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Ontario Energy Board
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October 10, 2006

ATT: E. Kirsten Walli, Board Secretary

Dear Ms Walli,

Cost of Capital and 2nd Generation
Incentive Regulation for Ontario's Electricity Distributors.
(EB-2006-0088) and (EB-2006-0089)

In accordance with the September 21 2006 Technical Conference transcript, ECMI submits its comments with respect to the Cost of Capital and the 2nd Generation Incentive Regulation Mechanism (IRM) for Ontario's Electricity Distributors, dated July 25, 2006.

ECMI wishes to express concern in two distinct areas, i) the *codification of rate regulation* process proposed, and ii) the apparent attack on small and medium sized local distribution companies (LDCs).

i) A New Process

The Ontario Energy Board (OEB) appears to be experimenting with the *codification of rate regulation*, a new process that seems to be a first for Canada This approach appears to attempt to establish rates through a purely mechanical process. Given the new terrain, it is not surprising that most parties including OEB staff seem to be struggling with how to effectively deal with the current experiment.

Regulatory experiments are risky for regulators, for those who are regulated by them and for the customers the regulator is charged with protecting. This experiment seems to be part of a multi-pronged attack which includes; significant increase of regulatory burden in terms of filing requirements for information, and on another front reinterpreting, if not rewriting the Affiliate Relationships Code (ARC).

What is apparently lacking is the establishment of priorities by the Board which are clearly focussed on customers. The Chief Compliance Officer on a number of occasions has stated that enforcement of his unique interpretation of the ARC should be done without any consideration of the impact on customers. In their letters Board Staff appear to be putting themselves more and more in the role of the OEB itself. This "encroachment" is potentially dangerous for customers in that the opportunity for properly vetting decisions on items which some may consider minor changes may be lost.

Further in the cost of capital process, the fact that Board Staff recommendations to the Board are not proposed to be a public document implies that this part of the process is done in secret. Also, the process is short. The issues are too profound for many LDCs whether small or large to fully evaluate all the implications in the time line established by this process.

The apparent need for many "Z" factor considerations demonstrates that codification of this process is unwise. 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. It is possible to liken the excessive use of Z factors to the application of patches on a balloon. The more patches applied, the greater risk of leakage and greater difficulty in finding the leak.

Apparent Attack on Small and Medium sized Distributors

The apparent embedding of another OEB Staff driven attack on Small and Medium sized Distributors using the cost of capital within this process is further cause for concern. The implications behind the Cost of Capital initiative is that the Small and Medium sized Distributors are being unduly enriched by the Cannon method. When this assumption is combined with the fact that the only LDCs that experienced an increase in deemed equity include Hydro One with an 11% rate increase as part of EDR 2006 process, it is hard to accept that this cost of capital process is customer focussed regulation.

It is easy to assume that a higher debt cost or higher equity level for smaller and medium sized LDCs in the Canon method automatically results in higher rates to customers than would be the case for a larger or consolidated LDC. However, local operating costs for a smaller or medium sized LDC may be lower than those of larger LDCs. Contributing factors that may lead to this situation could include employee expectations which may manifest themselves as lower local real estate costs, a less rich benefit package, a lower hourly rate, roots (family etc) within the community.

The automatic assumption that a higher debt cost for a LDC results in higher rates to customers assumes operating costs and quality of service remain the same. If however, the lower return offered the community shareholder precipitates a divestiture by that shareholder then the assumption of status quo operating costs and quality of service is probably not valid. New owners and management may be reasonably focussed on other priorities in the broader expanded service area.

If a small LDC is merged with a much larger LDC, there may be deterioration in service quality within the former small LDC's service area as a result of the merger, but this deterioration would probably not be apparent in any analysis of the enlarged entity's service quality performance. If a smaller LDC is merged with a much larger LDC then change in things like local Service Quality Indicators would generally be lost in the rounding.

This attack on the cost of capital may be supported by some particpants. The apparent goal of the pursuit of a lower cost of capital appears to be driven by a desire to punish publicly owned OBCA Corporations explicitly without the recognition that the elimination of such entities may ultimately result in higher rates faced by those represented customers. A lower deemed cost of capital could precipitate the reduction of a fair market return for public shareholders.

Understating the cost of debt applicable to publicly held LDCs or in fact the cost of debt to their municipal corporation owners may result in a shareholder desire to liquidate the valuable community asset in pursuit of instant cash rather than accept a lower long term return based on an agenda driven statistical analysis of market forces on bond ratings (which may be accessible to larger LDCs and/or their equally larger municipal shareholders but are not generally accessible to smaller LDCs). This type of analysis clearly underpins any rationalisation for the conclusions reached in the Lazar Prisman report.

Both the Lazar Prisman report and the Lowry report recognised scale as an important factor in the cost of capital considerations. The Lazar Prisman report on Pages 21 and 22 makes reference to the notable "correlation" between Standard & Poor's bond ratings to the size of the entities being rated. That being that the larger entities should face a lower bond rating cost of debt while the smaller entities should face a higher bond rating cost of debt. As indicated in ECMI submission of July 4, 2006 in this process, there are two ways to capture this situation from a regulatory perspective. These include either a specifically higher deemed cost of debt for smaller LDCs or a higher equity component for smaller LDCs to reflect the higher risk recognised in the "correlation" of bond ratings for larger LDCs versus smaller LDCs. There is no indication that these comments were considered by Board Staff.

The MADD rush to a simple one shoe fits all cost of capital ignores the value of the LDC to the customer. Unit delivery costs are not of primary importance to most customers. The Service Quality Indices used by the OEB do not capture all of the items of importance to customers. MADD salesmen rely on a feeble Ontario energy process which purports to evaluate no harm to customers. This process fails to require any assessment of customer priorities and satisfaction before and after any proposed merger. Simplistic unit cost are often utilised as a substitute for real work which should add value to any MADD process. Board staff eagerness to embrace the simple answer and the one shoe fits all answer fails to serve or protect customers.

The recent MADD application involving Gravenhurst identified no harm to customers as the criteria which the OEB should use in determining the acceptability of a MADD application. No harm to customers is an appropriate criteria provided that the customers potential harm is considered on the basis of each of the clusters of customers involved in the MADD application. Such considerations should include rates and quality of service. Other potential harm to customers can flow from items in the quality of service not currently considered or measured by the OEB in its service quality indices catchment net.

The Board Staff stated objective “to avoid imposing barriers to consolidation within the electricity distribution sector” should reflect a careful balance of permitting the status quo in terms of structure and permitting the rationalisation of the industry. It is easy to interpret the “avoid imposing barriers to consolidation within the electricity distribution sector” to mean establish an artificial set of rules which demand a consolidation of the industry through financial punishment of smaller and potentially more cost effective distributors which may well currently provide a higher standard of service for the communities they serve because of their locally based and in many cases lower cost skilled staff. The status quo may often produce a higher value to customers than forced mergers or divestitures.

Conclusion

The OEB has a statutory right to establish codes, provided the drafts are published for comment and the responses are considered. We are concerned that the obligations may be lost if “reasons” are not published as part of the process indicating that responses have been considered. For example, ECMI submitted comments on July 4, 2006 prior to this session and we have no way of knowing if the comments were considered, rejected or lost. The way that Board currently approaches codes without responding with reasons is imperfect and the process needs to be enhanced.

It is not only a question of whether codification of rates can be done. It is more a question of whether it should be done, given the time line and the complexity of the issues.

Original signed by R. White

Roger White
President