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Please Reply to the TORONTO OFFICE

BY EMAIL and COURIER

December 6, 2006
Our File No. 2060389

Ontario Energy Board
2300 Yonge Street
26th Floor
Toronto, Ontario
M4P 1E4

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: Electricity Distribution – Multi-Year Rate Setting Plan EB-2006-0088/89

These are the submissions of the School Energy Coalition with respect to the Board's Draft Guidelines for Cost of Capital and Second Generation Incentive Regulation (the "Report").

Overall Comments – Substantive Issues

In our view, the Board in the Report has found an appropriate balance between protecting the interests of the ratepayers, ensuring the continued financial stability of the distributors, and achieving a reasonable level of regulatory efficiency. The combination of excellent work by Board Staff, a good consultation process, and the Board's overall assessment of the information before it has produced a thoughtful and thorough Report. While we don't particularly like all of the conclusions, we accept that, subject to a few comments later, it strikes a good balance.

Transitional Nature of Plan. The key overriding point to stress is that this is a transitional plan. Thus, what is important is to move in the direction of more robust rates, while giving the Board time to do the additional work required on some critical issues. It would, of course, be more conventionally "correct" for the Board to engage in cost of service proceedings for each of the 90 distributors for 2007. At least in theory, the result would be just and reasonable rates specific to each distributor. However, without the foundation from studies on issues such as cost allocation, depreciation, and the like, it would be difficult for the Board to maintain consistency and thus ensure that rates for all distributors are in fact just and reasonable. The need to sacrifice some level of thoroughness now is not for the purpose of expediency as much as it is for the purpose of maintaining consistency and fairness, while "buying time" in order to be able to actually do a thorough job in the future. The proposed transitional plan, by moving incrementally in the direction of more sustainable rates, is a reasonable compromise in the circumstances.

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Cost of Capital. The Board is, of course, aware of our concern, shared by many ratepayer groups, that the return on equity under the Cannon approach is too high for electricity distributors, and creates a substantial inertia that is preventing sectoral rationalization. The Report in fact comments on this at page 20, referring to the comments of Dr. Booth on the right level of ROE (under 8%), with which we agree. On the other hand, in the absence of real evidence on market transactions (such as proposed and actual M&A activity) and a full public debate, we believe it is reasonable for the Board to retain the Cannon methodology during this transitional period.

As to debt rates, we have a comment below on one omission from the Report that concerns us, but aside from that we think both the short and long term debt rates proposed are within a reasonable range for a transitional plan.

The last part of the equation is equity thickness. We have throughout supported the Staff Proposal of a standard split for all distributors in order to ensure neutrality for sector rationalization. We are concerned that the split has an overly thick equity layer (65/35 or 70/30 seems more defensible to us), but accept that in a transitional plan the 60/40 split is an appropriate approach. We are particularly mindful of the fact that the Board did not approve an additional return element for new investments. To the extent that there is capital investment pressure in this sector, we believe that an equity layer that is somewhat thick will act as the buffer for utilities that need higher than average levels of capital investment.

Incentive Regulation Structure. The Board has opted for a simple and easily accessible adjustment factor, together with a fixed X factor including both productivity and stretch factors. We are sympathetic to the concerns of some distributors (for example, those with declining load or low rates relative to their peers) that this ends up being pretty "rough justice", in that for some this will be very tight, while for others they will have lots of room within this price cap. Because this is a transitional plan, we believe that this simplified approach is justified.

We are also supportive of the Board's decision to limit Z factors and deferral/variance accounts strictly, and to opt for no off ramps. We have a comment below on the possibility that a cost of service option may effectively operate as a one-sided off ramp, but assuming the Board exercises control over that option, this overall approach of limiting exceptions produces the dual benefits of a) making ratepayer benefits under the IRM more reliable, and b) motivating utility management to operate in as disciplined and businesslike a way as possible.

Overall Comments – Process

We have commented before on the extensive consultation process employed here, which in our view allowed a good exchange of views. We have also commented that Board Staff was obviously listening, as seen by the evolution of their thinking and proposals. It is one thing to consult. It is quite another to keep an open mind and allow the input to forge new or modified ideas. Board Staff has, to their credit, done both.

We have also commented extensively elsewhere that consultation is not a substitute for evidence and the testing of evidence, in cases where the Board must reach conclusions based on facts. In this

case, it was clear throughout the consultation that both Board Staff and the participants would be informed by evidence on particular issues. Because it was a consultation rather than a formal proceeding, the filing of that evidence was not compellable, and as it turned out little was filed voluntarily. As we note below, this means that the Board's conclusions in the Report are to some extent built on a sandy foundation. In some cases, such as cost of capital, this means that it is appropriate for the Board to schedule in the next few years a more rigorous review, in which that evidence is filed, whether voluntarily or through compellability, and is tested in a disciplined and open process. The fact that, as a consultation, this was well done, does not change the fact that some issues cannot be fully run to ground without hard facts, tested thoroughly.

Subject to that caveat, we think that Board Staff should be commended for their pursuit of a model consultative process.

Remaining Issues of Concern

We would like to bring to the Board's attention four issues that, in our view, could benefit from either clarification or modification in the Report before it is made final.

Embedded Affiliate Debt. The Board has established that the rate for all embedded debt, including affiliate debt, is the rate approved by the Board in any previous decision. This raises two questions.

First, we wonder whether that includes decisions such as the 2005 and 2006 rate cases, in which embedded debt was included in the rate orders, but in most cases the prudence of the rate on embedded affiliate debt was not expressly considered by the Board. We assume that it would include, for example, the City of Toronto debt that was expressly considered in the Toronto Hydro rate case, but it is less clear that it should include the debt of a municipal owner set at, e.g. 7.5% in 2001 without any Board consideration of the rate, and embedded in rates since that time.

Second, we believe the Board should clarify the phrase "renegotiable-rate debt" on page 13 of the Report. If all or a substantial proportion of the term debt of a distributor is held by its municipal owner, then even if the provisions of the debt instrument fix the rate, the rate is in fact renegotiable because the municipality controls both sides of the equation. A municipality holding 7.5% term debt of its utility will keep that above-market rate as long as it continues to be above-market. However, if the deemed rate (and therefore the market) were to go up to 8%, the municipality can cause the debt to be repriced at that level within the Board's rules.

We note that this was essentially the issue addressed by the Board in the Toronto Hydro case, and we agree with the result in that case, which largely tracks the reasoning above. It is, we think, unfair that in the one case where the prudence of the embedded debt rate was considered, it was adjusted to current rates, but all those other distributors in similar situations are still paying their municipal owners rates above 7%.

In our view, there are two possible solutions to this. One is to clarify that embedded debt that has not been expressly considered in prior decisions is an open issue in each rate case. The second is to provide that debt of a type similar to that of the City of Toronto and Toronto Hydro would be

considered renegotiable-rate debt unless the ability to renegotiate is effectively removed (for example by requiring Board approval of any renegotiated rate).

Timing of ROE and Debt Rate Changes. The Board indicates, at page 43, that the changes to ROE and debt rates will be implemented as part of rebasing in 2008. It is not clear to us whether that means all distributors will have their cost of capital adjusted in 2008, or only those rebased in that year.

In our view, whether all are being adjusted in 2008, or only some in 2008 and the rest in 2009 and 2010, this result is highly inappropriate. The Board is already aware that the cost of capital is too high for distributors, because the current ROE is 9% and the embedded and deemed debt rates are at historical levels, higher than those today. It is submitted that, once the Board has determined that these rates are too high, as it has in this Report, rates based on the historical ROE and debt rates are by definition not just and reasonable. We estimate that rates based on historical ROE and debt rates would be at least $150 million too high for 2007 compared to the cost of capital guidelines contained in the Report.

It is one thing to defer implementation of a change because of practical limitations, or because there is some policy reason why it is not currently appropriate. Neither is the case here. It would be a simple matter to adjust capital rates in the 2007 filing to the correct levels, and the Report contains no policy rationale for a delay in implementing this change.

It is therefore submitted that the Board should modify the Report to provide for a recalculation of ROE and deemed debt rates using January 2007 data, and provide that those new rates shall be included in the IRM models filed by all distributors for rates effective May 1, 2007.

Cost of Capital – Transitional Status. A related issue is that raised by the phrase, on page 49 “The cost of capital policy will remain in effect until it is reviewed and changed by the Board.” This, coupled with the suggestion that capital rates – ROE and debt rates – will only be changed on rebasing, suggests that the Board’s cost of capital guidelines in the Report are not transitional in nature, while the IRM guidelines are transitional.

This is of considerable concern to School Energy Coalition. While this process included an extensive consultation, it did not include evidence nor the testing of evidence. Cost of capital is fundamentally empirical in nature, in which the Board’s conclusion must be driven largely by factual evidence. Without a process in which such evidence can be led, and compelled, and the evidence tested and debated, it is not in our view possible for the Board to reach a long-term conclusion on cost of capital. For example, the Board has before it the statements of Dr. Booth and others that a full study would produce an ROE, today, of under 8%, but the Board does not have any such study. Many participants in the consultation admitted that evidence of M&A pricing and considerations would inform the Board with respect to “market” rates for both debt and equity of Ontario electricity distributors. These and other examples demonstrate the need for a more formal process to set long term cost of capital.

In our view, the Board should clarify in the final version of the Report that its conclusions on deemed debt rate and ROE are also transitional in nature, and that it is the Board’s intention, over the

period of 2nd generation IRM, and with the additional information learned during that period, to carry out a more thorough review of the appropriate cost of capital for Ontario electricity distributors.

Cost of Service Option. We have some concern that, because the Report represents guidelines, any distributor can apply for cost of servive at any time. This is reiterated at page 43 of the Report. While the Board has warned, in the November 30th cover letter with the draft Report, that cost of service may be a time-consuming and difficult road (which should discourage some utilities from applying without a pressing need), the fact remains that this option has the potential to skew the overall sectoral rates for 2007 and beyond. We are particularly concerned by the fact that some utility representatives are already talking informally about a large number of cost of service applications being filed in 2007. While there is no way of knowing whether this will actually transpire (often cooler heads end up prevailing), phrases like "this spring will be frenzied" concern us.

If the average rate increase for all ratepayers in 2007, for example, exceeds inflation because the "exceptions" drive the average up, this could be seen by ratepayers as a failure of the Board's regulatory processes. This could undermine the Board's considerable efforts to move rates in the appropriate direction.

We understand, on the other hand, that the Board cannot simply cut off the cost of service option in the context of a set of guidelines, however thorough. Distributors must always have the right to apply. We also understand that the Board has in this Report implicitly rejected our previous suggestions to deal with upward rate pressures, so we do not intend to re-submit them.

In that context, we therefore have three suggestions.

First, we propose that the Board include, in the IRM Model, a requirement for a complete USofA listing and filing of audited financial statements for 2006. Since the model will be filed in February or March, we assume that full USofA information and 2006 financial statements will be available for any well-managed utility. This proposal is intended to deal with the inherent assymmetry of the cost of service option. Because only the utilities have their financial information, they will decide whether to apply on a cost of service basis based on the potential to have higher rates. This will skew rates upward. By requiring the filing of 2006 financial information, it will be clear whether utilities filing under the guidelines are substantially overearning, and ratepayers will then be in a position to petition the Board in specific cases for a more detailed, cost of service type review. This results in the cost of service option being more balanced (still skewing rates upward, but less so).

Second, we propose that the Board amend the Report to make clear that, if a distributor seeks rates on a cost of service basis, new rates will only be effective from the date of the rate order at the end of what could be a lengthy rate proceeding. There will be no retroactivity, and any apparent "deficiency" from May 1, 2007 to the date of the rate order will not be recovered. The effect of this clarification would be that distributors that truly need an immediate cost of service review would still proceed, but those that are simply gaming the system would have something to lose.

Third, we are concerned that the 1% X factor may in fact be too low if those distributors needing high rate increases are excluded from the average. Rather than adjust this in 2007, however, we propose that the Board monitor the overall impact of the price cap regime to see if the effect of inflation less 1% for some and cost of service for others is producing inappropriately high rates. If that appears to be the case, the X factor could be reviewed for 2008 and 2009, for example, to adjust for this. In our view, it would be appropriate to state in the Report that the X factor is currently assumed to be 1% for each of the three years of the IRM, but that the Board will be monitoring it and may adjust it in the second and/or third years.

Conclusion

The School Energy Coalition believes that the Board's Draft Report is, with a few exceptions as noted above, an excellent base from which to set rates for the next three years. We appreciate having had the opportunity to participate fully, and hope that our participation has been of assistance to the Board.

All of which is respectfully submitted.

Yours very truly,
SHIBLEY RIGHTON LLP

Jay Shepherd

Cc: Interested parties (by email)