Newmarket Hydro

Responses to Board Staff Questions

EB-2006-0088/89

1. Access to Capital

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

Newmarket Hydro, Ltd. has not had difficulty obtaining capital in the past at reasonable rates. However, prior reasonable access to capital does not ensure future access. Concern over future access is amplified when regulators consider negative changes to the regulatory regime, particularly given past decisions. The reduction of ROE from 9.88% to 9.00% in 2006 and potential change through this Cost of Capital debate sets a precedent that remains a part of the regulatory environment. Complicating this issue, Newmarket is under Board Order 2005-0315 to assist in building the Holland Junction Station to enhance North York Region Ontario system reliability which will cause Newmarket Hydro Ltd to potentially raise an additional 4 million dollars from debt sources.

We are concerned that our capital investment plans identified and advanced under the existing regulatory structure must be reconsidered in light of proposed changes to the capital structure and rate of return. Moreover, an increased regulatory risk premium may raise the cost of capital debt.

The OEB may wish to note that there are real costs imposed by regulatory instability. Roger Morin in **New Regulatory Finance** (Public Utilities Report, Inc., 2006, page 43) paraphrases the US Supreme Court's opinion in Duquesne Light Co. et al. v. Barash et al. (109 S. Ct. 609, 1989) stating that: "…regulatory risk is a special class of risk that must be recognized by regulators when setting the allowed rate of return." He goes on to say that "Regulatory risk generally refers to the quality and consistency of regulation applied to a given regulated utility..." Significant regulatory changes such as those proposed would likely have a negative impact on Ontario regulatory risk and ultimately the cost of capital.

Overlaying the concerns related to the regulatory environment are those specific to municipal shareholders. They cannot increase debt to the LDCs. Consequently

capital markets – which have been largely avoided in the past - will need to be accessed to fund these large capital outlays.

2. Merger and Acquisition Valuations

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

Any information related to M&A activities, past or future, would be considered highly confidential and proprietary. We would be unwilling to share this information until such time as required by law.

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

Newmarket Hydro does not believe that the current capital structure has any impact with regard to the prospects of physical consolidation of electricity distributors. However, a change to the capital structure is less clear and could negatively impact prospects of industry consolidation.

Newmarket believes that the transfer tax, regulatory uncertainty and returns on equity are the greatest impediments to sector rationalization. Eliminating the transfer tax is the most significant tool for encouraging consolidation – and is in the hands of the government. An OEB decision to create a single capital structure and further reduce asset and equity returns will cause confusion among smaller utilities, lower their returns (and their values), raise their business risk and further increase regulatory risk. The resulting change in market value may impede decisions to consolidate – prices are sticky downward.

We are concerned that the OEB staff objective to "avoid imposing barriers to consolidation…" has been interpreted to promote rationalization. A wholesale change to capital structure will only further confuse the process and introduce additional regulatory risk.

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?

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)?

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

Newmarket supports using the Cannon Methodology for the updated May 1, 2007 distribution rate adjustment, including maintaining the existing 4 capital structure tiers. Using the current methodology as the foundation for rates along with the originally approved ROE formula will go a long way toward reestablishing confidence and regulatory stability as the long term goal of the OEB and its staff. We do not support the use of Cannon Methodology independent of the tier structure – particularly moving to the Staff-proposed 60:40 capital structure.

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?

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

Newmarket Hydro has no comments at this time.

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?

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

Response

For those utilities that might be required to adjust their capital structure, we support the use of a migration period. Allowing three years for smaller utilities and two for larger provides some time to prepare and execute a new capital plan.

We have directed OEB staff to Ibbotson Associates Valuation Edition - 2005 Yearbook, Chapter 7, pages 127 – 158. The study covers US stocks from 1926 to 2004 and indicates an excess return to small stocks of 6.41% - returns above the CAPM model based on the smallest 10% or 1,782 companies. The largest market capitalization of this category was US$ 263 million and the smallest US$ 1.4 million. Alternatively, combining the smallest two categories (20%) with market capitalization ranging from US$ 505 million to US$ 1.4 million, excess returns were 4.02%. Note that splitting the smallest 10% further raised the returns to the smallest 5%, but reduced sample size. This report references US stocks, which should serve as an indicator for Canadian stocks. Mr. Charmichael, in his testimony for Toronto Hydro, noted a similar trend with premiums for small Canadian companies.

We will expand upon the size related concept in our final submission. For a preview of the arguments please review: Size Effect in **New Regulatory Finance**, Roger A. Morin, Phd, Public Utilities Reports, Inc., 2006, pages 181 – 189.

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

A Z-factor covering only loss of a significant customer is insufficient to compensate small distributors for the additional risks they face. There are any number of risks that are normally diversified in large utilities but cannot be captured in the form of a Z-factor for large customer loss. Business risks must be addressed through a higher percentage of equity in the capital structure of small distributors. Debt is a fixed obligation and smaller distributors require additional flexibility from a higher percentage of equity in their capital structure.

The scenario suggested is an analogous situation to declining customer growth (question 11) and could also be treated via an X-factor adjustment. While use of a Z-factor or an X-factor adjustment could help mitigate small business risk, it does not address all risks faced by small distributors and should not replace a higher percentage of equity in the capital structure of small distributors.

8. Short-term Debt

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

Response

Newmarket Hydro currently has no working capital funded by short-term debt.

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)?

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

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

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

Newmarket Hydro supports maintaining the current re-basing approach.

However, should the staff decide to use a Z-factor approach Newmarket has the following comments. The North York Region is facing reliability issues that require additional infrastructure investment as identified by the Board in Decision 2005-0315. The OPA has issued a series of RFPs for demand response and generation to mitigate the transmission and distribution constraints now facing the region. The RFPs are only intended as partial solutions as we work through remedies to these serious problems. Clearly, the investment requirements in the Region are large and will increase as the region continues to grow over time.

The depreciation component of existing rates repays capital that funded previous capital expenditures of rate base assets. It is not intended to cover future capital expenditures. All future capital expenditures must therefore be accommodated via Z-factor treatment. OEB must ensure that such Z-factor treatment provides adequate rate increases to cover debt principal, debt interest, and return of and on equity capital.

It is important to note that while distributors will be reimbursed actual third party interest, third party debt principal repayment is funded via the depreciation component of rates. If the third party debt principal repayment term is less than the depreciation term, for example a 10-year debt repayment term versus a 25-year depreciation term, distributors will receive insufficient compensation from rates to fund debt repayment.

Incremental capital expenditures are by nature lumpy investments that cannot be accommodated through a price cap index mechanism. It is clear that Ontario utilities will be competing with other firms for investment capital. Rates must be sufficient to attract capital, and unless returns are sufficient, distributors will be unable to attract sufficient capital.

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?

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?

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

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?

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

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

Newmarket Hydro has no comments on the proposed CI factor at this time.

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

We believe it is appropriate to adjust rates for distributors with declining customer bases such that they are not adversely impacted by the implemented IRM.

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

Newmarket Hydro has submitted a smart meter deployment plan to the Ontario Energy Board in confidence, therefore we cannot comment further on this issue.