

**IN THE MATTER OF a consultation by the  
Ontario Energy Board on the Cost of Capital and  
2<sup>nd</sup> Generation Incentive Regulation for Electricity  
Distribution Companies.**

**SUBMISSIONS  
OF THE  
SCHOOL ENERGY COALITION**

1. The following are the School Energy Coalition (“SEC”) submissions with respect to the Staff Report dated June 19, 2006 in this matter.
2. ***Consultation Process.*** SEC has generally been pleased with the consultation process that the Board is employing for this initiative. Staff have been open about their thinking, have listened to stakeholder input, and have been willing to engage in debate to get to the right answers. In our view, they should be commended for the approach taken to date.
3. ***Use of Licence Conditions and Code-making Power.*** We have some concern about the choice of licence conditions plus Codes to establish rates for LDCs over the next three years. While we understand how that assists the Board in achieving regulatory efficiencies, another aspect of the Board’s role is to be the venue for public scrutiny of regulated entities. We have two suggestions to adjust the planned direction so that public scrutiny remains a key outcome.
4. First, we believe that, if the Board determines to continue in this direction, it should at the same time enhance the transparency of the LDC ratemaking process by making public all of the quarterly filings of the LDCs so that members of the public have a better understanding of their revenues and expenditures on an ongoing basis.
5. Second, we propose that the Board establish a stakeholder council, made of up representatives of major ratepayer sectors, to meet quarterly after the quarterly filings have been made. The role of the stakeholder council would be to provide input to the Board on the financial information filed, and to help the Board assess whether the “light-handed” regulatory approach being used in this case is producing the right results.
6. ***Industry Consolidation Goal and/or Impact.*** In this, as in all of its processes and proceedings relating to electricity distribution rates and regulations, the Board should in our view assess directly whether it wishes the result to promote consolidation (ie. mergers and

acquisitions), discourage consolidation, or remain neutral. In general, the Board appears to have taken the view in the past that industry consolidation will drive efficiencies, but that it should not be jammed down the throats of the local municipalities that own the smaller and more vulnerable LDCs. If the Board believes that is an appropriate stance in this case, then in our view the policy decisions made would suggest a simple structure for PBR (so that the LDCs are not forced into consolidation by the burden of paperwork), but the lowest reasonable cost of capital (so that the local municipalities do not see their LDC as a goose that lays golden eggs).

### **Cost of Capital Issues**

7. ***Introduction.*** Under the current rules, the overall cost of invested capital (debt plus equity) for an LDC ranges from 6.92% (if over \$1 billion in rate base) to 7.63% (if under \$100 million in rate base). In general, SEC believes that these overall costs are on the high side for most LDCs.
8. It is not possible, on the data in the Staff Report, to calculate an equivalent amount under the staff proposal, because no general formulae are proposed for the cost of short term debt and the cost of preference shares. If those two components are ignored, though, the Staff Report appears to propose a range of 6.61% to 6.95%, depending on the ROE beta used. While this is lower than the existing rates, we know that those rates are too high by a net of 30-50 basis points in any case (as we saw from evidence in the Hydro One and Toronto Hydro rate cases), so in fact the Staff Report appears to us to be proposing no change in the overall cost of capital for large LDCs, and a small decrease for small LDCs. At this high level, this does not seem like the right result to us.
9. ***General Goals and Parameters.*** The Staff Report notes that the Board's most thorough experience is with the gas utilities, and we agree that the experience of the gas utilities is useful information. However, we also believe that the Board should face directly the fact that the LDCs, with some notable exceptions, remain in the public sector. This raises three questions about the goals of the cost of capital rules.
10. First, is it a goal of this process to ensure that the cost of capital for each LDC tracks the actual cost of capital that would be experienced by that LDC if it was required to obtain all of its debt and equity in the public markets? If this is a goal, then there is little doubt that smaller utilities should have significantly higher debt and equity rates, and perhaps also more conservative debt/equity ratios, even than the current levels. On the other hand, this is in conflict with the second and third questions, set forth below. It is not clear to us that a market proxy, without consideration of other factors, is the only way to establish the fair cost of capital for Ontario's LDCs.
11. Second, we are concerned that market rates of return may encourage local municipalities to arbitrage their investment in the LDC against the market rates at which they can borrow. If a local municipality can borrow at 5.1%, as many can, and the LDC needs \$500 million of combined debt and equity at 6.95%, it is in the interest of the municipality to borrow \$500 million, provide it in the approved ratios to the LDC, and reap an annual profit as the go-

between of \$9.3 million. We believe that one goal of this process should be to discourage such a practice. In the best case, the capital rules would ensure as much as possible that local municipalities are indifferent as to whether they provide the capital to their LDC, or the LDC acquires that capital in the marketplace. This means that not only should the cost of capital to the LDC in the marketplace be considered, but also the cost of capital to the shareholder.

- 12.** Third, if one of the goals of this process is to encourage (gently) industry consolidation, or at least not discourage it, then providing the municipalities that own LDCs with an overall rate of return that is significantly in excess of their actual cost of capital is not a good idea. It is more difficult for a municipality to bite the bullet and sell or merge their LDC if the municipality has become dependent on the budget benefits of the net profit on either the LDC's operations, or the capital arbitrage.
- 13.** For these reasons, we believe that it is appropriate to set both the debt rate and the ROE at the lower end of the reasonable range, and to make other decisions with respect to cost of capital consistent with these principles.
- 14.** *Capital Structure.* We agree with the Staff Report that fixing the same deemed capital structure for all LDCs is a good approach. Although there are undoubtedly differences in the risk levels of small vs. large utilities, we do not believe that adjusting the capital structure is the best way to reflect those risk differences. This conclusion is supported by the Lazar/Prisman report (page 7).
- 15.** On the overall split between debt and equity, we do not believe that a 60/40 split is appropriate. The paradigm should be a well-run, financially solid LDC. If that assumption is used, then the capital structure of the gas distribution companies is probably the best split, ie. 65/35 (or 64/36, as is the case with Union).
- 16.** That ignores, however, the issue of preference shares. As we understand the Staff Report at page 8, the proposal is that each LDC has the option to include up to 4% as preference shares, but no obligation to do so. Since the cost of capital of preference shares will undoubtedly be lower than the cost of common equity (and see our comments below on this issue), we do not see why any LDC would elect to include preference shares, thus reducing their overall return on invested capital. If the market rate for preference shares is 6% and the deemed common equity rate is 8%, for example, shifting 4% of capital to preference share would mean a loss of 8 basis points in overall rate of return on invested capital. Almost all LDCs, financed primarily by their public sector owners, would not elect to do this. Therefore, we conclude that the preference share "option" will have no practical impact, and therefore the real common equity number being proposed is 40%.
- 17.** The Board should, in our view, consider an alternative in which the LDC is required to include 4% preference shares in its deemed capital structure. If the Board were to do this, it would have to have a formula or default for the return on those preference shares, which we discuss below. However, if the Board did proceed with a mandatory preference share

component, the result is a 64/36 practical split between debt and equity, since preference shares in this context have a coupon rate closer to debt than to equity.

18. In those circumstances, we would agree that the 64/36 effective capital structure is a good rule for Ontario LDCs, and we would recommend that the Board adopt it.
19. We are also concerned with the proposal that a portion of the debt component be short term debt, but for a different reason. As the information provided in the Lazar/Prisman Report indicates, this would mean that LDCs would have wildly varying amounts of short term debt relative to their overall capital. Since the allowed rate on short term debt would be lower than the rate on long term debt (currently), this means that there could be significant differences in the overall return on invested capital.
20. In our view, these differences are not fair to the LDCs. As a practical matter, most LDCs will include most or all of their working capital requirements in their long term debt plan if they are borrowing in the market, simply because the working capital requirements are ongoing needs that do not change a lot from year to year. While they cycle repeatedly, the need is a constant need. It is properly matched against long term debt to maintain a level of cost certainty.
21. A better approach, it seems to us, is to identify a specific percentage of capital needs that a typical utility should leave in short term paper rather than in its long term plan, and apply that percentage to all utilities as part of their deemed capital structure. We believe that the appropriate percentage is 10%, so that 64% “debt” would be made up of 50% long term debt, 10% short term debt, and 4% preference shares. In our view, a utility with a sophisticated financing strategy would have a structure in this range.
22. ***Cost of Long Term Debt.*** The Staff Report proposes a risk-free rate that starts with the average of the forward estimates for 5, 10 and 15 year zero coupon Canadas. It then adds a market spread over Canadas to get a deemed long term debt rate, currently about 6.01%.
23. Our first observation is that, whatever the formula, it should produce a result that makes sense given current market conditions. Otherwise, you have to be concerned that the formula is either flawed or insufficiently robust.
24. In this case, we know from the evidence in the Toronto Hydro rate case that they can borrow at about 5.0% for their long term debt. That accords with what observers can see in the market today, and the current experience of other utilities such as Hydro One. It also accords with the experience of other public sector entities such as school boards, which also currently borrow in the 5% range.
25. What we conclude from this is that the approach of Dr. Cannon, which would today produce a long term debt rate of 5.15% for a large LDC, and 5.6% for a small LDC, is closer to the market reality. Prima facie, it should be preferred.

26. The main difference between the methods appears to be in the derivation of the riskless rate. In the Lazar/Prisman report, the authors discuss their proposal to switch from 30 year Canadas (proxied as 10 year with an adjustment), as used by Cannon, and a mix of 5, 10 and 15 year zero coupon Canadas. Their basic premise is that these are better predictors of the actual market in the rate year, presumably starting at least six months after the calculation.
27. With respect, that does not appear to be correct. While Drs. Lazar and Prisman do not provide the raw data for the calculation, we estimate that Dr. Cannon's methodology, applied last year, would have been a much better predictor of market rates for utility debt in Ontario than the methodology proposed by Drs. Lazar and Prisman.
28. We therefore urge the Board to reject the methodology of Drs. Lazar and Prisman for the riskless rate and the long term debt rate, and instead use the existing methodology initially proposed by Dr. Cannon.
29. **Cost of Short Term Debt.** We agree with the Staff Report that the rate to be used should be the rate the Board determines from time to time for regulatory asset accounts.
30. **Cost of Preferred Equity.** We believe that a formula should be developed for the Board by appropriate financial market experts that estimates the appropriate coupon rate for utility preference shares based on market data. Today, that rate would be below 6%.
31. **Cost of Common Equity.** Subject to our comments on the riskless rate, which we have noted earlier, we agree with the revised approach of Drs. Lazar and Prisman to the calculation of the beta and the expected return in the market. If Dr. Cannon had derived, from the data then available to him, a beta in the range of .357 as is currently the case, his ROE numbers would be quite similar to those of Drs. Lazar and Prisman.
32. We agree with the use of 50 basis points as a proxy for flotation costs, but we note that the work done to validate this number, either currently or in the past, has been relatively sparse. We believe the Board would benefit from a review of average total flotation costs for utility offerings in Canada, so that this number can be given a better foundation.
33. **Overall Recommendations.** We therefore recommend that the Board establish the following rules for cost of capital:
  - a. Fix the deemed capital structure for all LDCs at 50% long term debt, 10% short term debt, 4% preference shares, and 36% common shares.
  - b. Use the Cannon methodology, updated, to determine the cost of long term debt.
  - c. Use the Board-approved rates for regulatory asset accounts to determine the cost of short term debt.
  - d. Develop a new, market-driven formula for the cost of preference shares.

- e. Adopt the Lazar/Prisman methodology for return on common equity, but with the riskless rate adjusted to reflect Dr. Cannon's approach, which has proven to be more accurate.

### **Second Generation PBR Issues**

- 34. ***Introduction.*** SEC has gone on record on more than one occasion as supporting a long-term, simply formula-driven rate structure for distribution utilities that guarantees rate increases of less than the rate of inflation. If an incentive regulation structure is properly designed (see below), in our view there is no need for earnings sharing, as in fact we want the LDC to generate as many efficiencies as possible, so we want them to have as much incentive as possible to do so.
- 35. In the context of the second generation PBR currently being proposed, we see that as a further transitional methodology, and not an end-state in itself. As has been noted by Energy Probe and others, this PBR is not based on a true rebasing, and therefore is inherently flawed. However, we understand that the Board needs to put in place a method that will move utilities in generally the right direction, without creating any major hardships for either LDCs or their ratepayers, while the Board takes the time to rebase each of the existing LDCs properly over a period of years. We agree that this method, while hardly optimal in a perfect world, is a good compromise given the actual realities facing the Board.
- 36. Because this is a transitional methodology, our comments are not directed at achieving the best possible PBR mechanism. Rather, our comments are directed at balancing short-term efficiency, simplicity, and time management against the need to generate a close approximation of just and reasonable rates.
- 37. ***Initial Rebasing Year.*** The Board proposes that utilities have their first full cost of service in 2008, 2009 or 2010, depending on the cohort to which they are assigned. Subject to our comments on assignment to cohorts, below, we agree with this approach, with two main exceptions:
  - a. Toronto Hydro came in for their 2006 rates using a forward test year approach, but with shockingly limited information. (The Board said, at page 8, "there is no question that the evidence was, putting it politely, 'light'"). They also, more importantly, advised the Board that they are currently preparing a major asset condition assessment and capital spending program that will be available in the next few months. These two factors show a pressing need for a review before 2008.
  - b. Hydro One Distribution also came in for their 2006 rates, but with more detailed information. However, the company has two divisions, and the other one, Transmission, is slated to have its rates reviewed for 2007. In order for the Board to have a full picture of the activities of Hydro One, we believe that both Transmission and Distribution should be before the Board for new rates for 2007.

We therefore urge the Board to set 2007 as the rebasing year for both Toronto Hydro and Hydro One. We note that this has the added advantage that they become the “guinea pigs”, in effect, for all of the LDCs in their rebasing process. The Board can develop experience with this part of the ratemaking cycle of LDCs through these two large utilities, with more extensive resources, and other LDCs can watch the process that these two go through to get a better sense of how to handle their own rebasing when it arises. If these two utilities are rebased in 2007, they can then be rebased again in 2009, at which point they should be into the 3<sup>rd</sup> generation PBR.

38. ***Use of GDPPI.*** We agree with the use of GDPPI as the base escalator, using the national number, not limited to domestic inputs. This is the broadest indicator, and in our view the one that most closely tracks changes in the actual costs of goods and services to the LDCs.
39. ***Adjustment for Cost of Capital.*** We have expressed our concerns in the stakeholder consultations about how the cost of capital adjustment should be incorporated into the rate adjustment formula. Simply put, we are concerned that cost of capital is not about a percentage price change from year to year, but is logically an impact on revenue requirement. It is not really amenable to being included in the formula for percentage rate change, because the percentage impact on rates will vary from utility to utility.
40. We recommend that the Board instead provide that the first step in the PBR formula should be to “normalize” the base year EDR model (revenue requirement and therefore rates) using the new cost of capital figures (and, after 2007, the new deemed capital structure). This is relatively easy to do, given that the model on which the base year prices have been set will have already been filed. It may even be possible for Board staff to do this if the LDCs wish, and Board staff could then supply the normalized rates to the individual LDCs. Once that is done, it should be those normalized rates to which the GDPPI escalator and the productivity factor (and any other percentage adjustments) are applied to get the new rates for the test year.
41. ***Productivity Factor.*** The Staff Report proposes a fixed productivity factor of 1%, which is a reduction in the annual inflation escalator. We have two comments on this number.
42. First, while this has the advantage of simplicity, it does appear to use to be generally low for utilities that have never been subjected to regulatory scrutiny in the past. Common sense suggests that in this situation there should be some initial efficiencies available in most cases that might not be the case in a more mature regulatory regime. In effect, there appears to be a lack of an adequate stretch factor. That having been said, this is one of those areas where simplicity in the transition period trumps getting to a more elegant answer. In 3<sup>rd</sup> generation PBR, we hope that a larger productivity factor can be employed. In the meantime, subject to our suggestion below, we believe that an average productivity factor of 1% is reasonable in a short-term transitional PBR mechanism.
43. Second, setting a fixed productivity factor for all LDCs will reward the most inefficient LDCs and penalize the most efficient.

44. In general it would appear to us that LDCs with higher prices should have more room to generate productivity gains than LDCs with lower prices. We therefore propose a small and simple adjustment to the productivity factor based on relative prices. The Board should calculate the relative price levels of all LDCs for 2006, and rank them in order from highest prices to lowest. Those in the top decile (the highest 10% in price levels) would have a productivity factor of 2.0% for 2007, and those in the bottom decile (the lowest 10%) would have a productivity factor of 0.2%. Each decile above the bottom would have 0.2% higher productivity factor, so for example the fifth decile (ie. 40-50%) would have a productivity factor of 1.0%. Once all LDC prices had been established for 2007, the same ranking would take place for that year, and the deciles would be used to determine productivity factors for 2008, and so on.
45. The effect of this proposal is that the biggest outliers on rates would be moved very gently toward the mean. Further, it is the perfect opportunity to do this, because at most they would have a 2% productivity factor, which is well within the range that could be applied to all LDCs anyway. At the other end of the spectrum, those LDCs with low rates would effectively be rewarded for their efficiencies by having more breathing room in their costs (or higher profits, if that is the route they select).
46. It is submitted that, without adjusting for the relative price levels of the LDCs (which is, in this case, a rough proxy for the existing efficiencies already built into their costs), any fixed productivity factor is too easy on the high priced LDCs, and too onerous for the low priced LDCs.
47. **Relative Pricing Factor.** In the event that the Board determines that a variable productivity factor is not the best approach for the PBR formula, it is submitted in the alternative that the Board should adopt a further reduction in the escalator that reflects the relative prices of the utility. In our view, the additional reduction in the annual escalator should apply only to those LDCs whose prices are above the provincial mean, and should vary in direct proportion to the extent to which the LDC is offside from the mean. While we believe that using a variable productivity factor is a simpler and more elegant solution to the problem (and with milder impacts on the high priced LDCs), a separate relative pricing factor has the advantage of adding a small amount of additional transparency to the process, and we think that it can be a viable alternative.
48. **Z Factors and Off Ramps.** As we understand it, the Staff Report is proposing Z factors for only smart meters and tax rates, and we agree that those are sensible adjustments.
49. In general, SEC is opposed to Z factors and off ramps, and believes that utilities under incentive regulation should see the revenue requirement generated by the formula as the budget within which they have to manage the utility, set priorities, and decide how best to spend a fixed amount of money. This fundamentally alters the ratemaking paradigm that a utility is entitled to recover their prudently incurred cost of service plus a reasonable return on invested capital. Instead, it proposes the paradigm that the utility should be granted a reasonable envelope, out of which it has to incur its cost of service, and then retain the

amount left over as its return on invested capital. We agree that this is a better paradigm, which promotes more business-like management of the LDC.

50. We note that this approach also limits the extent to which the Board has to be continually involved in the affairs of the regulated utility during PBR, “adjusting” this and “reconsidering” that. While we generally oppose Z factors and off ramps in a more mature PBR structure, that opposition is even more important in this transitional plan where regulatory efficiencies are such a key goal.
51. We note that Board staff has, in their June presentations, contemplated that some LDCs will want to “adjust rates for another reason”, and will be able to do so. We saw a fair amount of this in both 2005 and 2006, although thankfully it was less than some people feared might happen. While of course there will be emergency situations in which the Board must consider unusual rate changes, it is important that the Board send the message to the LDCs (including restrictions and/or penalties in their licence conditions) that the formula prices are not the floor, on which they can seek exceptions. The formula prices are the norm, and exceptions must be truly “exceptional” to be considered.
52. ***Term of PBR Period.*** SEC believes that longer PBR period give utilities more room to invest for future efficiencies, and thus are better for both LDCs and ratepayers in the long term. However, as this is a transitional plan, we agree that a period of one to three years in PBR is a reasonable approach. It is driven, it appears to us, not by how long the optimum PBR period is, but rather by how many years it will take the Board to rebase all of the LDCs.
53. ***Selection of Cohorts.*** In general we agree with the comments of Board staff on how it will be determined which utilities are rebased in 2008, 2009 and 2010. In addition to our comments in paragraph 37 above, we believe that larger LDCs should be considered earlier if possible, as their rebasing will affect more ratepayers and therefore is implicitly more urgent.
54. ***Overall Recommendations.*** While SEC believes that the Staff Report is for the most part a good proposal that should be implemented, we have proposed the following changes:
  - a. Toronto Hydro and Hydro One should be rebased in 2007, one year earlier than any of the other LDCs.
  - b. The K factor for cost of capital should be applied, not in the escalation formula, but as a normalization of the base year prices prior to escalation. Attempting to include it in the escalation formula would be too complex.
  - c. The productivity factor should average 1%, as proposed in the Staff Report, but should vary from 0.2% to 2.0% by utility based on their relative price levels.
  - d. The ability of LDCs to apply for rate adjustments outside of the PBR mechanism should be strictly circumscribed.

- e. In selecting the LDCs for each year of rebasing, the Board should also prefer to look at larger ones earlier, since more ratepayers will be impacted in those cases.

All of which is respectfully submitted on behalf of the School Energy Coalition this 7th day of July, 2006.

**SHIBLEY RIGHTON LLP**

Per: \_\_\_\_\_  
Jay Shepherd