EB-2006-0088/89

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.

ANSWERS TO BOARD STAFF QUESTIONS

FROM THE

SCHOOL ENERGY COALITION

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)?

Not applicable.

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.

Not applicable.

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?

It appears clear from the input given the Board to date that there is a substantial reluctance on the part of municipalities to part with their very lucrative LDC investments. From the point of view of a municipality, they own a utility that carries almost no risk as an investment, but generates a weighted average cost of capital (ie. return) of 7% to 8%, far greater than their returns on other investments. Reducing the equity component, and moving to a more realistic ROE, combine to reduce the overall return on utility ownership. This makes owning the distributor less "addictive", and would allow muncipalities to consider mergers and acquisitions with a more open mind. They would still have many other reasons to retain ownership, but the annual increment to their budget would be less relevant.

4. **<u>Return on Equity – Cannon Methodology</u>**
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:

We do not believe that the Cannon methodology should be retained. In our view, it overstates the appropriate ROE, as is clear from the evidence of both Dr. Booth and Drs. Lazar and Prizman. Our answers below assume that the Board determines otherwise, and elects to retain the Cannon approach.

a. Should the ROE be updated for May 1, 2007 distribution rate adjustments?

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)?

The Cannon methodology only works if you start from his original ROE and work forward incrementally. Starting from 9.00%, for example, would not only be methodologically incorrect, but would produce a result that has no theoretical justification. It would just be random.

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?

Assuming retention of the Cannon approach, ROE at rebasing would simply update the calculation in the manner Cannon stipulated.

5. **<u>Return on Equity and Rebasing</u>**
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?

No.

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?

Not applicable.

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?

There are some LDCs that should be allowed a reasonable transition period to move to a lower equity percentatge. The use of a fixed transition period, however, ignores the substantially different capital needs of the utilities. See our comments below on an alternative approach. We agree that, however the transition is accomplished, it can be incorporated into the K-factor, as long as the K-factor is specific to the individual LDC, as many parties have proposed.

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

We believe that the transition to a higher debt level can be accomplished most easily by a formula that assumes that all capex are financed by debt until the desired debt/equity ratio is achieved. For example, a utility with $200 million of rate base, currently at 50/50 debt equity, has to increase its debt level to 60/40. If its annual capex are $10 million, and annual depreciation is $5 million, then after one year its debt would increase from $100 million to $110 million, while its rate base would increase from $200 million to $205 million (54/46). After a second year, debt would increase to $120 million, and rate base to $210 million (57/43). After the third year, debt would increase to $130 million and rate base to $215 million (60/40). The length of the transition would be determined by the level of new capital spending needed for the specific utility. In the case of utilities with very low annual capital spending, an acceleration of the adjustment might be required, but for most utilities the transition would take no more than three years.

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?

The appropriate solution for a substantial change such as this is cost of service, since the impacts are not likely to be simple enough for a straightforward adjustment. The proposed IRM would allow for that in any case, since any distributor could apply for an exemption from their licence condition in extreme circumstances. Upon receiving such an application, if the Board thought that the impact on the financial viability of the applicant was potentially significant, it could respond by a) accelerating the LDC's cost of service rebasing, b) seeking evidence on the specific impact of concern, or c) any number of other such solutions. Therefore, in our view a Z-factor for this kind of extraordinary event is unnecessary. If the Board want to assist LDCs, it could provide that material losses of revenue are only likely to be considered serious if they would reduce effective ROE to, say, the level of the debt rate, but that would be a guideline only. The impacts of revenue losses would vary from one distributor to another. It would not, in our view, be good regulatory policy to risk the financial viability of distributors by restricting the Board's flexibility in these situations.

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)?

As a guideline, an impact that would reduce the effective ROE to below the debt rate would prima facie be serious enough to warrant a detailed review.

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?

Not applicable.

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)?

No. Capital spending adjustments must be made in the context of a cost of service review, so that all impacts of the capital demands are considered, and so that capital and operating pressures on rates are balanced against the resulting impacts on ratepayers. Also, if capital spending is separate from the IRM, the Board creates a faulty economic signal for utility managers, in which opex must be contained but capex are less restricted. This necessarily biases utility managers in favour of capital solutions. Managers should be selecting optimal solutions, without such an artificial bias.

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

No applicable.

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

No.

***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)?***

Not applicable.

10.	**<u>CI-factor</u>**

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?***

As per our comments above, a CI-factor would send the wrong signals to utility managers.

***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?***

Not applicable.

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

[The answers to this and the balance of the subquestions in #10 assume that, despite our urging, the Board determines that some form of CI-factor is appropriate. We do not agree with that result.] The Board should not approve a capital budget without reviewing the capital spending plans on which it is based. Once the Board disaggregates capital spending from other components of rates, in our view it has an obligation to ensure that the capital spending amount approved is reasonable in the circumstances, and it cannot accomplish that result without reviewing capital spending plans.

***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?***

Either 2006 rates are just and reasonable or they are not. If they are not, then the problem is with 2006 rates, and it is more serious than the level of rate base. If 2006 rates are just and reasonable, however, then by definition the rate base number incorporated into those rates is a reasonable one and should not be further adjusted. Mathematically, any further adjustment would of necessity make 2006 rates no longer just and reasonable.

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

Capital spending should as a matter of normal utility management be based (to the extent it is driven by load growth) on weather normalized load growth, so any adjustment factor should also use that base.

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?

Parameters should not be used unless tested in a proper review process.

11. **<u>Declining Customer Base</u>**

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?

The impact of growth on productivity is not binary, but a relatively continuous spectrum. If the fair average productivity factor across the province is 1.0%, that would include LDCs with negative growth and those with high growth. On that assumption, a variable productivity factor would only be fair to ratepayers if the average productivity factor across the province continued to be 1.0%. Subject to our more general comment below, it would make sense, in our view, to have a productivity factor that varied from 0.7% to 1.3% based on growth level, as long as the growth level metric results in the overall average remaining constant.

We note that we continue to be concerned that adjusting productivity factors for growth deals with one exogenous variable while ignoring other, more important variables. For example, a distributor that has been diligent in keeping its costs down over the years, and so is already highly efficient (which in our view is most obvious by looking at their customer bills relative to other distributors), is penalized by having to live with the same productivity factor as their less efficient peers. We continue to believe that a productivity factor that varies by relative customer bill level (higher factor for those with higher bills) would start to take steps in the direction of fairness between distributors (and, of course, between their customers).

b. Are there alternative approaches that the Board might consider to address constraints on operating efficiencies possible under declining customer base conditions?

Distributors with declining customer bases should be the prime candidates for mergers and acquisitions. The Board should, in its cost of capital policies, ensure that the municipalities that own less viable distributors are motivated to look at mergers and acquisitions favourably.

12. **<u>Smart Meter incremental funding</u>**

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?

Yes.

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

Not applicable.