E-MAILED, & COURIERED

Mr. Peter O'Dell
Acting Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 26th Floor
Toronto, Ontario
M4P 1E4

Dear Mr. O'Dell:

Re: Newmarket Hydro Ltd. Submission on the Process for Establishing 2006 Electricity Distribution Rates

We appreciate and wish to thank the Ontario Energy Board ("Board") for the opportunity to participate in their informal consultation regarding the 2006 distribution rate setting process. Please consider our written comments below.

General Comments

We are concerned with the regulatory burden of a seemingly detailed and time-consuming process proposed by the Board with regard to setting electricity distribution rates. Increased regulatory burden may also increase costs to consumers, with no improvement in service, or reliability. It may also not be in keeping with the Minister of Energy's objectives to provide a stable rate environment for electricity consumers, as they will experience rate changes in 2005, 2006 and likely 2008. We also urge the Board to consider that other regulatory processes are also being implemented concurrently on LDC's by other regulators such as the Electrical Safety Authority.

The process for the 2005 rate increase, which incorporates DSM ("Demand Side Management") and the third tranche of the Market Based Rate of Return, has not been finalized, and yet we are embarking on the 2006 process. We share the Board's concern to have re-based rates "correct" prior to implementing PBR phase 2. However, the Ontario electricity industry continues to be in an extremely volatile state of transition. We also have no experience with how DSM initiatives will impact cost of service and revenues. To embark on cost of service studies between now and 2006 may not provide the correct foundation for re-based rates going forward.

We request that the Board consider between now and 2008, a more simplified process coupled with a reasonable Return on Equity ("ROE") for LDC's which would allow LDC's, their shareholders, creditors, and investors, to plan, and manage the risks in Ontario's electricity industry, and provide stable and predicable rates for business and residential consumers. The original Board objectives as outlined in their Decision with Reasons RP-1999-0034 indicated light-handed regulation, and efficiencies through innovation and non-Board-prescriptive measures, which are in keeping with this request for a simplified process.

The current timelines may be unrealistic for all stakeholders, should the Board's process, as preliminary outlined, be adopted. We understand the necessity for an accelerated filing process, however we wish to bring to the Board's attention that this may place hardship on the smaller LDC's that cannot always react quickly to this process.

In response to the direct issues as outlined in "Establishing 2006 Electricity Distribution Rates Potential Issues for Generic Methodology Review" we offer the following specific comments:

1. <u>Use of Comparator's to assist the prudence review of LDCs' costs</u>
   The Electricity Distribution Rate Handbook ("EDRH") section 1.4 refers to Cost Allocation Studies, not Cost of Service Studies. We have some concerns that the Board is now embarking on reviewing more than they originally set out to do, e.g. costs per customer, billing and collection expenses per customer, etc. Of greatest concern with this is the integrity, accuracy and comparability of data that will be collected. We suggest that more efforts be placed first in ensuring that a standardized collection format be introduced for the collection of financial and non financial data, before embarking on developing cohorts. In simple terms, our concern is that we would like to ensure that we are comparing apples to apples.

   Developing Cohort comparators and comparisons should be consistent with criteria that were developed by the Service Quality Reporting Working Group. One of the suggestions for cohorts includes comparisons by weighting different groups e.g. comparing an LDC to all of the LDC's in Ontario, as well as adjustments for geographical location, customer base, age of plant, etc., since no two LDC's share exactly the same demographics.

   We agree that electricity distributors need to know targets at least 18 months prior to having to apply for 2006 rates. This will allow distributors to develop and revise practices to implement and meet targets which will in turn ensure that the rates going into PBR 2 will be re-based properly with room to adjust for unknowns such as DSM and other initiatives.

Having hundreds of items to collect, analyze and compare will be costly and time-consuming. The bottom line is that the overall cost (rate) to a consumer for the overall services received by that consumer (in that rate class). Therefore a line by line comparison may not be beneficial to the consumer especially if these costs must be borne by an LDC on a continual basis.

It should be noted that the electrical distribution environment is unlike the gas industry, as there are numerous LDCs to compare to, which is good for PBR. When there are only a couple of distributors, as is the case in the gas industry, then it is prudent for a regulator to require more detail on costs. We suggest to the Board that the rate process for regulating gas distributors not be applied "wholesale" to electricity distributors.

No two LDC's are alike, even if they have the same number of customers. Different regions of the province have different economic conditions, are in different growth stages, they have different residential vs. commercial percentages, different costs of living, purchasing agreements costs and have different access to labour pools. These factors can make direct comparisons difficult.

Therefore we believe in the use of comparatives; however we ask the Board to consider the above points in their process.

Revenue Requirement – General Issues

2. Test Year for establishing Rate Base/Revenue Requirement

Given time constraints, we recommend the most recent test year, say 2004 with allowances to adjust for OMERS, implementing new ESA regulations, DSM, other imposed initiatives et al. However a more accurate approach would be; if time permits, an average of the last three years should be used with adjustments for inflation over that period and for the future. In using one base year there can be material timing differences when LDC's incur expenditures, there can also be differences in accounting policies and one year may have unusually low or high expenditures. Therefore using one year as base case may not be realistic. We recommend that a rolling three year average with an adjustment for inflation be considered as a benchmark with an additional adjustment mechanism put in place to consider any abnormal cost incursions and future inflation.

3. Load Forecast

LDC's already provide load forecast to the IMO to meet market rules. Weather is a risk factor. Therefore proper and reasonable Return on Equities "ROE's" should be sufficient to withstand any risks associated with weather, local and provincial economic downturns, regulatory uncertainty and now the potential of legislative uncertainty with the Provincial government preparing to limit growth in the province.

A simplified process would have the effect of reducing regulatory costs compared to that of developing, and monitoring load forecasts for the industry while at the same time allowing for innovation by individual LDCs. The risk of having a one size fit all load forecast is that if the methodology is wrong, then the whole province is wrong.

4. Test Year Adjustments

Depending on the test year chosen, adjustments allowable should include, OMERS, DSM, market legislative changes, billing system changes to accommodate settlement changes due to day-ahead market change or implementation of wide-spread smart-metering. Our concern again is that one base year may not provide enough information as compared to a three year average.

5. Weather Normalization

See comments under Item 3 above for Load Forecasting. A fair market return on equity which recognizes risk due to weather, DSM, economic factors, market legislative changes, and provincial legislative changes may eliminate the necessity to develop normalization processes.
In direct response to the question should the ROE be reduced if weather risk was removed the answer would be no because LDC's need to earn a rate of return on the asset base (equity) irregardless of weather. Gas rates are subject to risk of weather when calculating their return.

6. (Maximum) Return on Equity for 2006 Electricity Distribution Rates

The maximum ROE should compensate LDCs for the business risks in the current Ontario industry.

It should attract investment and provide supply stability to this industry.

It is suggested that the Board seek input from financial investors as to their perspective on the returns they would find attractive for investment in the industry.

7. Debt/Equity Structure

The current deemed D/E structure(s) is still appropriate as financial institutions have come to understand, appreciate, and endorse this model. It is important to provide consistency in the structure for financial institutions, and comparability among utilities. Most importantly, staying with deemed D/E structures is good for customers as it discourages attaining abnormally high equity values.

8. Debt Rate/Cost of Capital

We would agree with matching the Debt Rate to reflect current economic conditions and interest rates.

9. Depreciation Rates

We recommend adoption of accounting practices as proscribed by the Canadian Institute of Chartered Accountants and set out in their Generally Accepted Accounting Principles. Using Generally Accepted Accounting Principles would not only provide a basis of consistency and comparability across this industry but also other provincial utilities and private corporations.

10. Transfer Pricing and Shared Corporate Services

The Affiliate Relationship Code requires as a condition of licence, that LDC's demonstrate market pricing. It is in the best interest of the consumer if Fair Market Value is used ("FMV") in determining costs. The Board, in order to determine FMV could request a sample of prices in order to determine a benchmark FMV. Due to the confidential nature of some third party pricing these actual results could not be released. However the Board from this data could deem a FMV price range to test any service in question.

11. Low Voltage and Wheeling Costs

This issue is unique to only a handful of LDCs, therefore it should be dealt with separately from this generic process.

12. 2006 Taxes/PILs

We believe that the current methodology of PILs is fair and adequate. To enforce different tax strategies and tax planning initiatives may be a very difficult task to administer and may force inefficiencies through the system. We believe that there needs to be some consistency across the industry, but we have some concerns with some ideas presented at the discussion on July 6th and 7th, 2004 and in the discussion paper.

We believe by allowing the flow through of PILs/Taxes or building actual PILs/Taxes paid into the rate structure may increase inefficiencies and reward inefficient LDC's. For example an efficient LDC would be assumed to have higher earnings than an inefficient LDC, thus the efficient LDC may be paying more in PILs/Taxes. The more the LDC pays in PILs/Taxes, then the greater amount of PILs/Tax costs are built or recouped in the rates. Thus the more efficient LDC will have higher rates than an inefficient LDC, which is not good for the customer. The ending result will be then both LDC's will make similar returns but the efficient or profitable LDC has paid more to the Ontario Finance corporation and its' customers are now paying more in rates.

We would recommend that the current PILs/Tax structure stay in place and as an incentive to all LDC's to earn a greater rate of return that they be allowed to retain ½ of the amount of earnings greater than their Return on Equity and return the other ½ to the consumers.

<u>Revenue Requirement – General Issues</u>

13. <u>Definition of Distribution Rate Base</u>

Capital Contributions between Board-regulated entities only, should be included in the rate base. This will provide incentive for parties to share assets; it would also be in the best interest of consumers as duplication of plant would be minimized.

14. <u>Rate Base Measurement Date(s)</u>

The timing difference between calendar (report) year and the rate year should not be an issue because the rates are applied going forward based on historical performance. The reporting methodology should be consistent with that being proposed from the Service Quality Reporting Working Group which is considering rolling 3-year or 5-year averages and consistent among all LDC's. It should be kept in mind that that rate increases should be introduced for consumers in an "off-peak" season to minimize bill impacts or bill shocks.

15. <u>Working Capital Component of Rate Base</u>

There should be a formula for a minimum working capital allowance "WCA" which would then allow for LDC's to determine their own level of

WCA to meet their own particular business requirements. It would also minimize the impact of negligent shareholders who place their LDCs in positions where they had little or no WCA which is not in the best interest of consumers.

Some WCA requirements may be different among LDC's because some may have different levels needed to meet requirements from financial institutions due to external borrowing. Also some may need higher WCA for a few years in order to finance or fund projected future capital expenditures.

Therefore we submit that working capital may be an area where a minimum level should be established and enforced by the Board.

16. Capitalizing Expenses

There needs to be consistent, standardized and equal treatment of accounting for the capitalization of costs. We have noticed that different LDC's have different accounting policies which are not applied consistently in regards to the capitalization of expenses. Depending upon the particular accounting policy used this could materially effect the Operational, Maintenance and Administration costs reported. We recommend that capitalization policies should be applied in conjunction with Generally Accepted Accounting Principles as proscribed by the Canadian Institute of Chartered Accountants, and that the Board enforces a set standard throughout all LDC's.

17. Capital Projects

There should be a materiality threshold set, above which the Board would scrutinize the total expenditures and capital investment for prudence. However we ask the Board be realistic in their requirements to avoid the necessity of hiring additional capital accountants but we understand the need to audit large capital projects and indeed all capital policies for reasonableness, prudence and the protection of the consumer.

18. Contributed Capital

There is a process under the Distribution System Code ("DSC") that accounts for this. This issue should be removed from the list.

19. No-Cost Capital

No comment at this time.

20. Rate-Setting Treatment of Capital Gains

Capital Gains must be tracked for accounting and income tax purposes. It should be brought to the Board's attention that there can be significant differences between accounting gain or loss and an income tax gain or loss. This income tax gain or loss may have an impact on an LDC's rates depending on what tax treatment the Board approves.
In addition to the difference between accounting and tax values we wish to bring to the Board's attention that they have not included capital losses in this issues list.
Therefore we recommend to the Board that at this time the LDC's be allowed to keep any capital gains.

Operating Expense Issues

21. Distribution "Wires Only" Expenses
    We have no comment at this time.

22. Post Retirement Benefits and Premiums
    We recommend that the costs included in rate setting process follow the criteria as indicated by the Canadian Institute of Chartered Accountants. In regards to pension premiums most LDC's are part of the OMERS pension plan and thus their contributions are predetermined.

    As LDC's have no ability to change the OMERS contribution rates, we recommend to the Board that they strongly consider that these costs are predetermined.

    We also bring to the Board's attention that the original rates did not have the OMERS contribution included in the cost structure therefore we recommend that the next design has a method or function whereby the LDC may have a chance to recover these benefit increases.

23. Site Restoration and Removal Costs
    These costs should be included and calculated as indicated by the accounting principles as indicated by the Canadian Institute of Chartered Accountants.

24. Insurance Expense
    LDC's have different levels of insurance coverage, although most insurance is through one carrier. We recommend to the Board that there should be some comparative guidelines so one can compare policies and a central authority to ensure that there is a minimum amount of insurance coverage held by all LDC's. Our concern would be that some

LDC's which have minimal coverage thus having a lower Administration and Operations cost, would be our comparator, and we have acted with prudence to ensure that some future event does not inflict financial hardship on our customers.

25. <u>Bad Debt Expense</u>
Since the board has deemed a security deposit policy for all LDC's, then the LDCs should be allowed to recover their bad debts through rates provided they have been diligent in the application of the DSC.

26. <u>Employee Compensation and Staffing</u>
It is not necessary to single out these costs if rates and delivered services are consistent with others. In certain instances, compensation must be superior to other industries, other regions or other utilities in order to avoid talented employees from leaving. This would also avoid the additional cost of recruitment, training and learning inefficiencies.

If comparatives are to be used, then other benchmarks should be considered including the Ministry of Energy, the EDA, the OEB and Hydro One; as well as, general benchmarks from other industries to ensure compensation is fair and reasonable across our industry as a whole.

27. <u>IT Costs</u>
Our concern would be that it is not efficient for all stakeholders to track, report, and benchmark single cost items like IT costs. A simpler, overall process that examines, the rates charged and the services rendered to each customer class is a more prudent expenditure of effort, time & money. This is not an issue for all LDCs and should not be included on an issues list.

<u>2006 Rate Design Matters</u>

28. <u>Advertising, Entertainment, Charitable/Political Contributions, Employee Dues, R&D</u>
We would argue that how a LDC spends its monies is subject to general prudence provisions as guarded by Generally Accepted Accounting Principles and the Ontario Energy Board; however certain Advertising and Entertainment expenditures may not be subject to detained review except by the Shareholder not by the Board.

29. <u>Specific (Miscellaneous) Service Charges</u>

This is a low priority and should not necessarily be uniform across LDCs. LDCs should be allowed to continue to provide cost justifications for any adjustments applied for. When there is sufficient time to deal properly with miscellaneous service charges, it can be added to an issues list.

30. <u>Unmetered Scattered Load</u>
    This issue may need to be expanded to include MUSH intersection lighting, bus shelters, etc.

31. <u>Time-of-Use Rates</u>
    Deemed street-lighting accounts should qualify as interval metered/TOU.

    TOU issues could be dealt with DSM and smart-metering initiatives process instead of a rates process issue.

32. <u>Fixed/Variable</u>
    Given the nature of electricity distribution and uniformity among some rate classes such as residential rate class, it may be prudent for residential customers to be on a fixed distribution rate only. This would help to minimize the need to develop weather normalization processes.

33. <u>2006 Rate Mitigation</u>
    The sooner rates are re-based "correctly" the fairer they are to customers. Ontario electricity consumers have enjoyed less than market value electricity distribution rates for several years. Rate mitigation measures delay rebased rates being "right", thereby delaying proper implementation of PBR2. Phasing in of rates tends to be unfair to new customers who end up bearing interest costs due to delayed implementation of full rates, and who would not have gotten the added cost had the full rates been implemented when they were needed.

<u>New Issues</u>

34. <u>Resolve wholesale/retail settlement 15 minute intervals vs hourly</u>
    The wholesale settlement is done based on hourly intervals while retail rates are based on 15 minute interval settlement left over from pre-market billing/rate setting practices. This issue should be addressed in the 2006 rate setting process.

Given the short time frame (a week) between the time additional issues were raised during the consultation, and the submission deadline of July 16, 2004 it is our intention to comment on the additional issues subsequent to this submission.

In summary, we would like to see a simplified rate setting process that minimizes the regulatory burden on all stakeholders but which readily reveals LDC "outliers" in terms of overall rates (value) for electricity distribution services delivered to the various customer classes. The burden of proof would lie with the "outlying" LDCs to defend their rate applications and unique situations. The number of "outlying" LDCs is expected to be small thereby greatly reducing the amount of data for intervenors, and stakeholders, including Board staff, to compile and analyse. This makes for a more efficient and cost-effective process. It also leaves time to concentrate on ensuring the integrity of data collected and the many other initiatives that require stakeholders' attention at this time.

We hope our comments will be useful and we look forward to participating in the generic hearing. Should you have further questions, please direct any to the undersigned at (905) 953-8548 or e-mail to gyoung@nmydro.on.ca; or iclinton@nmhydro.ca.

Sincerely,

Paul Ferguson, P. Eng
President

cc: M. Garner, K. Ritche, J. Vranstidis – OEB
G. Young, I. Clinton - Newmarket Hydro Ltd.
bcc: D. Akers, J. Richardson