COLLUS Power Corp (Member of ECMI Group)
Responses to questions from OEB Staff
as part of the Technical Conference process
October 10, 2006

OEB Staff questions

1. Access to Capital (addressed to distributors)
Please provide any information available on situations where your distribution utility has experienced difficulties in obtaining financing for capital investments on reasonable terms. What reasons were given for the inability to raise capital or on unreasonable (i.e. above-market rates)?

Response

It is difficult to establish the "market rate" for an individual LDC. An LDC might go to considerable effort to determine its particular "market rate." Only then would it be in a position to assess whether or not it had experienced difficulties in obtaining financing for capital investments. The answer may be dependent upon how the LDC has participated in the debt market. Each time an LDC obtains financing a number of variables are in play at that time so there is not a single answer for the rate paid but only when the rate is paid is it a market rate. Financing negotiations are a sensitive matter for LDCs and no direct response is provided to this question as the response could be prejudicial against this LDC's potential borrowing and the associated rates in any subsequent financial negotiations.

2. **Merger and Acquisition Valuations** (addressed to distributors)
Please provide information available specifically on the valuation (relative to the net book value) of your distribution utility (if you were considering or effected the sale or merger of your utility) or of another distribution utility that you were considering or effected a merger or acquisition with.

Response

Many of the presenters have suggested that what investors are looking for when they invest in a regulated entity is a predictable future stream of revenue. To the extent that the OEB modifies the expectations for a stream of revenue those potential investors may go elsewhere or investment may come with some other and potentially new conditions such as preferred share status.

The chances for rationalisation of the industry may be materially diminished by the Board Staff proposed reduction in return on equity and the associated future stream of revenue.

LDC's value is a sensitive matter for LDCs and no direct response is provided to this question as the response could be prejudicial against this LDC's ability to enter into merger discussions or equity discussions.

If a valuation was requested by a municipal shareholder of a third party and provided to the shareholder, the LDC does not own the information and cannot provide it.

3. **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?

Response

A change in the deemed capital structure could have a positive or negative impact on sector rationalisation. Larger LDCs would likely be more attractive for sale than smaller LDCs as the equity portion for larger LDCs is increasing under the Board Staff proposal compared to the status quo. In contrast, smaller LDCs would likely be less attractive for sale than larger LDCs as the equity portion for smaller larger LDCs is decreasing under the Board Staff proposal compared to the status quo. These equity adjustments impact the potential future stream of revenue and would impact any valuation accordingly.

If a reduction in the return were paired with the change in deemed capital structure initiative, it could result in deferral of any or all rationalisation activities. Many might defer decisions until PBR III (3) is introduced.

4. **Return on Equity – Cannon Methodology**
Several parties have suggested that the Board retain the existing method of calculating the ROE as documented in Dr. Cannon's paper "Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario", dated December 1998, and consistent with the ROE methodology used in rate regulation of natural gas distributors under the Board's "Draft Guidelines on a Formula-Based Return on Common Equity for Regulated Utilities". If the Board was to retain the current methodology:
   a. Should the ROE be updated for May 1, 2007 distribution rate adjustments?

Response

Yes

b. What should the starting point for the ROE applicable to electricity distributors (e.g., 9.88% from the first Distribution Rate Handbook or 9.00% as calculated in the 2006 Electricity Distribution Handbook)?

Response

The risk premium or premiums and cost of risk free debt should be updated consistent with the previous methods applied in the Cannon method including the panel of experts.

c. If updates to the ROE are not done annually (e.g. under IRM), then how should the ROE update be done at the time that distributors file rebasing applications?

Response

As the PBR 2 regime is a 3 year regime, the return should be fixed once for all LDC's during the 3 year period as the performance adjustment including stretch factor is already aggressive. Further adjustment in the equity should not be made during the 3 year period. If the debt level is updated, it should be updated for all LDCs.

5. **Return on Equity and Rebasing**

The staff proposal currently would have the IRM price cap formula applied to existing Board-approved distribution rates, largely set through 2006 EDR applications.

a. 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?

Response

To fully comment would require a trend analysis comparing GDP-IPI with debt rates and market returns. The requirements of this full and comprehensive analysis exceeds the time and resources available to this LDC. This question is profound in that appears to imply acceptance of the Board Staff's proposed method of adjusting LDC rates in PBR 2. Given the reports and information currently available in this process, the Board Staff proposal appears to be inadequate as a basis for PBR 2.

No specific response is available.

b. If so, is an ROE adjustment required in 2007 and while a distributor is subject to the price cap index? What are the implications of not changing the Return on Equity (ROE) currently allowed in a distributor's approved distribution rates until the distributor files a Cost of Service (rebasing) rate application during the period 2008 to 2010?

Response

If the Cannon method is revisited as suggested in the response to question 4, then it might be appropriate to adjust the return on equity specific to the LDC's rate base for 2007 through 2010. Such an adjustment would be a one time adjustment for the period 2007 through 2010, based on the specific dollar adjustment required as a result of the ROE adjustment. For LDCs rebasing in the period between 2007 through 2010, the adjustment in rates would exclude a general adjustment in ROE but be based only on the relative change in accepted operating expenses and any CI adjustment both as a percentage of the revenue requirement.

6. **Capital Structure**

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

a. What are the implications, advantages and disadvantages of such an approach?

Response

The proposed capital structure disadvantages small and medium sized distributors because it fails to recognise the size risk influence identified in the Lazar Prisman report in their reference to the Standard and Poors page 21/22 and also recognised by Cannon in the OEB PBR 1 method.

Similarly, the proposed capital structure advantages the largest distributors because it fails to recognise the size risk influence.

b. Are there alternative approaches that the Board might consider?

Response

Continue to use the Cannon approach or apply a different risk premium on the equity component for smaller, medium and large sized distributors which is commensurate with the scale risk identified by the vast majority of parties to this process.

7. **Load Concentration-related Business Risk**
While Board staff have proposed a common capital structure applicable to all distributors, several stakeholders have commented on business risk, possibly related to a material loss of revenues due to the loss of a customer or business sector served by the distributor and where that customer or business sector constitutes a significant portion of the load and distribution revenues for the distributor.

a. Could any significant risk that might materialize due to the loss of a significant load concentration be mitigated by Z-factor (or analogous) treatment?

b. If yes, then what would be the criteria for identifying an occurrence of such an event (e.g. what percentage of distribution revenue attributable to loss of a single customer should be the threshold for identifying a material revenue loss)?

Response

While the idea of making adjustments for loss or growth in customers is appealing, the absence of clear rules for Z-factor consideration, load concentration related business risk may not be satisfactorily addressed. An ad hoc approach responding to individual cases differently mitigates any benefits flowing from a codified process. Further, the use of Z factors may result in more applications for specific consideration requiring more hearings to consider and establish appropriate action. The use of a Z Factor only recognising down side risk is asymmetrical and may be unfair to customers. Rather than an asymmetrical Z factor adjustment, it may be more appropriate to build a symmetrical adjustment which deals with these factors into the PBR 2 process.

8. **Short-term Debt** (addressed to distributors)
At the Technical Conference, staff heard that not all working capital is funded by short-term debt and that some may be funded by long-term debt.

a. What percentage of your actual working capital is funded by short-term debt?

Response

The question implies that working capital needs are funded by either short term debt or long term debt. This ignores the fact that some working capital needs are funded by equity. Working capital requirement fluctuate on a day by day, week by week, month by month basis and a percentage funded by short term borrowing may vary from day to day depending on the LDCs specific capital structure and cash needs. These needs may also be dependant on such externalities as the load shape (from month to month) of the LDC.

b. What percentage of your rate base does short-term debt represent?

Response

If the rate base were defined including working capital allowance, it might be possible to provide an estimated weighted average percent of rate base in response to such a question but not without significant work with information which may not be available. The commodity component of the working capital allowance and its influence on the working capital allowance is material and should be kept current. Further changes in load shape may change those needs from month to month and be different for a given month from the same month in a different year. Such differences may be more dependent on economic conditions than on weather or load growth or load decline.

The question (8b) implies that there is a relationship between working capital allowance and short term debt. If an LDC, because of the volatility of the working capital requirements, chooses to fund working capital through equity rather than short term debt, then the portion that short term debt represents of the rate base is not sufficient in establishing the return which should be granted on the working capital allowance.

9. **Incremental Capital Expenditures**
Some distributors at the conference expressed concern over aging infrastructure and the need for increased investment in that infrastructure to maintain appropriate levels of service.
   a. What are your known circumstances of where this could arise (addressed to distributors)?

Response

No current assessment of the assets is available or provided. A universal assessment of all LDC assets is not the way many LDCs manage their assets. A common approach is to assess a different portion of the geographic area served in each year over a number of years. This type of planning regime may or may not provide a more stable annual capital infrastructure needs environment.

b. Should incremental capital spending that is not attributable to load growth be treated outside of the price cap index (similar to what is proposed for CDM)?

Response

Items like the rate freeze or constraints imposed though the regulatory regime often constrain an LDCs ability to invest in infrastructure. In such cases, prioritisation of capital requirement investments will include considerations like -

- **those imposed by the lies along and must serve obligations**
- **capital investments to 3rd parties such as Hydro One Networks Inc for transformer station capacity**
- **emergency capital needs**
- **more orderly (regular) capital infrastructure investments**

Growth may be inadequate as the only adjusting factor which would apply in any determination of a CI Factor. If the funding of capital needs resulting from growth are dealt with through the Distribution System Code then the first bullet above may deal with that requirement. If the growth relates to the second bullet above it is unclear how that adjustment would flow from a single growth factor adjustment. These two adjustments do not deal with the emergency and normal infrastructure capital investments which may be warranted under a prudent stewardship program. It is therefore unclear whether the proposed CI adjustment is sufficiently comprehensive to deal with capital requirements. When these considerations are added to the Board Staff proposal for the curtailment of equity for small and medium sized distributors, it may not be possible to fund what was previously considered normal capital expenditures within the proposed new framework.

i. If so, should it be eligible for Z-factor treatment?

Response

While the idea of making adjustments is appealing, the absence of clear rules for Z-factor consideration may not be satisfactorily addressed. An ad hoc approach responding to individual cases differently mitigates any benefits flowing from a codified process. Further, the use of Z factors may result in more applications for specific consideration requiring more hearings to consider and establish appropriate action. The use of a Z Factor only recognising down side risk is asymmetrical and may be unfair to customers. Rather than an asymmetrical Z factor adjustment, it may be more appropriate to build a symmetrical adjustment which deals with these factors into the PBR 2 process.

c. Are there alternative approaches that the Board might consider?

Response

Whatever approach is decided upon, that approach should be done on the basis of establishing a level playing field for all LDCs in terms of their ability to meet capital needs.

d. If the Board were to provide for special treatment of these investments, should a threshold apply? If so, how might that be expressed (e.g., percentage of current CapEx budget less depreciation)?

Response

A clear universal threshold should apply in all cases. The threshold should be established by the amount that the proposed capital expenditure (net of depreciation) represents as a percentage of the rate base.

10. **CI-factor**

During the technical conference, Mr. John Todd proposed a methodology for a CI-factor as part of the IRM price cap formula as a means for including incremental capital expenditures not related to load growth as an increment to the price cap index.

a. What are the implications, advantages and disadvantages of adopting such an approach?

Response

HONI implied in their submissions that capital is needed to restore deficiencies in its system condition. See response to question 9, as it is hard to separate normal from other capital needs.

b. Mr. Todd suggested that a distributor file an Asset Condition Assessment Study as support for the proposed CI-factor. Such a study does not directly indicate the cost of incremental capital expenditures needed to address deficiencies in the system. What information on the proposed capital expenditures should a distributor be required to file in addition to the Study?

Response

Prioritisation and the relative dollar value of each project underpinning a specific capital expenditure might be helpful. Ultimately, priorities are a moving target and emergency situations may create opportunities to adjust priorities producing longer term benefit to customers.

c. What are the implications of adopting this approach where CapEx plans are not reviewed and approved by the Board?

Response

Lack of assurances from the Board that specific capital investments will not be partially or wholly disallowed from rate base considerations creates such a risk for LDCs that it might be viewed by some as sufficient grounds to defer such infrastructure capital investments.

d. The CI-factor methodology as proposed seems to start from a 2006 rate base. Hydro One Networks has a 2006 rate base that has been reviewed during its 2006 distribution rate application by virtue of applying on a forward test year. However, most electricity distributors filed 2006 distribution rate applications on the basis of a 2004 historical test year with allowable adjustments. Hence, the public information for most distributors reflects a 2004 rate base. What changes need to be done to the CI formula to properly adapt it for when 2006 distribution rates are calculated on a 2004 historical rate base?

Response

As the 2004 rate base for most distributors is what underpins the rate levels, then 2004 should be used as the basis for any CI adjustment in those cases.

e. Should the load growth factor be weather normalized? If so, how should this be done?

Response

Weather normalisation is not a prime consideration in establishing capital needs. Any normalisation type adjustment used to establish the growth factor should be done on the same basis as the establishment of the revenue statistics in the EDR 2006 process. That is, any growth adjustment should be based on a similar 3 year historic period for historic test year filers. The relative levels of those historic test periods should be used to establish the growth factor.

Capital assets are constructed for the longer term and standards are seldom set for the short term nor should they be constructed without regard for extreme weather conditions and potentially some normal growth over the life of the assets.

f. Some of the parameters for the calculation of the CI-factor, as proposed, may not be readily available from prior filings where the data were subject to review by the Board. By what process would the Board review and test the reasonableness of the parameters if a distributor were to apply for a CI-factor?

Response

See response to e)

11. **Declining Customer Base**

Some distributors have documented declines in their customer bases.

a. Would it be reasonable to adjust the X-factor, for example, to 0.7 for a distributor that has negative growth in its customer base over the period 2002 to 2005?

b. Are there alternative approaches that the Board might consider to address constraints on operating efficiencies possible under declining customer base conditions?

Response to a) & b)

The concept of an adjustment to the X-factor is reasonable but in our view would be difficult to implement and monitor in a consistent and equitable manner. Revenue adjustment could be based on a specific calculation based on expected revenue reduction exclusive of any revenue reduction covered by an LRAM consideration. The adjustment in the X factor could then be determined on a dollar for dollar basis. Variance accounts could be used to keep the customers and the LDC whole.

12. **Smart Meter incremental funding**

In the July 25, 2006 Staff discussion paper, staff proposed incremental amounts of smart meter funding of $1.00 per month per metered customer for distributors working to achieve the Government's objective of 800,000 smart meters in place by the end of 2007, and $0.30 per month per metered customer for other distributors.

c. Are the proposed increments reasonable?

d. If not, what should they be, and why?

Response to c) & d)

Experience will determine whether the increments are adequate. The use of a variance account for this activity would be useful in determining whether an LDC needs an incremental adjustment to meet the proposed timelines of this activity. The variance account would similarly determine whether the customers had over contributed to the activity and depending upon on scheduled implementation a rebate might be in order for the customers.