributors are able to maintain their financial viability and attract the capital necessary to provide reliable, quality service to their customers. It is critical, then, that the cost of capital is accurately calculated.

Newmarket Hydro has the following comments regarding staff's cost of capital recommendations:

- Regarding the riskless rate as determined in the manner recommended by Lazar and Prisman, we support use of forward rates, however we believe it is not appropriate to use the average of 5, 10, and 15-year term forwards. Generally, the risk free rate used for estimating cost of debt should match the life of the underlying assets supported by the debt. Similarly, the calculation of returns to equity holders should reference risk free rates and market returns of equal duration. The averaging of shorter duration instruments changes the risk profile to a 10-year term, which is significantly shorter than the current term of 30 years, and does not appropriately support either equity or assets. We therefore propose that the 20-year or 30-year forward rate(s) be used to determine the riskless rate, and the spread of A/BBB corporate bonds of similar duration be used to determine the deemed long-term interest rate. Similar adjustments should be made within the equity return calculation.

- The Return on Equity (ROE) determined in the manner recommended by Lazar and Prisman may have been calculated in error. We provide a suggestion as to the corrected calculation below, resulting in a 4.8% increase to the ROE.

Lazar and Prisman calculated the pre-tax and after-tax, unlevered betas per the following formula¹:

$$\mathbf{Ba} = \mathbf{Be} / [1 + (1-T)*(D/E)]$$

Where: **Ba** = unlevered, after tax asset beta
Be = levered equity beta
T = the tax rate
D = % debt
E = % equity

Note that the after tax, unlevered beta is an ASSET beta, NOT an EQUITY beta.

From the ASSET BETA, the ASSET RETURN and then the LEVERED EQUITY RETURN are calculated.

Lazar and Prisman have calculated the after tax ASSET beta, Ba:

Ba = unlevered, after tax asset beta =	0.3572
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We then use the following formula² to calculate the ASSET RETURN, Ra:

$$\mathbf{Ra} = \mathbf{Rf} + \mathbf{Ba} * (\mathbf{Rm} - \mathbf{Rf})$$

Where **Ra** = after tax, unlevered return on assets = WACC
Rf = risk free rate
Rm = market return

Assuming staff's values for each of these: Rf = 0.0501
 Rm = 0.1060

Then we calculate that	Ra =	0.0701
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The after tax unlevered ASSET return is converted to the after tax levered EQUITY return Re per the following formula³:

$$\mathbf{Re} = \mathbf{(Ra - (1-T)*D * Rd)/E}$$

Where **Re** = after tax return on equity = ROE
Rd = debt interest rate

Where above we calculated: Ra = 0.0701
 And assuming staff's values for each of these: T = 0.3604
 Rd = 6.01%
 E = 40%
 D = 60%

THEN AFTER TAX EQUITY RETURN ⁴	Re = ROE	11.8%
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Footnotes

¹ See p. 35 of their 14 June 2006 paper.

² See footnote 17, page 219, Brealey-Myers Principles of Corporate Finance, fifth edition

³ See page 520, Brealey-Myers Principles of Corporate Finance, fifth edition

$$R^* = Rd * (1-t)*D/V + Re * E/V = WACC$$

$$\text{so } Re = [Ra - Rd * (1-t) * D/V] / E/V$$

⁴ If Lazar and Prisman's low end market return is used, the resulting ROE is 8.7%.

Note that using the formulae above will provide the appropriate equity return based on a given debt structure. The adjustment “re-levers” the equity return to reflect the target debt structure, per standard corporate finance theory.

We also provide for your reference 2005 allowed return on equity decisions for US utilities, which averaged 10.58%. Often, ROE is referenced as a spread over 10-year Treasuries; the average spread was 621 basis points over 10-year treasuries (see appendix).

Below are select comments and/or requests for your guidance on the following issues:

- Newmarket Hydro believes that asset size is an appropriate factor in establishing a distributor’s debt/equity ratio. Smaller utilities with few resources may be less able to handle the amplified financial risk associated with leverage than larger utilities. Since equity serves as a source of financial cushion, increasing the required amount of leverage puts these smaller utilities at greater risk. Capping the equity percentage at 40% means that utilities with higher equity percentages in their capital structures will not be able to capture the full, allowed return on their equity, creating additional financial hardship. It is important to remember that expected returns are a function of business risk and financial risk [$E(r) = \text{risk free rate} + \text{business risk premium} + \text{financial risk premium}$]. While Newmarket Hydro understands that staff wishes to standardize the rate process to the greatest extent possible, we are unsure if we support the 60/40 deemed capital structure for utilities smaller than \$100 million in assets and will reserve extended comments on this factor at this time. {Source: Leveraged Betas and the Cost of Equity, Harvard Business School, Note 9-288-036, 12/11/91 }.
- It is important to consider the fact that small businesses generally require higher rates of return on equity to attract capital. This point was addressed to some extent under the previous plan through the segmenting of utilities by asset size into varied capital structures. Under the current proposed plan, simply fixing the capital structure without further segmenting equity returns may be insufficient to equitably compensate smaller utilities for the greater risks inherent in their business.
- We support fixing the riskless rate, rather than imposing an annual review, and we suggest fixing the riskless rate for the duration of ratebasing cycle. However, we also note that in an environment of rising interest rates, this proposal could cause financial hardship for any distributors with a significant amount of floating interest rate debt in their capital structure.
- We will acquiesce to staff’s proposal of quarterly reporting of monthly service quality reporting data, but it does cause undue administrative expense to utility staff.
- Please confirm that the 50bp allowance for flotation and other transaction costs, which staff recommends continues to be applied to the equity risk premium (ERP), will also be applied to deemed costs on affiliate debt transactions.

- In the 20th June 2006 presentation and in the text of the draft report, staff proposes that the appropriate capital structure for distributors is 40% common equity (including 4% preferred shares) and 60%, however, in the Appendix to the Staff report, Staff recommends 36% equity and 64% debt – the preferred equity has been included with debt. Please clarify the proposal terms.

Newmarket Hydro thanks staff for their consideration of these issues.

Sincerely,

Iain Clinton, CA
CFO
Newmarket Hydro Ltd.
590 Steven Court,
Newmarket, On
L3Y 6Z2
Tel 905-953-8548 ext 2300
Fax 905-895-8931
Email: iclinton@nmhydro.ca

Appendix I

2005 Electric Rate Case Decisions

Date	Company	State	Allowed ROE	Yield on 10 Year Treasury	BP Spread
1/6/2005	South Carolina Electric & Gas	SC	10.70%	4.29%	641
1/28/2005	Aquila	KS	10.50%	4.16%	634
2/18/2005	Puget Sound Energy	WA	10.30%	4.26%	604
2/25/2005	PacifiCorp	UT	10.50%	4.27%	623
3/10/2005	Empire District Electric	MO	11.00%	4.46%	654
3/24/2005	Consolidated Edison	NY	10.30%	4.59%	571
3/31/2005	Texas -New Mexico Power	TX	10.25%	4.50%	576
	1st Quarter Averages		10.51%	4.36%	615
4/4/2005	Central Vermont Public Svc	VT	10.00%	4.46%	554
4/7/2005	Arizona Public Service	AZ	10.25%	4.47%	578
5/18/2005	Entergy Louisiana	LA	10.25%	4.07%	618
5/26/2005	Savannah Electric & Power	GA	10.75%	4.08%	667
5/26/2005	Altantic City Electric	NJ	9.75%	4.08%	567
6/8/2005	Public Svc New Hamprrshire	NH	9.62%	3.94%	568
	2nd Quarter Averages		10.12%	4.18%	592
7/19/2005	Wisconsin Power and Light	WI	11.50%	4.23%	727
8/5/2005	Cap Rock Energy	TX	11.75%	4.43%	732
8/15/2005	AEP Texas Central	TX	10.13%	4.27%	586
9/28/2005	PacifiCorp	OR	10.00%	4.26%	574
	3rd Quarter Averages		10.85%	4.30%	655
12/12/2005	Madison Gas and Electric (WI)	WI	11.00%	4.55%	645
12/13/2005	OGE Electric Service (OK)	OK	10.75%	4.54%	622
12/16/2005	Pacific Gas and Electric (CA)	CA	11.35%	4.45%	690
12/16/2005	San Diego Gas & Electric (CA)	CA	10.70%	4.45%	625
12/16/2005	Southern California Edison (CA)	CA	11.60%	4.45%	715
12/22/2005	Wisconsin Public Service (WI)	WI	11.00%	4.44%	656
12/21/2005	Cincinnati Gas & Electric (OH)	OH	10.29%	4.49%	581
12/21/2005	Avista (WA)	WA	10.40%	4.49%	592
12/22/2005	Consumers Energy (MI)	MI	11.15%	4.44%	671
12/28/2005	Westar Energy North (KS)	KS	10.00%	4.38%	562
12/28/2005	Kansas Gas and Electric (KS)	KS	10.00%	4.38%	562
	4th Quarter Averages		10.63%	4.46%	629
	2005 Average		10.58%	4.35%	621

Source: Regulatory Research Associates

Original Source: Lehman Brothers Research Report (3/15/06)