

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

2006 Return on Equity  
Issue #6  
New DRH#3.2.1

**Contact: Andy Hoggarth** ([ahoggarth@puc.org](mailto:ahoggarth@puc.org))

**1. Summary of work to date:**

Examined issues relating to determination of equity returns, appropriate utility capital structures, debt cost rates, working capital allowance and potential adjustments to address 1999 financial losses in 2006 rate making.

**2. Questions of scope:**

- Rebasing in 2008 (see 3.1)
- Will the Board undertake a review of return on equity and associated issues, including working capital, no later than implementation of 2008 rates.

**3. Unresolved Issues:**

What will be the basis for the determination of ROE for 2006 rates?

The group considered some approaches to dealing with this issue, which were the following:

*Alternative A: Mechanistic Interim Update 2006/Full Update No Later Than 2008*

A mechanistic update of return on common equity would be undertaken by Board staff, not by Dr. Cannon or other expert witnesses, based solely on the consensus forecast of Canada long-term bonds. This update would be available for use by utilities in filing their 2006 applications. A full review of the appropriate rate of return on common equity would be undertaken no later than 2008.

*Alternative B: Status Quo for 2006 and Full Update No Later Than 2008*

Maintain existing 9.88% return on common equity for 2006, and possibly 2007, with a full update no later than 2008.

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

Alternative C: Full 2006 Update

A full study would be undertaken by Dr. Cannon to be completed by December 2004 and applied to the setting of 2006 rates. This study would encompass return on common equity, cost of debt and capital structure. It would be based on Dr. Cannon’s assessment of the risk level facing Ontario’s electricity distributors. It is expected that Stakeholders will have opportunity to file their own evidence, which could not be filed any less than two months after the filing of Dr. Cannon’s report.

Alternative D:

This alternative is similar to Alternative C except that it requires a further ROE update by no later than 2008.

Crossovers:

- C&DM decisions as they relate to potential ROE premium adjustments for LDC’s achieving annual C&DM goals.
- Debt/Equity – the capital structure impacts risk.
- Rate Design – impacts risk (i.e. 100% fixed may decrease risk while 100% variable would increase certain risks).
- Use of historical test year, future test year or some combination of the two, may impact the formula methodology and use of data.
- Adjustments to the test year being considered by sub group EDR 3.1 may impact distributor risk levels.
- RPP may affect risk.

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

Capital Structure (Debt/Equity)

Issue #7

New DRH #3.2.2

**1. Unresolved:**

What would be the appropriate Capital Structure(s) for LDCs?

Status Quo for Capital Structure:

Under Alternatives A and B for ROE, the status quo for capital structure would be maintained until the study is updated.

Updated Capital Structure:

Under Alternative C and D, there would be a full update, including consideration of short-term debt as part of the 2006 rate-setting exercise.

Crossovers:

- ROE review.
- Use of historical test year, future test year or some combination of the two, may impact the formula methodology and use of data.
- Adjustments to the test year being considered by sub group EDR 3.1 may impact distributor risk levels.

Recommended Path:

It is expected that this issue will go to hearing and that there will likely be submissions and possibly evidence filed.

**2. Unresolved:**

What are the appropriate definitions of deemed and actual capital structure?  
Which should be used for rate setting: deemed or actual?

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

Crossover:

- PILs

Recommended Path:

Sub -group continues to seek resolution for the deemed / actual definitions and applications.

Debt Rate  
Issue #8  
New DRH #3.2.3

**1. Unresolved:**

What is the appropriate Debt Rate for the LDCs?

Status Quo:

Under Alternatives B for ROE, status quo will be maintained for the debt rate until the study is updated.

Updated Debt Rate:

Under Alternative A, a mechanistic update of debt rate will be part of the 2006 rate-setting process.

Under Alternatives C and D, a full update of debt rate will be part of the 2006 rate-setting process.

Crossover:

- ROE review.
- Capital structure review
- Adjustments to the test year being considered by sub group EDR 3.1 may impact distributor risk levels.

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

Recommended Path:

It is expected that this issue will go to hearing and that there will likely be submissions and possibly evidence filed.

**2. Unresolved:**

What are the appropriate definitions of the deemed and actual debt rate?  
Which should be used in rate setting: deemed or actual?

Crossover:

- Affiliate relationships related to capitalization: e.g. who originally incurred the debt? Affiliate / shareholder?
- Capital structure
- PILs

Recommended Path:

Sub -group continues to seek resolution.

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

Working Capital Allowance  
Issue #15  
New DRH #3.6

Major Points of Discussion/Background:

The subgroup agreed that a formulaic approach to working capital remains best overall, but improvements in the accuracy of the formula should be reviewed in the near future. In particular, LDCs require a working capital allowance (“WCA”) calculation that reflects estimated/potential changes in major flow through funds such as the cost of power to avoid the major cash flow problems experienced in the past. For example, at market opening, volatile cost of power significantly impeded LDC’s cash flows. If the historical test year is used, LDC’s would prefer the option to use a “forecast” cost of power in the WCA calculation. While each LDC has the right to file an individual lead-lag study as part of its 2006 application, it was stressed these are complicated to complete and review. It was therefore preferable that a new generic formula be eventually produced, based upon a co-operative industry study.

Proposed Consensus:

The subgroup specifically recommends that:

2006 Rate Year

1. The working capital allowance remain unchanged at 15%, but that the list of eligible controllable expenses and cost of power be updated to include all those accounts added to this category since the 1999 trial balance was set. The subgroups will continue work on identifying accounts that should be added.

No Later than 2008 RATE YEAR

2. An industry wide lead-lag study be undertaken by the Board and the results used to establish a new default WCA formula for rate setting purposes.

The rationale for the recommendation include:

- a) Lead-lag studies take time to complete; therefore allowing status quo for 2006 should provide sufficient time to have results for the 2007 rate year.
- b) Many market changes have been made since the original WC formula was established such as:
  - a. Billing / settlements lags after market opening
  - b. Recent legislative initiatives, such as ban on disconnects during winter months
  - c. Net debit balance of deferral accounts,

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

- d. Risk allocation under market rules.

Crossover:

- Any adjustments to actual billing quantities for 2004 that are made for rate setting purposes should also apply to calculation of the cost of power component of working capital and test year adjustments (see 3.1).
- Potential impacts of RPP.
- .

Proposed Path:

- Lead-lag study to be sponsored by OEB, for implementation no later than 2008 rate year.
- The subgroups will continue work on identifying accounts that should be added to the basis for working capital allowance.

**STANDARD TEMPLATE - Sub-Group – DRH 3.2/3.6**  
(RP-2004-0188 “2006 Electricity Distribution Rates”)

Treatment of Financial Losses

Issue # tbd

New DRH # 3.2.4

Major Points of Discussion/Background:

This issue relates to the treatment of 1999 operating losses (negative returns) that were deemed to be non-recoverable. Section 3.4.1.4 of the DRH stated that, “Any utility with a negative ROE in 1999 will be subject to the floor value of 0 percent.”

There may be as many as 17 utilities that had operating losses in 1999.

Some utilities have cut back on operating expenses and capital expenditures due to the insufficiency of revenues. This could eventually lead to service quality reductions and non-sustainable conditions in the electricity distribution system.

Unresolved Issue:

This issue has been considered under test year Tier 2 adjustments (see 3.1). Are there any further adjustments required on this issue?