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December 12, 2006

Delivered by E-mail and Courier

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, Suite 2700
Toronto, Ontario
M4P 1E4

Dear Ms. Walli:

Re: Re: Ontario Energy Board File Nos. EB-2006-0088/EB-2006-0089
Cost of Capital and 2nd Generation Incentive Regulation Mechanism

We are counsel to the Coalition of Large Distributors (Enersource Hydro Mississauga, Horizon Utilities, Hydro Ottawa, PowerStream, Toronto Hydro and Veridian Connections, collectively referred to as the "CLD") in the above-captioned matter.

The CLD has read the Ontario Energy Board's (the "Board's") draft "Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors and Associated Guidelines" (the "Report") and concurs with the Board's determination on many of the issues involved in establishing the cost of capital. However there are some issues that the CLD urges the Board to reconsider its findings in certain areas of the Report, as discussed below.

Cost of Capital

The CLD supports the Board's proposal to maintain local electricity distribution companies' ("LDCs'") return on equity at 9% for 2007 as a transitional mechanism. The CLD commends the Board for balancing this complex issue by means of a simple, mechanistic update to 2006 rates using the GDP-IPI – X formula. The Board has correctly noted that, should the current ROE of 9% also be updated for 2007 rates, there would inevitably be some double counting as the GDP-IPI formulation does include some consideration of changes in cost of capital (p. 29). Additionally, changing only one element of an LDC's revenue envelope (the return on equity) amounts to a partial rebasing, which the Board should reject on grounds of fairness. CLD supports the concept that changing return on equity should occur only when LDCs apply for a full cost of service rebasing.

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The CLD remains concerned about the Board's proposed cost of short term debt in the capital structure, the arbitrary basis for determining the amount of short-term debt within the capital structure, and the lack of a capital adjustment factor for the reasons outlined below.

- The Board's assertion that it "does not accept a need for a capital investment factor in an incentive regulation mechanism because the implementation of comprehensive incentive regulation is intended to encompass both capital and operating costs" (page 37) is particularly troubling. The CLD notes that 2nd generation is not a "comprehensive incentive regulation" – it is simply a price adjustment mechanism over a couple of years. This fact was conceded by the Board's expert Dr Mark Lowry during the Technical conference. In addition the CLD would agree that "containing capital expenditures is a key to good cost management" and that under incentive regulation, a distributor is responsible for making its investments based on prevailing business conditions. However, since market opening LDCs have been required to balance these investment decisions based on business conditions with unforeseen regulatory and legislative obligations. The CLD would suggest that this be discussed with stakeholders in the context of the more permanent 3rd generation IRM scheme.

- Further analysis of LDC working capital would provide an appropriate signal of an LDC's short-term liquidity needs which should be the basis for an appropriate short-term debt component in rate base. The arbitrary 4% component proposed by the Board does not support the achievement of an efficient capital structure, or a proper weighted average cost of capital for LDCs.

- Of greater concern to the CLD is the Board's proposed treatment of the cost of short-term debt. The CLD notes that, the proposed average of the 3-month bankers' acceptance ("BA") rate plus a fixed spread of 25 basis points is too low, and recommends that the Board change the calculated deemed short-term debt rate to a rate that more accurately reflects LDCs' cost of short-term funds of 3-month BAs plus 75 basis points. In practice, the actual spread is entirely influenced by the LDC's credit rating.

- For additional clarity concerning the ROE updating methodology applicable for rate years following 2007, the CLD also wishes to set out its view of that process and the components involved. The CLD understands that the updating process applies to long bonds and the equity risk premium, and that the 50 basis point floatation cost factor remains static. In the result, movements in long bond rates affect the level of the ERP, but after those two elements are determined, the 50 bps is added to their sum to produce the final allowed ROE.

Incentive Regulation

The CLD is supportive of the Board's objective to provide regulatory certainty to distributors during the Rate Plan as several rate-related studies are carried out. However in developing a more permanent 3rd generation IRM and carrying out these rate-related studies the CLD would urge the Board not to consider 2nd Generation IRM as a scheme that provides incentives to distributors; it is simply a formulaic rate adjustment method.

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Distributors do not have an incentive to achieve further efficiency improvements within the 2nd Generation IRM if the resulting cost savings could be "clawed back" in the near future through rebasing. A mechanism which ensures that utilities continue to benefit from cost savings for a substantially longer period of time needs to be considered in 3rd generation IRM. A more permanent incentive regulation mechanism entails the protection, promotion and creation of incentives that are essential to its success.

The price cap formula is simple and transparent, thereby easing regulatory burden for the regulator and distributors. Although the proposed price-cap rule does not recognize differential efficiencies across utilities and requires a common productivity improvement of 1%, the CLD anticipates that future refinements will incorporate such differences.

As the Board begins to develop its 3rd generation IRM, the CLD would urge the Board to consider the paper entitled "INCENTIVE CREATION AS THE KEY TO INCENTIVE REGULATION" submitted by Dr Yatchew in review of the Board staff discussion paper. Dr Yatchew outlines very clearly the requirements for an effective incentive regulation mechanism scheme.

Other factors

Service Quality Requirements (SQR):

The CLD does not object in principle to the establishment of minimum service quality and reliability standards, in line with good utility practice and historical performance levels. However, the CLD observes that the prior service quality review exercise undertaken by the Board found that there were definitional and data consistency problems associated with some of the existing measures (e.g., locates, emergency response), and with the ability of some utilities to accurately record measures of reliability. Therefore the CLD concludes that imposition of minimum standards should await and be informed by the resumption and conclusion of the service quality review. The CLD looks forward to participating in that review.

The CLD also notes that, since the rebasing exercise will implicitly assume the costs of the existing service and reliability levels for each utility, it would be unfair to substantially increase the performance standards in these areas without recognition of the increased costs that would be incurred to meet them.

Allowance for smart meters:

The CLD submits, and believes, that many of the Smart Meter Investment Plans ("SMIP") submitted on December 15th will demonstrate that the $1 smart meter rate rider originally proposed is insufficient to cover the substantial financing needs for the introduction of smart metering.

As a result, many distributors will likely be required to submit rate applications to recover smart meter costs beginning May 1, 2007. However we suggest that the more pragmatic approach would be for the Board to deal with an allowance for smart meter within the 2nd generation IRM rate adjustment. This would help ensure a timely implementation of smart meter programs. Dealing with several individual rate

applications would risk delays in the installation of smart meters and potentially affect the implementation of the government's overall program.

There are a few ways the Board could facilitate a timely implementation of smart meters by providing funding to distributors for their investment requirements and to help mitigate future rate impacts. The first would be to approve a generic smart meter rate rider to May 1, 2007 rates. The quantum would be informed by distributors' SMIPs. The second method would be for the Board to approve a generic per unit smart meter rate rider. This would take into account the different implementation rates across LDCs. Finally, the Board might adopt a utility specific adder. This is the most accurate approach as the rider would be based on utility specific costs. The objective underlying all options for setting a smart meter rate rider or rate component is to compensate LDCs for prudent capital, operating, and financing costs along with the regulated return on equity, consistent with the deemed capital structure supporting LDC investments. Differences between the Smart Meter Rate Rider/ Component and this level of required compensation is carried in variance account 1555 and settled through future rate adjustments.

In closing, the CLD appreciates the Board's reconsideration of its initial intention to codify the Cost of Capital and Second Generation IRM policies, and its replacement of that approach with the establishment of a simple, mechanistic update to 2006 electricity distribution rates and Cost of Capital and IRM-related guidelines. The use of guidelines will enable LDCs to base their 2007 rates applications on the best available information and using the most appropriate methodology – the Board will have the necessary information before it to support its Decisions on just and reasonable rates for 2007, while an individual LDC will, if necessary, have the opportunity to address specific issues with the OEB in order to ensure that those just and reasonable rates will provide a reasonable opportunity for the LDC to earn the allowed rate of return.

Yours very truly,
Borden Ladner Gervais LLP

Original Signed by James C. Sidlofsky for J. Mark Rodger

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