EB-2006-0088/89

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.

SUBMISSIONS

OF THE

SCHOOL ENERGY COALITION

1. The following are the final submissions of the School Energy Coalition ("SEC") with respect to the consultation phase in this matter. Except where we have specifically noted changes in our views, these submissions should be read in conjunction with our submissions of July 7, 2006 (the "Preliminary SEC Submissions") on the initial Staff Report, our submissions of August 14, 2006 (the "Detailed SEC Submissions"), and our answers to Board Staff questions dated October 11, 2006 (the "SEC IR Responses").

2. These submissions are divided into two parts. In Part I, we list our recommendations with respect to the issues under discussion. In Part II, we comment specifically on some of the positions taken by other parties, and provide our recommendations on how the Board should deal with those positions.

3. Prior to making our submissions, we note that SEC has made submissions in EB-2006-0087 arguing strenuously that the 87/88/89 process (consultation plus codes) for setting rates is not appropriate, and should be changed to reflect a more balanced, open and rigorous approach to the adjudicative process. While SEC is in this document once more providing substantive submissions on the issues raised, these submissions should not in any way be construed as resiling from or modifying our views with respect to how the Board should conduct itself in deciding rate issues, including the issues in this proceeding.

Part I - Recommendations

4. The Board has not been able to adduce sufficient evidence to make the decisions necessary in this proceeding. What has been produced is pitiful, in part because of the lack of compellability of the parties. This can only be done in the context of a proper hearing, at which evidence is adduced (in some cases, compelled) and tested, and the issues can be decided on a firm factual base. However, based on the information currently available to the Board (which in our view is inadequate), we believe that the following statements are likely to be true.

Transitional Cost of Capital and Capital Structure

5. ***The capital structure should be 60% debt, of which 8% is the deemed short term component, and 52% is the deemed long term component, and 40% equity, of which 4% should be preferred equity and 36% should be common equity.*** As we have previously noted, this is too thick an equity component, but given the preference share component it is close enough for a transition set of rules. In our view, the preference share component should only be included if it is mandatory and not optional. If it is not mandatory, the equity thickness should be 36% in this transitional plan, and long term debt should be increased to 56%. In the longer term, it is more appropriate to set the equity percentage at 30-35%.

6. ***The cost of arms-length debt should be set at the agreed rate, regardless of the term, subject to the normal rules respecting prudence.*** This appears to be the consensus of all parties, and should apply to both long term and short term debt. However, we note that this is the current rule, and is suitable for this transitional plan, but it is not necessarily the best long term rule. A better long term approach may be to establish an envelope for the cost of debt capital (or all capital, for that matter), and let LDCs do their best to stay within that envelope or even better that rate. This would incent creative financing approaches and promote financial discipline in LDCs.

7. ***The cost of non-arms-length debt should be set at the ninety-day market rate for A-credits at the time of the rate application. The one exception should be non-arms-length term debt that cannot be modified or repaid without an order of the Board. The rate for that debt should be the market rate for that term at the time of issuance. If the debt was issued prior to January 1, 2007, the market rate should be updated to the date of the rate application, but at the market rate for the remaining term, and then it should be fixed until the maturity date.*** This is a change from our previous position, which was that the rate should be reset each year at the term rate in existence at that time. Having heard the comments of others, we believe that this will continue to encourage municipalities to hold onto this debt. The goal of the Board should be to make the municipalities that are shareholders neutral about whether to hold this debt, or have it provided by third parties. Our revised recommendation would put the municipalities, and other affiliates, in the position that if they try to "keep their options open", using their utility like a convenient savings account, the rate on their debt will be very low. Only if they provide stable long term funding to their utility will they benefit from the higher long term market rates.

8. ***The Board should commission a study of the activities of Ontario LDCs in borrowing on the capital markets, or in other arms length transactions, such study to be carried out over the next two years and then available to inform the Board when setting the rules for 3rd Generation Incentive Regulation.***

9. ***Short term debt should be dealt with in exactly the same way as long term debt – market rates for arms-length, 90 day paper rate for non-arms-length.*** This is a change from our previous position, designed to be consistent with our recommendation on long term debt.

10. ***The preference share rate should be set at an appropriate market rate, using "allowed ROE less 200 basis points" as a transitional rule. The Board should commission a study of the appropriate preference share rate for LDCs, to be considered in setting the rules for 3rd Generation IRM.*** Because the proposed transitional rate is an after-tax rate, the effective before-tax rate is still well over 9%, which is more than enough for utility preference shares in today's market.

11. ***The ROE proposals of Lazar and Prisman, resulting in a range of 7.00% to 7.87%, assuming that the comparable group is regulated energy companies, most closely reflect the market reality.*** SEC believes that these levels are still on the high side, but this is an appropriate transitional rule. We note Dr. Booth says that, notwithstanding his acceptance in the interim of the Cannon number, if he were to do the analysis directly he knows he would end up with a result below 8.00% as well ("in the sevens", Tr:TC2-4). In fact, in his view this is just a matter of calculating correct data, and the fact that his result, and that of Lazar and Prisman (and that of Prof. Wilbur for Union Gas recently) are the same is just a function of all of them doing what amounts to the same calculation, even if they come at it different ways.

12. ***It is not appropriate to add a premium to cover new investment.*** Not only is this not the way the market works, as a number of parties have noted, but there is no evidence that it is necessary or that a particular premium achieves the goal proposed. If LDCs need additional money for new investment, it may be appropriate to recognize this in their rates, perhaps through the Z factor (see below), but it is not appropriate to adjust their cost of capital.

13. ***No need for a flotation or transaction premium has been established, and none should be included in ROE.*** The total of 50 basis points proposed amounts to more than $50 million annually in additional charges to ratepayers. The Board cannot and should not impose such an additional burden without evidence supporting these charges. No such evidence has been provided, despite the fact that the question was clearly put at the Technical Conference and the lack of evidence discussed. Dr. Booth, who did comment on it (Tr:TC2-7+8), questioned whether it was valid at all, since the market value of LDC debt is already above book. He noted that the CAPM result is the market return revealed by the data, and by definition the flotation allowance is a payment above market return.

14. ***To the extent that the Board allows exceptions to the cost of capital or capital structure rules in individual cases, the default rule should be adjusted so that the same average arises once the exceptions are taken into account.*** For example, Dr. Camfield proposes that individual LDCs be allowed to seek exceptions to the ROE levels or the capital structure rules. He agrees, though, that if such exceptions are allowed, that will have a tendency to increase the average ROE, and one way to deal with this would be to adjust the default ROE so that, averaged with all the exceptions, it will come in at the appropriate province-wide average (Tr:TC2-159-60).

Transitional Incentive Regulation

15. ***Use of 2006 is an appropriate base year for all utilities except Hydro One and Toronto Hydro, both of which should be rebased in 2007.*** This is a continuation of our earlier submissions on this point, which have not been answered by any party.

16. ***GDPPI using final domestic demand is the most appropriate escalator for 2nd Generation IR.*** There are pros and cons of each of the possible escalators, including the different types of GDPPI, but in the end the proposed escalator has the best balance of reliability, accessibility, and appropriateness. We do not believe that an industry-specific escalator is necessary or useful.

17. ***A productivity factor that has variations around the mean, but across the province averages 1.13%, is appropriate as a transitional rule.*** There appear to be lots of indications that an average X factor of 1.00% to 1.25% is the correct range, although parties have argued for an average of lower and higher. The revealed X factor level for electricity in the U.S. is 1.56%, but there is a productivity differential between the U.S. and Canada. It appears that the U.S. data equates to 1.13% when that differential is factored in. As this is a transitional plan, choosing 1.13% as the average is a pragmatic decision that we would support.

18. ***LDCs, ratepayers, or others should, in the LDCs' 2007 rate cases, be able to apply for a productivity or X factor that is greater or less than the provincial average of 1.13%. Three factors have been identified in this proceeding that would justify such a variance: higher or lower than average growth; unusually high or low need for capital renewal expenditures; and higher or lower than average rate levels. The Board should, in the 2007 rate applications of individual LDCs, accept evidence from LDCs and intervenors that the 1.13% default X factor is too high or too low in that particular case based on one of these three factors. The maximum range should be 0% to 2.25%. In setting individual rates for LDCs, the Board should target a province-wide weighted average for all LDCs of 1.13% for each of the three years of the plan.*** Many LDCs have taken the position that they have "special needs", and therefore a 1% (or 1.13%) X factor would be unfair to them. Some of those pleas are reasonable, and it is in everyone's interests that those utilities have an adjustment to a fair level. However, once those with lower X factors have been identified, the average for the remaining LDCs should logically be higher. The easiest way to achieve this is to set the X factor for each LDC based on the evidence in their rate application, and then ensure through balancing (or mathematical adjustment) that the weighted average of all X factors is the appropriate level, ie. 1.13%.

19. ***Any K Factor should be calculated for the specific LDC, rather than making an attempt to apply the same factor for all LDCs.*** We believe that all parties, including Board Staff, now agree with this in principle. It has been demonstrated that individual K factors must be calculated in order to get a general number, and the general number is useless if the individual factors are already available.

20. ***SEC is strongly opposed to Z factors and off ramps because they generally result in rates being higher than those set simply on the basis of escalator less productivity factor. There should be no off ramps, and the only Z factors should be those formulaic***

adjustments that have been specifically identified in advance, e.g. statutory tax rates; approved DSM expenditures, etc. We have been consistent in these views, and have expanded on them in the Preliminary SEC Submissions, the Detailed SEC Submissions and the SEC IR Responses. We reiterate our comment that LDCs always have the option to apply for an exemption from the rules if some major fact makes their continued application no longer appropriate. In those circumstances, we believe the Board's benchmark of materiality should be whether, without a review, the ROE of the utility will be less than its debt rate.

21. ***For similar reasons, SEC is opposed to earnings sharing.*** The best way to ensure sound financial management of utilities is to require them to live within their budgets (with as little safety net as possible, hence few Z factors and no off ramps), and to allow them to keep all of the results of their efficiency initiatives until the next rebasing.

22. ***Selection of cohorts for early vs. late cost of service should include as important factors a) the size of the utility, and b) the level of distribution bills relative to other LDCs.*** The size factor is especially true of Toronto Hydro and Hydro One, which need to go early because they each have particular issues that urgently need attention from the Board. With respect to level of distribution bills, SEC has for some time now been asking the Board to take action on the wide variation in overall prices (ie. total bills for the same service) between LDCs. It is straightforward to do a comparison of sample customer distribution bills between LDCs, and identify which ones charge the most for a given level of service. All other things being equal, it is the ratepayers of those high-priced utilities that are most in need of action by the Board to review their LDC's operations. By bringing many of those high-priced LDCs in for cost of service early, the Board will be able to get a handle on this problem as quickly as possible. Further, if those utilities need to be directed to take actions to get certain costs down over more than one year, this would get them started right away on that process.

<u>Part II – Comments on the Positions and Submissions of Other Parties</u>

23. ***Long Term Debt Rate.*** Board Staff, as well as many utilities, seek to "construct" a debt rate to be applied to non-arms-length long term debt. The Board Staff proposal would result in a non-arms-length debt rate of more than 6.00%. This is a significant part of rates. We have the following comments:

    a. It is not necessary to make this rate up. There are Ontario LDCs with traded debt, and the market yields provide a clear signal of the interest rate that is appropriate. This is currently in the range of less than 5.00%. We note that Dr. Lazar (Tr:TC1-30) agrees that the market rates for those LDCs with traded debt are evidence that can help set the rate for the rest.

    b. Some utilities object that the yields on traded debt do not reflect the longer term debt that they should be issuing to their municipalities. This is a legitimate point, and to the extent that municipalities are willing to provide long term stable funding that they cannot choose to change when they feel like it, the market rate (e.g. 10 years) should be adjusted to reflect the longer term (e.g. 30 years). However, this again is not difficult. The bond market

clearly and easily reveals the yield spread between 10 year bonds and 30 year bonds, for example. It is 5-20 basis points.

c. Some utilities object that yields on high rated utilities like Toronto Hydro or Hydro One should not be applied to smaller utilities whose financial position is weaker. This is an enticing argument, until you focus on its implications: municipalities owning smaller and weaker utilities will be rewarded with higher interest rates. This directly incents poor financial management of utilities. In our submission, utilities should be given a debt rate standard that is what they as a group are expected to achieve, and they should then go out and try to achieve that standard. If they choose to retain municipal ownership of their debt, the municipality simply has to live with the standard return. If they choose to go to the market, they should be expected to use creative financing techniques (such a joint borrowing, as is the case with school boards) as a normal part of prudent management. As we have noted earlier, in the longer term they should be given an "envelope" for financing costs, with the opportunity to do better and keep the difference.

d. It is incomprehensible to us that small local school boards can find a way to borrow at 5.00%, but local distribution companies not only are unable to achieve that, but for the most part don't even try to access the public markets. LDCs should be held to a higher standard than is implied by the 6.00% or more authorized debt rate currently being proposed.

24. ***Capital Structure.*** Almost all of the distributor representatives appearing in this consultation have pushed for a tiering of the capital structure, as in the four strata that are currently in place. In our view, this goes against common sense, for a number of reasons:

a. We have asked a number of times for someone to justify allowing the City of Chatham, for example, to earn more from its LDC investment than the City of Hamilton, or the City of Toronto. The only proposed justification is the claim that there is a risk differential between the investments. We think that is largely untrue. Yes, there are differences in risk between LDC equity investments, but there is no evidence before the Board that, in Ontario, that risk differential is correlated in any way to size. Small LDCs can be well managed and strong, while large LDCs can be poorly managed and weak.

b. Of greater concern is the likely fact that stratification of capital structure inhibits sector rationalization, for two reasons:

i. In the cases of potential purchases of LDCs, it creates a situation in which the value of the overall debt and equity investment in the LDC to the vendor is greater than the value to the purchaser (which would likely have a lower weighted average cost of capital because of thinner equity allowance). The government has recently suspended the transfer tax to allow rationalization, but removing that barrier will do nothing if an LDC is worth $100 million to the existing owner, and only $90 million to the prospective purchaser.

ii. The other way to rationalize is through the merger of multiple smaller LDCs. Stratification of capital structures would require each of the shareholders of the merging companies to take a hit on their return as the "price" of getting economies of scale. Mergers generally benefit ratepayers by driving down costs. Forcing LDCs to reduce their overall WACC when they merge would also appear to drive down rates, a benefit to ratepayers, except that if the capital structure problem is a barrier to the merger, ratepayers not only don't get the reduction in WACC, but they don't get the economies of scale either.

This is one area in which the utilities had an opportunity to file evidence that would assist the Board, but refused to do so. Information on the considerations that went into proposed mergers and acquisitions would help the Board to know whether stratification is a barrier to rationalization or not, but almost all LDCs refused to provide that information. As we note later, in our view the Board should conclude from this refusal that this information, if filed, would demonstrate that stratification of capital structure is such a barrier.

c. The Board has already seen that some mergers have gone ahead despite stratification of capital structures, but instead of integrating operations the merging companies have kept the entities separate. A policy that forces utilities to use artificial corporate setups is likely to be wrong. It is not good policy to turn utility managers into "rate planners", gaming the rules like tax planners in the private sector.

25. ***Capital Requirements.*** A number of utilities have made a big deal about their need to make major investments in capital renewal over the next few years. Board Staff responded to these allegations with a proposal that there be an additional return for new equity investments. Utilities have proposed instead a CI factor to increase rates more than the normal IRM formula. None of these submissions have merit:

a. The most obvious reason to reject these arguments is that there is no factual basis on which to consider them. The utilities have been asked to file, for example, business plans and capital investment plans, and they have declined to do so. As we have noted in other places in these submissions, we believe that the Board should infer from this that the supporting evidence they have refused to file would be contrary to the positions they have taken.

b. The second reason is that the CI proposal from Mr. Todd would provide an additional rate increase for every single LDC whose rate base did not decrease by at least 1% a year. So, for example, an LDC with a constant rate base, where new additions exactly equal depreciation plus retirements, would still have a positive CI factor, and therefore an additional rate increase. This exposes the CI proposal for what it is: an indirect way to increase the annual rate increase for everyone under IRM.

c. The effect of a CI factor, even if properly designed, is that operating expenses are subject to a formula adjustment, while capital expenses are reviewed on a cost of service or partial cost of service basis. An inherent problem with this is that the Board has no information on what an appropriate annual adjustment formula should be for operating

expenses alone. The last time the Board experimented with a limited PBR for O&M (Enbridge 2000-2002), the result was a mess that has undermined the relationship between that utility and its ratepayers. That relationship is only now starting to recover.

d. A CI factor cannot be implemented fairly under a price cap model, because part of prices is controlled by the annual carrying costs of capital. Once the Board has to look in each individual case at the capital requirements of the LDC, that portion of the revenue requirement is essentially set by that review. In order to set the remainder of the revenue requirement, the debates over load projections, weather normalization, etc. have to occur. These debates are avoided if a price cap is used, but are required if any part of the revenue requirement is set directly.

e. The use of a CI factor invites gaming by the LDCs, since they are incented to shift spending from operating to capital if they can do so to accomplish the same operational goals. For example, an LDC would not outsource customer care to a third party, even if that is in the long term best interests of the company and its customers, because buying and owning a new CIS would allow higher rate increases for capital, without any reduction in the component of rates associated with O&M.

26. ***Rate-Setting Philosophy and Relevance of Cumulative Rate Increases.*** A number of LDCs have complained that they were stuck in a rate freeze for much of the last few years, with the result that they have a backlog of capital requirements, or they don't have room in their current budgets for additional capital spending that is urgently required. When asked, they took the view that if they need money for something, they are simply entitled to get it from the ratepayers, and the impact on the ratepayers is irrelevant. With respect, that is neither the legal reality, nor good public policy:

a. First, LDC "needs" are not absolute, as every Board member knows. While a rate applicant may make intense arguments in favour of the urgency of a given expenditure, in the end utilities usually can and do survive and even prosper on significantly less than the amounts they told the Board are "essential". This is not a surprise, since it is true in unregulated businesses as well.

b. Second, the Board's role is not to facilitate cost pass through; it is to be a proxy for the market. In the market, prices are set in part by the cost of production, and in part by the ability and willingness of customers to pay. If customers are willing or able to pay less than the current cost of production, one of three things must happen: the cost of production must go down, the customers must be convinced to pay more, or the product or service must be discontinued as being uneconomic. Usually a combination of the first two is what eventually happens. The Board, in acting as a proxy for the market, should be ensuring that it is just as much driving the cost of production down as it is asking the customers to pay more.

c. Third, many LDCs have in fact had significant increases in the past few years. SEC asked LDCs to provide rate information, but only a few did. (This is one more example where the LDCs had information that could have been of assistance, but they declined to provide

it.) The CLD members did provide this information, and it is instructive. The bill of a typical residential customer has gone up in the last five years at least 24.2%, at most 152.1%, and on average 64%. For a typical GS < 50 KW customer, the low is 17.2%, the high is 146.9%, and the average is 55.9%. For GS >50KW, the low is 19.3%, the high is 170.6%, and the average is 58.7%. Just to put that in context, if these numbers are representative of the province, Ontario's schools are paying something like $25 million per year more in 2006 than in 2000 for electricity distribution, with no change in service. There are some obvious reasons for this, of course (such as market rate of return), but nonetheless the concept that this fact is irrelevant to the Board's consideration of just and reasonable rates is, frankly, ridiculous.

d. We note that, when we sought to get a rate comparison over time from the Board, we found that this data is not readily accessible. While everyone at the Board was very helpful, and this information is all technically public information, the fact is that apparently no-one at the Board keeps track of how much the bills of customers are increasing over time. We believe the Board should be concerned if it does not have access to information and comparisons such as this, and should implement a system for tracking and publishing that information.

27. ***Return on Equity.*** Much was made of uncertainty – political and regulatory – in the market's perception of the risk of LDC equity investments. To explore this, SEC asked LDCs to file their most recent bond rating reports, since those will directly identify the market's perception of their risk. Not all rated utilities filed their reports. For those who did, two facts immediately leap out:

a. All are rated for their debt at A, A(low) or A-, ie. investment grade securities. None of those who filed their rating reports are on creditwatch (and neither are any others - Mr. Carmichael, Tr:TC1-134).

b. In 2005 the ratings of Powerstream, Veridian, Enersource and Toronto Hydro were upgraded, notwithstanding that this was at the very start of a process for re-evaluating LDC rates and setting them on a new footing. There was considerably more uncertainty about the future then than now, when the 2006 rates are known, and the process for the next few years is also known.

28. ***Availability of Evidence.*** Understandably, the utilities have argued in various ways for higher returns, either through higher ROE, higher equity thickness, or higher debt rates, but with a few exceptions they have been unwilling to file empirical evidnece supporting their positions. In our view, the Board should draw a negative inference where a party has evidence relevant to a position they are taking, and they decline to file that evidence (with or without an excuse). Some key examples of evidence not available:

a. Mergers and acquisitions data, including both consummated and aborted deals, and the internal analysis done at the time. The experts appear to agree that M&A deals provide a good indicator of the appropriate returns on LDC investments in Ontario (see, e.g. Dr. Lazar at Tr:TC1-35), and that if there are premia in the deals, then one of the reasons is

that the purchaser is willing to take a lower return than the Board-allowed rate (see, e.g. Dr. Camfield at Tr:TC2-168). Many utilities have made investment decisions relating to proposed mergers and acquisitions (see, e.g, Mr. Sardana, Tr:TC1-136), whether or not completed, and the Board would be greatly assisted in knowing the investment analysis that took place. From the refusal of the utilities to provide any of this information, we believe the Board should conclude the investment analysis will show clearly that a real ROE of much less than the Board-approved ROE is acceptable to LDC investors. This is confirmed by the information on Fortis/Aquila and on Kinder Morgan/Terasen, the only M&A data that was filed and discussed at the Technical Conference.

b. Debt covenant data. A number of utilities have claimed in their submissions that the proposed new ROE and/or capital structure rules would have the effect of putting them offside on debt covenants. When asked to provide details, they have none to provide. The Board should, in our view, conclude that the ROE and capital structure decisions under consideration will not have an impact on LDC debt covenant compliance.

c. Business plans and capital investment plans. As noted earlier, LDCs claim to have the "need" for rate increases to cover urgent capital renewal requirements, yet when asked to file the planning documentation that would back that up, they decline to do so. That information, by the way, could also inform the Board with respect to appropriate productivity factors, and with respect to cost of capital issues, especially as they apply to a multi-year plan.

d. Rate base data. This is public information, yet most utilities were unwilling to provide a breakdown of how their rate base has been increasing since 2000. Indeed, some responded to a question on this by saying "the LDC's Board may be in conflict with its fiduciary duties if it releases this information", which is of course just silly, and reflects a lack of understanding of both fiduciary law and the responsibility of regulated entities to provide information to their regulator. We believe that rate base data would show, for many LDCs, substantial capital spending since 2000, and substantial increases in rate base. This would be useful is assessing capital needs during the IRM period, for example.

e. Asset age distribution. Although utilities have talked at length about their aging infrastructure, they for the most part declined to file data on the age distribution of their existing assets. As with other areas, we believe that failure to provide available backup data for their proposition forces the Board to conclude that they are unable to support that proposition – ie. the need for exceptional capital renewal spending in the next three years - with empirical evidence.

Conclusion

29. The School Energy Coalition appreciates having been given the opportunity to participate in this consultation, in which a number of important issues have been aired. If any further information or clarification would be useful, we would be happy to provide it. SEC intends to participate in any hearing or other adjudicative process the Board may propose to obtain evidence on these issues, and bring them to a conclusion.

All of which is respectfully submitted on behalf of the School Energy Coalition this 27th day of October, 2006.

SHIBLEY RIGHTON LLP

Per: ______________________
Jay Shepherd