

Ontario Energy Board

RP-2004-0188

ISSUES DAY

November 1 & 2, 2004

**REPORT OF THE FINANCIAL PARAMETERS &
WORKING CAPITAL SUB-GROUP**

NEW DRH 3.2/3.6

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FINANCIAL PARAMETERS & WORKING CAPITAL

NEW DRH 3.2/3.6

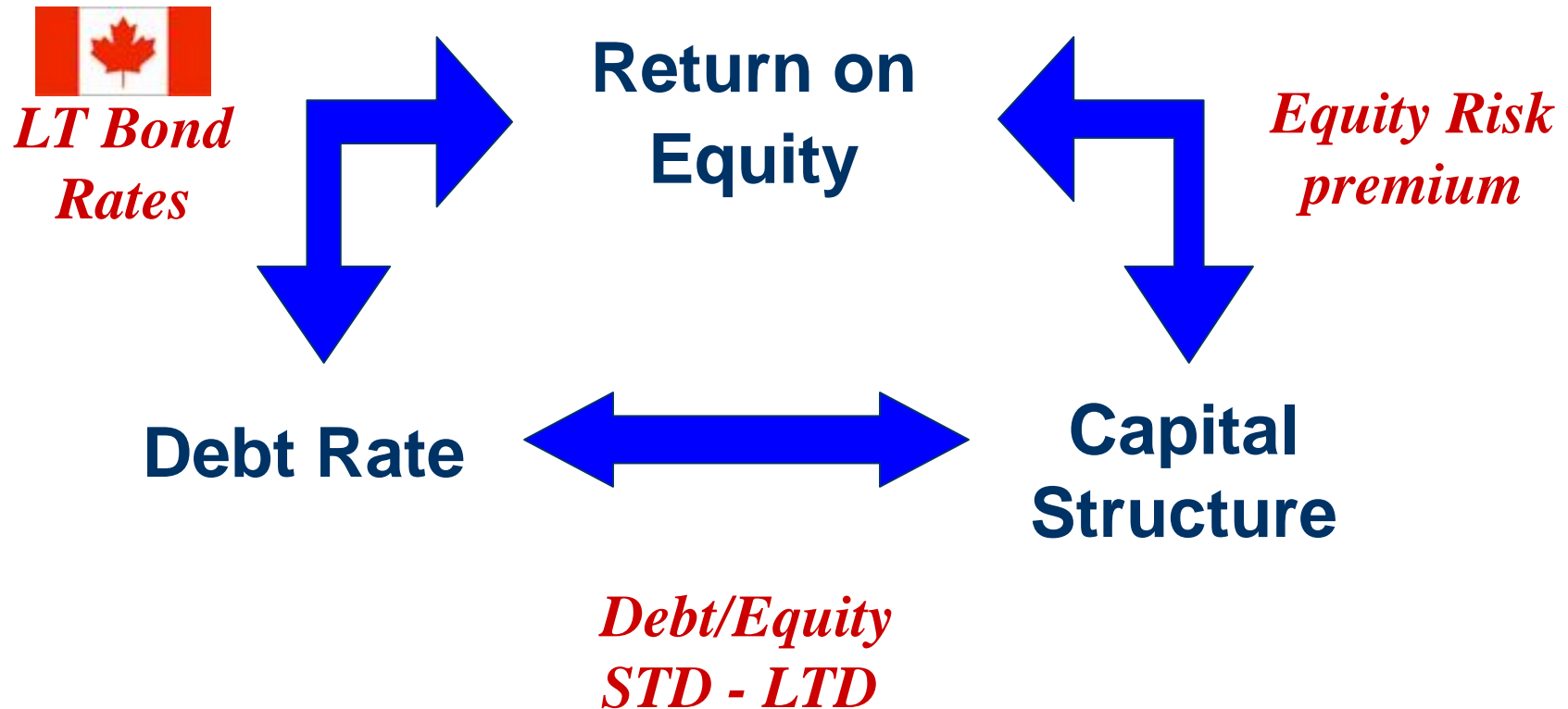
- 1. Return on Equity**
- 2. Capital Structure**
- 3. Debt Rate**

4. Working Capital Allowance

5. Treatment of 1999 Financial Losses

FINANCIAL PARAMETERS & WORKING CAPITAL

NEW DRH 3.2/3.6



FINANCIAL PARAMETERS & WORKING CAPITAL

NEW DRH 3.2/3.6

Questions of scope:

- Will the Board undertake a review of return on equity and associated issues, no later than for implementation of 2008 rates.**
- Re-basing in 2008.**

Alternatives - Matrix

	A	B	C	D
Status Quo				
ROE		2006		
Capital Structure	2006	2006		
Debt Rate		2006		
Mechanistic update				
ROE	2006			
Capital Structure				
Debt Rate	2006			
Full study & hearing				
ROE	2008	2008	2006	2006&8
Capital Structure	2008	2008	2006	2006
Debt Rate	2008	2008	2006	2006

2006 Return on Equity

Unresolved:

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:

2006 Return on Equity

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.

2006 Return on Equity

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

This update would be available for use by utilities in filling their 2006 applications. A full review of the appropriate rate of return on common equity would be undertaken no later than 2008.

2006 Return on Equity

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.

2006 Return on Equity

Alternative C: Full 2006 Update

A full study would be undertaken by Dr. Cannon to be completed by December 2004 and applied to the settling of 2006 rates. This study would encompass return on common equity, cost of debt and capital structure.

2006 Return on Equity

Alternative C: Full 2006 Update

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.

2006 Return on Equity

Alternative D: Full 2008 Update

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

2006 Return on Equity

Crossovers:

- **Conservation & Demand Management decisions as they relate to potential ROE premium adjustments for LDC's achieving annual C&DM goals.**

2006 Return on Equity

Crossovers:

- **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).**

2006 Return on Equity

Crossovers:

- **Use of historical test year, future test year or some combination of the two, may impact the formula methodology and use of data.**

2006 Return on Equity

Crossovers:

- **Adjustments to the test year being considered by sub group EDR 3.1 may impact distributor risk levels.**
- **Regulated Pricing Plan may affect risk**

2006 Return on Equity

Recommended Path:

It was clear from the vast majority of stakeholders there is support for a full review (study) of ROE. An appropriate amount of time is required to allow for a full study and stakeholder consultation process. Board decides scope and resulting evidentiary requirements.

Capital Structure (Debt/Equity)

Unresolved:

- What would be the appropriate Capital Structure(s) for LDCs?
- Should guidelines be issued relating to the use of common vs preferred or other special shares.
- Which should be used for rate setting: deemed or actual?

Capital Structure (Debt/Equity)

Alternatives A and B: Status Quo for 2006 and Full Update No Later Than 2008

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

Capital Structure (Debt/Equity)

Alternatives C and D: Full Update for 2006 and additionally, under D a further update in 2008.

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.

Capital Structure (Debt/Equity)

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.

Capital Structure (Debt/Equity)

Crossovers:

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

Capital Structure (Debt/Equity)

Recommended Path:

Board decides scope and resulting evidentiary requirements.

Debt Rate

Unresolved:

- What is the appropriate Debt Rate for the LDCs?
- What are the appropriate definitions of the deemed and actual debt rate?
- Which should be used in rate setting: deemed or actual?

Debt Rate

Unresolved:

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

Debt Rate

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

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

Debt Rate

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

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

Debt Rate

Alternatives C & D: Full Update for 2006 and additionally, under D a further update in 2008.

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

Debt Rate

Crossover:

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

Debt Rate

Recommended Path:

Board decides scope and resulting evidentiary requirements.

Working Capital Allowance

Major Points of Discussion/Background:

- 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.

Working Capital Allowance

Major Points of Discussion and Background:

- If the historical test year is used, LDC's would prefer the option to use a "forecast" cost of power in the WCA calculation.
- Inclusion of security deposits in working capital allowance is an unresolved issue

Working Capital Allowance

Major Points of Discussion/Background:

- 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.

Working Capital Allowance

Question of Scope:

- Will the Board sponsor a working capital study in time for implementation into 2008 rates?

Working Capital Allowance

Recommended Path: 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 sub-group will continue work on identifying accounts that should be added.****

Working Capital Allowance

***Recommended Path: No Later than 2008
RATE YEAR***

2. Sub-group recommends that 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.

Working Capital Allowance

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.
- Potential impacts of Regulated Pricing Plan.

Treatment of Financial Losses

This issue has been considered under test year adjustments (see Subgroup 3.1).