IN THE MATTER OF a consultation by the Ontario Energy Board on the Cost of Capital and 2nd Generation Incentive Regulation for Electricity Distribution Companies.

Board Staff Questions to Participants of September 18-22, 2006 Technical Conference

As outlined in the September 21, 2006 technical conference transcript, the Board is providing for further information to be gathered in this process, as requested by most parties. The sponsors proposed the following steps:

- First, parties may submit written questions to other parties on or before September 27th;
- second, parties will respond to those questions by October 11th;
- thirdly, on October 17th the Board will host a Technical Conference for a discussion of the questions and answers; and
- finally, the date for filing comments (currently scheduled for October 6th) is extended to October 27th.

The Board will not compel anyone to answer any questions with respect to these questions. Parties are free to respond or not respond. Clearly the Board hopes that the parties will co-operate to the maximum degree possible in order that the Board can benefit from all relevant information.

During the technical conference, staff identified three areas where further information is needed: access to capital, mergers and acquisition information, and impact of changing capital structure on the sector rationalization. In addition to these areas, staff has identified the following questions. Unless otherwise noted, the questions are addressed to all interested parties.

1. **Access to Capital** (addressed to distributors)
   Please provide any information available on situations where your distribution utility has experienced difficulties in obtaining financing for capital investments on reasonable terms. What reasons were given for the inability to raise capital or on unreasonable (i.e. above-market rates)?

2. **Merger and Acquisition Valuations** (addressed to distributors)
   Please provide information available specifically on the valuation (relative to the net book value) of your distribution utility (if you were considering or effected the sale or merger of your utility) or of another distribution utility that you were considering or effected a merger or acquisition with.

3. **Impact on Sector Rationalization**
   What impact (positive or negative), if any, might changing capital structure for most Ontario electricity distributors have on the prospects of physical consolidation of electricity distributors?

4. **Return on Equity – Cannon Methodology**
   Several parties have suggested that the Board retain the existing method of calculating the ROE as documented in Dr. Cannon's paper "Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario", dated December 1998, and consistent with the ROE methodology used in rate regulation of natural gas distributors under the Board's "Draft Guidelines on a Formula-Based Return on Common Equity for Regulated Utilities". If the Board was to retain the current methodology:

   a. Should the ROE be updated for May 1, 2007 distribution rate adjustments?
   b. What should the starting point for the ROE applicable to electricity distributors (e.g., 9.88% from the first Distribution Rate Handbook or 9.00% as calculated in the 2006 Electricity Distribution Handbook)?
   c. If updates to the ROE are not done annually (e.g. under IRM), then how should the ROE update be done at the time that distributors file rebasing applications?

5. **Return on Equity and Rebasing**
   The staff proposal currently would have the IRM price cap formula applied to existing Board-approved distribution rates, largely set through 2006 EDR applications.
   a. Does the change in the inflation or price escalator factor of the price cap index, measured by GDP-IPI (Final Domestic Demand) as proposed by staff, reasonably track or proxy also the changes in the debt rates and market returns (and therefore the distributors ROE) year to year?
   b. If so, is an ROE adjustment required in 2007 and while a distributor is subject to the price cap index? What are the implications of not changing the Return on Equity (ROE) currently allowed in a distributor's approved distribution rates until the distributor files a Cost of Service (rebasing) rate application during the period 2008 to 2010?

6. **Capital Structure**
   Several distributors have raised concerns about migrating quickly to a new capital structure. Consider a scenario whereby the Board were to phase in the change from the existing size-related capital structure to the common structure, for rate-making purposes, over several years. For example, a large distributor with over $1 billion in rate base might move from its deemed 35% equity to 40% over two years, to mitigate possible rate impacts on ratepayers. As another example, a small distributor with a rate base of less than $100 million could migrate from its current deemed 50% equity to 40% equity over three years, to

mitigate the impact on corporate restructuring and on the distributor's shareholder(s). This change in the capital structure would be accomplished through the K-factor while the distributor is under an incentive rate mechanism (IRM) scheme, and a distributor migrating to the new capital structure would also factor such migration into its Cost of Service rebasing application.

a. What are the implications, advantages and disadvantages of such an approach?
b. Are there alternative approaches that the Board might consider?

7. **Load Concentration-related Business Risk**

While Board staff have proposed a common capital structure applicable to all distributors, several stakeholders have commented on business risk, possibly related to a material loss of revenues due to the loss of a customer or business sector served by the distributor and where that customer or business sector constitutes a significant portion of the load and distribution revenues for the distributor.

a. Could any significant risk that might materialize due to the loss of a significant load concentration be mitigated by Z-factor (or analogous) treatment?
b. If yes, then what would be the criteria for identifying an occurrence of such an event (e.g. what percentage of distribution revenue attributable to loss of a single customer should be the threshold for identifying a material revenue loss)?

8. **Short-term Debt** (addressed to distributors)

At the Technical Conference, staff heard that not all working capital is funded by short-term debt and that some may be funded by long-term debt.

a. What percentage of your actual working capital is funded by short-term debt?
b. What percentage of your rate base does short-term debt represent?

9. **Incremental Capital Expenditures**

Some distributors at the conference expressed concern over aging infrastructure and the need for increased investment in that infrastructure to maintain appropriate levels of service.

a. What are your known circumstances of where this could arise (addressed to distributors)?
b. Should incremental capital spending that is not attributable to load growth be treated outside of the price cap index (similar to what is proposed for CDM)?
    i. If so, should it be eligible for Z-factor treatment?
c. Are there alternative approaches that the Board might consider?
d. If the Board were to provide for special treatment of these investments, should a threshold apply? If so, how might that be expressed (e.g., percentage of current CapEx budget less depreciation)?

10. **CI-factor**

During the technical conference, Mr. John Todd proposed a methodology for a CI-factor as part of the IRM price cap formula as a means for including incremental capital expenditures not related to load growth as an increment to the price cap index.

a. What are the implications, advantages and disadvantages of adopting such an approach?
b. Mr. Todd suggested that a distributor file an Asset Condition Assessment Study as support for the proposed CI-factor. Such a study does not directly indicate the cost of incremental capital expenditures needed to address deficiencies in the system. What information on the proposed capital expenditures should a distributor be required to file in addition to the Study?
c. What are the implications of adopting this approach where CapEx plans are not reviewed and approved by the Board?
d. The CI-factor methodology as proposed seems to start from a 2006 rate base. Hydro One Networks has a 2006 rate base that has been reviewed during its 2006 distribution rate application by virtue of applying on a forward test year. However, most electricity distributors filed 2006 distribution rate applications on the basis of a 2004 historical test year with allowable adjustments. Hence, the public information for most distributors reflects a 2004 rate base. What changes need to be done to the CI-formula to properly adapt it for when 2006 distribution rates are calculated on a 2004 historical rate base?
e. Should the load growth factor be weather normalized? If so, how should this be done?
f. Some of the parameters for the calculation of the CI-factor, as proposed, may not be readily available from prior filings where the data were subject to review by the Board. By what process would the Board review and test the reasonableness of the parameters if a distributor were to apply for a CI-factor?

11. **Declining Customer Base**

Some distributors have documented declines in their customer bases.

a. Would it be reasonable to adjust the X-factor, for example, to 0.7 for a distributor that has negative growth in its customer base over the period 2002 to 2005?
b. Are there alternative approaches that the Board might consider to address constraints on operating efficiencies possible under declining customer base conditions?

12. **Smart Meter incremental funding**

In the July 25, 2006 Staff discussion paper, staff proposed incremental amounts of smart meter funding of $1.00 per month per metered customer for distributors working to achieve the Government's objective of 800,000 smart meters in place by the end of 2007, and $0.30 per month per metered customer for other distributors.

c. Are the proposed increments reasonable?
d. If not, what should they be, and why?