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via electronic mail to BoardSec@oeb.gov.on.ca and courier

Mr. Peter H. O'Dell, Assistant Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, Suite 2700
Toronto, ON 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)

The purpose of this letter is to provide preliminary comments in connection with the "Draft Staff Report: Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors" – henceforth the "Report" – posted on the Board's website on June 20, 2006. These comments are provided on behalf of Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc., collectively referred to herein as "The Utilities". Please note that Enersource Hydro Mississauga will be submitting a separate letter however, its views are consistent with those expressed herein.

This document will only address matters related to 2nd Generation Incentive Regulation (EB-2006-0089). It is the intent of the Utilities to also file expert reports on this topic with the Board by August 14th, 2006. Comments with respect to the Cost of Capital (EB-2006-0088) will be filed separately and individually by the Utilities' members. Even though comments on Cost of Capital are being filed separately, the Utilities support the concerns expressed by the EDA in their submission that Cost of Capital and incentive regulation issues are interdependent.

The requisite electronic copies of this letter in Word and PDF formats are sent to the attention of the Board Secretary by email and three (3) paper copies by regular mail to the office of the Board.

General

In the view of the Utilities the Report represents a useful first step in the development of an incentive based regulatory mechanism. An appropriately designed price-cap approach has been shown to be effective in inducing efficiency improvements in other jurisdictions but will require further study if it is to be applied in the Ontario context. Efficiency improvement through productivity gains is a central objective already shared by all the under-signed utilities. However, it is of critical importance that the regulatory regime that is implemented be given careful consideration.

The comments in this letter reflect the initial assessment of the Utilities as well as discussions with Board staff in a meeting with the OEA Utility Sector Committee on June 27th. The Utilities have not been able to establish positions with respect to most issues as it is having difficulty understanding the rationale underlying the Board staff proposal. Instead, issues are raised and questions posed in the hopes that further clarification can be provided.

Incentive Regulation Mechanism

The 2nd Generation IRM Formula

Though Board staff has indicated that determination of the price-cap formula has been guided by balancing competing objectives, there is no theoretical or empirical evidence given that would support the efficacy of the proposed mechanism and ensure that the resulting rates are 'just and reasonable'. In fact, many of the proposals presented by Board staff appear to be made in order to provide for regulatory simplicity.

Specific IRM and cost of capital regimes can have serious business implications. They can have critical impacts on financial, operating, investment and customer service aspects of each utility. They can affect reliability and even influence the structural evolution of the

sector as a whole. Implementation of an inappropriate approach will cause more harm than good.

The focus of 2nd generation IRM appears to be on cost cutting. It is unclear whether the Board staff have accumulated evidence to suggest that there are major efficiencies left to be found. Ontario distribution utilities have been in a rate freeze since rate unbundling in 2001and are only now implementing the 2006 rates that in most cases are based on 2004 costs. Prior to 2001, most electric utilities had kept rates frozen since 1993, and some even had rate decreases during that time. Therefore there has been a period of 13 years in which Ontario LDC's had to continuously improve operational efficiency. Moreover, Ontario distributors have had a history of informal yardstick competition, which, arguably, has had a beneficial impact on cost control. In addition, we question whether municipally owned distributors will be able to find 1% efficiency gains each year without compromising reliability and safety and while implementing appropriate capital programs. Without the benefit of having published reports on SQI performance we are unable to assess whether the Board is concerned with current reliability levels nor whether these concerns are being appropriately addressed by the proposed approach. Also, are there service quality concerns that may have been caused by delays in capital expenditures under the rate freeze?

Dividing distributing utilities into 3 tranches does not necessarily address the issue of regulatory burden. Even with one-third of distributors rebasing in each of 2008, 2009 and 2010, the Board will be processing 30 applications per year based on a future test year approach. While the 2nd generation IRM may be "mechanistic" the process still involves Board review and approval of all rate schedules.

There is now a significant body of evidence that stability of the regulatory regime plays an important role in incentive creation.[1] Thus, it would seem that regulatory efficacy would be enhanced if a predictable and durable regime were in place.

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[1] Dr. Mark Lowry's presentation suggests that longer term (5+ year) PBR schemes correlate with strongest incentive power. Incentive Regulation for Ontario Power Distribution, Dr. Mark Newton Lowry, Pacific Economics Group, LLC, June 20, 2006, slide # 63.

The plan presently being put forth in the Report begins with an interim 2nd Generation Incentive Regulation Mechanism. However, while the mechanism is intended to " lay a foundation for the 3rd generation incentive rate adjustment mechanism"[2], the Report states that the approach being proposed "is independent of the development of 3rd Generation IRM." [3] From the point of view of the distribution utility, there is likely to be a continued period of regulatory uncertainty, which could have a significant and deleterious impact on capital and financial planning. Furthermore, if it is not practical to develop both the 2nd and 3rd Generation mechanisms into an integrated, logical approach in time for 2007 rates, then what assurance can be given that the design of the 2nd Generation mechanism will not inappropriately prejudice the design of the 3rd Generation mechanism?

In summary, the present plan does not provide long-term predictability and regulatory certainty given that 2nd generation is proposed to be in place for only up to 3 years. Perhaps regulatory efforts should be focused on providing interim stability and relief while developing a durable long term 3rd generation IRM.

The "K" factor

The "K" factor will differ for distributors depending on their current deemed capital structure. How will this "K" factor be determined? Board staff indicated that it will be adjusted only for the change in ROE. Will the proposed debt/equity structure be used to determine the ROE impact on revenue requirement or will it be based on the deemed capital structures in the 2006 EDR Handbook? Example calculations which reflect the approach being contemplated as well as the effects of tranche allocations would be helpful.
Have Board staff performed preliminary calculations to assess the potential impacts on utilities of implementing the proposed approach? Prior to the implementation of any new regulatory rule, it would seem that an analysis assessing the impacts on utilities would need to be performed.

Board staff is proposing a single capital structure for all distributors. There is concern amongst distributors over the implications of moving to a "one size fits all" capital

[2] Ontario Energy Board, The Board's Multi-Year Electricity Distribution Rate Plan, June 20, 2006, slide #3.
[3] Report, page 14, Section 3.1.

structure, particularly within the proposed timeframe. For many distributors, this will have significant impact on revenue requirement, the ability to meet required expenditures, the ability to compete on the capital markets, on merger and acquisition activity, and even on meeting bank covenants.

With respect to the appropriate capital structure, Board Staff note that there is no evidence to suggest that different size-based capital structures are required. The converse is also true that, neither is there evidence to suggest that different capital structures are not required. The evidence in either instance is simply absent, and the need for more comprehensive review via a Hearing process becomes that much more compelling.

While Board staff has suggested that a single capital structure will assist industry restructuring and evolution, the deemed capital structure is but one issue in a merger or acquisition decision. The 33% transfer tax and the moratorium on Hydro One's sale / acquisition of assets are more significant hurdles than a difference in capital structure. Other processes such as moving to a common collective agreement are probably more problematic than a single capital structure.

Cost Escalation

Board staff is proposing that the base revenue requirement for 2nd generation IRM be that established under 2006 EDR. Most LDCs' revenue requirements were established using 2004 as a test year, making the cost data underpinning the going-in rates for 2nd generation IRM two years out of date. The Utilities suggest that all historical test year filers under 2006 EDR have their current rates adjusted by the GDP-PI price escalator for 2005 and 2006, as part of the 2007 2nd Generation IRM adjustments.

The "M" Factor

It has been suggested by Board staff that smart meter expenditures be placed in a deferral account for consideration in 2008.

We suggest that it would be more appropriate to incorporate an "M" factor to capture smart meter investments given that the current $0.30 was intended as "seed" money for the 1st year only. Delaying recovery of these costs may impede other critical infrastructure

investment and increase the potential for rate shock in 2008. Thus, incorporating smart meter costs in 2007 will help smooth future rates.

The "X" Factor

The use of a 'one size fits all' efficiency offset assumes that all distributors are presently at similar efficiency levels. In fact, less efficient distributors may find it easier and less costly to achieve the prescribed efficiency gains. Given the interim nature of 2nd generation IRM, incentives are created for distributors – acting in the best interest of their shareholders and customers – to seek timing advantages when applying for re-basing.

The Inflation Factor

There is some concern that the GDP-PI may not be adequate as an appropriate indicator of inflation. Has sufficient consideration been given to issues such as the capital intensity of the electricity distribution sector and the costs of other inputs?

The "Z" factor and Off-Ramps

The absence of an off-ramp or "Z" factor may adversely affect distributors that have large infrastructure investments within the 2nd generation IRM timeframe. The formula does not facilitate, and indeed may hamper, timely and optimal capital expenditures during the 2nd generation IRM period. In the alternative, would the Board accommodate utility requests for re-basing in a particular year as a method of off-ramp relief?

Timing of Applications

Consideration must now be given to the timing of filing of applications for both 2007 and more particularly for 2008. Given that the Board's own benchmarks for application processing require 280 days, and the fact that 2008 rate applications are to be based on a full forward test year, utilities must be given adequate time to prepare their evidence. The process of identifying and advising those utilities that are to be included in the first tranche must happen almost immediately.

What certainty will the Board provide to individual utilities regarding their scheduled rebasing tranche? Will the determinants used to group utilities be re-examined annually and utilities subsequently moved between tranches? Is there a risk that a utility may be advanced in the queue if it over-earns while still in 2nd Generation IRM?

Compatibility with the Gas Sector

Much of the Board staff proposal is based on regulation of the gas industry in Ontario and electricity industries in certain other jurisdictions. Evidently, one of the objectives has been to 'level the playing field' between gas and electricity. Yet perhaps it is a bit premature to proceed in this direction so quickly. From the point of view of optimal regulation of electricity distribution, there are ways in which electricity differs materially from the gas industry in Ontario and indeed from electricity distribution in other jurisdictions.

One important difference is the number of electricity distributors in Ontario. In comparison there are very few gas distributors. Moreover, few jurisdictions worldwide have a large number of electricity distributors.

A second important distinction is that distributors in Ontario are municipally (or provincially) owned whereas the gas companies are privately owned. This has implications for capital structure, (gas companies have access to equity capital), the efficacy of price-cap mechanisms in incentive creation, the ability to provide incentives to staff to find efficiencies, and for corporate decisions (e.g., electricity companies may place greater emphasis on rate smoothing and rate impact mitigation given that they are municipally owned).

A third major difference is that electricity companies have an obligation to serve while gas companies do not. This further constrains the former group. Leveling the playing field does not imply implementation of identical regulatory regimes, rather it entails a harmonization of regulatory approaches.

Conclusion

The Utilities appreciate the opportunity to participate in this consultation process and cautions that any revision to the existing regulatory regime must be carefully considered before being implemented in order to 'get things right'. The comments in this paper are intended to facilitate this journey.

Please contact the undersigned for clarification of anything in this paper.

Yours truly,

R. Zebrowski, Vice-President
Regulatory Services
(on behalf of The Utilities)

RZ/acc

cc: L. Anderson, Hydro Ottawa Limited
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