FINAL SUBMISSIONS OF THE CONSUMERS COUNCIL OF CANADA

TO THE ONTARIO ENERGY BOARD

OCTOBER 27, 2006

THE COST OF CAPITAL AND 2ND GENERATION INCENTIVE REGULATION FOR ONTARIO'S ELECTRICITY DISTRIBUTORS CONSULTATION PROCESS

EB-2006-0088/EB-2006-0089

I. INTRODUCTION:

On April 27, 2006, the Ontario Energy Board ("Board") initiated consultations regarding the review of the cost of capital applicable to electricity distributors and the development of a 2nd Generation incentive regulation mechanism ("IRM") for setting distribution rates during the period 2007-2009 ("Rate Plan"). On July 25, 2006, Board Staff released a Discussion Paper addressing these two issues, identifying options and presenting its views on a number of preferred options ("Board Staff Paper"). On August 14, 2006, interested parties submitted comments on the Board Staff Paper.

On July 7, 2006, the Board commenced a parallel proceeding to amend the licences of electricity distributors to implement the new methods for setting rates that are developed as a part of this proceeding.

During the week of September 18, 2006, the Board held a Technical Conference to allow the Board and interested parties to seek clarification on the submissions, which included papers prepared by experts on both the cost of capital and the incentive regulation issues. That initial Technical Conference was followed by a further round of questions by parties and a subsequent Technical Conference on October 17.

These are the final submissions of the Consumers Council of Canada (“the Council”). The Council has jointly sponsored the Submission of Dr. Laurence Booth regarding the cost of capital issue with the Vulnerable Energy Consumers Coalition (“VECC”), the Industrial Gas Users Association (“IGUA”), and the London Property Management Association (“LPMA”) which was filed on August 14. The Council will make submissions on both the cost of capital and incentive regulation regime, but will not repeat all of its submissions made on August 14.

On October 20, the Council made separate submissions to the Board regarding the jurisdictional issues related to the development of new Codes and Licence Amendments. The submissions herein are subject to the Council’s views on the limits of the Board’s jurisdiction.

II. OVERVIEW:

The Council recognizes the challenges faced by the Board in regulating over 80 electric distribution companies (LDCs”). The Board must balance the need to ensure that rates are just and reasonable and based on the cost of providing distribution service with the need for regulatory efficiency. Accordingly, as indicated in its previous submissions, and subject to the Council’s view that each LDC retains the right to have its rates set on the basis not of a formula but on its individual circumstances, the Council supports the implementation of a multi-year transitional mechanism to set rates during the Rate Plan period. Acceptance of that plan is contingent on the commitment made by the Board to rebase all of the LDCs during that Rate plan period.

The Council reiterates its position regarding the Board’s proposal to set rates beyond this period that all stakeholders must be given a full opportunity to make proposals for setting rates beyond the transitional period and participate in any review of those proposals by the Board. Acceptance of the price cap model for the years 2007-2009 should not be seen as acceptance of that particular model beyond that period.

All parties must recognize that any plan to set rates for over 80 LDCs during the next three years cannot be perfect. The approach adopted by the Board must attempt to balance the interests of the ratepayers and the shareholders, but it must also be as practical as possible. If the approach is not practical, not viewed as a transition mechanism and not fair to all stakeholders it will likely not be sustained for a three year period. Therefore, the intended goal of regulatory efficiency will be lost.

As set out below the Council largely supports the proposed price cap approach. With some enhancements the Council accepts it as a reasonable transition approach to setting rates within the Rate Plan period. With respect to the determination of the cost of capital, the process to date has illustrated that there are many contentious issues that have not been resolved and remain outstanding. Most parties, including the Council, take the position that, in the absence of a full evidentiary proceeding, those issues cannot and should not be determined through this consultation process. Accordingly, like other stakeholders, the Council believes the appropriate approach for the Board to follow would be to maintain the status quo regarding the determination of an appropriate return on equity ("ROE") for electric LDCs.

One issue which does not arise in this proceeding but which, in the Council's view, must be addressed sooner rather than later, is whether municipally-owned LDCs should be allowed to earn a return on their investment. The decision to allow them to earn a return on their investment was made in the context of a different design for the electricity sector. The Council believes that the decision now needs to be revisited.

The Council will address what it views to be the key issues regarding both cost of capital and the incentive regulation approach below.

III. COST OF CAPTIAL:

A. Return on Equity:

In setting the cost of capital for electric LDCs, the Board must ensure that the ROE is sufficient for the distributors to attract investment and earn an appropriate return, but also consistent with the setting of just and reasonable rates for electricity customers. Striking the appropriate balance between the interests of the LDC shareholders and the ratepayers in this context is difficult given the fact the Board is faced with the task of determining an appropriate return for more than 80 LDCs.

It is clear that some form of formula approach is the only alternative. It is not practical, and perhaps not even possible, for the Board to separately assess an appropriate cost of capital for each of the Ontario LDCs on a case-by-case basis. The exiting formula has been in place since 1999 and has been accepted as an appropriate methodology for setting approved return on equity levels for both the Ontario electric LDCs and the natural gas LDCs. It is also an approach commonly applied by regulators across Canada. If the Board is prepared to move off of that approach it should only do so if becomes convinced that the approach does not result in return levels that balance the interests of utility shareholders and ratepayers. The Council does not believe that the Board has, through this process, been provided with compelling "evidence" that would warrant the need to adopt a new approach.

The determination of the cost of capital was vigorously debated throughout this process, with a whole range of proposals and assertions being advanced by the stakeholders, including Board Staff. Regrettably, none of the proposals and assertions was subject to cross-examination. From the Council's perspective the Board must explicitly acknowledge that the submissions by parties to this process and their experts are not evidence. The Board should not make decisions to implement changes in the absence of a full evidentiary process to test those proposals and assertions.

Both Dr. Booth and Ms. McShane (appearing on behalf of Hydro One Networks Inc.) acknowledged that the current formula approach would be an acceptable way to setting the ROE for the Rate Plan period. Dr. Booth, in his submission, noted that the Board has in recent years "fully reviewed" its adjustment mechanism and he has seen no evidence in the last 2 ½ years to justify changing the explicit decision (reached following a full evidentiary proceeding) by the Board to maintain the use of the mechanism. (Submission of Dr. Booth, dated August 2006, p. 21)

The Council supports using the currently Board approved ROE of 9% as the benchmark for determining the ROE allowed for 2007 through the existing formula approach. Board Staff was seeking input from parties as to whether the Board should be concerned about the ability for Ontario's electric LDCs to raise capital. There was no evidence provided that continuing to use the current formula approach to ROE would jeopardize the ability of the Ontario electric to raise capital.

The Council notes that if the Board adopts a method of determining the ROE that is perceived to be unfair to LDCs it will likely be faced with individual applications from many LDCs for a utility specific determination of the ROE. In the alternative, if the Board adopts a methodology that is adverse to the interests of ratepayers, intervenors may intervene in many more applications that they otherwise would and present their own evidence. Adopting an approach that is supported by both intervenors representing ratepayers and LDCs will, in our view contribute to one of the Board's objectives which is regulatory efficiency.

B. Capital Structure:

In the 2006 Electricity Distribution Rate ("EDR") Handbook, the Board established capital structure and debt rates for Ontario LDCs based on size. Those LDCs with the highest levels of rate base are subject to a 65%/35% debt/equity structure and a deemed debt rate of 5.8%. The Handbook sets out 4 tiers that specify different capital structures and debt levels for difference sized LDCs.

Under the Board Staff proposal, as set out in the Discussion Paper, all LDCs would be subject to a 60/40 % debt/equity structure. Included in a 40% equity component would be any preferred shares up to a maximum of 4% of rate base. Board Staff has indicated its view that there is need for a significant expansion of investment in the electricity distribution infrastructure and that this poses additional risks relative to the gas LDCs. Its proposal to set a higher equity level is reflective of that view. (Board Staff Paper, p. 13)

Dr. Booth does not support the specific proposals advanced by Board Staff. He supports a 36% equity component and does not support municipal LDCs having a preferred share component in their capital structure as "preference shares are issued by companies with private shareowners as a means of increasing key coverage ratio targets and thus improving access to capital markets." (Submission of Dr. Booth, p. 25)

On the issue of risk there has been no convincing evidence advanced in this process that demonstrates that the Ontario electric LDCs are riskier than either the Ontario electric gas LDCs or other Canadian LDCs. Many of the LDCs pointed to what they view as exposure to significant political risk and regulatory risk, but as Dr. Booth noted that risk is risk related to past periods. The Board must determine if there is sufficient rationale for continuing with a tiered approach to capital structure based on some level of relative risk of Ontario electric LDCs. In addition, the Board must determine if the electric LDCs are sufficiently riskier than other Canadian LDCs to justify higher equity levels.

The Council supports a debt/equity ratio of 36/64 %. As Dr. Booth stated this is broadly in line with what is allowed elsewhere. (Submission of Dr. Booth, p. 22) The Council notes that it is clearly in line with what this Board has approved for the Ontario natural gas LDCs.

If the Board is convinced by the submissions of some of the smaller LDCs that they may be harmed financially with a 36/64 equity/debt ratio then the Board may want to consider different treatment for LDCs under a certain threshold level.

The Council notes the comment by Board Staff that they have considered a "need for significant expansion of investment in electricity distribution infrastructure" in arriving at a higher proposed level of equity. (Board Staff Paper, p. 13) If the Board accepts the higher equity level on that basis, the Council urges the Board be careful about further compensating LDCs for the same reason either through either a premium on the equity return of 50-150 basis points as suggested by Board Staff or through the implementation of the CI factor as proposed by Hydro One Networks ("HON").

The Board has proposed eliminating the tiered approach to capital structure on the basis that "they are more alike than they are different with respect to the risks they face…". (p. 13) If the Board is also attempting to promote rationalization of the distribution sector through this proposal the Council is of the view that it should be explicit about its objectives in this regard.

C. Cost of Debt:

With respect to debt costs the Council accepts that an appropriate approach is to distinguish between third-party debt and affiliated debt. For affiliated debt the Council accepts Dr. Booth's proposal to use current yields on utility debt that is well traded in the capital market such as EGD's plus a 20 basis point liquidity premium.

With respect to third-party debt the Council supports actual cost rates for that debt. This is consistent with the proposal being advanced by Board Staff. In the most recent Toronto Hydro Energy Services Ltd.'s 2006 rate proceeding, it became apparent that using the actual debt rate for such affiliated debt would be inappropriate and unfair to utility ratepayers.

From the Council's perspective any short-term debt component should be costed at a market rate. The Board could establish the appropriate rate on an annual basis.

IV. INCENTIVE REGULATION:

A. Objectives of 2nd Generation IRM:

As noted above, and again subject to the resolution of the jurisdictional issues, the Council is generally supportive of the approach being advanced by Board Staff for the transitional Rate Plan period. From the Council's perspective what needs to be paramount is that through this process the Board, consistent with its statutory objectives, must protect the interests of consumers with respect to prices. In addition, the Board must ensure through this period the adequacy of reliability and quality of electricity service.

The Council supports a price cap approach for the transition period. We will comment below on some of the parameters suggested by Board Staff and other stakeholders.

B. Annual Proxy Adjustment for Cost of Capital:

Board Staff's proposal is that rates be adjusted by an incentive formula that would include as one adjustment factor, recognition of changes to the existing capital structure and return on equity ("ROE"). Those distributors that will be rebased will have the proposed cost of capital method applied to their revenue requirements. Until rates are rebased the adjustment factor would be applied to adjust their revenue requirements. (p. 20)

There will be two separate "K" factor adjustments to account for changes in ROE and capital structure from what is currently reflected in rates. The first will adjust rates in 2007 to reflect changes in the ROE if that change is more than 10 basis points from the approved 2006 ROE of 9%. For those that will not be rebased in 2008 the "K" factor would numerically approximate the adjustment necessary to move a distributor from its current capital structure to the proposed common structure. (p. 20)

As noted in its earlier submission the Council accepts that the K- factor methodology is an appropriate approach. To be fair, however, the Board should apply individual K factors to each LDC rather than attempting to group LDCs into categories.

C. Term and Starting Base:

Rebasing for all distributors will take place in either, 2008, 2009 or 2010. As noted above the Council accepts this approach as reasonable as long as rebasing entails a full cost of service review. In addition, the Council sees no need to adjust 2007 to reflect three years of escalation. 2006 rates were set on the basis that they were adequate for 2006. 2007 rates should be indexed using the 2006 rate levels.

Consistent with this approach, there should be a mechanism whereby LDCs that feel compromised by this approach can apply for an earlier rebasing.

D. Price Escalator:

Board Staff is proposing that a GDP-IPI (Gross Domestic Product Implicit Price Index) as the inflation proxy for the 2nd Generation IRM. Board Staff is also proposing that the Canada GDP-IPI for final domestic demand be used as opposed to the Ontario value. The proposal will take 4th quarter GDP-IPI data for the rate adjustments. (p. 23). The Council accepts the use of the Canada GDP-IPI as the inflation proxy for the 2nd Generation IRM. Other approaches should be considered in the context of the 3rd Generation IRM.

E. X-Factor:

Board Staff is proposing that distributors be subject to a 1% X-factor for the duration of the 2nd Generation IRM. To the extent the 1% is representative of X factors typically employed in other jurisdictions the Council supports the use of it for the Rate Plan period. The Council notes Dr. Lowry's observation that the X-factor is conservative. With

respect to a 3rd Generation IRM the Council submits that a more comprehensive assessment of an appropriate X-factor should be considered.

F. Contingencies and Mid-Term Issues:

The Board Staff proposal sets out an allowance for Z-factors (adjustments during the plan) for unusual events beyond the control of management. Examples include changes in regulation, changes in accounting or tax rules, and natural disasters. In order for costs to be considered for recovery through a Z-factor Board Staff is proposing that the costs be subject to four tests: causation; materiality; inability of management to control, and prudence. The materiality threshold would be .2% of net fixed assets. Distributors will be required to submit evidence to substantiate that the costs that were incurred meet the four criteria outlined above. (pp. 27-28)

Board Staff is not proposing that the IRM will allow for “off-ramps”. (p. 28)

As noted in its previous submissions, the Council accepts that the use of Z-factors is appropriate during an incentive regulation plan. However, the tests for determining whether Z-factors are appropriate must be clear and set out prior to the commencement of the plan. The onus will be on the LDCs to justify any Z-factor adjustments. The evidence provided in support of a Z-factor application must be thorough and subject to testing by the Board and intervenors prior to approval. Consistent with the 2006 EDR process there should be an onus on the LDCs to bring forward Z-factors that may increase the revenue requirement or reduce it. In effect, the use of Z-factors must be symmetrical and should not be limited only to cost increases.

As the specific Z-factors are not defined at this time, prior to the finalization of the plan the Council suggests that the Board provide an opportunity for all parties to comment on proposed Z-factors and the regulatory process by which they will be considered. From the Council’s perspective the more prescriptive and limited the Z-factors the better.

G. Earnings Sharing:

Board Staff does not propose that there will be any earnings sharing mechanism ("ESM") as a part of the 2nd Generation IRM plan. Board staff and some of the IR experts reject the use of earnings sharing on the basis that an ESM is thought to reduce the distributor's efficiency incentives. (p. 28) However, given this is a transition plan, the Council does not view this as a typical IR regime where the primary focus of the plan is to drive out sustainable productivity improvements.

The Council continues to support an asymmetrical earnings sharing mechanism for over-earnings in excess of 100 basis points above the approved ROE. An asymmetrical mechanism is appropriate as LDCs will have the ability to apply for Z-factor relief if earnings are expected to be below the allowed ROE because of unforeseen circumstances. Dr. Lowry agreed at the Technical Conference that an ESM can be an appropriate mechanism to ensure ratepayer protection in the context of IR regimes.

Frankly, the Council does not see any downside in the Board mandating an asymmetrical earnings sharing mechanism. If LDCs, in the context of this transitional plan, achieve earnings well above the allowed ROE (beyond 100 basis points), then from the Council's perspective this would demonstrate that some of the plan parameters may not have been properly defined. The Council urges the Board to consider the inclusion of an ESM as an appropriate ratepayer protection mechanism. To simply reject it on the basis that it may hinder efficiency gains would be inappropriate.

H. Capital Expenditure Requirements:

Hydro One Networks sponsored the evidence of John Todd to advance a proposal for the use of a Capital Investment ("CI") adjustment factor in order to recognize incremental capital requirements during the 2nd Generation IR plan. Under the proposal a CI factor would be incorporated into the formula to represent the percentage increase in rates required to recover the costs associated with a distributor's unfunded capital investment

forecast. The intent is to eliminated any financial incentives created by the plan to defer capital investments until rebasing.

The Council does not support the implementation of a CI factor for the following reasons:

- There could be a significant amount of administrative burden associated with the approval of an LDC's CI factor;
- There would be no opportunity to reduce rate base going forward if at the time of rebasing the expenditures were deemed not to be prudent;
- The LDCs will be allowed adjustments not for forecast spending, but based on historical capital spending trends which may not be reflective of ongoing requirements;
- The CI factor may well overstate the impact of capital spending on the revenue requirement.

To the extent some LDCs can demonstrate the need for significant capital spending requirements over the next three years the Board should establish a process that prioritizes the rebasing of those LDCs. It is clear that LDCs like Toronto and HON should be rebased in the first tranche given their expressed need for urgent capital spending. The answer is not to put forward a proxy amount in the formula that may not be representative of their requirements. For many of the smaller LDCs the need for significant may not be there and they should therefore be rebased at a later time.

I. Service Quality:

Distributors have been reporting on their performance on the service quality indicators (SQIs) that were prescribed by the 2006 EDR Handbook. Board Staff is recommending that the Board resume its service quality requirement (SQR) review and implement the resultant indicators and associated performance standards through an amendment to the Distribution System Code. This would make the SQR regime mandatory. (Board Staff Paper, p. 29)

The Council continues to support Board Staff's recommendation that SQRs be developed, embedded in the Distribution System Code and deemed mandatory. In any incentive regulation model it is essential to ensure that safety, reliability and quality of service are not degraded during the course of the plan.

J. Conservation and Demand Management:

With respect to CDM, the Council supports the principle that the costs be dealt with separately from the 2nd Generation IRM. It still remains unclear how any spending beyond the third tranche is to be dealt with and how the LDC's rates will be affected by the Ontario Power Authority's ("OPA") expanded role to deliver and fund CDM. The Council has identified a number of outstanding issues regarding CDM:

- How are 2006 CDM expenditures beyond the third tranche spending to be dealt within the context of the price cap?
- Currently the OPA's plan is to provide CDM funding to LDCs in October 2007 in the context of the Minister's Directive dated July 13, 2006, in which he set out his expectations for a proposed LDC/CDM fund of up to $400 million to be spent over a three-year period. To the extent LDCs want to continue with current programs (and prior to October 2007) how is that facilitated?
- Even with the OPA assuming responsibility for some LDC CDM activities, how will the Board deal with applications from LDCs for CDM spending outside the OPA's current programs?
- To the extent that LDCs participate in the OPA's CDM fund there may well be impacts on utility revenue requirements or issues that require Board consideration. How will those be addressed in the context of the 2nd Generation IRM?

The Council notes that the OPA, in the context of developing the framework for the LDC/CDM fund is attempting to address OPA/OEB issues related to LDC CDM

initiatives. The Council encourages the Board to develop, as soon as possible, a set of clear guidelines for CDM spending in the period 2007-2010. When draft guidelines are developed there should be an opportunity for stakeholders to provide input before they are finalized. The Board might also consider a working group process prior to assist it in the development of these guidelines. From the Council's perspective there was not sufficient discussion through this process for the Board to finalize the rules around CDM spending going forward.

K. Smart Meters:

The Council proposes the establishment of a working group to determine how smart meter costs should be incorporated into rates during the 2nd Generation IR plan period. It is important, from the ratepayers' perspective, to ensure the costs included in rates are appropriate and the recovery of those costs are consistent with the principle of cost causality. There must be a clear accounting of the expenditures, an assessment of prudence and a clear process established to as to how those costs are allocated to customers. To date the Council has not seen a sufficient justification for the $1.00 and $0.30 rate adders proposed. The smart meter initiative requires significant expenditures to be made over the next several years and it is essential that the interests of ratepayers are protected in the context of this initiative.

L. Determination of Rate Plan Groupings:

Board Staff intends to commence a study to design a process to select distributors for each year of rebasing. Criteria may include, but not be limited to the following:

- Comparator and cohort information screening (e.g. costs and rates)
- Urgency of cost allocation issues
- Prior direction in a Board Decision
- Need and ability to implement new rate design
- Financial viability and realized earnings (e.g. significant over/under)

The Board will hold a stakeholder consultation on this design process and hopes to be able to announce the first grouping in March 2007, at a minimum, to be rebased in 2008. (p. 32) In the context of this review it is essential from the Council's perspective that he Board consider the interests of the ratepayers and the LDC shareholders on an equal footing.

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