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BY COURIER

October 25, 2006

Ms. Kirsten Walli
Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON.
M4P 1E4

Dear Ms. Walli:

EB-2006-0088/EB-2006-0089 – Multi-year Electricity Distribution Rate Setting Plan Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089) – Hydro One Networks' Comments

In accordance with the procedure outlined at the Technical Conference on September 21, 2006 by Mr. Kaiser (September 21, 2006 Transcript, page 109), I am attaching ten (10) copies of Hydro One Networks' comments. An electronic copy of Hydro One Networks' comments will also be sent by email to both boardsec@oeb.gov.on.ca and to edr@oeb.gov.on.ca.

Participants to this proceeding will be provided with a copy of the comments by email.

Sincerely,

Susan Frank

Attach.

c. EB-2006-0088/EB-2006-0089 Participants

IN THE MATTER OF a consultation by the Ontario Energy Board on the Cost of Capital and 2nd Generation Incentive Regulation for Electricity Distribution Companies RP-2006-0088 and RP-2006-0089.

FINAL SUBMISSION HYDRO ONE NETWORKS INC.

INTRODUCTION

1. Throughout these proceedings, Hydro One Networks Inc. (Hydro One) has actively participated through written comments and submissions, oral presentations and responses to written questions. In each of these instances Hydro One's aim was to assist the Board staff through focusing comments that help expedite the implementation of the proposed 2nd Generation Incentive Regulatory Mechanism (2GIRM) and alert the Board's staff to the need to quickly move forward with the development of the 3rd Generation IRM (3GIRM). Our aim was also to highlight to all stakeholders the concerns Hydro One has with Board staff's proposals with respect to the cost of capital and their proposal for return on equity (ROE).

INCENTIVE REGULATION

2. Having provided a comprehensive set of inputs Hydro One wishes to focus this submission on key messages that it hopes will help the Board in coming to a decision with respect to moving forward with the implementation of incentive regulation for electricity distributors in Ontario. In this respect Hydro One wishes to focus its submission on the implementation of 2GIRM and the development of 3GIRM.

Implementation of 2GIRM

3. Hydro One is supportive of the Board staff's proposal for moving to incentive regulation in Ontario. In this respect, the proposal for transitional mechanisms to

mechanically adjust distribution rates starting in 2007 while the Board deals with rebasing of all distributor rates in the 2008-2010 period is a reasonable approach that allows the Board to manage the process in a timely manner. The focus is on simplicity such that rates can be adjusted and approved in an expedient manner given the short period of the 2GIRM.

4. In order to achieve the timeliness and effectiveness of 2GIRM, Hydro One recommends that the Board quickly issue a set of guidelines that will provide the LDCs with the necessary information to expedite filings for rate adjustments. As part of its participation in the consultation process Hydro One provided a summary of key elements that need to be considered in terms of formulating the guidelines for submissions. This information is contained in Hydro One's Questions 1-6 for Board staff under the section 2nd Generation IRM – How will the proposal be implemented.[1]

5. The gist of Board staff's response to Hydro One's questions suggests that many of the issues raised by Hydro One had not yet been fully considered[2]. Therefore, there is a pressing need to move on those matters given the short lead time for the implementation of 2GIRM. LDCs need to have clear and unambiguous directions for implementing this process otherwise the benefits of a simple 2GIRM model will not be realised.

6. Hydro One wishes to bring to the Board's attention the matter of the Capital Investment (CI) factor which Hydro One proposed as an additional adjustment mechanism to be included in the 2GIRM price cap formula. The rationale for inclusion of this factor was described in Hydro One's August 14, 2006 written submission[3], and the matter was debated at some length during the Technical

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[1] Written Questions to Parties: Hydro One questions to Board Staff & its Consultants dated September 27, 2006.

[2] CoC/IRM - Staff's response to questions from Hydro One Networks Inc., dated October 11, 2006.

[3] EB-2006-0088/EB-2006-0089 – Multi-year Electricity Distribution Rate Setting Plan Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089) – Hydro One Networks Submission and Expert Reports, August 14, 2006

Conference on September 22, 2006.[4] The proposal hinges on the need to recognize the costs likely to be incurred by LDCs in respect of capital investments during the term of 2GIRM.

7. For some LDCs the term of 2GIRM will extend for up to three years. Like Hydro One most LDCs are faced with an aging distribution infrastructure and the potential for expansion caused by the need to incorporate new distributed generation in response to Government's directives for implementation of new supply mix. These matters put upward pressure on the need to invest capital. The staff proposal for price adjustment during 2GIRM does not allow for rate base growth during the term of 2GIRM and therefore LDCs potentially stand to lose cost recovery (depreciation, interest, return) if they make investments as required. As Hydro One pointed out in its written material and at the Technical Conference, this lack of cost recovery provides a disincentive for utilities to invest.

8. The use of the CI factor is discretionary in that only those LDCs that have a need to do so would make use of this adjustment. In that respect each LDC would submit the necessary information in support of its request for a CI adjustment to the price cap formula and it would allow the Board to examine the circumstances in making its decision. The proposal is simple to implement, readily verifiable and provides an element of credibility check in that a utility's has to justify its intent for the application of a CI factor and it has to demonstrate at future rebasing proceeding its success in having carried out the work for which it had sought cost recovery.

9. The discussion at the Technical Conference demonstrated interest in the proposal, with some utilities indicating their investment needs supported the concept. Given the pressure on investment in the distribution infrastructures Hydro One recommends that the Board approves the inclusion of the CI factor in the price cap formula for 2GIRM.

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[4] OEB Transcript, September 22, 2006.

3rd Generation IRM

10. Throughout the consultation process Hydro One has indicated its support for the implementation of a 3rd Generation IRM (3GIRM) as the longer-term and enduring incentive regulation process for electricity distributors in Ontario.

11. The concern raised by Hydro One and other Intervenors pertaining to 3GIRM is the conspicuous absence of any detail. The onset of 3GIRM is imminent given that the first tranche of 30 LDCs that have their rates rebased in 2008 will be subject to 3GIRM starting in 2009. Therefore the lead time for implementation of 3GIRM is very short.

12. Board staff has indicated that 3GIRM will be distinctly different from 2GIRM and therefore there is no expectation that the latter will provide any learning that would be helpful as a transition into 3GIRM. Rather, the expectation is that 2GIRM is a transitional mechanism that provides for automatic adjustment to distribution rates whilst the Board deals with rebasing of utilities distribution rates over the three year period. In this respect there is little expectation that 2GIRM will produce any significant incentives for LDCs, particularly for those that are subject to one or two-year periods under 2GIRM. Therefore, 3GIRM is a completely new process that will be developed from scratch.

13. In its presentation at the Technical Conference, Hydro One indicated that Inflation, Productivity and Performance are the key areas in its vision of incentive regulation[5]. To date little time has been spent to examine these subjects in detail. Board staff have proposed some very broad assumptions in terms of these elements as these pertain to 2GIRM. Therefore, there is little or no knowledge at this time as to what details are applicable to the distributors in Ontario. The need for performance drivers and the mechanisms by which these are enforced is an obvious area that requires a great deal of effort.

[5] Hydro One presentation at Technical Conference: - Slide # 3, September 22, 2006.

14. Each of those areas indicated above requires detailed studies to provide the necessary information that will enable the adoption of an appropriate model to incent the electricity distributors to perform during the plan period. Such studies necessitate the collection and analysis of significant data to yield the desired information. This is not a trivial exercise and experience from other jurisdictions where incentive regulation is in place underlines the need to set aside sufficient time.

15. All of the above point to the fact that the move to 3GIRM will require a lot of work and the time is short before 3GIRM has to be implemented. The effort to design a successful 3GIRM requires the cooperation of the OEB, the LDCs and interested stakeholders with a common view of achieving the goal of incentive regulation. Hydro One urges the Board to convene an industry working group that is tasked with the responsibility for designing the 3GIRM and that this is done as soon as possible.

COST OF CAPITAL

Capital Structure

16. Board staff is proposing an equity ratio of 40% for all LDCs, including up to 4% of actual preferred shares. The proposed equity ratio, according to Board staff, takes into account the allowed common equity ratios for the gas utilities (35% and 36% for Enbridge Gas and Union Gas respectively) and their conclusion that a thicker equity ratio is warranted for the electricity distributors. The rationale for Board staff's conclusion is that the risks of the gas utility business have been examined thoroughly through the regulatory process, unlike the electricity distribution industry, and that the electricity distribution industry requires significant investment in infrastructure, which imposes additional risks on the electricity distributors relative to the gas utilities. Hydro One agrees that the required investment in infrastructure imposes additional risks, and accepts that a common equity ratio of 40% is reasonable for a large LDC like Hydro One.

17. However, preferred shares are not equivalent to common equity[6], and a capital structure of 36% common equity and 4% preferred shares is not as strong a capital structure as 40% common equity.[7] Hydro One adopts the position taken by Ms. McShane in her expert report filed with the Board on August 14, 2006. As indicated in her report, from the perspective of debt holders, preferred shares are more akin to equity; from the perspective of common shareholders, they are a form of leverage. Essentially, they are a hybrid with characteristics of both debt and equity. Thus, the preferred shares should be treated as a separate component of the capital structure rather than equivalent to common equity as OEB staff has proposed.

18. As recommended by Ms. McShane, an appropriate capital structure for Hydro One would contain 40% common equity as well as a preferred share component of up to the 4% level that has been previously maintained. [8] Hydro One agrees with Ms. McShane that, with an appropriate common equity return, a capital structure with 40% common equity and up to 4% preferred shares should be adequate for Hydro One's distribution operations to maintain debt ratings in the A category on a stand-alone basis and access the debt markets on reasonable terms and conditions to raise the capital necessary to make its required infrastructure investments.

Return on Equity

19. Board staff is proposing that the allowed equity return be set in a range of 7.50% to 8.37%. The proposed range represents the application of a new and untested methodology proposed by the Board staff's experts, Drs. Lazar and Prisman. The

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[6] Board Staff agreed during the technical conference of October 17 that preferred shares and common equity are not equivalent.

[7] If HONI's distribution capital structure were set at 36% common equity and 4% preferred shares, it would be virtually identical to Union Gas' most recently approved capital structure, and thus would not compensate HONI for the additional risks imposed on the LDCs relative to the gas utilities.

[8] In its recent decision for the ATCO Utilities (Decision 2006-100, ATCO Utilities 2005-2007 Common Matters Application, October 11, 2006), the Alberta Energy and Utilities Board concluded that it was cost-effective for the individual ATCO utilities to maintain a target preferred share component of 6% in addition to the common equity ratios the EUB had previously approved in its Generic Cost of Capital Decision 2004-052 dated July 2, 2004. In the Generic Cost of Capital Decision, the EUB had determined the appropriate common equity ratio without adjustment for the impact of the use of preferred shares.

proposed ROEs are based on a mechanistic application of a single test, the Capital Asset Pricing Model. The proposal has been made without any testing of the results by reference to other market data or tests, nor any consideration of the impact of the utilities' ability to access the capital markets on reasonable terms and conditions on a go-forward basis. This is in stark contrast to the approach that has been taken historically by this Board and by all other regulators in Canada, which has involved an in-depth scrutiny of all return on equity evidence. In that context, Dr. Booth, in his report on behalf of VECC, IGUA et al commented,

> "Broadly speaking the 9.0% allowed ROE was in line with what was being allowed elsewhere. I would therefore expect that the Ontario discos should continue to get the fair ROE that is being allowed elsewhere unless there is a full hearing to test the assumptions behind the allowed ROE. In this respect it is important to note that the OEB fully reviewed its adjustment mechanism in 2003 and subsequently both the NEB and the BCUC have fully investigated their adjustment mechanisms, so there is a full evidentiary basis for their decisions."

20. Hydro One agrees with Dr. Booth on that point; in fact, a full evidentiary process has not been carried out. Hydro One believes that the Board would be remiss if it adopted the Board staff's recommendations in the absence of a full evidentiary proceeding. Moreover, Hydro One notes the concerns that have been expressed by both equity analysts and the debt rating agencies with respect to the reasonableness of the Board staff's proposed range of ROEs. Those concerns include the conclusion that allowing a return in the range recommended by Board staff would be confiscatory. In this context, it is important to recall that the Board, in EB-2005-0421 (Toronto Hydro, April 2006), has expressly recognized that the allowed returns on equity for the LDCs are subject to the same standards as all other utilities.

> "And, as a matter of law, utilities are entitled to earn a rate of return that not only enables them to attract capital on reasonable terms but is comparable to the return granted other utilities with a similar risk profile."

21. Specific concerns that Hydro One has with Boards staff's proposed methodology include:

    (1) Reliance on a 10-year average forward rate to set the risk-free rate.
        (a) The methodology to determine the rate is complex and has not been used elsewhere;[9]
        (b) The accuracy of the data was not verified;
        (c) The 10-year rate is incompatible with the long-term nature of the utilities' assets.
    (2) The market risk premium proposed was based on a relatively short-term average of experienced market returns
        (a) The experienced returns in the equity market over a five or ten year period are very unstable and are unlikely to be representative of the expected return in the future;
        (b) As Ms. McShane's report pointed out, the average (arithmetic) actual returns for the S&P/TSX composite for the five-year periods ending in 2000 to 2005 ranged from 2.5% to 16.1%. Using market returns which demonstrate this much volatility could produce extremely unstable returns (which bear no resemblance to investors' required returns) and extremely unstable rates to customers.
    (3) The beta used by Board staff was highly dependent on the companies included in their sample (which itself was made up of companies with little comparability to the LDCs). The elimination of a single company in Board staff's sample that had been acquired raised the average beta of the remaining companies sufficiently to increase Staff's 8.37% ROE by more than .60% (to over 9.0%) without changing any of the other of their proposed parameters.

22. Hydro One continues to support the recommended 10.5% return recommended by Ms. McShane. Nevertheless, in the absence of a full evidentiary proceeding, the

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[9] During the September technical conference, Dr. Booth explained why, in his view, the forward rate was inappropriate as an estimate of the risk-free rate to be used in the context of determining the allowed return.

Board should continue to rely on the previously approved methodology for determining the ROE. This methodology, which has been called the "Cannon methodology", was in fact initially proposed by the Board in its 1997 Draft Guidelines, and applied to the gas utilities.[10] The methodology, as set forth in the Guidelines, has two components, the Initial Setup and the Adjustment Mechanism. The Initial Setup has two steps: (1) Establish the forecast of the long-term Canada yield for the test year and (2) Establish the implied risk premium. The Adjustment Mechanism also has two steps: (1) Establish the forecast long Canada rate and (2) Apply the adjustment factor. The adjustment factor was specified in the Guidelines at 0.75.

23. In his December 1998 report entitled "A Discussion Paper on the Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario", Dr. Cannon recommended that the same methodology be applied to the electricity LDCs, including both the Initial Setup and Adjustment Mechanism components. The full methodology was adopted in Hydro One's Transitional Rate Order for both Transmission and Distribution Rates in April 1999. The application of the Adjustment Mechanism resulted in an ROE of 9.88% (based on December 1999 data, which resulted in a forecast long Canada yield of 6.2%) being adopted for Hydro One's transmission and distribution rates in EB-1999-0526 (March 1, 2000). The same ROE of 9.88% was adopted for the LDCs in the Electricity Distribution Handbook dated March 9, 2000.[11] The methodology was reviewed in a full evidentiary proceeding for the gas utilities in RP-2002-0158 and both the Initial Setup and Adjustment Mechanism were reconfirmed in January 2004. [12]

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[10] Implemented initially for Enbridge Gas in EBRO 495 to set fiscal year 1998 rates.

[11] In the Board's Reasons for Decision in RP-1999-0034 dated January 18, 2000 which dealt with the 2000 Handbook noted that the methodology for setting the return for the LDCs was based on the same methodology used by the Board in regulating natural gas utilities and which was applied in setting the rates for OHSC's transitional rates. The Decision stated that the actual value of the ROE would be calculated using December 1999 data.

[12] In its recent decision for Natural Resource Gas (EB-2005-0544, dated September 20, 2006), the Board allowed NRG a risk premium of 50 basis points above that allowed for Enbridge Gas, effectively confirming the reasonableness of the level of the ROE being awarded the gas utilities under the existing Guidelines.

The review above demonstrates two facts:

(1) The Board's intent was, from the beginning, to apply the full Draft Guidelines ("Cannon") methodology to the LDCs;[13] and

(2) When the Board fully reviewed the Guidelines in RP-2002-0158, it reconfirmed the reasonableness of both components.[14]

In the absence of a full evidentiary proceeding, the Board should continue to apply the full Draft Guidelines ("Cannon") methodology, including the Initial Setup and the Automatic Adjustment Mechanism. The correct application of the methodology, including the 0.75 adjustment factor, would result in a return on equity of 8.65% using the August 2006 Consensus Forecast.[15]

[13] It bears noting, that, in the 2006 Electricity Distribution Rate Handbook, the Draft Guidelines methodology was not correctly applied. The full implementation of the methodology, at the forecast 5.2% long Canada yield, would have resulted in an ROE of 9.13%, rather than the 9.0% contained in Section 5.1 of the Handbook. (9.88% + 0.75 X (5.2%- 6.2%) = 9.13%).

[14] Since the Board's reconfirmation of the Draft Guidelines, there have been ROE decisions by both the EUB (July 2004) and the BCUC (March 2006) that adopted initial allowed returns and adjustment mechanisms that produce returns similar to those that would apply to the LDCs pursuant to the continuation of the full "Cannon methodology".

[15] 9.88% + 0.75 X (4.56%-6.2%) = 8.65%.