December 12, 2006

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

Ms. Walli:

Re: PWU Comments – Draft Report on Proposals for Cost of Capital (EB-2006-0088) and 2nd Generation Incentive (EB-2006-0089) for Ontario's Electricity Distributors

The Power Workers' Union ("PWU") represents a large portion of the employees working in Ontario's electricity industry and has utmost interest in regulatory proceedings that impact the energy industry and the provision of ongoing service quality and reliability to customers. Attached please find a list of PWU employers.

The PWU appreciates the opportunity to provide comment on the Draft Report: on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors.

Attached please find our comments.

Yours truly,

Don MacKinnon
President

List of PWU Employers

Atomic Energy of Canada Limited (Chalk River Laboratories)
Barrie Hydro
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brighton Beach Power Limited
Brookfield Power – Mississagi Operations Brookfield Power
Brookfield Power – Lake Superior Operations
Bruce Power Inc.
Corporation of the City of Dryden - Dryden Municipal Telephone
Corporation of the County of Brant
Electrical Safety Authority
EPCOR Calstock Power Plant
EPCOR Kapuskasing Power Plant
EPCOR Nipigon Power Plant
EPCOR Tunis Power Plant
Erie Thames Services Corporation
Goldman Hotels Inc. - Hockley Highlands Inn & Conference Centre
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
London Hydro Incorporated
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
Mississagi Power Trust
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Ontario Power Generation Inc.
Orangeville Hydro Limited
PUC Services Inc.
Sioux Lookout Hydro Inc.
Sodexho Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation

EB-2006-0087
EB-2006- 0088
EB-2006-0089

Power Workers' Union Submission on November 30, 2006 Draft Report on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors and Associated Guidelines

1 INTRODUCTION

On November 23, 2006, the Board issued a letter stating that, in the interests of achieving a more timely setting of electricity distribution rates for the 2007 rate year, the Board would discontinue its code-based approach and instead implement its cost of capital (CoC) and 2nd generation incentive regulation policies for 2007 rates by means of guidelines.

On November 30, 2006, the Board issued a draft "Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors and Associated Guidelines" (Draft Report). The draft report details the Board's policies on CoC and 2nd generation incentive regulation and includes guidelines on how the policies will be implemented and provides information for distributors in preparing their rate applications for the 2007 rate year.

This submission contains the PWU's comments on the Board's Draft Report.

2 COST OF CAPITAL

2.1 BOARD'S PROPOSAL ON CAPITAL STRUCTURE

The Board states that a single capital structure - a split of 60% debt, 40% equity – is appropriate for all distributors. The Board also states that it is not convinced that the concerns that have been expressed by distributors and certain members of the

investment community - that a reduction in equity thickness or return might result in a lower credit rating - warrant differentiated deemed capital structures.

On the other hand, the Board states that, in order to avoid the unintended consequences of transition causing gross mismatch between actual and deemed, it has determined that a staged implementation will be used. In addition, if the change in capital structure, and the increase in debt, leads to higher costs for new third-party debt, those higher costs will be reflected in rates.

The Board provides the following rationale for its support for a single capital structure: First, 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. In particular, there has been considerable restructuring through mergers and acquisitions resulting in fewer and larger distributors. In this regard, the Board makes a reference to the recent Government announcement of a new two-year transfer tax exemption, which may spur further consolidation. Therefore, the Board states, the trend underscores the need to ensure that the Board does not create barriers to consolidation, one of which is the differing capital structure of distributors.

Second, load concentration risk, which was the primary focus of distributor concerns, is not necessarily related to distributor size because there are mid-sized distributors such as Horizon Utilities, Oakville Hydro and EnWin Powerlines with concentrated loads and therefore, size is not a key determinant of, or proxy for, risk.

Third, 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, indicates that many smaller distributors have leveraged themselves with debt to levels in excess of 50%. The Board concludes that these distributors do not appear to be experiencing particular financing concerns as a result of this debt load.

2.2 *PWU'S COMMENT ON CAPITAL STRUCTURE*

In the PWU's view, the right capital structure is one that strives to strike a balance between the objectives of regulatory efficiency and regulatory effectiveness. The Board's decision to introduce a uniform capital structure creates the appearance of simplicity; however, it is a concern particularly to small-sized distributors in terms of regulatory effectiveness. The PWU finds the Board's reasons for its preference for a single capital structure unconvincing on the following grounds.

1. The PWU agrees with the Board that the distribution sector has gone through a considerable restructuring through mergers and acquisitions resulting in fewer and larger distributors. However, the fact of the matter is that there are still small-sized distributors to whom the 40% equity will pose a significant challenge for ongoing investment in their systems and for maintaining system reliability and quality. Moreover, the fact that there has been considerable restructuring through mergers and acquisitions despite the current differences in capital structures shows that the Board would achieve little from a single capital structure in terms of promoting consolidation. In fact, the PWU is not aware of any evidence presented to the Board, either in filed submissions or during the technical conferences, that suggest differences in capital structures have acted as barriers to consolidation. The one major barrier to consolidation, which the Ontario government acted upon recently has been the transfer tax. As the Board noted in the current report, the new two-year transfer tax exemption announced by the government is expected to spur further consolidation. This should be interpreted by the Board as a reason why it should not be unnecessarily concerned about the differing capital structure of distributors as barrier to consolidation but rather as a reason why it should not take a path that will have detrimental consequences on small distributors.

2. Second, some stakeholders raised concerns that during the transition to the new deemed structure some distributors will restructure and take on more debt, possibly violating existing debt covenants or risking credit rating downgrades.

The response of the Board seems to be that a distributor's actual structure does not have to be the same as its deemed capital structure. However, the deemed capital structure is understood to be the optimal structure, which the LDCs should strive to achieve. If the reality is that many LDCs cannot, as a practical matter, meet the deemed capital structure, they will have no choice but to make special application to the Board for a variation from the deemed capital structure. The Board has made it clear that such applications may require a significant length of time to process. If distributors have no choice but to file applications with alternative principles or mechanisms that are inconsistent with the Board's expected final report, they will have to face lengthy and expensive processes. The outcome, therefore, will be contrary to one of the primary objectives of the Board, i.e., achieving regulatory efficiency.

3. It is not clear how the existence of some mid-sized distributors with concentrated loads leads the Board to disregard the load concentration risk that many small distributors face or to conclude that size is not a key determinant of, or proxy for, risk.

To conclude, while appreciating the Board's effort to help distributors make the transition to a single capital structure through a staged approach, the PWU is of the view that the Board should opt for a mechanism that is both efficient and effective in the first place. In this respect, the PWU believes that the two size-based categories recommended by staff's consultants, Dr. Lazar and Dr. Prisman, i.e. a 50/50 debt-equity ratio for all LDCs with a rate base of less than $300 million, and a 60/40 split for all LDCs with a rate base in excess of $300 million, strikes the balance between the two objectives.

2.3 BOARD'S PROPOSAL ON RETURN ON COMMON EQUITY

The Board has determined that the current approach to setting return on common equity (ROE) will be maintained. ROE will be determined using a modified CAPM method

which includes a consensus forecast rate plus an equity risk premium (ERP) and an implicit 50 basis points (0.5%) for floatation and transactional costs. There will be no adjustment for a preferred share component of equity in rates, although distributors can, if they choose to do so, use preferred shares within their financing structure. On the other hand, the Board states that it is not convinced that a premium for infrastructure investment is warranted at this time. The Board has indicated that it may consider a measure of distributor capital investment to select distributors for rate rebasing in each of 2008, 2009, and 2010. Moreover, the Board has indicated that it may examine the need for and appropriate form of any capital investment incentives once a study to be undertaken in 2007/08 examines and establishes the extent and amount of capital upgrades required to ensure system reliability.

2.4 PWU'S COMMENT ON RETURN ON COMMON EQUITY

The PWU welcomes the Board's decision to keep the current approach to setting return on common equity and commends the Board for responding positively to the views of stakeholders, including distributors and consumers, who have recommended the retention of the Board's current approach rather than the adoption of Dr. Lazar's and Dr. Prisman's method. However, the PWU has concerns in the following two areas:

First, in its previous comment on the issue of special premium for new infrastructure investment, the PWU recognized the need to incent investment in new infrastructure, but also called the Board's attention to the need for a fair ROE for LDCs in order to enable them to achieve system safety, reliability and service quality standards on their existing systems. While realizing the implementation problems associated with an arbitrary premium for new infrastructure investment, the PWU is of the view that the need for incentive for new capital investment on new and existing infrastructure should not be marginalized. This concern is further reinforced, as the PWU's comments on the Incentive Regulation part of this report will show, by the Board's rejection of a proposal for a Capital Investment Factor (CI Factor). Moreover, the Board's position that it will examine the need for and appropriate form of any capital investment incentives only

after the completion of a study to be undertaken in the 2007/08 fiscal year would impose planning problems for distributors and also could mean a proposal that will be too late for the 2nd generation IRM. The next 1-3 years are extraordinary in terms of the significant amount of investment needed for new as well as existing infrastructure.

Second, the PWU recommends that the Board give serious consideration to the concerns expressed by some stakeholders, including the PWU, with the proposal for a method that solely relies on the Capital Asset Pricing Model (CAPM) to determine the ERP.

3 INCENTIVE REGULATION

3.1 PWU COMMENTS ON INCENTIVE REGULATION

3.1.1 TERM AND STARTING BASE

The PWU understands that the term (up to 3 years) and starting base (2006 rates) for the 2nd Generation IRM have already been established. While we understand that, in approving the 2006 rates, the Board determined that the approved rates are just and reasonable for 2006, there may be LDCs that will be facing circumstances significantly different from 2006 in 2007-2009, for whom therefore, 2006 as a base year for 2007-2009 may result in financial hardship. The PWU also realizes that the Board has indicated that it will be developing the criteria it should use to determine the Rate Plan groupings. The Board should consider the circumstances of these LDCs in its criteria to groupings. To enable LDCs in this circumstance to maintain service safety, quality and reliability, the Board should allow these LDCs the opportunity to apply for first tranche rebasing consideration.

3.1.2 PRICE ESCALATOR

The PWU realizes that the Board's decision to choose GDP-IPI over industry specific input price index (IPI) is largely a result of the lack of any readily available industry specific index. The Board also indicates in the Draft Report (page 30) that "some of the required data may not be available to construct a credible industry specific index".

On the other hand, the PWU is concerned with the Board's explanation for choosing GDP-IPI because "it is published by a trusted source" and that "it is likely more easily understood by the public than an industry-specific measure". The PWU believes that the Board should move towards the IPI for the 3rd generation IRM. The PWU believes that the Board could develop the index with transparency through the Board's consultation process. The updating of the industry specific IPI in the Board's 1st generation PBR[1] demonstrates that once a robust price cap mechanism has been developed, the Board can readily derive the IPI for the annual rate adjustments. The overriding reason guiding the Board in this respect should be that the IPI index tracks industry input price fluctuations better than an economy-wide measure and that is particularly relevant to transmission and distribution which are capital intensive.

3.1.3 X-FACTOR

The PWU realizes that the selection of the 1% X-factor for 2nd Generation IRM is a function of simplicity, particularly considering the "short" duration of the 2nd Generation IRM. Ideally, the X-factor should be as specific as possible and attempt to explicitly consider the productivity capabilities of the electricity distributors. This of course would require an examination of Ontario distributor-specific evidence.

The PWU also realizes that in order to drive the 2nd Generation IRM process and looking forward to the 3rd Generation IRM, the Board needs to start somewhere and considering the lack of sound and more specific data, the Board's choice of a single X-

[1] http://www.oeb.gov.on.ca/documents/backgrounder_ipi_210102.pdf

factor is understandable as a transitional exercise. For the long-term, the Board should look for ways of gathering sufficient data and information that would result in appropriate and more specific X-factors.

These considerations do not change the fact that the proposed X-factor is set in the absence of any evidence on how it relates to the LDCs' historic productivity and productivity potential. Moreover, the proposed X-factor relies on the deliberations of a productivity factor carried out in North American jurisdictions outside of Ontario. The impact may be one that requires cost-cutting beyond a level that can be compensated for through efficiency measures. These cost cuts can be expected to result in cuts in system maintenance and investment that will result in lower service safety, quality and reliability performance.

The PWU understands that some distributors had proposed that the value of the X-factor should be 0.7%, stating a conservative approach was appropriate for 2nd Generation IRM. The PWU considers the 0.7% value, identified as reflective of acknowledged productivity trends without a stretch factor from the PEG Report, as reasonable which can serve as a learning opportunity looking forward to the 3rd generation IRM and at the same time lessen the risk of unnecessary cost cutting that harms service safety, quality and reliability performance. The PWU would like to draw the Board's attention to the submissions of some distributors who have indicated that as a result of the proposed 1% X-factor, they would be forced to cut their non-labour operating costs as they could do little with respect the remaining costs.

3.1.4 CAPITAL INVESTMENT UNDER INCENTIVE REGULATION

The Board has declined to accept the addition of a capital investment (CI) factor as proposed by Hydro Networks Inc.'s consultant Mr. Todd of Elenchus Research Associates because, according to the Board, it would mean that incentive under the price cap mechanism would be significantly reduced because the factor would address incremental capital spending separately and "outside" of the price cap. The Board also states that the proposed CI factor would unduly complicate the application, reporting,

and monitoring requirements for 2nd Generation IRM because it would require special consideration to be implemented effectively.

The PWU's understanding is that the proposed CI factor was intended to address the critical need for investment in sustaining and renewing Ontario's distribution infrastructure within the term of 2nd Generation IRM. The 2nd generation IRM should incent distributors not only to improve operational efficiency and reduce costs but also to undertake the necessary capital investment to accommodate growth in their service areas and to maintain appropriate level of reliability and quality of service. The Board should realize that without such an incentive for capital investment, distributors tend to defer necessary and required capital spending. The PWU understands that the implementation of the CI factor does add some complexity. However, given the fact that only very few distributors who can prove to the Board that they need to make significant amount of investment in the coming few years (using a thorough asset condition assessment report) will file for the CI factor, the PWU is of the view that the process will not be as complicated as suggested by the Board.

3.1.5 SERVICE QUALITY

The PWU supports the Board's decision to resume its Service Quality Regulation ("SQR") review to refine the Board's SQR regime. The PWU also supports that the review will include consideration for public reporting of SQIs. This reporting should be an integral aspect of all regular filings of the LDCs under any multi-year IRM.

It is important to stress, however, that the Board should heed the impacts of such factors as the X-factor, incentive for new investment, and others on the service performance of distributors. Having service performance requirements in place will not guard against system deterioration if the LDC does not have sufficient funds to carry out the required system maintenance and investment.

Finally, the PWU observes that SQI reporting is only useful if there is an effective means to ensure that the actual service quality of LDCs does not deteriorate, or in cases that it does, is rectified promptly. As a result, in the development of any 3rd generation IRM scheme, the Board must devise a mechanism for the integration of

financial penalties and rewards in relation to service quality as a corollary to the economic incentives for cost-cutting that otherwise govern an IRM scheme.