



The Voice Of Ontario's Electricity Distributors

December 12, 2006

Board Secretary
Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto, ON M4P 1E4

Via email to BoardSec@oeb.gov.on.ca and by courier

Dear Board Secretary:

**Re: Multi-year Electricity Distribution Rate Setting Plan
Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation
Mechanism (EB-2006-0089)**

The Electricity Distributors Association ("EDA") is the voice of Ontario's local distribution companies (LDCs).

Enclosed are the comments of the EDA in response to the draft "Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors and Associated Guidelines".

Please direct any questions or comments to Debora Steggles at 905.265.5323 or at dsteggles@eda-on.ca.

Yours truly,

Debora Steggles
Vice President, Policy and Government Relations

Encl.

**EDA Comments on Multi-year Electricity Distribution Rate Setting Plan
Cost of Capital (EB-2006-0088) and
2nd Generation Incentive Regulation Mechanism (EB-2006-0089)**

In its draft Report on Cost of Capital and 2nd Generation Incentive Regulation, the Board sets out several proposals. The most significant change is the proposal to adopt a single deemed capital structure of 60% debt to 40% equity for all LDCs, regardless of size.

In the draft Report, the Board proposes to make a finding rejecting the proposition that size is a factor in assessing the riskiness of LDCs, despite the fact that nothing was put before the Board during the consultation to justify such a conclusion, other than the unsupported assertions of Board staff. In fact, the Board has previously determined that size was a factor to be taken into account and classified LDCs into four size-based categories for the purpose of establishing capital structures for ratemaking purposes.

The draft Report points to the previous consolidation of LDCs that occurred and states at p. 6:

A recent Government announcement of a new two-year transfer tax exemption may spur further consolidation. This trend underscores the need to ensure that the Board does not create barriers to consolidation. In the Board's view, one of those barriers is the differing capital structure of distributors.

This proposed Board view is not supported by any evidence. What the draft Report does not take into account is that all of the previous consolidation occurred during a time when, in fact, size was taken into account. There was nothing before the Board during the consultation process, other than the unsupported assertions of Board staff, to suggest that this had any impact on consolidation. Furthermore, no party has identified this as a barrier to consolidation. In fact, since the last round of consolidation, the primary barrier has been the transfer tax, not size-based capital structures.

In any event, the issue is not whether there needs to be further consolidation of LDCs. The issue is whether size is a factor in determining a fair return on invested capital. The draft Report refers to comments from LDCs regarding the need to take size into account. However, there were expert reports produced during the consultation that went beyond mere comment on this issue. The report does not give any recognition to the fact that, in addition to Dr. Cannon's original work and the Board's adoption of sized-based capital structures, there were additional reports from others, including Dr. Morin, Mr. Camfield and indeed the experts retained by Board staff, who all identified size as a relevant factor.

The draft Report states at p. 7 that: "A distributor, regardless of size, when planning and making decisions to manage its business risk, will organize its financing in line with its business needs." This is undoubtedly true, but this does not mean that business risk is not affected by size.

At p. 7, the draft Report also states:

This conclusion is corroborated by the Board's examination of 2005 financial data filed by electricity distributors, which show that the distributors exhibit a variety

of actual debt-equity structures. According to the data, many smaller distributors have leveraged themselves with debt to levels in excess of 50%. These distributors do not appear to be experiencing particular financing concerns as a result of this debt load.

This is a problematic statement. When the available data from the 2006 rates filings of LDCs and from the report prepared by Lazar and Prisman is analysed, it would appear that the vast majority (75 percent) of the small-sized LDCs actually have debt levels less than the deemed debt level of 50 % for such LDCs (see Appendix A: Comparison of actual and deemed capital structures LDCs).

If the Board is concerned that the timeline for incentive regulation will be adversely affected by a proper consideration of evidence at this time, then it should be under no illusions on the impact to that timeline that will result from ignoring the material that was presented in the consultation altogether and proceeding on the basis of unsupported assertions about the irrelevance of size, and worse still, on the basis of irrelevant considerations such as LDC consolidation.

The Board, in its Draft Guideline on ROE (1997) stated “The Board is of the view that an adjustment to the utility-specific risk premiums should be done only when there is a clear indication that relative risks have changed. The Board also believes that the capital structures should be reviewed only when there is a significant change in financial, business or corporate fundamentals”.

As things stand, there has been "no clear indication that relative risks have changed" and there has been no evidence that there has been a "significant change in financial, business or corporate fundamentals". In fact, Board staff stated that they:

do not have a risk assessment of the Ontario electricity distribution industry. Risk as considered by Board staff is on a relative financial basis derived from the work produced by the consultants retained by Board staff.

However, the Board staff consultants indicated that "there is less variability for each measure of profit rates as the LDCs increase in size". Variability in profit measures is a textbook definition of risk which is why the Board staff consultants recognized a need for size-based capital structures.

In the absence of a proper evidentiary basis to support a significant change to a single deemed capital structure of 60% debt to 40% equity for all LDCs, the Board should proceed on the basis of the only approach that has been properly established to date, namely the Cannon methodology with the size-based deemed capital structures. LDCs face enough challenges ahead as it is and an approach that borders on arbitrary is not the right way to proceed, particularly when there is a real risk that it will not yield a fair return on investment.

APPENDIX A - Comparison of actual and deemed capital structures LDCs

Utility	Size - rate base	Debt Ratio - debt/(debt+equity)	Deemed debt ratio	Difference
	(a)	(b)	(c)	(b)-(c)
Source		L & P report Table 2	EDR 2006	
Canadian Niagara Power - Port Colborne	Small	0.0%	50.0%	-50.00%
Fort Frances Power Corporation	Small	0.0%	50.0%	-50.00%
Grand Valley Energy Inc.	Small	0.0%	50.0%	-50.00%
Midland Power Utility Corporation	Small	19.2%	50.0%	-30.80%
West Coast Huron Energy Inc.	Small	20.3%	50.0%	-29.70%
Lakeland Power Distribution	Small	24.9%	50.0%	-25.10%
Brant County Power Inc.	Small	27.3%	50.0%	-22.70%
Sioux Lookout Hydro Inc.	Small	29.1%	50.0%	-20.90%
Tillsonburg Hydro Inc.	Small	29.3%	50.0%	-20.70%
ELK Energy Inc.	Small	31.3%	50.0%	-18.70%
Kenora HE Corp. Ltd	Small	31.6%	50.0%	-18.40%
Collus Power Corporation	Small	33.3%	50.0%	-16.70%
Hydro 2000 Inc.	Small	35.0%	50.0%	-15.00%
West Perth Power Inc.	Small	36.9%	50.0%	-13.10%
Parry Sound Power Corporation	Small	37.5%	50.0%	-12.50%
Rideau St. Lawrence Distribution Inc.	Small	37.5%	50.0%	-12.50%
Hearst Power distribution Co. Ltd.	Small	37.9%	50.0%	-12.10%
Wasaga Distribution Inc.	Small	38.1%	50.0%	-11.90%
Guelph Hydro Electric Systems Inc.	Small	39.7%	50.0%	-10.30%
Haldimand County Hydro Inc.	Small	39.9%	50.0%	-10.10%
Norfolk Power Distribution Inc.	Small	40.5%	50.0%	-9.50%
Festival Hydro Inc.	Small	41.0%	50.0%	-9.00%
Milton Hydro Distribution Inc.	Small	41.3%	50.0%	-8.70%
Bluewater Power distribution corporation	Small	41.7%	50.0%	-8.30%
Centre Wellington Hydro Ltd.	Small	42.2%	50.0%	-7.80%
St. Thomas Energy Inc.	Small	42.5%	50.0%	-7.50%
Westario Power Inc.	Small	42.5%	50.0%	-7.50%
Ottawa River Power Corp	Small	42.8%	50.0%	-7.20%
Innisfil Hydro Distribution Systems Ltd.	Small	43.5%	50.0%	-6.50%
Lakefront Utilities Inc.	Small	43.6%	50.0%	-6.40%
Northern Ontario Wires Inc.	Small	43.6%	50.0%	-6.40%

Oshawa PUC Networks Inc.	Small	44.2%	50.0%	-5.80%
Hydro Hawkesbury Inc.	Small	44.4%	50.0%	-5.60%
Whitby Hydro Electric Corp.	Small	44.8%	50.0%	-5.20%
Cambridge and North Dumfries Hydro Inc.	Small	45.5%	50.0%	-4.50%
Peterborough Distribution Inc.	Small	45.6%	50.0%	-4.40%
Grimsby Power	Small	45.7%	50.0%	-4.30%
Orillia Power Distribution Corp	Small	46.1%	50.0%	-3.90%
Halton Hills Hydro Inc.	Small	46.7%	50.0%	-3.30%
Wellington North Power Inc.	Small	47.0%	50.0%	-3.00%
Thunder Bay Hydro electricity Distribution Inc.	Small	47.3%	50.0%	-2.70%
Woodstock Hydro Services Inc.	Small	47.5%	50.0%	-2.50%
Erie Thames Powerlines Corporation	Small	47.7%	50.0%	-2.30%
Clinton Power corporation	Small	47.8%	50.0%	-2.20%
Orangeville Hydro Limited	Small	48.1%	50.0%	-1.90%
North Bay Hydro Distribution Ltd.	Small	48.2%	50.0%	-1.80%
Welland Hydro Electric System Corp	Small	48.9%	50.0%	-1.10%
Burlington Hydro	Small	49.1%	50.0%	-0.90%
Niagara Falls Hydro Inc.	Small	49.1%	50.0%	-0.90%
Kingston Electricity Distribution Ltd.	Small	49.3%	50.0%	-0.70%
Renfrew Hydro Inc.	Small	50.2%	50.0%	0.20%
Wellington Electric Distribution	Small	51.2%	50.0%	1.20%
Terrace Bay Superior Wires Inc.	Small	51.4%	50.0%	1.40%
Canadian Niagara Power Inc. (Fort Erie)	Small	53.5%	50.0%	3.50%
Brantford Power Inc.	Small	54.4%	50.0%	4.40%
Chatham-Kent Hydro Inc. (Middlesex Power)	Small	54.4%	50.0%	4.40%
Niagara-on-the-Lake Hydro Inc.	Small	56.0%	50.0%	6.00%
Veridian Connections Inc. Scugog	Small	56.5%	50.0%	6.50%
Gravenhurst Hydro	Small	58.3%	50.0%	8.30%
Waterloo North Hydro Inc.	Small	59.4%	50.0%	9.40%
Tay Hydro Electric Distribution Co. Inc.	Small	59.5%	50.0%	9.50%
Atikokan Hydro Inc.	Small	61.1%	50.0%	11.10%
Greater Sudbury Hydro Inc.	Small	71.1%	50.0%	21.10%
Cooperative Hydro Embrun Inc.	Small	80.9%	50.0%	30.90%
PUC Distribution Inc.	Small	90.2%	50.0%	40.20%
Espanola Regional Hydro Distribution Corp	Small	105.7%	50.0%	55.70%
Chapleau PUC Utilities corporation	Small	131.5%	50.0%	81.50%