London Hydro

October 26, 2006

Kirsten Walli, Board Secretary
Ontario Energy Board
PO Box 2319,
2300 Yonge St, Suite 2700
Toronto, Ontario, M4P 1E4

Re: 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. (EB-2006-0088 and EB-2006-0089)

In it's submission to the Board of August 14, 2006; London Hydro has offered its views and recommendations with respect to the Board Staff's Proposal (the "Proposal") on the Cost of Capital and 2nd Generation IRM. While reference to those submissions will be helpful, we summarize the following key points for the Board's consideration:

1. The Staff's proposed capital structure of 60/40 is without basis and ignores the fundamental firm specific issues that impact on a firm's cashflows and its ability to attain that 60/40 capital structure. Evaluating macro industry risks only, as the work to date has done, is wholly incomplete. Comparison to gas regulation and gas companies because of size and other operational comparability constraints is completely inappropriate.

2. Accepting the Proposal, which is badly premised, and allowing negatively impacted firms to apply for exceptions through a non-defined Z factor or other application process, is bad regulation.

3. There lacks a proper evaluation of the smaller firms' ability to attain this capital structure. The Board Staff and experts have offered nothing in this regard. The empirical observations of firms in the sample groups used by the Board experts bear no size or financial capacity characteristics of the majority of firms being regulated.

4. There has been a lack of proper consultation with firms and particularly the financial community in establishing what the impact of the Proposal will mean in real and practical terms.

5. There has been no meaningful reason offered as to why the existing Cannon framework is inappropriate.

6. We have suggested that the existing Cannon methodology better aligns with the fact that there are wide differences in firm size and financial capacity, and balances that with appropriate and efficient regulation. The Staff Proposal for a uniform structure strays further away from this mark and has an uneven impact on firms and their customers throughout the industry, despite a single and uniform obligation to serve.

7. The existing Cannon framework has trade-offs, is not exact, but is better representative of reality and is fair. In London Hydro's opinion, it is better regulation than the Proposal.

We have heard the input provided to-date by Board Staff and other stakeholders on the Proposal and we offer these final comments on the following specific issues.

<u>The universal 60/40 debt/equity structure proposed by Board Staff.</u>

Based upon the input and opinions provided by the vast majority of stakeholders and industry experts, including Dr. Lazar and Dr. Prisman, the overwhelming opinion on this issue is that a stratified debt/equity structure based on utility size is justified.

In the responses issued by Board Staff on October 11, 2006 from various stakeholders the following information was provided:

<u>Question # 5 from Bluewater Power</u>
Q5. *Does Board Staff have any evidence that suggests the current deemed debt/equity structures for LDC's in Ontario are wrong (i.e. do not accurately reflect the risks faced by LDC's)? If so, please provide that evidence.*

<u>Board Staffs response.</u>
A5. *Staff has found no evidence to suggest that the current debt/equity structures are reflective of utility risk.*

<u>Question # 22 Coalition of Large Distributors (CLD).</u>
Q22. *Please provide Board staff's updated risk assessment of the Ontario electricity distribution industry. In particular, please provide detailed analysis of the risks to distributors associated with:*

- *The Ontario Power Authority's Standard Offer Program;*
- *The Ontario Power Authority's plan to contract with LDC's for CDM; and*
- *Smart Meters*

Board Staffs response.

A22. *Board Staff does not have a risk assessment of the Ontario electricity distribution industry. Risk as considered by Board Staff is on a relative financial basis derived from the work produced by the consultants retained by Board staff.*

The response by Board Staff to Bluewater question #5 is illustrative of the fact that Board Staff have not undertaken any study or analysis to justify the abandoning of the existing debt-equity structures. Additionally, no evidence, information or analysis has been provided to show that a common 60/40 debt equity structure is reflective of utility risk.

The response by Board Staff to CLD question #22 indicates that the only data used for determining LDC risk assessment was that derived from the work produced by the consultants retained by Board Staff. We assume Board Staff are referring to the work performed by Lazar and Prisman whose recommendation based upon their risk assessment was that LDC's with a rate base of less than $300 million should have a debt-equity split of 50/50 and those over $300 million should be 60/40.

Recommendation

While perhaps not a perfect solution to addressing the different risks faced by LDC's in Ontario, the current stratified debt/equity structures at least attempts to address this issue, whereas the 60/40 proposal fails to acknowledge that it exists.

The existing stratified debt/equity structures which factor in an element for the varied utility risks related to size of operations should not be abandoned for a single common structure that is not reflective of the differing utility sizes in Ontario.

Board Staffs Guiding Objectives to the "Proposal"

Board Staff has not adequately demonstrated how their proposal achieves the 6 guiding objectives that they have set out.

Guiding Objectives # 1 -Protect customers in relation to prices.

The 2006 EDR filing data published by the Board on their website indicates that approximately 43% of customers in Ontario are served by utilities with an existing debt/equity structure of 65/35. Establishing a common debt/equity structure of 60/40 for all utilities in Ontario results in price increases for these customers and price reductions for the approximately 39% of all customers served by utilities that currently do not have a 60/40 structure.

Many of the utilities incurring price reductions currently have amongst the lowest rates in Ontario, and thus in some instances, the Proposal will provide price protection where it is least required.

Guiding Objectives # 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.

This objective suggests or implies that the existing stratified debt/equity structures may impose a barrier to consolidation.

In responding to Board Staff's question #3 of September 27, 2006:

"Impact on Sector Rationalization

What impact (positive or negative), if any, might changing capital structure for most Ontario electricity distributors have on the prospects of physical consolidation of electricity distributors?"

The majority of respondents to this question indicated that there was either no impact or offered only a theoretical possibility of impact if isolated from the other factors such as Transfer Tax considerations or economies of scale to be achieved.

In the context of the significant level of consolidation that has already occurred in the industry, neither the Board Staff nor any other stakeholders to this proceeding have offered any concrete examples of where the existing debt/equity structures have been a barrier or even a significant consideration to consolidation.

Many stakeholders commented that the most significant barrier to consolidation was the Provincial Transfer Tax. This barrier has now been removed for a two year period commencing October 17, 2006 as announced by the Provincial Government.

No compelling evidence or supporting data has been presented by any party to indicate that the existing or proposed debt- equity structure will either impede or promote consolidation in the industry. Industry consolidation will occur over the next two years due to the Transfer Tax exemption, and not as result of any changes in deemed debt/equity structures.

Financial Impact of Proposals

In the responses issued by Board Staff on October 11, 2006 from various stakeholders the following information was provided:

Question # 8 from CLD

Q8. *Please indicate whether Board staff has carried out an analysis of the impact on Interest Coverage Ratios for LDC's with outstanding third-party debt from moving to a lower return on equity. If such an analysis has been carried out, please provide results.*

Board Staffs response.
A8. *"No, this analysis has not been done."*

Question # 37 from CLD

Q37 *In developing its positions on issues related to capital structure and the cost of capital, did Board staff or the Board consult members of the financial community to assess their views on the appropriateness of the proposed approach, or have Board staff relied largely on the analyses provided by members of the academic community? If the financial community was consulted, please provide documentation of the discussions, copies of correspondence that was exchanged and details of the views or opinions that were expressed*.

A37 *This process has been designed to gain insights on cost of capital and incentive regulation from all interested parties. From time to time, staff does meet informally with members of the financial community. Staff has not actively solicited the views of the financial community on its cost of capital and incentive regulation proposals, beyond providing due notice of this process and allowing participants to bring forward information that they consider to be germane. Staff notes that some of those views have been brought forward anecdotally by participants in this process. All information related to these consultations has been posted on the Board's web site.*

The Board Staff's Proposal will alter the debt-equity ratios; ROE and deemed debt rates and it will impact each and every LDCs' rates, cashflows, revenues and interest coverage ratios. For specific utilities, these proposals may have very negative financial implications which will have a cascading effect lowering credit ratings and raising the actual cost of borrowing. To date, there has been no specific analysis presented of the potential negative impact on any single or group of utilities.

London Hydro fails to comprehend how Board Staff could bring forward such significant proposals without actively soliciting the views of the financial community. Information has been provided outlining the negative reception of certain industry observers in the financial community. It is the financial community's views, not those of Board Staff or their consultants that determine how these proposals will be translated into credit ratings, borrowing capacity and borrowing costs. Simply put, the rubber hits the road when utilities actually have to arrange financing and the omission of the financial community from this process leaves a large gap between the theory and implementation.

Over the last several years, the LDC community has been faced with many challenges brought on by changing regulation and the politics of power (see Bill 100 - the first time; Bill 210 - the Rate Freeze, etc.). Many of these challenges have severely stressed the financial health of the industry and prevented LDCs from earning the permitted ROE. Board Staff's Proposal would only continue this established pattern. The proposed changes must be considered in light of the cumulative impact of these prior events and that one of several reasons why London Hydro is opposed to the Board Staff Proposal.

All of which is respectfully submitted.

If you require any further information, please contact me directly.

Sincerely,

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