October 11, 2006

Kirsten Walli, Board Secretary
Ontario Energy Board
PO Box 2319, 2300 Yonge St, Suite 2700
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Re: IN THE MATTER OF a consultation by the Ontario Energy Board on the Cost of Capital and 2nd Generation Incentive Regulation for Electricity Distribution Companies. (EB-2006-0087, EB-2006-0088 and EB-2006-0089)

Board Staff Questions to Participants of September 18-22, 2006 Technical Conference

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

London Hydro suggests that the question has little if any relevance to the evaluation of the OEB Proposal. London Hydro is concerned that this is an indication that the OEB is willing to introduce regulation through this Proposal that has been demonstrated to be fundamentally flawed and that produces an inequitable result across utilities and then suggesting that if you have a problem come see us. While exception based regulation may be helpful to reduce OEB workload, it first and foremost has to be predicated on sound regulation. This is not the case with this Proposal. The Technical Conference has demonstrated that there are severe issues with content and completeness of the research, the sampling used and the interpretation of the practical consequences of the Proposal.

The financial circumstances to date and the ability to date of a utility to obtain financing has little relevance as we suggest to you that the Proposal itself will significantly alter the distribution revenues and the cashflows of certain utilities and therefore their ability to obtain financing. All at a time with significant and unprecedented capital investments required due to Provincial initiatives such as Smart Meters, as well as increased pressure on infrastructure to sustain economic expansion and retain service levels. The past and present financial circumstances of the utility, which admittedly has transitioned in the last six years from holding higher levels of cash and self-financing with internal cashflows to an entity more reliant on external financing, is an inadequate comparator and not a relevant predictor of the future debt capacity of the entity entering into this new horizon under this Proposal.

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

We suggest that any valuation information will be of little relevance as it is specific to the entity itself and coloured by the individual characteristics of the utility's service territory, customer demographic, operational and management capacity etc., as well as the motivations of the parties to the transaction. The valuations will be unduly influenced by the transfer tax and perceptions of the viability and attractiveness of the Ontario energy marketplace which is the result of Provincial government policy. Accordingly, current valuation information will be of little relevance to the discussion at hand.

While we suggest that the past and current valuations have little relevance here, looking to the future which is of relevance, we do know that this Proposal as it stands will unevenly reduce the value of certain utilities, in that distribution revenues and therefore cashflows will be reduced for some entities and not others. In fact, we submit that the majority of Ontario customers will see little or no rate relief from this Proposal and some utilities serving them will enjoy greater cashflows and higher valuations. A minority of Ontario customers will see rate relief under this Proposal and the utilities serving them will have cashflows reduced and valuations decreased.

During the Technical Conference we observed that there seemed to be an obsessed fixation on the over earning capabilities of utilities based on recent valuations of M&A transactions in other jurisdictions. Further, those valuations were solely being driven by the regulated rate of return and if that was not controlled then valuations would soar. While we do not support the comparability of those transactions to the Ontario marketplace, we would like to comment on the valuation obsession as it pertains to the Technical Conference and this question. In simple terms:

i. **Few if any Ontario utilities have earned the notional rates of return which are considered to be the minimum but appropriate returns. Government policy has eroded that further through Bill 210 and reinvestment initiatives in Conservation and Demand Management. Therefore theoretical returns have never been practically applied or achieved. Valuations therefore have suffered and are below the norm.**

ii. **Transfer tax significantly impedes the utilities from pursuing consolidation and capitalizing on synergies to improve rates of return. Therefore valuations have suffered and are below the norm.**

iii. **The Proposal further takes the above starting point of poor valuation and further erodes valuations for some.**

Valuations are dictated by arms length buyers and sellers able to negotiate without compulsion to act, in an open marketplace. In that environment management will decide and negotiate value which is specific to the circumstance. The OEB received an excellent practical submission from Toronto Hydro's expert that suggested that the valuations are also driven by other management motives such as risk diversification (regulatory and other), operational synergies etc. The financial academics, at best, had little to counter this submission, other than to suggest that financial theory suggests that an investor can better risk diversify their portfolio than a company and its management.

While we do not disagree with the portfolio theory, we see that it has little relevance here. In all practical circumstances management is driven to pursue returns and hence value, while reducing risk. They do and will consider the practical considerations of regulatory risk and diversification in that pursuit. Whether that is congruent with portfolio theory on risk diversification is of no matter to them as this does not align with their goals or compensation. Therefore valuations are and will be coloured by this drive and the specific circumstances of the acquisition under consideration.

Should the regulator care? We should encourage this and the OEB as regulator should embrace and encourage management that properly and aggressively pursues returns and higher valuations. That is healthy for the industry – that drives efficiencies. That drives consolidation. The issue here is how to approach excessive returns.

We respectfully suggest that the regulator should not be fixated on valuations as those will be driven by many drivers including entity specific and macro factors, as well as rate of return. To spend considerable time and regulatory burden proving, comparing and controlling this relationship is not efficient. Regulatory efficiency, industry rationalization and alignment of all stakeholder interests would be better protected with an earnings sharing mechanism that would allow management to aggressively pursue better returns that will benefit the company and the ratepayer.

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

In our response to question 2, we outlined that the Proposal will have an uneven and inequitable result for utilities throughout the industry as it will impact distribution revenues and cashflows differently. What that does for consolidation is not easily predictable. If certain utilities are punished and undervalued in relation to their peers then perhaps they will be motivated to sell. On the other hand, maybe municipal owners will say lets retain this entity until embedded issues are resolved.

In general terms, the *actual* capital structure attainable by an entity is not an impediment in any way to the desirability of a transaction. That will be measured by the earnings before capital service costs of the pre-capital servicing return of the target company. We do not believe that differing *actual* capital structures have any impact (positive or negative) on the prospects of physical consolidation of electricity distributors.

We do not believe that the OEB should be concerned with this and should not have it as one of its objectives and it is representative of the regulator over-thinking the situation and being concerned with issues that the market can address. In addition, the OEB in the Technical Conference to date has provided no definitive response or reason as to why this should be a consideration and how their Proposal supports or disrupts that consideration.

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

a. Yes

b. 9.00%

c. At the time that distributors file rebasing applications

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

a. No, it is not appropriate to make such adjustments using the inflation proxy as that is not the sole determinant in the market establishing those rates. As the capital rates have a significant impact on the financial performance of a utility, a proxy should not be used in the first place. Further, we believe that the current proposed GDP-IPI is a questionable inflation proxy and we have contended that it does not track the inflation in our industry. To use it further in establishing capital rates would add insult to injury.

b. The implications are that there is further introduction of regulatory lag and that is a problem that needs to be resolved and not augmented. Introduction of proxies and shortcuts to reduce regulatory lag at the expense of utilities is not a good approach. Regulatory lag needs to be addressed at a holistic level and that would include looking at changing the annual distribution rate implementation date, improving data filing and compliance procedures, and shortening the rate application review process through various methods including the introduction of effective benchmarking. Addressing these elements would allow for the shortening of the time for receipt of data, its review and its consideration and implementation into rates.

6. Capital Structure

Several distributors have raised concerns about migrating quickly to a new capital structure. Consider a scenario whereby the Board was 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.

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

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

Response

i. **The Board staffs question is based upon the premise that a 60/40 common debt/equity split for all LDC's is appropriate, to which we fundamentally disagree.**

The Board staffs proposals of debt / equity splits, in isolation of the return rate changes, will result in rate increases for the approximately 43% of customers serviced by utilities with an existing 65/35 debt equity structure and rate reductions for the approximately 39% of those customers serviced by utilities with a 55/45 or 50/50 debt equity structure.

These rate adjustments are being proposed without any apparent consideration of the existing rate level differences between these utilities.

ii. **The Board should maintain the existing debt equity structures used in the 2006 EDR filing 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

a. The question is wrongly premised on the assumption that the common capital structure can be accommodated if unique risk elements are absorbed through Z factor relief. In our submission to you of August 14, 2006 we described to you and illustrated that an optimum capital structure of a utility is specific to that utility based on first and foremost the cashflows that are produced, and secondly the risks inherent in those cashflows. Both elements need to be considered and rationalized in defending the application of a common capital structure. In fact, we have suggested to you that because you cannot readily do this, to balance regulatory efficiency while acknowledging these unique differences, and to achieve a fairer result for all utilities, that a simpler and more effective approach would be using the stratified capital structures based on rate base size – as conceptually embraced by the Cannon method.

Rate design, customer demographic, load and density, and quality of rate base are significantly different for all utilities across the industry which impacts cashflows and risk to those cashflows. Both those cashflows and risks will determine the optimum capital structure that a given utility can attain. To focus solely on individual risks to the utility while overlooking its cashflow capabilities is inappropriate given that there are different cashflows to every utility. To impose a 60/40 capital structure throughout the industry, which arguably is a capital structure that is more in line with larger utilities with greater cashflow and less underlying risk, we argue is an inappropriate starting point.

In fact, in the Technical Conference proceedings to date there have been no submissions that have adequately addressed the ability to attain an optimum capital structure. The experts have intimated that an optimal capital structure can only be observed through empirical evidence.

Why is that? It is because companies arrive at an optimum capital structure by pushing for the maximum amount of low-cost debt to the point where insolvency or leverage concerns do not impact on the cost of the underlying debt or the cost of equity. That optimal capital structure and debt/equity ratio is achieved by the utility based on its dealings with its individual capital providers taking into consideration the individual cash flows and risks associated with that utility.

So we rely on empirical evidence, however the empirical evidence cited in this regard is weak as it applies to large non-comparative companies that bear no resemblance in cashflows and risk to the average of the 90 or so utilities of various size in Ontario. The best data that we have is the OEB collected data that all parties have commented on as being unusable.

So where are we at?

i. **Can unique business risk be addressed in a Z factor?**

Yes it can but it does not solve the issues related to the Proposal.

ii. **Is a Z factor adjustment mechanism efficient regulation?**

We suggest that the regulatory process and burden of proof to address this issue through a Z factor mechanism is too large and expensive. Furthermore, if we cannot address the concept of unique risk and cashflows now in these proceedings, how will it be better accommodated in a Z factor application?

b. Not applicable - based on response to a)

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?

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

Response

a. Not applicable – we do not believe that the historical data and responses to this question will further the process. We do believe that the Proposal amount is inadequately substantiated.

b. Not applicable – we contend that the question is getting way too granular here. In fact we suggest that rate base in the long run will not be financed with 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)?

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 Cap Ex budget less depreciation)?

Response

In general, planned (or budgeted) capital expenditures should be funded through the normal revenue streams (operation expense recover and/or rate base return rates) as opposed to a Z-factor adjustment. As we are all aware the Z-Factor adjustment was designed to "address extraordinary events, which could include catastrophic natural events and the recovery of additional approved costs outside of the PBR rate adjustment mechanism framework (such as business re-engineering or transition costs)". If adequate return rates and operating expense levels are approved in a timely fashion (minimizing regulatory lag) these normal planned capital expenditures should not require a Z-factor adjustment.

a. We recently completed substantial upgrades to our infrastructure which was a six year program that commenced at or around 1999 and was self-funded through internal resources. Based on that experience we suggest to you that the concerns raised by many are real and that infrastructure investment is a real concern that requires real and appropriate corporate returns. If we were to now embark on such a program it would all be externally financed and we would expect that this Proposal would not positively impact that implementation.

b. The Z factor application and disposition mechanics are not a desirable approach; however, to the extent used must be clearly articulated and efficient for all parties so that regulatory lag is minimized.

c. There are probably other options available; however it would be an onerous task to adequately explore these other alternatives in this timeframe. This is the research that should have been initially considered in the staff Proposal.

d. No threshold should be dictated. The applications should be assessed as to it merits and relative materiality when received – to address unique differences.

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 Cap Ex 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

No Comment

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

a. No Comment

b. No Comment

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.

a) Are the proposed increments reasonable?

b) If not, what should they be, and why?

Response

a. In the context of lower return rates (from debt/equity structure and return rates) it is completely inadequate. A conservative estimate on smart meter spending in the London Hydro service territory is $40 million. We are currently planning to spend the majority of this expense in the 2008-2010 budget years. Our current recovery rate of $0.30 per residential customer will net a total of $450,000 per rate year. If rebasing occurs in 2010 (using 2008 as a base year) only ½ of the 2008 expenditure will be included in the rate base (assuming rules similar to 2006 EDR are utilized). The full value of the smart meter expenditure will not be incorporated into rate base until the 2013 (potentially); we submit that this is unacceptable considering the current funding plan. Even if the full

$4.00 estimated revenue recovery per residential meter is initiated, London Hydro will only recover $6 million per year. The lag on expenditure and recovery is still uncertain.

a. **It should clearly match the rate of expenditure eliminating all regulatory lag and on a specific application basis like CDM budgets.**

The above include all of London Hydro's responses to the OEB Staff questions.

If you require any further information, please contact me directly.

Sincerely,

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