

Corporation de distribution électrique de Hearst
Hearst Power Distribution Company Limited
925 rue Alexandra Street
Hearst ON

October 10, 2006

Ontario Energy Board
27th Floor
2300 Yonge Street
Toronto, Ontario
M4P 1E4

Attention: 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)
Hearst Power Distribution Company Limited**

In accordance with the September 21 2006 Technical Conference transcript are four (4) hard copies and an electronic copy of the requested responses.

An electronic copy has been sent to the Schools Energy Coalition.

Nicole C. Leduc
General Manager

Encl.

Responses to questions from OEB Staff and School Energy Coalition (SEC)

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 your 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 through 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.

School Energy Coalition (SEC) questions

General

Information is not filed on a confidential basis as it is not apparent that this process and the non – universality and voluntary nature of this filing will provide traditional confidentiality protections.

1. Many parties have raised the issue of whether the proposed changes to cost of capital and to rates will have a negative impact on the financial health of LDCs. Please file your most recent annual audited or unaudited, as the case may be, financial statements. If your LDC represents more than 50% of the assets of a holding company, please file the holding company's most recent annual audited or unaudited, as the case may be, financial statements.

Response

The LDC audited statements are attached.

2. A number of LDCs have, in their submissions, raised the question of whether the proposed changes in cost of capital are a surprise to LDCs and for that or other reasons will erode the foundation of their current business plans. The PWU has also relied on this proposition in its submissions. Please file your most recent multi-year business plan, if such a document exists and has been reviewed and/or approved by any of your shareholders or your board of directors. If the business plan includes unregulated business activities, please redact all parts of the plan that relate to an unregulated business and don't relate to the regulated utility business. If the business plan includes other confidential information, please file the document in confidence so that the Board's protections for confidential filings can be engaged.

Response

Business plans are often strategic items and as opposed to a specific project complete disclosure to a 3rd party would be unreasonable disclosure of commercially sensitive material. No specific response is provided.

3. If your LDC has carried out a merger or acquisition of an LDC since 1999, or has prepared an investment analysis of a proposed merger or acquisition of another LDC, or has prepared an analysis of a potential sale of your LDC to another LDC, please provide that investment analysis, business case, or similar document showing the financial parameters of the deal or proposed deal, including in particular any calculations of expected overall return or return on equity, and advise of the eventual result of the proposed transaction. If any such document contains confidential information, please file the document in confidence so that the Board's protections for confidential filings can be engaged.

Response

Valuation of an LDC contains extremely commercially sensitive information and if provided could certainly be detrimental in any future potential merger or divestiture discussions. If this information is made available it could “impose barriers to consolidation within the electricity distribution sector.” No specific response is provided.

4. Dr. Yatchew posits, at page 16 of his report, that mergers or acquisitions of LDCs may have been cancelled, repriced, or otherwise materially affected by uncertainty about whether the acquiror would be able to receive the benefit of savings generated by the transaction. If your utility has any documents showing that this was a consideration in any transaction, please file those documents. If any such document contains confidential information, please file the document in confidence so that the Board’s protections for confidential filings can be engaged.

Response

Such documents would probably contain extremely commercially sensitive information and if provided could certainly be detrimental in any future potential merger discussions. If this information is made available it could “impose barriers to consolidation within the electricity distribution sector.” No specific response is provided.

5. Several parties have suggested that the proposed changes in the ROE and capital structure may cause LDCs to be offside on their debt covenants. Please advise whether such changes may cause your utility to be offside on your debt covenants, and if so file the text of such covenants, the amounts of borrowing to which they relate, and whether the lender is an affiliate/shareholder or an arm’s length third party.

Response

The short term cost of money may be very dependent on the specific situation in which an LDC finds itself. The disclosure of the existence or non existence of debt covenants could jeopardise any potential future borrowings. No specific response is provided.

6. An important issue in this proceeding is maintaining the creditworthiness of the LDC. If your LDC has been rated by Standard & Poors, DBRS, Moody’s, or Dun and Bradstreet within the last 18 months, please file the last full rating from each rating agency, plus any updates since that full rating. If your LDC is rated and you have a public sector shareholder, please also advise the shareholder’s debt rating(s) if any.

Response

A bond rating by a bond rating agency may or may not be valid. Further, the credit rating of a public sector shareholder where it is a municipality that operates under the Municipal Act is not relevant because the MA imposes all sorts of requirements on the Municipality. Potentially the Ontario government may provide an implicit guarantee to any borrowing by a municipal corporation. The Ontario government has demonstrated its willingness to appoint a Superintendent to administer the activities of a municipality should its debt become of concern to the Minister. The statute which created municipally owned LDCs clearly states that such LDCs are OBCA companies and therefore can go bankrupt.

No specific response is provided.

7. The ability of utilities to attract equity investment has been raised as a critical issue by many parties. Please provide the date, amount, investor identity and terms of the last common equity investment in your utility. If there was an offering or disclosure document, please file that document.

Response

The LDC's Board may be in conflict with its fiduciary duties if it releases this information. If any LDC finds itself unable to raise debt in the public market, then demands on existing equity imposed by the Distribution System Code or Transmission System Code or other Codes may leave them cash poor. In any case, LDCs are constrained in attracting equity investment without potentially triggering the Transfer Tax.

No specific response is provided.

8. Mr. Camfield believes that inadequate returns will result in lower than required investment in capital assets. Please provide for your utility the opening rate base, capital expenditures, and closing rate base for each year from 2000 to 2005 inclusive, and your current projected numbers for 2006.

Response

The LDC's Board may be in conflict with its fiduciary duties if it releases this information. If any LDC finds itself unable to raise debt in the public market, then demands on existing equity imposed by the Distribution System Code or Transmission System Code or other Codes may leave them cash poor. In any case, LDCs are constrained in attracting equity investment without potentially triggering the Transfer Tax. The LDCs rate base would have to be defined for each year as the working capital allowance is not determined for each year nor the basis for such determination established by the OEB. It is not possible to provide the rate bases as requested.

No specific response is provided.

9. Please provide a chart showing your fixed asset age distribution measured by dollar amount (e.g. \$120 million at 25-30 years old).

Response

This LDC does not have such a chart.
No specific response is provided.

10. For each LDC that has debt traded in the public markets, either directly or indirectly, please provide a chart for the period 2003 to date showing the average yield of your debt (broken down by issue if you had more than one outstanding) each month in the market, and for the same month the average yield of 10 year Canadas.

Response

Not all long term debt is issued for a 10 year period. Negotiated terms for long term debt are often negotiated in a different period than the actual date of issue. Specific response to this question might be misleading.

11. At pages 11 and 17 of his report, Dr. Yatchew notes that utilities already have an “informal yardstick competition” currently going on. Please file any efficiency comparisons between Ontario LDCs in the possession of your utility, including any line item or similar benchmarking, any estimates of “best practices” standards, any formal or informal studies, etc.

Response

The question posed is not sufficiently specific to permit an answer. No specific response is provided.

12. At page 12 of his report, Dr. Yatchew discusses the importance of aligning performance compensation plans to incentive regulation plans. Please provide the performance based compensation plan of your utility, if any, together with a list of any changes to that plan between 2000 and today.

Response

**Any such alignment would have to occur over a period of time consistent with the terms of any such contract. As this information may relate to filing information specific to an individual it may well be in violation of Federal protection of privacy information.
No specific response is provided.**

13. Please describe any attempts your utility has made in the past to borrow in the market in common or in tandem with other LDCs. If you have proceeded with or proposed any such transaction, please describe the structure, the impact on cost of capital, and the result.

Response

The disclosure of the existence or non existence of attempted joint borrowing debt covenants could jeopardise any potential future borrowings.

No specific response is provided.

14. If your utility has a holding company of which at least 50% of its consolidated assets are assets of the LDC, please advise whether the debt rating of the holding company is different from the debt rating of the LDC, and if so advise the two ratings.

Response

The LDC does not have a Holding Company.

15. Please provide the “Bill Impacts” pages of the 2006 EDR Model for your utility, and comparable calculations using the year 2000 and 2003 approved distribution rates.

Response

The requested information is attached.

16. Please provide a list of the Tier 1 adjustments sought by your utility in your 2006 rate application, the dollar amount of each, and the total revenue requirement applied for.

Response

The requested information is attached.