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**DELIVERED BY E-MAIL AND COURIER**

October 27, 2006

Ms. E. Kirsten Walli  
Board Secretary  
Ontario Energy Board  
2300 Yonge Street, 27<sup>th</sup> Floor  
Toronto, ON M4P 1E4

Dear Ms. Walli:

**Re: Ontario Energy Board consultation on Cost of Capital and 2<sup>nd</sup>  
Generation Incentive Regulation for Electricity Distributors  
Submission of the Coalition of Large Distributors  
OEB File No: EB-2006-0088 and EB-2006-0089**

1. We are counsel to the Coalition of Large Distributors (the “CLD”), comprising Toronto Hydro-Electric System Limited, Enersource Hydro Mississauga Inc., PowerStream Inc., Horizon Utilities Corporation, Veridian Connections Inc. and Hydro Ottawa Limited.

**Background**

2. The matters considered within the recently concluded Technical Conference process all pertain to the approach to be taken by the Board in establishing distribution rates over the 2007 to 2010 period. Over the course of 2006, the Board has consulted with stakeholders on the development of parameters to be used in determining LDCs’ cost of capital and a 2<sup>nd</sup> generation incentive regulation mechanism (“IRM”) to be used to adjust a distributor’s rates pending rebasing (the “Code Development Process”). Board staff filed position papers and stakeholders have responded with proposals of their own. These discussions and materials presented have no formal status before the Board; they do not constitute evidence, but rather reflect a broad discussion on a range of possible approaches and outcomes.
3. In a parallel process the Board has commenced proceeding No. EB-2006-0087 on its own motion to amend the licences of electricity distributors (“LDCs”) to make provision for methods and techniques to be applied by the Board in determining distribution rates over this period (and potentially beyond 2010). Parties filed written submissions with the Board arising pursuant to Procedural Order No. 1 in this proceeding on Friday, October 20.

4. In its correspondence to all stakeholders dated April 27, 2006, the Board described the objectives of its multi-year electricity distribution rate setting plan as follows:
  - to provide greater regulatory certainty to distributors during the 2007-2010 period as several rate-related studies are carried out;
  - to begin to drive efficiency improvements in the distribution sector; and
  - to lay a foundation for the 3<sup>rd</sup> generation incentive regulation mechanism.
5. The CLD respectfully submits that Board staff proposals regarding cost of capital and IRM parameters to be implemented through codes as mandatory LDC licence conditions will not meet the OEB's stated objectives:
  - They raise numerous jurisdictional issues as discussed in the October 20, 2006 submissions of the CLD and other participants, and therefore do not provide greater regulatory certainty;
  - There are no incremental incentives to enhancing efficiency in the proposed mechanism for setting rates that would not also be present with traditional cost of service regulation, as the mechanism is simply a price adjustment mechanism; and
  - Again, as this mechanism is simply a method of price adjustment with no real incentives, it does nothing to lay a foundation for the 3<sup>rd</sup> generation of incentive-based rate making.
6. Accordingly, the CLD strongly recommends that Board staff recommend to the Board that it discontinue its pursuit of establishing codes to determine cost-of-capital and IRM.
7. In its October 20, 2006 submissions on the licence amendment proceeding (EB-2006-0087), the CLD make the following recommendations:
  - (a) The Board should not proceed to promulgate codes for cost-of-capital and IRM;
  - (b) The Board should instead issue non-binding guidelines for cost-of-capital and IRM;
  - (c) In the alternative, if the Board intends to promulgate new codes, the Licence Amendment proceeding should be comprised of a valid, duly constituted oral hearing that includes an examination of the issues currently excluded by the Board in its Procedural Order No. 1; and
  - (d) In the further alternative, if cost-of-capital and IRM codes are promulgated pursuant to item (c) above, the Board should articulate the clear expectation that the threshold for distributors to obtain a licence exemption from these codes will be minimal to ensure that distributors will be treated fairly by not being denied the right to bring forward a rate application of their choice based upon evidence that the LDC deems appropriate.

8. The CLD herein provides further submissions in support of the above noted recommendations in the context of its observations and conclusions arising from its participation in the Technical Conference process.

**The OEB should issue Filing Guidelines as opposed to creating new codes as licence conditions**

9. The CLD appreciates the immediate challenge and dilemma facing the Board in having to facilitate and effect some 90 LDC rate changes by May 1, 2007 while preparing for the rebasing of all LDCs over the 2008-2010 period. The CLD is supportive of the Board's attempt to have an approach in place that reflects regulatory expediency but which also provides LDCs with the continued ability to file applications with the Board. The CLD submits that these objectives can be achieved through an alteration to the Board's existing Rate Handbook approach that has been successfully utilized to date. New filing guidelines would continue to provide a default framework for the entire LDC sector with respect to cost of capital and IRM until a full and proper review of these issues through a duly constituted hearing can be conducted by the Board.
10. The CLD submits that the various reports and ensuing discussions at the Technical Conference clearly lead to only one reasonable conclusion: the existing record is wholly inadequate to justify any significant departure from the status quo.
11. It is also apparent that the materials presented by Board staff and their consultants contain weaknesses, some of which have only been discovered by the CLD since the conclusion of the Technical Conference. For example, Dr. Lazar and Dr. Prisman have indicated that they have used the total return of the TSX index in the calculation of cost of capital. However, upon review of the data obtained directly from the Toronto Stock Exchange (attached), it appears that the data used was only the capital return. The total return index includes dividends that are assumed to be reinvested. The impact of this discrepancy is that the equity market return used by Board staff consultants has been understated by approximately 2%. As such, the calculated Equity Risk Premium would be significantly understated.
12. In short, the CLD submits that in addition to the concerns expressed in its pre-filed materials and from the reports tendered by Mr. Carmichael and Dr. Yatchew, there is additional new concern that the material relied upon by Board staff may contain serious flaws.
13. Accordingly, to attempt to implement cost of capital and IRM codes based upon the record to date, which is based on an untested approach supported by no evidence, is fraught with risk and uncertainty and is liable to result in various negative unintended outcomes for LDCs and their customers. These issues were also addressed in the CLD's October 20 submissions to the Board.

**Return on Equity**

14. In the absence of any appropriately tested alternative approach, the CLD believes that the only appropriate course of action is to establish the ROE through the proper application

of the mechanistic update contained in the December 1998 report prepared by Dr. William Cannon entitled “A Discussion Paper on the Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities” (the “Cannon Methodology”).

15. The correct and proper application of the Cannon Methodology was summarized in a letter prepared by Ms. Kathleen McShane that was introduced into evidence during Toronto Hydro’s 2006 rate proceeding (Ex. J.3.1). A copy of this letter is attached.
16. In essence, the Cannon Methodology involves the following multi-step approach:

**Initial Set-up**

- (a) For the test year in question determine the forecast of the long-term Canada yield; and
- (b) Determine the implied risk premium.

**Adjustment Mechanism**

- (a) Determine the forecast long Canada rate; and
- (b) apply the adjustment factor.

17. The Cannon Methodology has been utilized by the Board in establishing ROE for both natural gas and distribution utilities.
18. The CLD also recommends that the Board be transparent in its application of the Cannon Methodology by publishing the data it intends to use to update the parameters within the formula. LDCs and their customers need to be able to clearly understand how the Cannon Methodology is being applied and what information is being used in that formula. This will greatly assist LDCs in making their applications for rate adjustments effective May 1, 2007.

**Capital Structure**

19. The CLD takes no position at this time on whether one industry-wide capital structure or a tiered capital structure is most appropriate because the necessary risk assessment has not been completed. However, if the Board adopts the status quo as the approach going forward, it is not appropriate to adopt one aspect of the Cannon Methodology (mechanistic update) without the others (capital structure).

**Working Capital Allowance**

20. The CLD supports Board’s staff position, as indicated at the Technical Conference, that no adjustments are being contemplated to the working capital allowance at this time.

## Short Term Debt

21. As Board staff indicated during the Technical Conference, since their main concern involves certain LDCs that may be exploiting the difference between short term and long term debt rates, Board staff should deal with these situations on a case by case basis. There is no evidence that suggests that LDCs pursuing arbitrage arising from the difference in short and long term debt rates is anything other than an isolated event involving a very limited number of distributors. As such, there is no need to require a short-term debt component in the capital structure.

## 2nd Generation Incentive Regulation Mechanism

22. The CLD submits that the proposed 2<sup>nd</sup> Generation Incentive Regulation Mechanism (“IRM”) is a misnomer given that it really serves as a price adjustment mechanism. As Dr. Yatchew clearly articulated in his paper and during the Technical Conference, there are no incremental incentives in the proposed 2<sup>nd</sup> generation IRM that would not also be present with traditional cost of service regulation. In short, savings that are attained by LDCs need to be retained for some period of time. This feature is absent from the current proposal.
23. However, the CLD views 2<sup>nd</sup> Generation IRM as a transitional mechanism until a true 3<sup>rd</sup> Generation IRM can be developed. The CLD submits that the emphasis should be spent on developing an appropriate 3<sup>rd</sup> generation mechanism as soon as possible that does focus on the creation of true incentives.
24. The CLD also makes the following submissions on specific components of the mechanistic elements of the proposed IRM:
  - **Adjustment for cost of capital (K-factor)**
25. There would no longer be any need for a K-factor if the Cannon Methodology properly applied is adopted since this approach already incorporates changes in the adjustment for ROE based on utility specific data.
  - **Price Escalator**
26. There is no evidence to suggest that Canada GDP – IPI will track the real world experience of Ontario LDCs. However, the CLD is prepared to accept the Board staff’s proposal as an interim measure.

- **X-factor**

27. The Board staff proposal is based on broader industry indices without reference to efficiency improvements in electricity distribution in Ontario. The CLD believes that 1% is too high but recognizes that others believe that 1% is too low. This may be an indication to the Board that the 1% has been a reasonable compromise until the 3<sup>rd</sup> generation IRM is developed.

- **Smart Meter Funding**

28. It is becoming readily apparent to members of the CLD that Ontario distributors each have different smart meter funding requirements. In its answer to Board Staff Question 12, the CLD indicated that the incremental funding should be in the range of \$1.30 to \$1.50 per metered customer (as distinct from per smart metered customer) per month for those LDCs implementing Smart Meters on an accelerated basis. As such, the CLD submits that an incremental amount of \$1.30 per metered customer should be considered a minimum amount. Should LDCs require additional incremental funding for the plans from May 1, 2007 to April 30, 2008, those distributors need to be free to make an application to the Board for any amount beyond the \$1.30. Furthermore, annual adjustments to support Smart Meter investments will be required in each subsequent year.

- **Future Capital Expenditures**

29. The CLD continues to be extremely concerned that any IRM approach incorporate a capital adjustment parameter that takes capital investments into account. At present the Board staff's IRM model contains no allowance for additions to rate base during the 2<sup>nd</sup> generation IRM period. Various CLD members described very significant infrastructure renewal capital expenditures that will be required from 2007 onward. The absence of a capital adjustment mechanism remains a fundamental deficiency in the proposed IRM and may serve as a disincentive for LDCs to invest in infrastructure renewal.
30. The CLD recommends that a capital adjustment mechanism be incorporated into the current formula and that this matter also be a priority issue to be discussed in formulating the 3<sup>rd</sup> Generation IRM.

### **2007 Distribution Rate Applications**

31. As the CLD indicated in its October 20, 2006 submission, even if the Board were to issue draft codes after conducting an oral hearing on all the relevant issues in the licence amendment proceeding (including the inclusion of those issues currently excluded by the Board in Procedural Order No. 1), distributors retain the ability to depart from those codes and file application with the Board. The ability to act on this legislated right should not be burdened by an inappropriate regulatory scheme or by a burdensome administration (e.g. a single process to determine the licence exemption and the rate application).
32. Even apart from exceptional circumstances, the CLD is proceeding on the basis that distributors will be making applications to the Board early in the coming year in

connection with the 2007 rate adjustments. As described more fully in its October 20, 2006 submission, the CLD does not endorse an approach wherein utility rates are unilaterally adjusted by Board Staff without an application and input from the affected distributors. The CLD submits that the 2007 rate adjustment process will be facilitated by the issuance by the Board of a spreadsheet model, to be completed by the utilities, which will systematically and transparently calculate the numerous discrete adjustments that must be made to each distributor's existing rates to arrive at the proper outcome for 2007.

### **Summary and Conclusion**

33. The CLD respectfully submits:
- (a) that the Board should not proceed to promulgate codes given the untested and inadequate nature of the record on cost of capital and IRM to date;
  - (b) that the Cannon Methodology, properly applied, is a reasonable approach to establishing ROE in the absence of a complete evidentiary proceeding on cost of capital;
  - (c) that the CLD is prepared to accept 2<sup>nd</sup> Generation IRM as a transitional price adjustment mechanism, if the current proposal is amended to include an adjustment for capital expenditures;
  - (d) that the Board should initiate a comprehensive review of 3<sup>rd</sup> generation IRM as soon as possible;
  - (e) that the Board should confirm that all Ontario LDCs will be expected to make their own separate applications to adjust rates for 2007; and
  - (f) that incremental Smart Meter funding should be \$1.30 per metered customer per month. LDCs should be free to make applications for Smart Meter funding, supported by a Smart Meter implementation plan, if additional funding is required beyond the \$1.30.

All of which is respectfully submitted.

Yours very truly

**Borden Ladner Gervais LLP**

*Original Signed by J. Mark Rodger*

J. Mark Rodger

Encl.

Copies to:

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All parties of record

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