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Ontario Energy Board
Suite 2700
2300 Yonge Street
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ATT: E. Kirsten Walli, Board Secretary

October 27, 2006
Dear Ms. Walli,

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

In addition to the ECMI coalition comments following on the proposed process, ECMI has the following specific comments.

> It is recognised that the desire of the Board is to streamline the process and this is appropriate. However, this current process or processes may be so fundamentally flawed that all parties should consider a joint submission to Divisional Court seeking Divisional Court rejection or acceptance of the process. If Divisional Court rejects the current process, it will permit the OEB to get on with its fundamental duties in a timely process.
>
> Board Staff seem to out of hand reject the PBR 1 process which did not require a code to implement. After a thorough evidentiary and hearing process, PBR 1 was implemented and created an efficient process to the benefit of those regulated and other interested parties. The PBR 1 process dealt with in the order of 180 LDC applications and seemed to deal with them in an efficient fashion.
>
> The current process seems to insert Board Staff in the place of the Board. This undermines the credibility of the administrative tribunal process. This apparent insertion fails to recognise that it is the Board members who are the administrative tribunal not the Board Staff.

In accordance with the OEB's E-mail and web posting of October 11, 2006, the ECMI coalition (ECMIC) submits its comments on the Cost of Capital and 2nd Generation Incentive Regulation Mechanism (EB-2006-0088) and (EB-2006-0089).

Seven paper copies are enclosed and electronic copies in both Adobe Acrobat and Word have been sent this date by email to Boardsec@oeb.gov.on.ca.

Requested contact details are as follows:-
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Respectfully submitted for the Board's consideration,

Original signed by R. White

Roger White
President

ECMIC Comments on
Cost of Capital and 2nd Generation Incentive Regulation Mechanism
(EB-2006-0088) and (EB-2006-0089)

As it is not apparent that Board staff read ECMI's earlier materials, these are also included.

Because it is unclear what consideration if any has been given to prior ECMI submissions, on these matters, the earlier submissions are submitted for the full consideration of the Board.

ECMI apologises for any difficulties identifying references to the transcript of October 17th 2006, as the posted version of that transcript lacks page numbering.

As stated by Mr. Fogwill in response to Mr. McLorg in the transcript of the Technical Conference held on October 17th 2006 : "*This is not evidence. It's a consultative process that involves the conversation amongst a number of stakeholders*." Mr. Fogwill goes on to say "*We don't test evidence through this process*."

This recognition of the lack of an evidentiary process demonstrates one of the major shortcomings of this process and further demonstrates the need for a proper hearing on such matters.

The transcript of the Technical Conference held on October 17th 2006 included a question by Mr Rogers to Mr Fogwill:-

Mr. Rogers: "Now, I also wanted to ask a question. This seems like it is the best forum for it. I will explain that shortly.

In question 4, we had asked about jurisdiction for this approach of Codes of Conduct or codes for cost of capital and IRM. And the answer back, in part, was that the Board's license amendment proceeding, EB-2006-0087, is a more appropriate form for addressing concerns regarding the Board's overall approach to implementing the cost of capital incentive regulation methodologies.

But since these answers have come out and since the first Technical Conference, we now have the first procedural order for the licence amendment hearing, and you will note that some of the issues that are taken off the table deal with some of these questions, whether IRM is appropriate, the details of the cost of capital study, whether exemptions should be granted.

So I guess we're left with a dilemma that, you know, in this answer from Board Staff, it referred us to another forum; but in that other forum, now the issues that we're interested in have been taken off the table, so we're left with the question of where the parties get to raise these issues in this process."

Mr Rogers apparently pointed out that this untried process appears to preclude the opportunity to discuss issues of concern and refers participants to a separate but **non**-distinct process, namely the Licence Amendment Proceeding EB-2006-0087.

A criteria for the consideration of exemptions is fundamental to the Board doing its duty. In the absence of consideration of an exemption process or even a preliminary criteria for exemption, the Board has not addressed one of the fundamental factors which may demonstrate whether or not a code is appropriate, legal or even practical. Only by having a robust discussion on the exemptions can the appropriateness of the use of a Code process be determined. ECMIC would submit that the absence of this consideration is a fatal flaw to any determination of the validity of a Code process for the consideration of rates.

In its response to Board Staff question 6 on Capital Structure, VECC made the following response :-

6. Capital Structure
Several distributors have raised concerns about migrating quickly to a new capital structure. Consider a scenario whereby the Board were to phase in the change from the existing size-related capital structure to the common structure, for rate-making purposes, over several years. For example, a large distributor with over $1 billion in rate base might move from its deemed 35% equity to 40% over two years, to mitigate possible rate impacts on ratepayers. As another example, a small distributor with a rate base of less than $100 million could migrate from its current deemed 50% equity to 40% equity over three years, to mitigate the impact on corporate restructuring and on the distributor's shareholder(s). This change in the capital structure would be accomplished through the K-factor while the distributor is under an incentive rate mechanism (IRM) scheme, and a distributor migrating to the new capital structure would also factor such migration into its Cost of Service rebasing application.

VECC response
a) There are no disadvantages, capital structure changes are normally relatively straight forward to make. If a firm wants to increase its equity ratio it can retain earnings and then make a loan to the municipality to defease some of the debt on its balance sheet or simply pay back bank loans. If it wants to decrease its equity ratio it can borrow from the markets and buyback its shares. Allowing a municipality to smooth these effects may have minor "rate shock" benefits.

VECC appears to have implied that the changes in capital structure do not warrant consideration of a transition period. To the extent that the VECC's stated possibility of "rate shock" has impacts on customers, it mitigates against the Board's primary statutory obligation of rate stability, particularly if the "rate shock" results in any level of rate instability.

In response to Bluewater Power page 2 Question 2, dated October 12, 2006, Dr Lazar made the following response in part:-

> "W*hile there appeared to be differences in financial performance between the utilities with less than $300 million in total assets and those with more than $300 million, the differences did not always indicate that the "smaller" utilities fared worse or faced greater financial risks."*

In their earlier report Lazar and Prisman identified a correlation between size and ratings:-

a) The Lazar and Prisman report recognised that: "*Standard & Poor's has no minimum size criterion for any given rating level. However, size does turn out to be significantly correlated to its ratings. The reason: size often provides a measure of diversification, and /or affects competitive position. Small companies are, almost by definition, more concentrated in terms of product, number of customers, or geography. In effect, they lack some elements of diversification that can benefit larger companies. In addition, lack of financial flexibility is usually an important negative factor in the case of very small companies. Adverse developments that would simply be a setback for companies with greater resources could spell the end for companies with limited access to funds."* This clearly recognises size as an important cost of capital market consideration in that *"size does turn out to be significantly correlated to its ratings."*

Drs Lazar & Prisman appears to want to have it both ways with respect to ratings as the statement in the report is inconsistent with the response to Bluewater Power.

Later in the response to Bluewater Power page 2 Question 2, October 12, 2006 Lazar states

" we believe that we did comment at the Technical Conference that there were too many LDCs in the province and that consolidation probably was warranted."

No specific information is provided to support these views, either with respect to the financial performance or financial risks facing LDCs. Further there is no specific information provided to support the stated opinion with respect to the number of LDCs in the province. No specific information has been submitted or subject to examination.
In its deliberations, the Board should take into consideration the lack of opportunity to examine this and other "evidence?" put forward by Board Staff's experts.

The comment about too many LDCs reflects a systemic bias against smaller and medium sized LDCs whether it is in the report or not. ECMI would submit that this apparent bias substantively reduces the credibility of the Lazar Prisman analysis and creates a credible concern that this bias may well have steered the analysis to a predetermined outcome consistent with ECMI's observations of October 10 2006 to the Board Secretary about the stated goal of the likely interpretation of Boards Staff's stated objective:-

> *"6.* ***Establishing a common capital structure and incentive framework for all distributors.*** *The objective is to avoid imposing barriers to consolidation within the electricity distribution sector."*

"The Board Staff stated objective "to avoid imposing barriers to consolidation within the electricity distribution sector" should reflect a careful balance of permitting the status quo in terms of structure and permitting the rationalisation of the industry. It is easy to interpret the "avoid imposing barriers to consolidation within the electricity distribution sector" to mean establish an artificial set of rules which demand a consolidation of the industry through financial punishment of smaller and potentially more cost effective distributors which may well currently provide a higher standard of service for the communities they serve because of their locally based and in many cases lower cost skilled staff. The status quo may often produce a higher value to customers than forced mergers or divestitures."

The apparent inconsistency and confusion around:

- the process
- the recommendations for the proposed code and
- the lack of consideration for the implementation considerations of the code

together demonstrate that it is appropriate to revisit the evidentiary side of the codification process. If codes are to be implemented, the PBR 1 process provides a good model for the Board to consider. This model and attendant process with the rigour and discipline imposed by that process served LDCs and customers well.

As noted, previous ECMI submissions follow.

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ATT: Mr. John Zych, Secretary

July 04, 2006
Dear Mr. Zych,

OEB Draft Staff Report: Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. (EB-2006-0088) and (EB-2006-0089)

In accordance with the OEB's E-mail and web postings of June 19, 2006 and June 29, 2006, the ECMI coalition (ECMI) submits its comments on Board staff's initial proposals for both the cost of capital and the 2nd Generation Incentive Regulation Mechanism (IRM), dated June 19 2006.

Three paper copies are enclosed and electronic copies in both Adobe Acrobat and Word have been sent this date by email to Boardsec@oeb.gov.on.ca.

Requested contact details are as follows:-
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Respectfully submitted for the Board's consideration,

Original signed by R. White

Roger White
President

**ECMI Comments on OEB Draft Staff Report:
Proposals for Cost of Capital and 2nd Generation
Incentive Regulation for Ontario's Electricity Distributors.**

1. **Capital Structure and Return on Equity (ROE) – General**
Dr Booth's testimony (referenced on Page 7 of the Lazar and Prisman June 14 2006 report) which is relied on in the Lazar and Prisman report relates to an Ontario natural gas hearing. This testimony is not subject to cross-examination as it relates to the electricity market in Ontario and therefore should be disregarded as support for a uniform capital structure in the Ontario electricity market.
Lazar & Prisman's recommendation on the bottom of Page 7 of the June 14, 2006 report starts with the apparent reliance on Professor Booth's argument, referenced in the penultimate paragraph on Page 7 and fails to recognise two underpinning points in Professor Booth's testimony. The first point being that the testimony related to a natural gas hearing on the Ontario natural gas distribution market which is quite different from the Ontario electricity distribution market. The second point that "*ROE regulated firms have minimal risk in Canada due to the high degree of regulatory protection*" assumes that regulation of electricity distributors in Ontario will be similarly "protected." In the same paragraph, the Lazar and Prisman report states that "P*rofessor Cannon had earlier reached a similar conclusion*" without recognising that Dr Cannon suggested a capital structure based on size to recognise the risk faced by smaller LDCs in the Ontario market.
Similarly, in the same paragraph the Lazar and Prisman report states that "*DBRS has stated that it views regulation as a strength in assessing the credit risks of utilities since regulation assures financial stability and performance-based regulation shares future efficiencies*" but fails to recognize that that comment relates to "credit" or debt risk but not equity risk.

> A fair cost of capital is the total cost of capital. The word "fair" does not permit the use of simply one universal number for debt cost when one wants to consider debt and **<u>independently</u>** the use of simply one universal number for equity when one wants to consider equity.

This apparent desire to impose, contemporaneously, both a uniform capital structure and uniform risk premium on equity fails the fundamental test of fairness and the test of context of the evidence presented.

The leap in the Lazar and Prisman report from the penultimate paragraph on Page 7 to the last paragraph on Page 7 through, in ECMI's view, the inappropriate use of the word "*Consequently*" implies a connectivity which is, in ECMI's view, simply not valid given the points raised in our previous paragraph above. This lack of validity is compounded by jumping from independent statements about debt and equity (see our previous explanation) to linking he word "*Consequently*" in the last paragraph on Page 7 to "*capital charge*" at the end of the same sentence. This latter jump magically combines independent debt comments with independent equity comments to reach what in ECMI's view is an unsupported cost of capital or "*capital charge*."

Board Staff Proposal – Capital Structure

"Capital structure"
Staff proposes that the appropriate capital structure for distributors is 36% common equity (64% debt). In addition, distributors could include preferred shares as part of their capital structure to a maximum of 4%. In total this would then require 60% debt financing. From numerous sources, including Dr. Cannon's analysis and the work done by Lazar and Prisman, the general view of relative riskiness of electricity and natural gas distributors in other jurisdictions (primarily North America) is that ***there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario.*** *Therefore, staff is guided by the capital structure of the natural gas sector in Ontario with which the Board and financial markets are familiar. Natural gas distributors have a long history of financial stability and their current common equity share is about 36%."*
Ref Board Staff report page 8 (our emphasis)

As the Board staff's guiding objective number 6 is "*Establishing a common capital structure and incentive framework for all distributors*", then no one should be surprised by the Board's consultant's recommendations to adopt a single capital structure. However, this guiding principle does not require the return on equity premium to be common amongst all LDCs. While the PBR regime might be similar or common, the entry level risk premium on equity for a universal capital structure (debt / equity ratios) might be quite different.

Cost of Capital – not ROE
Both the Board's experts recognised size with respect to the cost of capital:-

Dr William Cannon presented a number of arguments for using size, based on assets, as the sole criterion for differentiating LDCs. Standard & Poor's has no minimum size criterion for any given rating level. However, size does turn out to be significantly correlated to its ratings. The reason: size often provides a measure of diversification, and /or affects competitive position. Small companies are, almost by definition, more concentrated in terms of product, number of customers, or geography. In effect, they lack some elements of diversification that can benefit larger companies. In addition, lack of financial flexibility is usually an important negative factor in the case of very small companies. Adverse developments that would simply be a setback for companies with greater resources could spell the end for companies with limited access to funds.
Ref: Page 5 "Calculating the Cost of Capital for LDCs in Ontario" Dr. Fred Lazar and Dr. Eli Prisman date June 14, 2006

b) "*Dr William Cannon presented a number of arguments for using size, based on assets, as the sole criterion for differentiating LDCs."* Dr Cannon recognised the additional risks associated with size through different capital structures (imputed debt & equity ratios).

c) The Lazar and Prisman report recognised that: "*Standard & Poor's has no minimum size criterion for any given rating level. However, size does turn out to be significantly correlated to its ratings. The reason: size often provides a measure of diversification, and /or affects competitive position. Small companies are, almost by definition, more concentrated in terms of product, number of customers, or geography. In effect, they lack some elements of diversification that can benefit larger companies. In addition, lack of financial flexibility is usually an important negative factor in the case of very small companies. Adverse developments that would simply be a setback for companies with greater resources could spell the end for companies with limited access to funds."* This clearly recognises size as an important cost of capital market consideration in that *"size does turn out to be significantly correlated to its ratings."*

There are two ways of recognising size implications:-

1. Dr Cannon chose capital structure to recognise size implications.

2. The alternative is to recognise size implications with a different risk premium for size if a universal capital structure (debt & equity ratios) is to be used.

One could say that LDC size does not matter with respect to debt cost but that debt cost may be based on different capital structures (debt & equity ratios). However, if a universal capital structure is imposed there is no evidence to suggest that size does not matter with respect to the cost of equity.

Similarly, if the capital structure is universally fixed at a higher level, it follows that the risk on the equity component of the LDC would increase. Therefore the risk premium should be larger for a smaller LDC to recognise the market response to equity requirements as opposed to debt requirements. While the cost of debt may be also universal in a regulated environment, there is generally a recognised risk premium on the equity part of capital structure.

However, Board staff in its proposal fails to recognise that size consideration has any merits in its statement: *"there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario"*
Ref; 2.2.1 Capital Structure Page 8

This statement is in conflict with the Board's own consultants on the cost of capital including Dr Cannon in previous proceedings and Drs Lazar and Prisman's report in the current proceeding.

The statement also ignores the fact that the OEB is a credible institution and its decisions have recognized size. To dismiss those decisions does regulation in Ontario a disservice. The province has LDC's ranging in size from a few hundred customers to in the million customer range. The exposure to regulatory cost risk faced by the small LDCs is disproportionately huge and potentially greater than any return on the rate base.

Further the statement appears to rely on the Ontario natural gas environment. The regulated natural gas industry in Ontario has few small natural gas distributors and those that exist may have unique customer characteristics which may fundamentally change the risk faced by the small gas distributor. The portability of the regulated natural gas Ontario experience into the Ontario electricity distribution market is not supported when size is dismissed as an important criterion.

These observations certainly support ECMI's perception of systemic bias on size identified under Point 4 below.

The statement *that* ***"there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario"*** fails to recognize that the OEB is a credible institution and its decisions have recognized size. To dismiss those decisions does regulation in Ontario a disservice. The province has LDC's ranging in size from a few hundred customers to in the million customer range. The exposure to regulatory cost risk faced by the small LDCs is disproportionately huge and potentially greater than any return on the rate base.

2. **Specific Debt Rates.**
   The proposals assume a market environment not a regulatory environment and assumed there would be automatic crossover in terms of the cost of debt for larger corporate (bonds). The Lazar and Prisman report proposals looked at an historical period when interest rates were relatively low and the cost of money (bond rates) were relatively stable and assumed a going forward relationship. Even if the conditions of the historic period considered remain stable over a longer term the market may not reflect the duration of the commitment that often underpins regulated entities' borrowings.

   Similarly, the staff proposal for long term debt is based on a bond comparison made with larger LDCs only. Smaller LDCs issue few if any bonds. Therefore the bond comparison is weighted heavily if not exclusively to larger companies.
   Ref: Section 2.2.3 Debt rate and Section 2.3 Table 4

   The staff proposal for short term debt section 2.3 Table 4 appears to presume that the Board's proposed interest rate on variance accounts will be adopted by the terminology "short-term" rate for variance and deferral accounts.
   Ref: Section 2.2.3 Debt rate and Section 2.3 Table 4

   The process initiated by the OEB is not complete as noted in the statement *"The Board is currently consulting on the appropriate rates for such accounts."*
   Section 2.2.3 Debt rate

   ECMI will not comment on short term debt costs until the aforementioned decision is rendered.

3. **Proposed Productivity Factor**
   The proposed productivity factor (stretch factor) of 1% of revenue (rates) in ECMI's view is too high. Capital items are regulated by code with the consequence that LDCs will have limited choices in how any capital cost reductions are achieved. For consideration, an LDC might have total allowed distribution revenue of $1million and

OM&A of about $650,000. In this case, the LDC would be required to realise a cost reduction of about 1.5% of OM&A. If this were repeated for 5 years, the consequential maintenance reductions which would be part of the 7.5% reduction could be significant. The Board Staff consultant recommended 0.5%. The leap to 1% in the Board Staff proposal is not consistent with the Ontario context.

4. **Economies of Scale**

The report's guiding objective 6 is:-
"6. ***Establishing a common capital structure and incentive framework for all distributors.*** *The objective is to avoid imposing barriers to consolidation within the electricity distribution sector."*
Ref: Page 5 of Draft Staff Report

This objective appears to assume that consolidation is a desirable process. The fact that it is included as one of the guiding objectives may reflect a systemic bias. Further, if there is an OEB bias in favour of consolidation, it should only be based on a specific, properly vetted Board policy in favour of consolidation. If there is a Board staff bias in favour of consolidation then this may be inappropriate as the OEB, in the absence of statute direction, has an obligation to not be biased when considering policy or applications.

"Economies of scale
It is generally accepted that there are economies of scale in electricity distribution. Thus, consolidation, especially among the smaller LDCs, is expected to lead to lower distribution costs. But mergers are not the only means by which the cost savings from economies of scale can be realized. Virtual utilities are an alternative to the outright sale of a LDC. That is, a LDC could outsource all of its operations to take advantage of any potential economies of scale, without the need for a change of ownership."
Ref: Page 5 "Calculating the Cost of Capital for LDCs in Ontario" Dr. Fred Lazar and Dr. Eli Prisman date June 14, 2006

Hydro One Networks Inc (HONI) in its evidence on Regulatory Assets made specific reference to "diseconomies of scale" which were present and a major contributing factor to the higher transition costs incurred by HONI. This is in apparent conflict with the assumption that consolidation is a desirable process and benefits customers by way of price.

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ATT: E. Kirsten Walli, Board Secretary

August 10, 2006
Dear Ms Walli,

OEB Staff Discussion Paper on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. (EB-2006-0088) and (EB-2006-0089)

In accordance with the OEB's E-mail and web postings of July 25, 2006 the ECMI coalition (ECMI) submits its comments on the Board Staff Discussion Paper on the Cost of Capital and the 2nd Generation Incentive Regulation Mechanism (IRM) for Ontario's Electricity Distributors, dated July 25, 2006.

Three paper copies are enclosed and electronic copies in both Adobe Acrobat and Word have been sent this date by email to Boardsec@oeb.gov.on.ca.

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Submitted by,

Original signed by R. White

Roger White
President

ECMI Comments on OEB Staff Discussion Paper on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. (EB-2006-0088) and (EB-2006-0089)

Introduction

ECMI is concerned that the technical conference, referred to in the Ontario Energy Board's (the Board) July 25,2006 letter, appears to be put in the place of a hearing where the evidence of the experts is cross examined before customers must rely on a Code or Handbook. If customers are to rely on this process for just and reasonable rates then it must be a robust process where evidence is thoroughly examined. In the absence of such a process, it may be difficult for the Board to demonstrate that it has fulfilled its primary obligation for the protection of customers as established in Bill 210

The proposed "de-construction" of 2006 rates and subsequent derivation of "re-constructed" 2007 rates is silent on any ongoing consideration related to any potential adjustment which may be warranted as a result of the cost allocation process.

X-factor

The 1% X-Factor is of concern, in terms of both its origin and quantum.

Origin of X-factor

The Board Staff Discussion Paper relies entirely on the Pacific Economics Group (PEG) report for the selection of the 1% X-factor:-
"Instead, staff is relying on the deliberations on these issues carried out in numerous North American jurisdictions to provide relevant precedents for this 2nd Generation IRM".
Ref Board Staff Discussion Paper page 26

The PEG report itself refers to a sample average X-factor of 1.01 % for all macroeconomic industry which appears to include the 1.5% X-factor for all Ontario distributors for the period 2000-2003. This 1.5% X-factor is based on 5 and 10 year weighted average and the stretch factor is 0.25%.
Reference PEG report Table 1, Page 55

One of the major risks of accepting the PEG analysis is that it has been done after the fact. The cases that are being looked at are individual distributors based on an exhaustive hearing process around an individual LDC so the stretch factor identified may be based on a specific regulatory insight into what a reasonable stretch factor for a specific LDC being reviewed and therefore it may be a reasonable stretch factor as opposed to the arbitrary one shoe fits all approach currently put forward by Board staff.

It is important in understanding the Ontario X-factor of 1.5 % that the first generation PBR process which resulted after a robust hearing process incorporated an industry specific price index. This industry specific index may make increase the validity or reduce the validity of any stretch factor. The apparent leap to a federal GDP-IPI and suggesting that timing of it is more convenient than the provincial corresponding index ignores the fact that the first generation PBR was based not only on an Ontario index but also an industry specific index. Before such a change is introduced the Board should ensure that such a change is warranted and that it serves customers well.

Quantum of X-Factor

If a PBR 2 plan is to be imposed (with a base return on equity of 9% after taxes and a return on debt of 5.5% for an LDC with a $100 rate base) the plan should be sufficient to allow the LDC to continue to meet its debt obligations and the shareholder to continue to earn a fair return on its investment. The notion that "Return" is profit that goes into the pocket of the shareholder ignores the fact that an LDC has statutory obligations for capital investment associated with new customers and loads. This is not an expense item but it is in fact a reduction of the available net income which might be available for other purposes which should include a reasonable dividend to shareholders.

The return on debt and equity components would add to a contribution to revenue requirement of about $9.67 for a 50/50 debt/equity ratio and a tax rate of 35%. If the depreciation represents $5.50 then it would be reasonable to expect that the combined return of $9.67 and the depreciation of $5.50 producing a distribution cost of $15.17 then those components should be reasonably realisable after the implementation of any stretch factor. If the stretch factor and industry productivity index combine to 1% of revenue and total distribution revenue is $25 then the 1% represents in excess of 2.5% of Operation, Maintenance and Administration (OM & A) for each year that the PBR 2 regime is in place. This implies a reduction of the real distribution costs for OM & A of more than 7.5% for the 3 year period. This is ambitious and probably unrealistic given external pressures on such items as energy costs, insurance costs, pension and wages costs and regulatory costs which are prevalent in the current economy.

With the expected variations between distributors the 7.5% could readily swing between 5% and 10% real reduction in controllable distribution costs. This result would penalise distributors with a higher proportion of fixed costs.

If a 2.5% real reduction in the controllable component of distribution costs were imposed for a period of 10 years, the resultant 25% reduction in revenue to cover those costs would certainly have a real and measurable impact on services provided to customers.

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October 10, 2006

ATT: E. Kirsten Walli, Board Secretary

Dear Ms Walli,

Cost of Capital and 2nd Generation
Incentive Regulation for Ontario's Electricity Distributors.
(EB-2006-0088) and (EB-2006-0089)

In accordance with the September 21 2006 Technical Conference transcript, ECMI submits its comments with respect to the Cost of Capital and the 2nd Generation Incentive Regulation Mechanism (IRM) for Ontario's Electricity Distributors, dated July 25, 2006.

ECMI wishes to express concern in two distinct areas, i) the *codification of rate regulation* process proposed, and ii) the apparent attack on small and medium sized local distribution companies (LDCs).

i) A New Process
The Ontario Energy Board (OEB) appears to be experimenting with the *codification of rate regulation*, a new process that seems to be a first for Canada This approach appears to attempt to establish rates through a purely mechanical process. Given the new terrain, it is not surprising that most parties including OEB staff seem to be struggling with how to effectively deal with the current experiment.

Regulatory experiments are risky for regulators, for those who are regulated by them and for the customers the regulator is charged with protecting. This experiment seems to be part of a multi-pronged attack which includes; significant increase of regulatory burden in terms of filing requirements for information, and on another front reinterpreting, if not rewriting the Affiliate Relationships Code (ARC).

What is apparently lacking is the establishment of priorities by the Board which are clearly focussed on customers. The Chief Compliance Officer on a number of occasions has stated that enforcement of his unique interpretation of the ARC should be done without any consideration of the impact on customers. In their letters Board Staff appear to be putting themselves more and more in the role of the OEB itself. This "encroachment" is potentially dangerous for customers in that the opportunity for properly vetting decisions on items which some may consider minor changes may be lost.

Further in the cost of capital process, the fact that Board Staff recommendations to the Board are not proposed to be a public document implies that this part of the process is done in secret. Also, the process is short. The issues are too profound for many LDCs whether small or large to fully evaluate all the implications in the time line established by this process.

The apparent need for many "Z" factor considerations demonstrates that codification of this process is unwise. The absence of clear rules for Z-factor consideration may not be satisfactorily addressed. An ad hoc approach responding to individual cases differently mitigates any benefits flowing from a codified process. Further, the use of Z factors may result in more applications for specific consideration requiring more hearings to consider and establish appropriate action. It is possible to liken the excessive use of Z factors to the application of patches on a balloon. The more patches applied, the greater risk of leakage and greater difficulty in finding the leak.

Apparent Attack on Small and Medium sized Distributors

The apparent embedding of another OEB Staff driven attack on Small and Medium sized Distributors using the cost of capital within this process is further cause for concern. The implications behind the Cost of Capital initiative is that the Small and Medium sized Distributors are being unduly enriched by the Cannon method. When this assumption is combined with the fact that the only LDCs that experienced an increase in deemed equity include Hydro One with an 11% rate increase as part of EDR 2006 process, it is hard to accept that this cost of capital process is customer focussed regulation.

It is easy to assume that a higher debt cost or higher equity level for smaller and medium sized LDCs in the Canon method automatically results in higher rates to customers than would be the case for a larger or consolidated LDC. However, local operating costs for a smaller or medium sized LDC may be lower than those of larger LDCs. Contributing factors that may lead to this situation could include employee expectations which may manifest themselves as lower local real estate costs, a less rich benefit package, a lower hourly rate, roots (family etc) within the community.

The automatic assumption that a higher debt cost for a LDC results in higher rates to customers assumes operating costs and quality of service remain the same. If however, the lower return offered the community shareholder precipitates a divestiture by that shareholder then the assumption of status quo operating costs and quality of service is probably not valid. New owners and management may be reasonably focussed on other priorities in the broader expanded service area.

If a small LDC is merged with a much larger LDC, there may be deterioration in service quality within the former small LDC's service area as a result of the merger, but this deterioration would probably not be apparent in any analysis of the enlarged entity's service quality performance. If a smaller LDC is merged with a much larger LDC then change in things like local Service Quality Indicators would generally be lost in the rounding.

This attack on the cost of capital may be supported by some particpants. The apparent goal of the pursuit of a lower cost of capital appears to be driven by a desire to punish publicly owned OBCA Corporations explicitly without the recognition that the elimination of such entities may ultimately result in higher rates faced by those represented customers. A lower deemed cost of capital could precipitate the reduction of a fair market return for public shareholders.

Understating the cost of debt applicable to publicly held LDCs or in fact the cost of debt to their municipal corporation owners may result in a shareholder desire to liquidate the valuable community asset in pursuit of instant cash rather than accept a lower long term return based on an agenda driven statistical analysis of market forces on bond ratings (which may be accessible to larger LDCs and/or their equally larger municipal shareholders but are not generally accessible to smaller LDCs). This type of analysis clearly underpins any rationalisation for the conclusions reached in the Lazar Prisman report.

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The MADD rush to a simple one shoe fits all cost of capital ignores the value of the LDC to the customer. Unit delivery costs are not of primary importance to most customers. The Service Quality Indices used by the OEB do not capture all of the items of importance to customers. MADD salesmen rely on a feeble Ontario energy process which purports to evaluate no harm to customers. This process fails to require any assessment of customer priorities and satisfaction before and after any proposed merger. Simplistic unit cost are often utilised as a substitute for real work which should add value to any MADD process. Board staff eagerness to embrace the simple answer and the one shoe fits all answer fails to serve or protect customers.

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The Board Staff stated objective “to avoid imposing barriers to consolidation within the electricity distribution sector” should reflect a careful balance of permitting the status quo in terms of structure and permitting the rationalisation of the industry. It is easy to interpret the “avoid imposing barriers to consolidation within the electricity distribution sector” to mean establish an artificial set of rules which demand a consolidation of the industry through financial punishment of smaller and potentially more cost effective distributors which may well currently provide a higher standard of service for the communities they serve because of their locally based and in many cases lower cost skilled staff. The status quo may often produce a higher value to customers than forced mergers or divestitures.

Conclusion

The OEB has a statutory right to establish codes, provided the drafts are published for comment and the responses are considered. We are concerned that the obligations may be lost if “reasons” are not published as part of the process indicating that responses have been considered. For example, ECMI submitted comments on July 4, 2006 prior to this session and we have no way of knowing if the comments were considered, rejected or lost. The way that Board currently approaches codes without responding with reasons is imperfect and the process needs to be enhanced.

It is not only a question of whether codification of rates can be done. It is more a question of whether it should be done, given the time line and the complexity of the issues.

Original signed by R. White

Roger White
President

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October 20, 2006

ATT: E. Kirsten Walli, Board Secretary

Dear Ms Walli,

> **IN THE MATTER OF** the *Ontario Energy Board Act, 1998,* S.O. 1998, c.15, Schedule B;
> **IN THE MATTER OF** a generic proceeding initiated by the Ontario Energy Board pursuant to section 74 of the *Ontario Energy Board Act, 1998* to amend the licenses of electricity distributors to make provision for methods and techniques to be applied by the Board in determining distribution rates for licensed electricity distributors.
>
> **EB-2006-0087**

In accordance with the Procedural Order No 1 dated October 6 2006 ECMI submits its comments with respect to the above noted matter.

In examining the topic of codification of processes, ECMI will attempt to discuss this activity on the basis of:-

- The current process
- The advantages of a Code
- The obligations under the creation of a code
- Contrast with a hearing
- The advantages of a hearing over a Code
- Apparent systemic bias
- Conclusions

ECMI considers it inappropriate to utilise a Code process to determine whether Code are an appropriate way for the Board to fulfil its regulatory functions.

Further it is inappropriate to determine whether a Code is an appropriate process when the Codes have not been developed. The current process is such a fundamental departure from generally accepted regulatory processes that it requires a more substantive process than the one currently offered by the Board. The expertise and the witnesses required to support or refute the process are so fundamentally different from those required to comment on the cost of capital proposal that the current process is not sufficient to permit a proper examination.

The submissions under the current process are not evidence. They are neither provided under oath nor subject to cross examination under oath. Such cross examination permits examination of not only real evidence but examination of the reasons for the stated evidence and the validity of those reasons.

What this process needs to determine is not whether or not the Board has the right to do something but whether the proposed process mitigates the ability of the Board through the process to fulfil its obligations under the law. If it does, then it is a flawed process and should not be pursued. Even if the Board has the legal right to use such a process, it should not do so.

It is ECMI’s view that at the very least the current process requires a hearing to determine whether the proposed codification itself is outside the law. Such a hearing would permit the creation of evidence that is sufficiently transparent as to permit an evaluation which might permit a determination of the validity of the process.

It is important that the Board be permitted to establish Codes which govern the day to day activities of the regulated entities. The Distribution System Code, for example, outlines the principles that will be utilised by a regulated entity in fulfilling its statutory obligations. The orderly operation of the day to day activities of regulated entities was clearly the intent of providing a statutory basis for establishing Codes.

The establishment of a Code should not be so prescriptive as to preclude the proper and fulsome consideration of the merits of additional considerations which would produce a different answer.

The statutory creation of a right to establish Codes is not done in a void. This is particularly true in the case of administrative tribunals. Administrative tribunals under natural law have a duty to consider what is put before them and respond with reasons. Those duties are to ensure to the extent practicable, a transparent process to the benefit of those regulated as well as those being notionally protected by such regulation. When one considers the statutory provision for the establishment of Codes, the obligation for the Board to publish draft Codes and consider the responses is not done in isolation of the transparency obligation and benefits. The Board has not demonstrated its compliance with the statutory consideration obligation unless it provides the reasons for its decisions with respect to the ultimate Code and publicly documents the consideration process that resulted in the ultimate Code.

During this current process, it was suggested that Board Staff recommendations to the Board are not public documents. This invokes a veil of secrecy over the process which mitigates against its transparency and credibility. Errors in any private submissions to the Board reduce the credibility of the Board itself. Failure to disclose the full process leaves such errors hidden from public scrutiny. This is a travesty against those regulated and an affront to those whom the regulation purports to defend.

Unlike Codes, hearings deal with LDC specific matters and matters which are not sufficiently universal to be codified. The outcomes of the hearing process, whether it be a PBR regime or a specific rate application have implications for individual customers or groups of customers as opposed to all of the customers within the Board's jurisdiction.

The apparent need for many "Z" factor considerations in the Cost of Capital process demonstrates that codification of this process is unwise. The absence of clear rules for Z-factor consideration may not be satisfactorily addressed. An ad hoc approach responding to individual cases differently mitigates any benefits flowing from a codified process. Further, the use of Z factors may result in more applications for specific consideration requiring more hearings to consider and establish appropriate action. It is possible to liken the excessive use of Z factors to the application of patches on a balloon. The more patches applied, the greater risk of leakage and greater difficulty in finding the leak.

The rules of evidence associated with a hearing are clear and permit not only examination of the evidence but the underpinning rationale for the evidence submitted during the hearing process. A hearing process on an item such as rates may permit full examination of the impact of a proposal on individuals affected by that rate which a Code process may preclude other than through an appeal to the Board as to the application of the Code. If the Code is in any way unclear, then the determination or interpretation under the Code may not be based on the common regulatory considerations applied to other regulated entities under that same Code. Such inconsistency does not provide good regulation.

In examining Board processes, it is apparent that a systemic bias on the part of the Board should not exist unless there is a robust statutory underpinning of that bias and in fact for a fundamental bias to exist, ECMI would submit that there needs to be a clear and irrefutable statutory duty for such a bias.

Regulatory experiments are risky for regulators, for those who are regulated by them and for the customers the regulator is charged with protecting. This proposed experiment seems to be part of a multi-pronged attack which includes; significant increase of regulatory burden in terms of filing requirements for information, and on another front reinterpreting, if not rewriting the Affiliate Relationships Code (ARC).

What is apparently lacking is the establishment of priorities by the Board which are clearly focussed on customers. The Chief Compliance Officer on a number of occasions has stated that enforcement of his unique interpretation of the ARC should be done without any consideration of the impact on customers. In their letters Board Staff appear to be putting themselves more and more in the role of the OEB itself. This “encroachment” is potentially dangerous for customers in that the opportunity for properly vetting decisions on items which some may consider minor changes may be lost.

The apparent embedding of another OEB Staff driven attack on Small and Medium sized Distributors using the cost of capital within this process is further cause for concern. The implications behind the Cost of Capital initiative is that the Small and Medium sized Distributors are being unduly enriched by the Cannon method. When this assumption is combined with the fact that the only LDCs that experienced an increase in deemed equity include Hydro One with an 11% rate increase as part of EDR 2006 process, it is hard to accept that this cost of capital process is customer focussed regulation.

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The preceding comments on the current process, the potential advantages and need for a Code and needs which might support the development of a Code, the lack of fulfilment of the obligations which underpin the establishment of a Code, the deficiencies of a Code when compared to a hearing and the risk of systemic bias all demand that the proposed codification of the PBR process is inappropriate. Further, Codes should be pursued only when they are of a general nature governing day to activities of regulated entities.

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Respectfully submitted.

Original signed by R. White

Roger White
President