Ontario Energy Association

Ontario Energy Board
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December 12, 2006

Re: EB-2006-0088 (Cost of Capital) and EB-2006-0089 (2nd Generation IRM)

We would like to take this opportunity to comment on the *Draft Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors*. The comments reiterate, at a high level, many of the views provided in the detailed submissions made by our members and in our own earlier submissions.

As the direct interface with Ontario's electricity consumers, Local Distribution Companies (LDCs) ensure the continued reliability of the distribution infrastructure while delivering on or facilitating many of the government's new priorities, including smart meters, CDM and the standard offer program. Ontario's economic prosperity and the well-being and quality of life of all Ontarians, is highly dependent on long-term investments in efficiency and infrastructure. A key element in fulfilling these objectives is creating a positive environment for investment through the introduction of commercial incentives into the regulatory process and ensuring fair returns on these investments.

In 1998, LDCs were restructured as commercial enterprises under the *Ontario Business Corporations Act*, in recognition of the gains to be achieved from business efficiency and innovation. In a key 2004 speech, the Minister of Energy noted that "the current disincentives for local distribution companies would be removed, and LDC's would benefit from empowering their customers to conserve electricity and making their own systems more efficient."[1] More recently, in meetings with the OEA, OEB Chair Howard Wetston also emphasized the importance of allowing LDCs to share in efficiency gains. Given this background and the urgency to deliver on government priorities, we have been very supportive of the Board's efforts to introduce stronger commercial incentives.

[1] "CHOOSING WHAT WORKS FOR A CHANGE", Speech by the Ontario Minister of Energy introducing the McGuinty Government's plan for the electricity sector, April 15, 2004. http://www.energy.gov.on.ca/index.cfm?fuseaction=media.speeches&speech=15042004

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Currently, returns for Ontario's utilities are on the low end of the North American scale and often make it difficult to justify longer term investments. Unfortunately, the initial Board staff proposals on Cost-of-Capital (CoC) and 2nd Generation Incentive Regulation Mechanisms (IRM) further exacerbated this problem by prioritizing short-term cost containment and simplicity in the regulatory process, at the expense of fair returns to shareholders and longer-term incentives.

- In particular, the OEA had concerns about the proposed methodology for calculating Return on Equity (ROE), which produced ranges that were out-of-line with current business risks and comparable returns in other jurisdictions. On this topic, we agreed with the view of the investment community that the Board staff proposals failed to meet the Fair Return Standard established by the Supreme Court of Canada.
- We also emphasized the inherent differences between LDCs which underpinned the different capital structures and suggested that any changes be made carefully.
- Finally, we expressed concern about the short-term incentive periods proposed for 2nd Generation IRM, noting that they would do little to incent efficiency investments. Correspondingly, we recommended an immediate focus on developing a more robust 3rd Generation IRM.

In reviewing the recently released Draft Report of the Board, we are pleased to see a reconsideration of the methodology used to calculate ROE. By retaining the existing methodology, the Board recognizes the risks facing LDCs as they respond to a variety of cost pressures and government priorities. However, many of our distribution members – both gas and electric – continue to emphasize that current levels of ROE generated by the Board-approved formula remain inadequate. Several of our members also have concerns about the Board's one-size-fits-all approach to capital structure. Therefore, we emphasize the importance of using data to calculate the ROE that reflect both the nature and reality of global capital markets, as well as the importance of carefully thinking through any changes to the capital structure.

With regard to the 2nd Generation IRM, we recommend a quick implementation of the proposed approach and, in parallel, an immediate focus on developing the 3rd Generation IRM. In doing so, we note that the 2nd Generation IRM appears to be driven more by the principle of simplicity than by the desire to create real incentives, as any gains from efficiency investments are to be clawed back within 1-3 years. However, given the pressing need to implement a mechanism for determining 2007 rates, we suggest proceeding with the proposed 2nd Generation IRM mechanism, in full recognition of its shortcomings.

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More importantly, we urge immediate attention towards developing a more robust 3rd Generation IRM. To that end, we would like to make the following recommendations.

- First, it is essential that the term of the 3rd Generation IRM allow LDCs and their shareholders to benefit from efficiency gains. Without a sufficient time horizon, real and meaningful incentive-based regulation is simply not possible. Five years is increasingly being accepted by regulators as a *minimum* term.
- Second, we caution against a simplistic approach to the productivity factor (X factor). Ontario's LDCs are at differing stages in their evolution as commercial enterprises. While it is impractical to determine X factors for each individual LDC, we recommend that efforts be undertaken to assess the possibility of assigning X factors based on the relative performance of LDCs. The success of the plan, in our view, relies largely on the appropriateness of the X factor for each LDC.
- Finally, in contrast to the 2nd Generation IRM, we recommend the inclusion of a factor for capital investments. Many of these investments, in themselves, do not generate new revenues and, given the current investment climate, are unlikely to be made without regulatory incentives. Including a capital factor in the allowed ROE would create important incentives to undertake these investments.

We look forward to active participation in the development of the 3rd Generation IRM and recommend the OEB establish an industry task group to begin this process immediately.

In conclusion, we remain concerned that LDCs could be unfairly squeezed in an effort to minimize the impact of rising electricity prices on consumers' electricity bills, at the same time as they are being asked to deliver on a variety of new priorities. We strongly believe that distribution infrastructure is an essential component of the electricity cost structure and must not be overlooked as part of the government's commitment to true cost pricing. True commercial incentives that will drive long-term efficiency gains and new capital investments are a key part of minimizing that cost structure going forward.

Sincerely,

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