EB-2006-0088
EB-2006-0089

Response of Energy Probe Research Foundation to Board Staff Questions

Question # 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 # 3.

Energy Probe believes that, if efficiently pursued, consolidation of the now-fragmented electricity distribution sector offers the opportunity for significant long term reductions in cost and resulting benefits for ratepayers. The Board's current approach to LDC capital structure allows smaller utilities to maintain a higher equity ratio and therefore to collect a higher weighted average cost of capital than is recovered by larger utilities. This approach imposes a penalty on consumers who happen to be served by smaller utilities and also represents one barrier (among several) to the efficient rationalization of Ontario's distribution sector.

Energy Probe is therefore supportive of the approach proposed by Board Staff whereby the same deemed capital structure would be applied to all utilities.

Question # 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 # 4.

Energy Probe supports updating the ROE for May '07, and we believe that the Booth approach could be used to set the starting point and the approach at rebasing.

Question # 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 # 5.

a. **Energy Probe is not aware of any evidence to support the assumption that changes in inflation rates should be a proxy for the expected rate of return although low and falling interest rates should generally lead to declining costs of capital for utilities.**

b. **Not applicable.**

Question # 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 Board Staff Questions to Participants of September 18-22, 2006 Technical Conference 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 # 6.

a. **Immediate implementation would enhance regulatory clarity. Where smaller utilities are required to replace some equity with debt, the deemed cost of new debt should be applied in developing the WACC.**

b. **The only instance when immediate implementation of the proposed structure might be reviewed would be in the case of a merger of utilities where the merger is underway but not completed, the combined entity would have been below the lowest size threshold, and the proposed transaction would fail contractually if the regulatory change was made. The onus would fall to the applicant to demonstrate to the Board's satisfaction the utility's special circumstances.**

Question # 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 # 7.

The claimed business risk appears to be hypothetical. When regular rate reviews were not being conducted by the Board due to government imposed rate freezes, Energy Probe acknowledges that the business risk for utilities was elevated. However, the current outlook is for utilities to have access to the regulator in the event of significant disturbances, at the latest by the end of their IRM term. In addition, the utilities already have allowances for bad debt and authorities to require security from customers. If any changes are required, they should be considered through case-by-case treatment rather than a generic Z factor.

Question # 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)?**
    i. **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 # 9.

Energy Probe suggests that due to the long period of regulatory uncertainty LDCs have faced, there are likely to be utilities who have postponed needed capital projects, particularly for existing customers. While the Board should provide utilities in these circumstances with reasonable opportunities for recovery, specific utility circumstances should be considered by the Board. One consideration that the Board should reflect on is the history of payouts to owners, so that the Board can ensure that capital backlogs have not developed due to gaming of regulation. Incremental capital spending should not be dealt with through a generic Z factor.

Question # 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 # 10.

Energy Probe has no comments on the proposed CI-factor.

Question # 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 # 11.

Energy Probe suggests that X factors should be set for groups of utilities facing similar circumstances. A utility's load trend would be a significant cost factor, as would other factors such as historic investments in efficiency-enhancing technologies.

Question # 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 # 12.

It would appear to Energy Probe that only a handful of LDCs, led by Milton Hydro, have any chance of having their share of the Government's proposed 800,000 smart meters in place by the end of 2007. Those LDCs that are successful should be rewarded through providing them with the opportunity to recover their costs. Energy Probe has insufficient data to advise the proper quantum.

Respectfully submitted at Toronto, Ontario this 11th day of October, 2006.

Tom Adams
Executive Director