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VIA EMAIL AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
26th Floor
2300 Yonge Street
Toronto, ON
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Dear Ms. Walli:

**Re: OEB's Consultation on Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation for Electricity Distribution Companies (EB-2006-0089)**

**VECC's Final Written Comments**

As Counsel to VECC, I am writing to provide our final written comments on the OEB Staff's proposals regarding Cost of Capital determination and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. On August 14th, 2006 VECC provided detailed comments regarding the OEB Staff Discussion paper on these issues. VECC subsequently sponsored (along with other rate payer groups) an expert submission on Cost of Capital from Dr. Laurence Booth Professor of Finance at the Rotman School of Business. VECC also actively participated in the September and October Technical Conferences.

Overall, VECC's views are generally unchanged for those expressed in our initial written comments in August. The main purpose of these comments is not to repeat those submissions but rather to address/respond to a number of issues raised in the written and oral submissions that have been made by others and to comment on a couple of new issues that have arisen during the process.

The comments are divided into two parts. Part A deals with the Cost of Capital proposals, while Part B deals with the design and implementation of a 2nd Generation Incentive Regulation Mechanism (2GIRM).

## Part A: VECC's Final Comments on Cost of Capital Proposals

## 1. VECC's Overall Submission

- **Based on the Expert opinion of Dr. Laurence Booth, VECC accepts that the Board Staff's proposals on Capital Structure, Methodology for setting the Return on Equity (ROE) and treatment of Long Term Debt fall within the zone of reasonableness .**

  As Dr. Booth states[1]
  "I accept Board Staff's recommendations as fair and reasonable. In my judgment if the Board had a "generic" electricity distribution (Disco) cost of capital hearing with company witnesses filing evidence, followed by interveners, the ultimate decision would be very similar to Board Staff's recommendations. Further Board Staff's recommendations are very similar to decisions from other regulatory hearings elsewhere in Canada. In this sense I accept the recommendations as fair and reasonable."

- **However, VECC submits that rather than adopt material changes to the methodology for setting the allowed Return on Equity such, as have been proposed by others, the Status Quo Board ROE Methodology should continue. The evidence supporting the need to change is incomplete and untested and it would be unfair to both ratepayers and Utilities to apply these proposals without a full Cost of Capital proceeding.**

  **The concept that the existing methodology is acceptable as the ongoing working model is shared not only by Dr. Booth, a rate of return expert witness frequently retained by utility customers, but also by Ms. McShane, a rate of return expert witness, frequently retained by utilities ( in this case, by Hydro One).:**

  > MS. McSHANE: Well, I think we need to clarify that.
  > I don't think it would be unreasonable to stay where we are, without going through a complete testing of all of the relevant information.
  > MR. JANIGAN: Yes.
  > MS. McSHANE: If that's what you mean, then I would agree with that.
  > MR. JANIGAN: Okay. And in terms of process, I understood you to say that, given the state of the record in this proceeding, it might be -- I use the term "unreasonable" -- it might be unreasonable to proceed to attempt to change the formula or to change what is being done currently, based on the state of the record as it exists

[1] Cost of Capital for Ontario Electricity Distributors. Evidence of Laurence D. Booth before the Ontario Energy Board. August 6, 2006.

> right now?
> MS. McSHANE: I would say that's correct. (Transcript Sept 20, 2006, 94)

**In addition, Dr. Booth's comments at the technical conference are dispositive of the issue of access to capital markets and the need for an additional premium to attract capital:**

> What we've seen in Canada over the last 10 to 15 years is a tremendous change in the structure of the capital markets. We've seen the Government of Canada basically come out of the bond market. There's very little new government financing in the bond market. We've seen a reduction in pressures in the bond market that this has generated.
> It's caused so many problems for the Bank of Canada in managing the public issue that they're basically buying up off-the-run bond issues and issuing them on the run in order to keep liquidity in the government bond market.
> The retreat of the Government of Canada in all sectors of Canada from the bond market has meant that the major demander of funds has disappeared, and for the last five years the financial system has been flush with cash.
> Basically, anything could be financed in Canada now, and has been for the last five years.
> In terms of what's going on, you can see that also in the private sector. The Investment Dealers' Association tracks the debt/equity ratios of Canadian corporations. They peaked about seven or eight years ago, and they're now at the lowest they've been for at least 20 years.
> We'd see that in the real return bond where the yield on the real return bond is now 1.6 percent. As recently as three, four years ago, it was 4-1/2 percent. So when I say it's silly to talk about problems in financing infrastructure, it's because there's a huge surplus of cash in the financial system.
> So I have no problem whatsoever that anything, the Ontario DISCO sector throughout the capital markets, can be financed.
> So, as a result, I don't think there's any reason whatsoever to offer a premium on an ROE that currently means they're so attractive that they're selling for twice book value. (Transcript, Sept 19, 2006 188-189)

## 2. VECC Commends Dr Booth's conclusions on the main Issues.

### 2.1 Capital Structure

Dr Booth provides his opinion that a size-related Capital Structure, such as that proposed by Dr. Cannon in his 1998 Paper, is not necessary and that a 36 % equity Component with no allowance for preference shares is appropriate (Page 25):

**Q. DO YOU AGREE ON SIZE BASED CAPITAL STRUCTURES?**

**A.** No. It is undoubtedly true that smaller utilities have inferior bond ratings and their debt sells on higher spreads than larger ones. This is due not to default risk but to the lesser liquidity in their bonds. Normally if they can access public bond markets it is through private placements so that the debt is difficult to trade and thus attracts a yield premium. At the extreme for very small utilities they may not be able to access the public markets at all and are restricted to bank debt and the term loan market. However, there are severe conceptual problems with allowing higher common equity ratios for smaller utilities, since it results in higher utility rates.

Dr. Booth expanded upon the relative risk of local electricity distribution companies in relation to capital structure at the technical conference:

> I've seen nothing in this hearing, or no evidentiary basis whatsoever, for the popular belief that gas distribution is lower risk than electricity distribution. I just don't see it. I don't see any evidence whatsoever for that, and the Alberta Board decided exactly the opposite, zero to 2 percent lower common equity ratio for electricity distribution.
>
> The fact is there's less competition for electricity than there is for natural gas, and the volatility of natural gas is way greater than the volatility of electricity prices. (Transcript, Sept 18, 2006, 201).

**Q. WHAT ARE YOUR VIEWS ON A PREFERRED SHARE COMPONENT?**

**A.** I don't think that it is appropriate or needed for municipal discos. Preferred shares are issued by companies with private shareowners as a means of increasing key coverage ratio targets and thus improving access to capital markets. I don't believe that the municipal Discos currently have any financial access problems. As a result I would recommend a 36% common equity ratio and the balance in debt.

## 2.2 Return on Common Equity

With respect to setting the Return on Common Equity Dr Booth states (page 17):

**Q. HOW DOES THE ALLOWED ROE CHANGE YEAR BY YEAR?**

**A.** "My understanding is that the major motivation behind the adjustment mechanisms is the desire to avoid repetitive hearings and any confusion over how the ROE is determined. By putting a utility on an automatic adjustment mechanism, the capital markets have a clear picture of future profits and the risk of being awarded an unexpectedly low allowed ROE is reduced along with regulatory lag. It is my perception from reading analyst reports that the adjustment mechanisms have been well received because of this. And (page 21)

"……. I would recommend that Board Staff reject their proposed "panel of experts" and their new estimate of the ROE. Instead I see no reason to change the ROE adjustment mechanism that the OEB reviewed in RP-2002-0158. In its January 16, 2004 decision the Board stated (paragraph 142)

> "Therefore, with respect to the first and primary issue of whether a new benchmark ROE should be established for EGDI and Union, we find that the current ROE Guidelines methodology continues to produce appropriate prospective results. We have not found any demonstrated need to set a new benchmark ROE."

Quite simply nothing of substance has changed in the past 2 ½ years to justify amending the OEB decision without a full evidentiary record. In my judgment this represents a fairer and transparent way of determining the allowed ROE than that proposed by Board Staff."

<u>2.3 Long Term Debt</u>

<u>Dr. Booth notes (page 27):</u>

Board Staff envision that utilities be allowed their embedded debt cost except on inter-affiliate debt where a typical spread over long Canada's be used to impute a debt cost. This imputed debt cost would be based on a "suitable sample of corporate A/BBB bonds." They further propose a limit of 8% on short term debt and recommend matching the maturity of the debt to the rate base. In my judgment these recommendations if adopted could cause some minor problems.

……….. "I suggest that the Board set an imputed debt cost on inter-affiliate debt based on the borrowing cost of EGDI's traded debt plus a 20 basis point liquidity premium reflecting that EGDI debt is well traded in the capital market. At the end of 2005 EGDI debt was rated DBRS A the same as Toronto Hydro and their 7 year bond issues were both trading at about a 50 basis point spread over similar maturity Canada bonds. This was also the same spread for EPCOR Utilities that has a DBRS A (low) rating. Quotes for the current yields on utility debt can readily be obtained from any of the major investment dealers."

**Q. CAN UTILITIES ATTRACT CAPITAL ON REASONABLE TERMS WITH 36% COMMON EQUITY AND THE OEB ADJUSTMENT MECHANISM?**

**A.** Yes. The crucial test is in the capital market in terms of are investors happy with these financial parameters. If they are happy then they are willing to pay a premium to control these assets and earn the allowed ROE. On the other hand if they are unhappy then these assets

> will sell at a discount. As a result we can observe how happy investors are simply by observing the prices paid for regulated assets. In this respect there have been several transactions over the last few years while utilities have been an ROE adjustment mechanism.

## 3. VECC Comments on Short term Debt

VECC believes that the Board Staff proposal for a short term debt allowance of up to 8% of Total Capital is not the main issue, rather the real issue is the Allowed short term debt rate.

Unfortunately this issue has not been adequately addressed by Board Staff or canvassed in the technical conference. None-the-less, if the rate is not reflective of the market then it is unfair to ratepayers and utilities.

Dr. Booth stated at the technical conference:

> So I think it's a straitjacket to impose some sort of restriction of short-term debt for the large number of electric DISCOs in this province that are relatively small.
> Unfortunately for them, their only access to capital is short-term debt and bank debt. So I don't think the recommendations of Board Staff in terms of short-term debt are practical in terms of a large number of the electric DISCOs in this province (Transcript Sept 18, 2006)

VECC notes that the regulated gas utilities provide a test year forecast of short term debt rates based on the outlook for short term interest rates( in their case Commercial Paper Rates).

VECC suggests that with respect to the Electricity Distributors, for amounts borrowed with under one year maturity, the allowed short term debt rate should be a fair reflection of market rates for the historic year and the range should be

- the average commercial paper rate for 30-90 day borrowings, to
- the chartered bank prime lending rate for commercial loans of less than one year (with no premium).

4. Panel of Experts

One recommendation that has been considered is the convening of a panel of experts to determine cost of equity in the future when the need arises from time to time. As is noted above, and referenced in the comments of Dr. Booth, VECC supports the formula approach to calculation of required ROE. If the generic Board approved formula is to be altered, it must be done through the convening of an appropriate hearing to study the same with the opportunity for all stakeholders to participate. Whatever the importance of experts in the process that cannot be delegated the role intended to be played by interested parties and the Board. **Part B: VECC's Comments of 2nd Generation IRM Proposals**

### Theory and Objectives of 2GIRM

- In both the written comments[2] and expert submissions[3] submitted in August as well as the Technical Conference discussions[4], various parties acknowledged that the key purpose of the 2nd Generation IRM was to address the fact that the OEB cannot rebase (based on a full cost of service review) all of the electricity distributors in 2007 and, therefore move immediately to a comprehensive incentive regulation scheme for all distributors. As a result, the purpose of the 2GIRM is to provide an effective transitional methodology that will allow the Board to approve just and reasonable rates for all distributors while undertaking the necessary work to permit all distributors to be place on a more comprehensive and long-term 3rd Generation Incentive Regulation scheme. Furthermore, it was generally recognized that the 2GIRM would provide only limited incentives for efficiency improvement, primarily due to the limited time frame involved (i.e., 1-3 years).
- VECC agrees with this perspective. VECC also agrees with Dr. Lowry's comments as to how the success of the 2nd Generation Incentive Mechanism should be benchmarked:

  > "My own opinion is that it's more of an attrition mechanism, in that if it provides acceptable compensation for most utilities over this short period, then it would be deemed a success. And if there was no obvious deterioration in service quality over the period, it would be deemed a success". (Transcript, September 21st, page 93)

  VECC's only caveat to Dr. Lowry's comments would be that the rates established via the process must balance <u>both utilities' and consumers'</u> expectations regarding just and reasonable rates.

### Form of IRM

- There appears to be general agreement that the 2GIRM should be based on a "price cap" as proposed by the OEB Staff. However, a number of the issues raised in the submissions and subsequent technical conference are better addressed through a "revenue cap" form of regulation. Two obvious examples of this are a) the CI factor/capital spending issue raised by Hydro One Networks and the CLD and b) the issue of whether ROE and debt costs should be adjusted annually. In both cases, a revenue cap formula would allow for a more explicit flow through of the required adjustments.

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[2] Coalition of Large Distributors, CCC, Schools and HONI
[3] Dr. Yatchew
[4] Dr. Lowry and HONI

- However, a revenue cap IRM mechanism requires additional inputs, such as a load forecast and capital in-service projections[5], which increase the complexity of the overall formulation and regulatory review process. As noted in VECC's August submission a price cap is a much simpler approach.
- VECC continues to support the use of a price cap formulation for the 2GIRFM. However, if the Board determines that major adjustments are needed, such as a CI-factor to address capital needs, then a revenue cap would be the preferred approach rather than adding imperfect "patches" to the price cap formulation.

**Cost of Capital (K-Factor) Adjustment**

- The main comments offered with respect to the K-factor adjustment proposed by the Board Staff were that :
    - It should be determined on a utility-specific basis[6]'
    - Implementation should be delayed[7] or dropped entirely[8]
    - The capital and ROE changes should both be adopted for 2007[9].

*Delay/Drop K-Factor Implementation*

- Arguments supporting delaying the K-factor centered around concerns that the proposed timing treated some utilities differently than others; while the argument for dropping the factor centered around the negative impact it would have on utilities' revenues.
- In VECC's view the Staff's timing proposals do lead to a fair and equal treatment of all utilities in terms of allowed ROE. In 2007, the K-factor adjustment would adjust <u>all</u> utilities' rates to reflect the updated ROE. Similarly, in 2008, <u>all</u> utilities' rates would be adjusted to reflect the deemed capital structure – whether they were rebased in that year or not.
- Finally, in VECC's view it is inappropriate to forego adjusting utilities' rates in order to reflect appropriate changes in ROE or capital structure simply because it reduces rates and utilities' cash flow. An equivalent argument exists that rates should not be increased at all during the 2nd Generation Incentive Regulation Period as this would increase consumers' bills and reduce their cash flow.

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[5] Note: The capital in-service projections could be based on a capital budget or a formulaic approach.
[6] Schools and CCC
[7] CLD
[8] Dr. Yatchew
[9] Schools

*Use of Utility Specific K-Factors*

- During the Technical Conference, Board Staff indicated that they had not yet decided whether to drop their proposal to calculate a common K-factor for all utilities with the same capital structure and use utility-specific K-Factors.
- As noted in VECC's August submissions the ROE component of a utility's base revenue requirement can vary widely. The same observation was made by the SEC in its submissions. Grouping utilities by capital structure will still result in significant differences between utilities in the same "group". VECC continues to be of the view that the only fair way to perform the K-factor adjustment is on a utility specific basis.

*No Subsequent Adjustments for ROE/No Adjustments for Debt Costs*

- Some parties[10] also raised the fact that, under the Staff Proposal, there would be no further adjustments for ROE after 2007 and no adjustments at all to capture changes in utility's debt costs. This issue is directly linked to Cost of Capital question #5 (a) posed by Board Staff:

  > "Does the change in the inflation or price escalator factor of the price cap index, measured by GDP-IPI (Final Domestic Demand) as proposed by staff, reasonably track or proxy also the changes in the debt rates and market returns (and therefore the distributors ROE) year to year?"
- The consensus among those parties[11] responding to this question is that while, in theory, GDP-IPI may track cost of capital changes, this would only occur over the long-term and may not be reflective of the electricity distribution industry which is capital intensive. Overall, the responses are consistent with VECC's August submissions.
- However, the issue is not easily addressed within a "price-cap" incentive regulation mechanism. First, any adjustment to the IRM formula for changes in ROE would require utility-specific calculations for the years post-2008 as well. It would also require obligating utilities to report any changes in debt costs so they too could be factored into the annual adjustment. Finally, there would inevitably be some degree of double counting as the GDP-IPI formulation does include some consideration of changes in cost of capital.
- As a result, in VECC's view, any attempt to correct the 2GIRM formula proposed by Board Staff will be imperfect at best. VECC also generally concurs with Hydro One Networks' conclusions on this matter that:

  > "In the short-term the impact should not be material, however this issue does need to be addressed as part of the 3rd generation IRM design."
- In conclusion, VECC's position is that there should be no explicit adjustments in the IRM formulation for ROE or debt costs post-2008.
- The only two qualifiers VECC would add were the raised in its August submissions, namely:

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[10] e.g. SEC

[11] CLD, HONI and SEC

    - If distributors were allowed to apply for a Z-factor adjustment as result of increases in debt costs, then they should also be obligated to apply for such an adjustment if their debt costs materially decrease.
    - Material changes in the embedded cost of debt (from those used in the 2006 EDR process) should be one of the factors used in the selection of distributors for rebasing.

**Term and Starting Point**

- In VECC's view, the 2006 approved rates at the appropriate starting point for the 2GIRM, whether determined on forward test year basis or based on 2004 (adjusted) results. As noted in VECC's August submissions:
    - Utilities had a choice as to whether to file for 2006 rates based on a forward test year or 2004 data,
    - The 2006 EDR process permitted distributors to make both Tier 1 and Tier 2 adjustments to their 2004 costs in order to help normalize and update them, and
    - Distributors that are facing significant cost pressures can petition the Board and request early selection for rebasing.

**Price Escalator**

- The CLD has expressed a couple of reservations regarding the use of the domestic GDPIPI index. First, they are concerned that the index excludes oil and gas, which they indicate are components of their cost structure. Second, they express concern that their costs (for example labour) are escalating at a higher rate than GDPIPI.
- With respect to the first concern, VECC notes that the domestic GDPIPI index only excludes oil and gas <u>exports</u>. It does not exclude oil and gas to the extent these commodities are used domestically. As a result, VECC believes that the CLD's concern is unwarranted.
- With respect to the second concern, VECC notes that GDPIPI index reflects not only increase in the prices of the inputs used domestically but also efficiency improvements in the overall economy. As noted by Dr. Lowry, the purpose of the X-factor is to then capture:
    - The productivity differential between the industry and the economy,
    - The price differential between the economy and the industry, and
    - A stretch factor.

  As a result, one would generally expect the annual change in the generic economy-wide inflation index to be less than the increase in the input prices for electricity distributors.
- VECC continues to support the use of domestic GDPIPI as the price escalator, but (as noted in its August submissions) believes that the calculation should be based on the year over year change in the annual GDPIPI value.

## X-Factor

*Level*

- Several electricity distributors[12] expressed concerns about the proposed 1% X-factor in that:
    - One size does not fit all, and
    - It was too high.
- VECC generally agrees that one size does not fit all with respect to efficiency improvement opportunities of electricity distributors. However, given the current status of the Board's benchmarking efforts, there is no information available that would allow for the specification of different X-factors for different distributors on a rationale basis. Attempting to introduce differentiated X-factors at this time would be equally unfair to electricity distributors.
- With respect to the view that 1% is too high, Dr. Lowry has indicated that 1% is a conservative value based on the range of values adopted by regulators for electricity and gas distributors' IRMs with economy-wide inflation factors. Furthermore, as VECC noted in its August submissions, given that utilities are able to petition the Board regarding the timing of their rebasing, it is reasonable to assume that the distributors who will be in the plan for 2-3 years are those best able to achieve efficiency improvements.

*Link to Load Growth*

- In its August submission Thunder Bay Hydro noted that the 1% productivity factor created a consider burden for utilities experiencing negative load growth. Subsequently, during the Technical Conference, the question was posed as to whether a lower X-Factor should be applied to distributors with negative growth.
- VECC acknowledges that growth is one potential source of efficiency. As result, those utilities facing negative growth (in terms of customers and/or volumes) face additional challenges under a price cap IRM. In VECC's view it is reasonable to provide some accommodation for such circumstances in the 2nd Generation IRM. However, the proposed solution (i.e., a lower X-factor) is problematic for a couple of reasons: a) the choice of a lower X-factor is arbitrary; b) the same solution would presumably apply to utilities regardless of the level of negative growth and c) presumably, then, an X-Factor in excess of 1% should be applied to utilities experiencing rapid growth. In VECC's view, the preferred approach is ensure that utilities experiencing negative growth are candidates for early rebasing.

[12] Chatham-Kent, CLD and its expert Dr. Yatchew, ECMI, HONI, London Hydro

**Contingencies (Z-Factors)**

- In the second draft of the Staff Discussion Paper the proposal was made to allow for limited Z-factor adjustments. Distributors have subsequently suggested[13] that the scope of allowed adjustments is too narrow and that allowance should be made for any LDC to "make its case".
- Also, during the Technical Conference it became clear that there were differences in understanding as to the process that would be followed for distributors who did "apply" for a Z-factor adjustment. With some parties[14] being of the view that there would be no public review of such applications.
- In VECC's view these two issues are closely linked. If there is no opportunity for public review and input regarding requests for Z-factors then there is a need to strictly limit the opportunities for such requests to factors such as accounting changes or tax changes that will affect all distributors. In such circumstances, it may indeed be more straightforward to <u>not</u> allow any Z-factor adjustments under the Code (as per VECC's August submissions) and address any required changes as either exemptions or amendments to the Code. This would ensure appropriate public input.
- If the Board decides to open up the circumstances under which electric distributors could apply for a Z-factor under the Code, then it is imperative that a public review process (as envisioned by Board Staff[15]) is permitted. However, permitting such adjustments are problematic even with a "public review process" as Z-factors are likely to prove to be one-sided. The main reason for this is that utilities will apply for Z-factors in cases where an increase in rates is being sought, but are unlikely to make such a request in the event that external circumstances give rise to the possibility of a decrease in rates. This point is evident from the submissions of the distributors[16] and the comments of Dr. Lowry[17] who saw Z-factors as serving to financially protect utilities.
- In VECC's view, the preferred approach would be to not permit Z-factors as part of the 2GIRM. Rather, the Board should include utilities seeking a Z-factor adjustment in the group that would be subject to rebasing that year. If this does not prove to be practical, then the utilities could apply for an exemption from the Code. This would allow for not only full consideration of the issues triggering the Z-factor but would also allow the Board and other parties to determine if there were any offsetting changes in costs that would mitigate the impact.
- In addition, VECC believes that if Z-factors are allowed then (as discussed in its August submission) an asymmetric earnings sharing mechanism should be adopted in order to address the asymmetry of information associated with Z-

[13] CLD
[14] HONI Expert – Mr. Todd
[15] September 22, 2006, pages 109-110
[16] CLD
[17] September 21, 2006, pages 3-4

factor determinations and protect interests of consumers as suggested in the following exchange:

> MR. SHEPHERD: But the earnings sharing that Ms. Chaplin was talking about would be typically asymmetrical. The earnings sharing protects the ratepayers and the Z factor protects the shareholders. You're familiar with that sort of structure?
>
> DR. LOWRY: Well, I don't know how common that is, but I suppose it's a logical responsibility. (Transcript, September 21, 2006, pages 32-33)

**Earnings Sharing Mechanism (ESM)**

- During the Technical Conference both Dr. Lowry and Dr. Yatchew rejected the idea of an earnings sharing mechanism. In Dr. Lowry's case[18] he saw an ESM as reducing the incentive for efficiency gains and also saw it as unnecessary in that utilities would have the "protection" of a Z-factor. Similarly, Dr. Yatchew[19] sees an ESM as diminishing the incentive to improve efficiency. VECC does not consider either of these points as being effective arguments for dismissing the use of an ESM as part of the 2GIRM.
- First, Dr. Lowry's observation that an ESM is not needed to protect the distributor's shareholders completely misses that point. In VECC's view, the purpose of the ESM is to protect consumers.
- Second, as noted earlier, incenting efficiency is not the primary purpose of the 2GIRM. Indeed conservative estimates for X-factor have been included as part of the plan. Instead, the main objective is to manage the transition period that is required in order to allow all electricity distributors to be rebased (using cost of service) and put on a (yet to be developed) more comprehensive third generation IRM. Given this perspective, VECC believes that ensuring the plan provides for balanced results for consumers as well as distributors should take precedent over trying to incent additional efficiency gains.

**Incremental Capital Expenditures**

- In their August submissions[20] some distributors raised the concern that the proposed 2GIRM did not make sufficient allowance for the upcoming capital investments that would be needed to sustain existing assets and support utility growth. This issue was further developed in September through the expert submission provided by Mr. Todd on behalf of HONI and the submissions of the CLD. In both cases, the parties suggested that distributors should be permitted to file capital spending forecasts that would lead to an (upwards) adjustment to their allowed price cap.

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[18] September 21, 2006, pages 30-32
[19] September 21, 2006, page 140
[20] CLD and HONI

*Need for a Capital Expenditure Adjustment Factor*

- During the Technical Conference, various experts[21] indicated that incentive regulation can lead to under funding of necessary capital programs as a result of either:
  - o The formula not providing sufficient funds to support the required levels of capital spending and/or
  - o The natural incentive utilities have, under performance based regulation, to not spend the funds allowed and increase their bottom line (i.e. net income).
- VECC acknowledges that there could be instances where the permitted rate increases under the 2GIRM are not sufficient to permit a distributor to recover the costs (including reasonable return) associated with necessary capital spending. However, any proposed solution to the issue must also address the second concern. It must also provide assurance to ratepayers that the capital spending they are funding through the adjustments is required and their money is being spent wisely.

*Addressing Capital Expenditure Requirements in an IRM*

- IN VECC's view, it is not practical to address incremental capital spending separately and "outside" of the price cap index. As Mr. Todd and Dr. Lowry acknowledged during the Technical Conference, the IRM formula put forward by Board Staff includes in it an allowance for increased costs due to capital spending. Indeed, even without the allowance for load growth the formula includes an allowance for capital spending to sustain existing assets since:
  - o The rates will be escalated each year by inflation less an X-factor while
  - o The "capital-related" costs associated with existing assets are likely to decrease (i.e., depreciation on existing assets is determined on a straight-line basis and therefore fixed but the "return" on the rate base associated with existing assets will generally decline going forward as existing assets are depreciated and their net book value decreases).

- This being said, there are several approaches that the Board could consider:
  1. As noted during the Technical Conference, not all utilities require a "special" adjustment to address the need for increased investment. One approach would be to simply re-base in the first go-round (i.e., 2008) utilities facing such circumstances.
  2. The need for a capital spending relief could be assessed based on historic capital spending levels (excluding exceptional one-off projects) and incremental spending requirements addressed via a deferral account.
  3. A CI-factor (similar to that proposed by HONI/Mr. Todd) could be incorporated into the price cap IRM formulation.

[21] Dr. Lowry and Mr. Todd

4. Another approach would be to adopt, for utilities claiming such circumstances, an alternative IRM scheme similar to that used by FortisBC where the Expense-Related component of the Revenue Requirement is adjusted on a formulaic basis but the Capital-Related component is reviewed on a cost-of-service basis.

Of the four, the first two are the most consistent with the Staff objective of administratively simple process that allows for the "transition" to a more comprehensive 3rd Generation IRM. At the other end of the spectrum, the last two are more complex and regulatory resource intensive. HONI/Mr. Todd's proposal is discussed in greater detail below.

*HONI's/Mr. Todd's CI-Factor Proposal*

<u>Overview</u>

Under Mr. Todd's proposal, distributors would have the option of filing a multi-year capital spending budget with the OEB and the total capital expenditures identified for each year would be used to develop a CI adjustment factor. If the adjustment factor was greater than 0.5% in any given year it would be incorporated into the distributor's IRM formula. As VECC understands the proposal, there would be no public review of the proposed spending[22]. Indeed, there is no expectation that even Board Staff would review the reasonableness of the spending projection. The only check (or "incentive") that ensures distributors file a reasonable and prudent capital spending budget is the fact that their rate base additions will be subject to a prudence review when their rates are rebased. However, even then under Mr. Todd's proposal, any adjustments would only apply going forward and there would be no clawback if the capital spending included in rates during the IRM period was either deemed to have been imprudently spent or was not spent at all[23]. Mr. Todd's proposal relies entirely on the prospect of a future prudence review and disallowance in <u>future</u> rates to ensure that capital spending proposals are reasonable and that the dollars are actually spent.

In principle, there are two advantages to the approach put forward by Mr. Todd and Hydro One:

- First, it provides additional funds to those utilities who, under the 2nd Generation IRM formula, would otherwise not have sufficient revenues to support necessary investments in capital infrastructure, and
- Second, it appears to be fairly simple from an administrative perspective.

However, as discussed below, both of these advantages are somewhat illusionary and, offset, by a number of disadvantages.

[22] September 22, 2006, pages 95-96
[23] September 22, 2006, page 54

General Concerns

Earlier VECC noted view that incentive regulation can lead to under funding of necessary capital programs as a result of either:

- The formula not providing sufficient capital funds and/or
- The natural incentive utilities have, under performance based regulation, to not spend the funds allowed and increase their bottom line (i.e. net income).

The approach put forward by Mr. Todd seeks only to address the first issue. Indeed, Mr. Todd's proposal relies entirely on the future rebasing process and the prudency review that such spending would have to go through at that time (prior to inclusion in rate base) to ensure that the funding provided for capital sustainment and growth was actually spent and spent wisely.

Under Mr. Todd's proposal, the utility only needs to provide an Asset Condition Assessment (ACA) study and Capital Expenditure plan (or trend line) in order to be granted a CI Factor adjustment. There is no need to provide any explanation or justification as to why the level of capital spending is necessary or even supported by the ACA study. Similarly, there is no need to support/explain any capital spending attributed to growth.

In VECC's view, this is unacceptable for the following reasons:

- First, as noted earlier, there would be no "claw back" of revenues already collected from consumers if the spending was found to be imprudent and/or the funds were not spend at all.
- Second, the administrative simplicity and lack of "burden of proof" associated with obtaining a CI factor adjustment is likely lead to a large number of utilities seeking to include the adjustment in their IRM formula. This in turn will increase the administrative burden at the time of "rebasing" and likely lead to administrative shortcuts in the subsequent prudency reviews.
- Third, Mr. Todd's proposal does not even require utilities to file a capital expenditure plan, but rather would allow them to rely simply on past capital spending trends. Such an approach increases the difficulty associated with testing the prudence of the spending after the fact, as there is no "program" to compare the actual spending to.
- Fourth, history has shown (e.g., Union Gas) that under spending of allowed capital does occur, even when utilities know they will subsequently face rebasing.
- Finally, the premise under an IRM formulation is the resulting rates are reasonable. However, as Dr. Lowry indicated there are no "North American" type IRM rate cap plans that include the type of adjustment Mr. Todd has proposed. Furthermore, those revenue cap plans that do (e.g., FortisBC and Terasen Gas) include processes that allow for review of the capital spending before it is included in rates.

## Detailed Implementation Concerns

There are a number of more detailed implementation issues associated with Mr. Todd's proposal including:

- Lack of necessary financial data
- Load forecast issues
- Overestimation of required IRM adjustment

Contrary to HONI's claims, the determination of the CI-factor requires depreciation and rate base data beyond that provided as part of the 2006 EDR[24]. Development of the CI factor requires information regarding the revenue requirement and rate base from the previous year in order to determine:

a) the capital related component of the revenue requirement as a percentage of the total revenue requirement and
b) the deprecation offset to the CI factor.

Mr. Todd indicated that the intent was to rely entirely on actual data that was readily available and verifiable such that a "hearing" to test the reasonableness of the data would not be required. However, the actual data required to support Mr. Todd's proposed adjustment will not be publicly available in time for the annual rate setting process. Under the Board's current filing guidelines, this information does not need to be finalized and filed with the OEB until April 30th which would be well after the filing date for a May 1st rate adjustment[25].

Development of the CI factor also requires information on load growth (again to determine the offset to the CI factor). In principle, the load growth used should be the utility's forecast load growth and not the historic 2002-2004 growth reported in the 2006 EDR process. Mr. Todd has suggested that more recent (i.e., the past year's) load growth be used as a proxy. Again, there is a problem in that even this information may not be readily available in the required form (i.e., weather normalized) for filing as part of a May 1st rate adjustment application.

There is another "load growth" related issue that needs to be addressed if the Board decides to adopt a CI-factor. Distributor revenues are based on both customer charges and volumetric charges. Therefore, simply using "load growth" (i.e., kWh growth) in the CI-factor calculation is not correct. Furthermore, there is no necessary correlation between load growth and customer growth as can be seen from the Hydro One Networks 2006 EDR Application where the 2004 to 2006 load was forecast to increase by less than 0.5% but the number of customers were forecast increase by 1.7% (Exhibit A, Tab 14, Schedule 3,page 20). Ideally the "load growth adjustment" should take into account both customer

[24] September 22, 2006, pages 69-70
[25] September 22, 2006, pages 69-70

growth and energy sales growth – weighted by their relative revenue contributions.

With respect to the third issue, Mr. Todd has acknowledged that the proposed CI factor is "imprecise" adjustment. VECC's concern is that the proposed CI factor formulation tends to overstate the required IRM adjustment associated with a proposed capital spending program. Various ways in which this over estimate arises are discussed below:

- As noted during the Technical Conference[26], as assets age their maintenance costs generally increase and one of the savings that results from investment in asset sustainment is reduced O&M costs. However, this reduction is not recognized in the CI factor formation.
- The CI factor adjustment is determined by calculating the percentage increase in rate base that arises due to the planned capital spending and assuming all capital-related expenses will increase by this percentage. While is assumption is reasonable in the case of the "cost of capital" (i.e., interest costs, return on equity, etc.), it is not reasonable in the case of depreciation. Depreciation on distribution assets is generally determined on a straight line basis using the initial book value and asset service life. Therefore, for existing assets, which have been partially depreciated, the depreciation expense will represent a larger percentage of net book value (rate base) than for similar new assets coming into service. This means that the increase in depreciation charges due to the addition of new assets will generally be less than the increase in rate base. The result is that the formulation put forward by Mr. Todd will overstate the impact on the revenue requirement of adding new assets.
- According to Mr. Todd each year's adjustment is determined independently. As a result, in those years where a CI factor is not required it is assumed that all revenues capital-related revenues provided under the IRM formulation are indeed needed to support capital spending. However, there is no demonstration required that this is the case.
- Furthermore, inclusion of a CI factor in one year, will automatically inflate the rates in subsequent years of the IRM term, even when the "additional" revenues are not required to fund capital spending. Indeed, this problem will be further aggravated if the utility is experiencing load growth.
- Finally, to compound this concern is the fact that actual carrying cost on any new investment will tend to decrease in subsequent years as the net book value associated with the assets decreases.

*Conclusion re Capital Expenditure Factor*

- In VECC's view the preferred option is to permit electricity distributors with substantial capital spending plans to apply for early rebasing and avoid

[26] September 22, 2006, page 127

entirely the need for a deferral account or an adjustment to the IRM formulation for capital spending.

- Should the Board decide that a capital expenditure adjustment factor is necessary then it is VECC's position that:
  a) Applications should involve a public process where the rationale and data inputs to the calculation can be questioned and tested. The type of information provided should include:
     - Historic spending levels
     - Business cases for large (one-off) projects
     - Materials that link the ACA study to the proposed spending plan and demonstrate why both the level of activity and timing proposed is prudent
     - Description and discussion regarding alternatives considered.
  b) A revenue cap formulation, similar to that used by FortisBC and Terasen Gas should be considered, in lieu of a price cap. This would ensure a proper tracking and no double counting of capital-related costs.
  c) If a price cap approach is adopted then the $2^{nd}$ Generation IRM should include an earnings sharing mechanism (ESM). Even if the Board concludes that an ESM is not required under the general IRM formulation, VECC believes that one should be adopted if a CI factor is included in a utility's IRM. Under such circumstances, an ESM represents an alternative to introducing a "claw back" in those circumstances where the proposed capital spending does not actually occur. It will also help address (though not fully) concerns that the CI factor determination (as proposed by Mr. Todd) tends to overstate the price adjustment required to support a given level of capital spending.

**Service Quality and Reporting Requirements**

- There was minimal discussion on these issues in either the August submissions by other parties or the September Technical Conference submissions/discussions. VECC continues to support the views/positions taken on these matters in its August 16, 2006 submission.

**Determination of Rate Adjustment**

*Smart Meters*

- In its August submission VECC indicated that it was unclear as to how the nine distributors deemed eligible in the Board Staff discussion paper for the $1.00 allowance were determined. Subsequently, Hydro One Networks raised the issue of why it was not considered to be eligible for the $1.00 increase.
- In VECC's view it is important that the Board establish clear criteria regarding which distributors will be eligible (in 2007) for the $1.00 increase in smart metering funding as opposed to the $0.30.

*C&DM*

- There was little discussion in either the August submissions or the Technical Conference regarding the process that would used to incorporate any incremental funding requirements for C&DM into the 2GIRM formulation. One of the reasons for this is likely the fact that after September 2007 the Ontario Power Authority will be providing funding for C&DM programs. However, it is possible that some distributors may wish to undertake C&DM programs which are not funded by the OPA. In its August submission VECC suggested that such funding requirements be addressed through either a deferral account or a rate rider with an associated variance account.
- One issue VECC did not address in its August submissions is how the 2GIRM should deal with distributors that received approval to include post-3rd tranche C&DM spending in their 2006 rates. For these utilities the associated spending forms part of their "base rates" and therefore will impact on their rates until rebasing. However, the programs the funding was intended to support may terminate entirely in 2007 and/or be funded by the OPA. Ideally, the funds generated by the inclusion of any post-3rd tranche C&DM spending in the 2006 rates would be tracked after 2006 in a deferral or variance account. A variance account would be appropriate in those instances where the distributor has approval to spend rate payer funds[27] (as opposed to OPA funds) on C&DM programs post-September 2007.

**Third Generation IRM**

- During the course of the Technical Conference a number of parties commented on the importance of starting work on the development of the third generation incentive regulation mechanism. VECC agrees and urges the Board to share with stakeholders its work plans in this regard as soon as possible.

[27] Note: This would exclude any 3rd tranche C&DM spending.

VECC appreciates the opportunity to make these final comments. If there are any questions or if clarification is required regarding the comments please contact either Roger Higgin (416-348-9391), Bill Harper (416-348-0193) or myself (416-767-1666).

Yours truly,

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