NEWMARKET Hydro LTD.

conserve

December 14, 2006

Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, Suite 2700
Toronto, ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

RE: Newmarket Hydro Ltd. ED-2002-0553 and the Cost of Capital EB 2006-88

Newmarket Hydro has reviewed the November 30, 2006 Draft Report of the Ontario Energy Board (the "Board") on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors and Associated Guidelines (Draft Report). Of particular concern to distributors such as Newmarket Hydro was the Board's decision regarding the Capital Structure for utilities $250 million or below in assets. Regulatory decisions supporting tiered capital structures and/or higher returns to small utilities cited in Alberta, Ontario, Florida, Maine and California may have been overlooked without comment:

- In ***Alberta Energy and Utilities Board Decision 2004-052 issued July 2, 2004***, the Board set different capital structures for eleven electric and gas distribution and transmission utilities, based on their different business risk profiles, and then established a common generic return on equity to be applied to each of the utilities under its jurisdiction.
- The ***State of Maine Public Utilities Commission, 9/26/2000 ORDER (Part 2) Docket No. 2000-96 and Docket No. 2000-175,*** they felt that "…to the extent that smaller firms may confront higher business risk than their larger counterparts, a lower debt ratio (and thus a higher equity ratio) can offset an increase to total risk by reducing financial risk (because total risk equals the sum of business and financial risk)."
- The Florida Public Service Commission established a leverage formula in ***Order No. PSC-03-0707-PAA-WS*** on June 13, 2003, whereby a small utility risk premium of 50 basis points is added to reflect that the average Florida WAW [water] utility is too small to qualify for privately placed debt.

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- The California Public Utilities Commission adopted, per ***D.99-03-032 and D.05-12-020***, a 30 basis point adder to a small utility ROE as a risk premium.
- The ***Ontario Energy Board in the Natural Resource Gas Limited (NRG) Decision with Reasons*** issued ***September 20, 2006*** found that an equity risk premium and higher equity cushion were methods of compensating for size and business risk. "... the Board is of the view that a risk premium of 50 basis points over Enbridge Gas Distribution Inc. is justified. It should be noted that while the Board has rejected the requested 150 basis points risk premium, it has increased the equity component from 35 to 42 percent which offsets this in part."
- the Board's "Cannon methodology" addressed the higher risk faced by smaller firms through the current tiered capital structure, allowing a higher equity cushion for small firms.

As provided in our experts' filing by Dr. Roger Morin and Energy and Environmental Economics, Inc., we disagree with the Draft Report's suggestion of a uniform capital structure and/or return without regard to the unique risks faced by small utilities. The cases cited, as well as this Board's own decisions and experts provide precedence for differentiating among small and large utilities. Furthermore, we believe that changing the current tiered capital structure will only increase the oversight burden on the Board as small utilities file for exceptions to this guideline.

Newmarket Hydro would also wish to comment directly on the following statements in the Board staff report:

1. "In particular, there has been considerable restructuring through mergers and acquisitions. While there were over 300 distributors in 1998, there are now less than 90. While there are some very small distributors in existence, the trend has been toward fewer and larger distributors. A recent Government announcement of 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."
   - The reduction of distribution utilities from 300 to fewer than 90 appears to prove the case that the tiered structure does not impede industry consolidation. As noted by numerous utilities during the proceeding, the great impediment to consolidation is the transfer tax, not the tiered capital structure. The Draft Report acknowledges and confirms this point – then reaches the opposite conclusion.
   - It is not obvious from the Board's objectives that it is tasked with encouraging consolidation; and, the tiered structure clearly does not create a barrier to consolidation. The implication that a tiered structure is as an impediment to industry consolidation is not obvious.

2. "The electricity distribution sector has undergone significant change over the last eight years, and that change supports the move from size-related capital structures to a common capital structure."

- Change equates to risk for regulated utilities. We believe that small utilities are disproportionately affected by regulatory risk given their limited resources and access to costly expertise. The US Supreme Court found in *Duquesne Light Co. et al. v. Barasch et al.* (109 S. Ct. 609, 1989) that regulatory risk is a special class of risk that must be recognized by regulators when setting the allowed rate of return. The Supreme Court of Canada in *Northwestern Utilities vs. City of Edmonton* [1929], 2 D.L.R., p. 8 states that rate levels should be just and reasonable to the consumer as well as to the utility; and in the latter case, the earnings should yield a fair rate of return on money invested. Risk can be offset through higher allowed returns to equity or a greater equity cushion. During the past eight years of transition, the Board, rather than raise equity returns to attract capital, unilaterally reduced Allowed Return on Equity from 9.88% to 9.0%. The Board is now contemplating that the least diversified (smallest) utilities should further decrease their equity cushion by 20% from 50% to 40% equity. In its filing, Newmarket Hydro has demonstrated a clear link between business/regulatory risks, size and fair returns to shareholders. The Board staff report ignores these risks to smaller utilities.

3. "The Board notes that load concentration risk, which was the primary focus of distributor concerns, is not necessarily related to distributor size. Horizon Utilities, Oakville Hydro and EnWin Powerlines are examples of mid-sized distributors with concentrated loads."
   - The Board should consider that these utilities are not mid-sized utilities in a North American sense; rather they fall within the micro-cap category studied by Ibbotson in their 2005 study on Firm Size and Return. The study reviews the smallest 20% of companies traded on the three major US exchanges. These companies have a 2004 market cap below $US 505M. The smallest 10% have a 2004 market cap below $US 263M, placing the utilities referenced well within the micro-cap category. Importantly, the incremental equity return not explained by CAPM increases as market cap diminishes (i.e. the smallest 10% attract a higher ROE than the smallest 20%).

4. "Based on changes to the sector over the last eight years and data from distributors' operations since 1999 the Board concludes that size is not a key determinant of, or proxy for, risk."
   - The Board has not presented any data that supports this statement. Eight years of data obtained during a market transformation period is referenced. This amount of data would not normally provide reliable information without substantial "scrubbing."
   - All elements of the cost of capital (capital structure, debt structure, debt rate, and equity return) are inextricably linked – one cannot be determined without the others. The changes proposed by the Board do not recognize these fundamental, inextricable relationships and may well result in the majority of cases to a cost of capital in violation of fair return principles.

5. "This conclusion is corroborated by the Board's examination of the 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 equity levels in excess of 50%. These distributors do not appear to be experiencing particular financing concerns as a result of this debt load."
    - It may be true that some smaller utilities had a higher debt to equity ratio than the deemed 50/50 structure at the time the 2005 financial data was analyzed. However, it may well be imprudent to infer from this data that a substantial change to the cost of capital would not impact the financial viability of Ontario's smaller LDCs. A single year's balance sheet is insufficient to describe future impact on all LDCs of the proposed drastic change to cost of capital. In fact, many smaller LDCs may not be viable in the long term if the cost of capital changes.
    - Debt levels are impacted by regulatory issues, such as a distributor's ability to incur additional municipal debt or receive additional municipal equity. Retaining earnings is currently one of the few ways Municipally-Owned distributors can increase equity to support capital expenditures without issuing new stock. Hence, the appearance of a high debt level as a percentage of rate base, may in fact be the result of balance sheet equity funded capex in advance of rate base.

6. "During the technical conference, one stakeholder acknowledged that 'small cap' firms do normally attract a risk premium in the market, but stated that information asymmetry is a major reason for this."
    - Information asymmetry was acknowledged as one among many reasons for the increased risk. The Draft Report says on page 7: "...load concentration risk, which was the primary focus of distributor concerns...", and one stakeholders' expert witness identified liquidity risk as another reason for the higher required return. In the final analysis, there are many reasons for the higher returns required by smaller firms. The Canadian Supreme Court required that utilities be allowed a fair rate of return on investment capital (see above). Numerous studies (e.g. Ibbotson, Fama and French) have noted a higher required rate of return for small firms. Further, Canadian regulators (including this Board) have ruled that small firms are entitled to a greater equity cushion to mitigate this additional risk.

The Board set the original regulatory framework at the time of deregulation from which all significant financial, strategic and economic decisions undertaken by utilities have been derived. Newmarket Hydro and others have heard from experts, cited studies and provided examples of utility board decisions supporting a risk premium for small utilities. The Cannon tiered capital structure allows small utilities to maintain equity cushion commensurate with their risk. This cushion benefits ratepayers, lenders and shareholders by ensuring a financially stable utility. Changing the regulatory regime raises questions of regulatory stability and fairness, and is sure to cause utilities to seek

relief from financial hardship. The relief may be in the form of an adder to equity returns or an increased equity cushion (or combination of the two – as in the NRG case).

On balance, Newmarket Hydro has been unable to reconcile the Draft Report recommendations for capital structure with information presented by experts in the technical conference and related filings. Given the dearth of supporting rational, we believe that the net result of the Draft Report will be to encourage small distributors to pursue alternative regulatory avenues, thereby increasing the demands upon the Board to ensure fair returns. We encourage the Board to review both the testimony and Draft Report and reconsider its position in favor of the current tiered capital structure.

Yours truly,

Iain Clinton, CA
Chief Financial Officer

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