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June 30, 2006

VIA EMAIL AND COURIER

Mr. Peter H. O'Dell
Assistant Board Secretary
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EB-2006-088/89.
OEB BOARD SECRETARY
File No: | Sub File: 5
Panel
Licensing Russ H., Lisa B.
Other Martine B.
00/04 3HC.

Dear Mr. O'Dell:

Re: Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089)

VECC'S Comments Re: June 19th, 2006 Draft Report

As Counsel to the Vulnerable Energy Consumer's Coalition (VECC), I am writing, per the Board's letter of June 19th, 2006, to provide our comments on the OEB Staff's Daft Report on the above issues. The comments are broken down into three sections:

- Overall Scope of Review and Approach
- Cost of Capital Proposals
- Second Generation Incentive Regulation Proposals (including implementation of cost of capital proposals).

Subject to the Board's direction on cost awards, VECC will be seeking to cooperate with other stakeholders to retain experts in the field of Cost of Capital and Incentive Regulation to comment on the technical merits of the Staff Proposals and the Reports prepared by the experts retained by the Board. At this time, VECC's comments will focus primarily on issues of clarification and implementation.

Overall Scope of Review and Approach

- In the Introduction to the Draft Report (page 3), it is stated that "this review will examine the cost of capital using the benchmark 1998 paper by Dr. Cannon .... as the point of departure. In addition to a review of the economic and financial issues that are discussed by Cannon, this review will include a broader examination of the risks faced by distributors". However, neither the Staff Report nor the Expert Report by Lazar and Prisman adequately explain the rationale behind a number of the proposed departures from the recommendations made by Dr. Cannon and subsequently adopted by the OEB following RP-1999-0034. Also, neither the Staff Report not the Expert Report contain reviews of the broader economic and financial issues discussed by Cannon or the risks faced by distributors as the description of the Scope of the Review suggests. Both of these comments are expanded on further below.
- The Report states (page 3) that "the Board will amend the licences of electricity distributors to stipulate that, in determining rates for the distributor, the Board will apply the methods and techniques set out in the new code". VECC understands that the OEB will be seeking comments on the use of Licence amendments and Codes to implement the new rate setting methodologies through a separate process. VECC strongly urges the Board to ensure that its proposals in this regard clearly set out:
  - The circumstances, if any, under which either the Board or electricity distributors will be able to depart from the Rate Setting Code(s).
  - The process that will be followed in reviewing and approving rate changes under the Code and, in particular, what opportunity will be provided for interested parties to either comment or more formally participate in such reviews.
  - The public accessibility of any information (e.g., Service Qualify Indicators, Financial Results, etc.) that electricity distributors will be required to file with the Board under the Code(s) in support of rate changes.

Cost of Capital

Capital Structure

- Staff proposes (page 8) that the appropriate capital structure for distributors is 36% common equity (64% debt) with the proviso that distributors could include preferred shares as part of their capital structure up to a maximum of 4%.
- VECC assumes that preferred shares would be included as part of the capital structure only if such shares have actually been issued and would suggest that the next draft of the Report include this clarification. Also, the next draft of the Report should clearly indicate that the allowed return on the preferred shares is subject to the Board's approval.

- Staff proposes (page 11) that the portion of short-term debt be "limited" to working capital. It is not clear from the text whether the proposal is to allow distributors a level of short-term debt up to the value of working capital or to set the percentage of short-term debt at that value. Since working capital allowances are based on 15% of the cost of power plus controllable expense, the percentage of rate base represented by short-term debt could vary materially among distributors if the level of short-term debt was to be equated to the level of working capital. Indeed, based on the 2006 EDR data published on the Board's web-site, working capital ranges from 10%[1] to 49% of rate base and averages just over 20%.
- In VECC's view, guidelines as to the amount of deemed short-term debt to be reflected in the capital structure should be clearly laid out by the Board, with no discretion on part of the distributors. However, rather than simply basing the short-term debt component on the level of working capital, it would be reasonable to limit the maximum amount of short-term debt as a percentage of overall rate base. VECC is not in a position to propose a specific upper limit at this time. However, the value should likely be no more than 15% of rate base.

Cost of Debt

- Staff proposes (page 10) that the risk free rate for debt be set based on an average of 5, 10, and 15 year forward rates for Government of Canada bonds.
- Staff then proposes (page 11) that:
  - Existing debt will be carried forward at the existing debt rate and that new third party debt rates will be set annually at a rate established for the particular debt instrument (short-term and long-term debt).
  - New debt held by affiliates would be limited to a maximum rate of the risk free rate plus a transaction premium determined by the spread between "A/BBB" corporate bonds and the corresponding Canada.
  - Similarly, for distributors with no debt or only associated party debt, the maximum allowable cost of debt would be set annually at the same rate as for new affiliate debt.
- Both the Staff Report and the Expert Report by Lazar and Prisman state that the forward rates are a better indicator of the future cost of capital than *Concensus Forecasts'* 3-month and 12-month forecasts for 10 year Canada bonds. However, neither report clearly explains why. VECC suggests that, given the current methodology has been employed by the Board for almost 10 years it would be useful to include in the next draft of the Staff Report an explanation as to why the proposed approach is preferable. Similarly, it would be useful if the next draft included a "layman's" description as to how the forward rate will be determined. Ideally, this would be at a level that the

[1] The reported range excludes Hydro One Networks whose 2006 working capital was determined using a different approach. The value for Hydro One Networks is 7.7%.

reader could understand how the calculations are performed and allow replication using updated data.

- VECC presumes that the rate applicable to existing associated party debt (e.g., debt held by the shareholder) would remain unchanged going forward and be based on the rate allowed for 2006 rates (per page 11). VECC requests that Board staff clarify if this is not the case and the rate is to be updated annually. VECC also notes that since most distributors filed their 2006 Rate Applications based on an historical (2004) test year that the Board will have to establish the maximum allowable rates for associated party debt issued in 2005 and 2006 as well as for 2007 and subsequent years.
- It is not clear from the Expert Report (page 46) exactly how the 1% point spread between the risk free rate and A/BBB corporate bonds was determined. Indeed, Lazar and Prisman recommend that a "panel of experts" select the corporate bonds to be used in the calculation. In terms of the Staff Report, it is not clear whether Staff is recommending a 1% spread be adopted or that a process be put in place to determine what the appropriate spread should be. VECC would request that this be clarified in the next draft.
- VECC would also note that, while nice in theory, in practice it is unlikely that a "panel of experts" will agree on the appropriate mix of corporate bonds. VECC's experience to date in regulatory proceedings is that cost of capital experts rarely agree. In addition, it may be difficult for parties to the proceeding to agree on the composition of the expert panel itself. VECC would suggest that as a starting point, Board Staff request that its experts set out what they believe to be a representative set of A/BBB rated corporations and how the spread should be calculated for inclusion in the next Staff Report.
- Finally, it is not clear from the Staff Report what the process would be for updating the cost of affiliate debt. On page 10 (paragraph 2) Staff indicates that it supports fixing the risk free rate for purposes of setting ROE for five years. In making this recommendation, Staff refers to two options put forward by Lazar and Prisman, one involving the fixing of the risk free rate for five years and the other using a panel of experts to select the appropriate sample annually. However, in reviewing the Expert Report VECC notes that both the options put forward by Lazar and Prisman for determining ROE (page 46) involve an annual update of the risk free rate. It is only the risk premium that is held constant for five years in the first option. In contrast, in their discussion regarding debt rates (page 31), Lazar and Prisman put forward three options. Two of these involve annual updating of the both the risk free rate and the premium for A/BBB rated corporations, while the a third calls for a constant cost of risk free debt.
- There should be a consistent approach to determining the annual risk free rate used in the derivation of the annual cost of affiliate debt and ROE. In VECC's view, the preferred approach would be to update the risk free rate annually. Furthermore, VECC would ask that the Staff Report clarify what the role of an expert panel would be in updating the risk free rate (as suggested on page 10, paragraph 2). In VECC's view, it is more likely that an expert

panel would be required to assist in the updating of the premium for A/BBB rated corporations and the risk premium for ROE (as noted by Lazar and Prisman, page 46).

Return on Equity

- Staff proposes (page 9) to follow a methodology conceptually similar to that currently used by the Board whereby the return on equity is based on a risk free rate plus an equity risk premium. However, the proposal differs materially in terms of how the risk free rate is determined (as discussed above), the equity risk premium would be established and how the equity risk premium would be updated annually.
- For the equity risk premium, the Staff Report proposes to adopt the approach put forward by Lazar and Prisman and use the Capital Asset Pricing Model (CAPM) to determine the value. In their report, Lazar and Prisman (page 47) recommend that a panel of experts be assembled to determine the sample of companies to be used in determining the "beta" required for calculating the risk premium. Presumably this same panel would define the data required to determine the expected rate of return on the market (per section 3.3.3 of the Expert Report).
- Since the sample used to establish the "beta" will likely consist of companies involved in other lines of business besides just electricity distribution (see Expert Report, pages 37-38), arguments could be made that some adjustment should be made to the derived risk premium to account for differences in business risk as between the sample companies and electricity distributors. Presumably, this is another area that the "expert panel" would need to address.
- As noted above, VECC is skeptical that a panel of experts could "agree" on the necessary parameters for calculating both the overall market return and the betas applicable to electricity distributors. Indeed the Board noted (page 36) in its RP-1998-001 decision regarding Hydro One Networks Transmission rates:

  > "The Board appreciates that a significant amount of professional judgment is involved in many aspects of the risk premium determination, including time period used to acquire data, utility specific relative risk adjustments, impacts of varying common equity ratios, use of various market measures, etc."

- In VECC's view the Board's determination regarding equity risk premium can be informed by the opinion of experts. However, the opinions will differ and the Board will (ultimately) have to render a decision. To facilitate this process, VECC would suggest that Board Staff request that its experts clearly set out what they believe to be an appropriate risk premium for electricity distributors, as opposed to just a range of values, for inclusion in the next Staff Report.
- Board Staff's proposal also calls the inclusion of a 50 basis points mark-up for flotation and other transaction costs. However, VECC points out that for

virtually all Ontario electricity distributors there were none of the typical floatation or transaction costs incurred when the industry was restructured and the "shares" are not publicly (or even privately) traded. In VECC's view, additional rationale is required to support this mark-up.

- The Appendix to the Staff Report appears to indicate a preference for the 10 year S&P (over the 5 year) in determining the overall market rate of return. However, this preference is not mentioned in the body of the Staff Report. If this is the Board Staff's preferred approach it should be clearly stated in the next draft.
- The Appendix also seems to suggest, by virtue of the range of results included for its proposal, that the Staff is undecided as to whether to adopt the Lazar and Prisman approach based on the CAPM or simply update the results of the Cannon Report in order to determine the equity risk premium. However, the body of the Staff Report expresses support for the CAPM approach. Again, VECC requests that that the nature of Staff proposals be clarified in the next draft. Also, VECC is unclear as to the "updating methodology" used to derive the 8.36% ROE value for the updated Cannon Method. Simply adjusting for the change in interest rates would yield a value of 8.26%, whereas application of the Board's 1997 ROE Guidelines would yield a value of 8.72% (i.e., 9.88% + 0.75*(4.45%-6.0%)).
- The Staff Report also makes reference to two options put forward by Lazar and Prisman for the annual update of the risk premium (one involving a panel of experts and the other a fixed/formulaic approach) and indicates that they are undecided as to which one to adopt (page 10).
- At this point, VECC's preference is for a formulaic approach to the annual update for ROE. VECC notes that in their conclusions, Lazar and Prisman suggest a specific annual adjustment formula. However, there is no rationale provided as to the basis for formula or why it is appropriate. VECC suggests that, in order to assist parties in commenting on the two options, an explanation as to the basis of the recommended formula should be included in the next draft of the Staff Report.

Incentive Regulation

Inflation (Price) Escalator

- The Staff Report agrees with Dr. Lowry's assessment that a macro-economic measure of inflation such as GDP-PI is preferable to CPI as a measure of inflation. VECC agrees that GDP-PI is a preferable measure, as it is more likely to capture the inflation rate relevant for electricity distributors when compared to CPI which is, by definition, heavily oriented to consumer goods.
- A question has been raised as to whether the Canada or Ontario GDP-PI should be used. VECC is of the view that the Ontario GDP-PI should be used as it will be much less susceptible to influence from oil and gas exports and swings in the associated prices.

- One issue that was not clear from the Staff Report is how the GDP-PI adjustment would be made, i.e., what value would be used? One approach would be to simply use the historical rate for the preceding year as reported. The other would be to use a forecast/historical value along with a subsequent true-up to the actual value in the following year. At this stage, and subject to further consideration, VECC's view is that the inflation index should be based on historical values and not subject to further adjustment or true-up. The short timeframe associated with the second generation incentive regulation period and the fact GDP-PI is a proxy for an industry specific index both suggest that the additional complexity that would be added by a true-up is not warranted. The next draft of the Report should include Staff's recommendations on this subject.

X-Factor

- When used in conjunction with a macro inflation measure, the X-Factor is meant to capture a number of considerations including:
  - Input price differentials (as between the economy overall and the electricity distribution sector);
  - Productivity differentials (as between the total factor productivity trend for the economy and the electricity distribution sector); and
  - A stretch factor.
- Board Staff has proposed that this value be set at 1.0% for the duration of the 2nd generation IRM. VECC notes that this proposal is materially less than the 1.5% value established for the first-generation PBR, although that plan utilized an industry specific price index as opposed to a macroeconomic price index. Some discussion of the conceptual difference between the two would be useful.

Contingencies and Mid-Term Issues

- Staff proposes that the 2nd generation IRM not provide for any Z-factors, based on the short term of the plan. VECC agrees and notes that the criteria used to select utilities for cost-of-service rebasing in 2008, 2009 and 2010 respectively could include financial performance and lead to utilities experiencing excessively low returns (or high returns as discussed below) to be selected early for rebasing.
- VECC notes that, as well as excluding any Z-factors, the plan should also exclude the creation of any new deferral accounts. Otherwise, electricity distributors will simply seek to use such accounts to address the types of issues they are precluded from addressing through the request for a Z-factor adjustment or off-ramp.

K-Factor (Cost of Capital) Adjustment

- Staff proposes the creation of two separate K-Factor adjustments to account for the change in ROE and cost of capital for distributors. The first adjustment would occur in 2007 and numerically approximate the adjustment for changes in ROE and debt rates. The second adjustment would occur in 2008 and reflect the move to a standard capital structure for all distributors. The intent behind introducing these adjustments is to make distributors indifferent to the timing of their rebasing from a cost of capital perspective by attempting to replicate the adjustment they will experience when actually rebased using the new cost of capital approach.
- VECC notes that a unique adjustment will need to be calculated for each distributor for 2007. The reasons for this are that:
    - ROE as a percentage of approved 2006 revenue requirement will typically vary from utility to utility. This means that even if only a standard percentage change in ROE is required for 2007 the impact on each utility's overall revenue requirement will be different and, therefore, the adjustment required in price will vary.
    - Not all utilities applied for and received approval for a 9.0% ROE for 2006. Furthermore, there are a limited number of utilities who did not apply for any rate adjustment for 2006 rates.
    - The need for an adjustment in debt rates for 2007 will vary by utility depending whether or not any new debt has been issued and, if so, how much.
- Similarly, a unique adjustment for each distributor will also be needed for 2008. In this case the reasons are that:
    - The overall cost of capital as a percentage of approved 2006 revenue requirement will also vary from utility to utility. This means that even if a standard adjustment could be established to cost of capital as a result of the capital structure change the impact on each utility's overall revenue requirement will be different and, therefore, the adjustment required in price will vary.
    - The four approved capital structures for 2006 will give rise to the need for different adjustments.
    - The variation in debt costs across utilities will impact on the adjustment required for capital structure.

  Finally, the 2008 K-Factor will also have to address any change in approved ROE as well as changes in the debt portfolio for individual distributors.
- VECC also notes that K-Factor adjustments will be required in 2009 in order to reflect (for the remaining 1/3 of distributors still on the 2nd generation IRM) any potential update to the ROE and cost of debt. Again, and for similar reasons, these adjustments will also have to be uniquely determined for each distributor.
- VECC requests that the next draft of the Staff Paper include more details regarding how the K-Factor will be established on an annual basis.

Earnings Sharing

- Staff's proposal does not include an earnings sharing mechanism (ESM) as part of the 2nd generation IRM. The rationale is that an ESM may reduce the distributors' efficiency incentives and introduce a potentially costly additional regulatory process.
- Given the short duration of the 2nd generation plan (i.e., only 1-3 years depending upon the timing of the re-basing), VECC does not see the 2nd generation IRM offering a strong incentive for efficiency improvement. VECC would expect that distributors have already availed themselves of any efficiency investments that could offer significant paybacks in just one or two years such that any sharing mechanism would be triggered.
- However, VECC notes that the need for an earnings sharing mechanism is reduced if the screening criteria used to select utilities for cost-of-service rebasing in 2008, 2009 and 2010 respectively includes early rebasing for utilities experiencing excessively high returns.

Service Quality and Reporting & Data Requirements

- Staff's proposals call for the Board to resume its SQR review and that the resultant indicators and associated performance standards be implemented by means of an amendment to the Distribution System Code. Staff also recommends that the frequency of reporting be increased to quarterly and that the results be published on the Board's web site.
- VECC concurs with all of these proposals. In terms of the SQR review, it is critical that the review be completed and the Code amendments implemented prior to the commencement of the 2nd generation IRM. Also, VECC would request that the Board publish not only current service quality reports on its web site but also comparable historic service quality data so that trends are readily apparent.
- Currently much of the financial information filed with the Board by distributors as part of the Electricity Reporting and Record Keeping Requirements is considered confidential. Furthermore, even information which is not confidential is not readily accessible. In VECC's view, utilities should be required to file and the Board should post on its web site annual financial results at the same level of USoA detail as was required to be submitted in the 2006 EDR applications.

Exclusions From the Price Cap Mechanism

- Throughout the Staff Report references are made to various items that would be excluded from the 2nd generation IRM and treated as a "separate calculation", including payments in lieu of taxes (page 14) and any new C&DM activities (page 20). Similarly, during the June 20th stakeholder session reference was made to Smart Meters and Riders for Recover of Regulatory Assets being excluded from the scheme.

- It would be useful if the next draft of the report included a section that dealt specifically with this topic and outlined what was and what was not covered by the adjustment mechanism. Related issues that need to be addressed are:
    - The treatment of Miscellaneous Charges (are they subject to annual adjustment or not?).
    - The ability of distributors to "adjust" the recovery of regulatory assets to address balances accumulated post-December 2004.
    - Disposition of other existing deferral accounts.

Groupings for Rebasing

- This topic was addressed during the June 20th stakeholder session but is not covered in the Staff Report. In VECC's view this is a critical component of the overall 2nd generation IRM scheme and warrants a section in the next draft of the Staff Report.
- Staff has suggested that the timing for rebasing will be based on a range of factors including:
    - Comparator and cohort information screening
    - Urgency of cost allocation issues
    - Prior direction in a Board Decision
    - Need and ability to implement new rate design
    - Realized earnings.
- Staff has also suggested that distributors advise the Board in writing if they foresee a need to be included early in the rate adjustment process. The ability of distributors to self-nominate themselves for early re-basing should help address distributor concerns about a lack of Z-factors and off-ramps in the scheme. However, it does not address concerns ratepayer may have regarding over-earnings, particularly since there will be no earnings sharing. As noted earlier, VECC considers it critical that realized earnings in the form of over earnings be a primary screening factor if there is to be a level playing field.
- Neither the Staff Paper nor the presentation on June 20th addressed the question of whether the timing for all utility reviews would be established when those distributors expected to file for rebasing in 2008 were identified or whether the utilities expected to file for rebasing in 2009 would be identified at a later date. While it would be cleaner to identify the timing of the rebasing for all distributors at the start of 2nd generation IRM, this may not be practical. Circumstances could change and more current data on financial or service quality performance should be taken into account when determining who should file for rebasing in 2009.

VECC looks forward to receipt of the Staff's planned July 20th draft and appreciates the opportunity to comment. If you have any questions regarding the

preceding comments please contact either Bill Harper (416-348-0193) or myself (416-767-1666).

Yours truly,

Michael Buonaguro
Counsel for VECC