Re: Board's Staff Proposal for Cost of Capital and
Second Generation Incentive Regulation Mechanism - EB 2006-0088/0089
Hydro One Networks Questions for Board Staff and Board's Consultants

Hydro One is pleased to provide questions in respect of the Board's Staff proposals for Cost of Capital and 2nd Generation Incentive Regulation Mechanism. The questions are organized to address three themes as follows:

- Where do we go from here
- How will the proposals be implemented, and
- Specific requests for clarification

<u>Cost of Capital</u> - Where do we go from here?

1. The Board's Staff proposal for a common capital structure and a common ROE simplifies the requirements for the Rate Plan period during the 2nd Generation IRM. It is a well know fact that the distribution businesses in Ontario are not uniform in either a financial or physical sense. Therefore, looking forward beyond that period there are concerns with maintaining a common approach which does not recognize diversity of utility structures (urban vs. rural), the varying customer base (customer density and proportion of industrial customers), cost levels (Capital & OM&A), and business risks (financial structures).

    a. What factors need to be considered by the Board to give consideration to move away from the common cost of capital consideration and what information would have to be gathered in this respect?

    b. If the Board is not prepared to recognize the need to differentiate between utilities, how will the Board propose to deal with the fact that differences will continue to exist in the utility sector despite the Board's intent to rationalize the industry to a common financial model where there is no accompanying physical rationalization?

2. The Board's proposal to enshrine the cost of capital parameters in a Code raises a number of questions looking beyond the 2nd Generation IRM.

    a. How would the proposed Code accommodate the move to 3rd Generation IRM and would it be necessary to continue with the Code post 2nd Generation IRM?

    b. Could the cost of capital parameters be a part of the incentive mechanisms under a 3rd Generation IRM?

    c. Will the capital parameters be set uniform for all utilities or will the Board take into consideration the difference in business risks across the utility sector to establish parameters to be utility specific or to group utilities into categories? If not why not? What criteria would the Board use to differentiate risk between utilities?

3. There is an enduring concern about the use of appropriate industry references for the purpose of assessing cost of capital requirements for the electricity distribution sector in Ontario. The norm is to use the natural gas and electric utilities in North America as the applicable reference.

    a. What does the Board envisage as a suitable industry reference moving forward beyond rebasing and into the 3rd generation IRM?

    b. By what process will the Board determine the suitability of the industry reference?

<u>Cost of Capital</u> – How will the proposals be implemented?

1. The Board proposes to establish a separate Code (under proceeding RP 2006-0087) that will confirm the cost of capital to be used in adjusting the LDCs annual revenue requirements for 2007 and during the Rate Plan period. It is assumed that the proposed Code will include the same amount of detail in respect of the level of RoE and the capital structure as is currently contained in the Distribution Rate Handbook.

    a. What process will the Board adopt to amend the Code to deal with changes to the cost of capital parameters beyond 2007 and what will be the associated timelines?

    b. Will these timelines be established to coincide with the current timelines for adjusting distribution rates in May 1 of the year?

    c. Will the process allow sufficient time for LDCs to make the necessary changes to their rate schedules for implementation by the required rate change date, particularly for those utilities that to date have not been able to harmonize their distribution rates?

2. As proposed by the Board Staff the process to establish the cost of capital entails the determination of (i) the capital structure, (ii) the equity risk premium, (iii) return on equity, and (iv) the debt rate.

    a. Will the Board set the above parameters on an annual basis or one time for the duration of the Rate Plan?

    b. Will the Code be prescriptive and contain specific formulae to calculate the parameter adjustments or will it contain a description of the approach to do the calculations? What information will be required to perform the calculations and what will be the source of that information?

    c. Is there a requirement for LDCs to provide any information to assist the Board in setting the parameters or will the Board establish these parameters without any LDC input?

Cost of Capital – Specific Request for Clarification

The following is a list of specific requests for clarification from Board Staff and its consultants.

Lazar & Prisman

1. Reference: Lazar and Prisman Report dated June 14, 2006, p. 39, Table 10

Could Drs. Lazar and Prisman please explain why the levered betas for 2004 and 2005 are identical?

2. Reference: Lazar and Prisman Report dated June 14, 2006, p. 19, Table 4

a) Are the after-tax ROEs shown in this table real or nominal returns?

b) What were the final proposals by OFGEM for the ROE for the distributors?

c) If the answer in part (b) is expressed in real terms, what would be the approximate corresponding nominal ROE?

3. Reference: Lazar and Prisman Excel interest rate file

Preamble: The raw data in the excel file show a 10- year zero coupon yield of 4.75% and a 30-year yield of 4.946% for May 19, 2006. The Bank of Canada shows yields of 4.3217% and 4.2557% for the same day.

(a) Can Drs. Lazar and Prisman explain why the differences are so significant?

(b) If Drs. Lazar and Prisman were using a different series of data than appears on the Bank of Canada website (e.g., one that includes more than just Government of Canada bonds), could they either explain why that would be appropriate or, if it is not appropriate, re-estimate the forward rate using the correct series?

(c) Would they also provide the forward rate for the longest available period?

4. Reference: Lazar and Prisman Report dated June 14, 2006, p. 46

Preamble: Drs. Lazar and Prisman report five and ten year market returns of 7.17% and 10.65% respectively. These returns are geometric averages.

Could Drs. Lazar and Prisman please provide the corresponding arithmetic average returns for the same periods?

5. Reference: Lazar and Prisman Report dated June 14, 2006 and Presentation dated June 20, 2006.

In the Report dated June 14, 2006, Drs. Lazar and Prisman recommend an unlevered beta of .357. In the June 20, 2006 presentation, they appear to recommend betas in the range of .2033 and .357. Could they please explain why their recommended beta changed?

Board Staff

1. Reference: Board Staff Discussion Paper dated July 25, 2006, Appendix A.

(a) Would Staff agree that it would be appropriate to remove Coast Mountain Power from their samples since it has been acquired?

(b) If the answer to (a) is yes, would Staff then agree that the average levered 60-week beta for the sample of All Rate Regulated Companies is approximately .70?

(c) Would Staff also agree that the approximately .70 beta for the sample excluding Coast Mountain is virtually identical to the unlevered .357 beta originally proposed by Drs. Lazar and Prisman when relevered for a 60%/40% debt/equity capital structure as shown in their June 20, 2006 presentation?

2. Reference: Board Staff Discussion Paper dated July 25, 2006, p.12.

Preamble: Staff recommends that only the inputs to the formula be updated annually to minimize uncertainty about changing formulae or parameters.

Could Staff please clarify what the formula is to which they are referring, and specifically what parameters they are recommending be updated?

3. Reference: Board Staff Discussion Paper dated July 25, 2006, p.12

Preamble: Staff states that Lazar and Prisman provide a simple spreadsheet mechanism that smooths the Bank of Canada data over a rolling six year period.

Could Staff explain in more detail what the rolling six year period is to which they are referring?

4. Reference: Board Staff Discussion Paper dated July 25, 2006, p.16

Preamble: Staff states that they have focused on using the shortest and longest terms available.

(a) Could Staff please verify that the forward rate that they used to derive the 8.37% ROE was not the 15 year rate, but was an average of the 5, 10, and 15 year rates?

(b) Could Staff please verify that the 15-year forward rate, according to the Lazar and Prisman interest rate file was 5.54%?

(c) Please explain why a longer term forward rate could not be estimated from the data and equations that were made available by Drs. Lazar and Prisman?

5. Reference: Board Staff Discussion Paper dated July 25, 2006, Appendix A

(a) Would Staff verify that the market returns of 8.09% and 10.06% used to estimate the risk premium are geometric averages?

(c) Would Staff please confirm that both Ms. McShane and Dr. Booth are of the view that arithmetic averages should be used to estimate the cost of equity?

(d) Could Staff please confirm that the EUB in their generic cost of capital Decision 2004-052 and the BCUC in its March 2, 2006 ROE decision for Terasen Gas both concluded that it was appropriate to use arithmetic averages in estimating the market risk premium?

(e) Could Staff please provide the arithmetic average returns corresponding to the 8.09% and 10.06% used in Appendix A?

6. Reference: Board Staff Discussion Paper dated July 25, 2006, pp. 12-13

Preamble: Staff recommends a common equity ratio of 40%, but included in the 40% are any preferred shares issued by the distributor up to a maximum of 4%.

(a) Is it Staff's opinion that preferred shares are equivalent to common equity? If not, please explain the justification for the proposal to include in the 40% up to 4% preferred shares?

(b) Staff says that a thicker common equity ratio is justified for the LDCs than for the gas distributors. Can Staff confirm that both Enbridge Gas and Union Gas also have some preferred shares in their regulated capital structures?

(c) If an electric LDC had 36% common equity and 4% preferred shares, would its total equity ratio be significantly different from that recently approved for Union Gas?

(d) If it is Staff's intention for the electric LDCs to have thicker equity than the gas LDCs, and the gas LDCs have preferred shares in addition to common equity, would Staff's objective be met if its proposal to include up to 4% preferred shares in the 40% equity were approved by the Board?

<u>2nd Generation IRM</u> - Where do we go from here?

1. Hydro One supports the adjustment proposal for transition; and is of the view that the industry needs to progress quickly to conclude its implementation and to start consultations on the longer term 3rd Generation IRM (3GIRM) regime.

   a) When will the Board release a timetable for process and stakeholder consultations for developing the 3GIRM.

   b) Since the Board is disposed to LDCs nominating their submission in respect of rebasing to any of the recommend cohorts, can the Board provide guidelines on the type of information it will need from the LDCs for self-nomination?

2. The board had not set out an indicative threshold for quality assurance but rather proposes to use the current SQI's and performance measurements.

   a) What procedure will the Board adopt to ensure adherence to the standards of service; for example, penalties for deterioration and rewards for improvements.

   b) What incentives does the Board intend to use in the 3GIRM and how will they be determined? How will the Board assess whether a LDC can attain the proposed thresholds?

   c) How will the Board link SQI thresholds with the investments that an LDC needs to maintain the minimum standards of service?

3. The Board has provided factors that need to be considered in developing the 3GRIM. Looking beyond the transition period,

   a) What are the principles that underpin the incentive plans that the Board intends for the LDCs after 2nd Generation IRM (2GIRM)?

   b) What lessons has the Board learned from other jurisdictions that successfully implemented incentive regulation; and how is the Board going to apply these to the design of an effective 3GIRM?

   c) What procedures and plans does the Board have to constituting stakeholder Work Groups that will assist it in developing the 3GIRM?

   d) Please describe how the Board intends to encourage the LDCs to make efficiency savings during the incentive regulatory periods; and how the Board might link investments and efficiency?

   e) To what extent has the Board gone to confirm whether beyond 2007, its 1% productivity factor proposal will be an appropriate level in Ontario? What types of information will the Board require to ensure that its long term incentive regime reflects the inherent features of the Ontario electricity distribution industry?

f) Will the Board move to judge productivity on an individual basis? If so, Hydro One believes that LDCs may need to demonstrate viability to serve their customers; therefore, can the Board provide some guidelines on the following:

   i. Information about the condition of assets.
   ii. How might the Board consider linking rewards and penalties to a LDCs ability to serve?

g) Given the differences in the efficiency levels between LDCs in Ontario, what procedure can the Board use to categorize or perhaps implement LDC specific productivity levels?

h) How does the Board plan to deal with negative productivity factors; where relevant, how will the Board apply lower productivity factor across all LDCs?

2nd Generation IRM – How will the proposals be implemented?

1. The Board proposes a simplified and transparent regime, in which the governance of the IRM will be done by a Code.

   a. What procedure will it use to establish the components of IRM; for example the inflation factor?

   b. If necessary, how will the Board modify these components; who can raise the need for a modification; the timetable for industry consultations and dissemination of final decisions?

2. It is assumed that the Board will define the productivity factor.

   a) If the Board needs to alter the productivity factor in response to low growth and / or to capital investment, can the Board reveal how it might calculate the new factor? Has the Board performed any scenario analysis in this respect and if so could it share that analysis with the industry?

3. The Board has recommended a price cap formula for the transition period.

   a) What plan and procedure will the Board use for periodic assessments of the LDCs operations to ensure applicability throughout the Rate Plan period?

   b) How will the Board treat new investments? Hydro One recommended that the Board includes a CI factor in the 2GIRM model; reference Hydro One’s presentation at the technical conference. There was significant discussion on the topic at the Technical Conference but Hydro One did not hear any dismissal of the proposal. Can the Board provide feedback on the proposal and identify any shortcomings that it feels might inhibit its implementation in the 2GIRM?

4. The Board Staff propose allowance for ‘Z’ Factors in the 2GIRM model. There was some discussion at the Technical Conference regarding the process for utilities to make submissions for Z-factor consideration.

   a. What process is the Board planning to adopt in this respect that will reflect the mechanistic nature of adjustments to prices during 2GIRM?

   b. What should LDCs expect to be required to submit as supportive material for the ‘Z’ factor adjustments?

   c. Given the nature of 2GIRM can the LDCs assume that approvals of such submissions will not require a public review, and if not then why not? What requirements would the Board need to expedite the process and make it mechanistic?

5. If the Board has concerns about Hydro One’s CI factor and considers using deferral account regime as a way by which to capture incremental capital costs during 2GIRM,

   a) What will be the basis for a LDCs qualification to use the deferral accounts?

   b) What tracking period as well as timetable for reviews of the amounts in the accounts should the LDCs’ expect?

6. Has the Board assessed whether the existing SQIs and performance measurement metrics adequately represent the utility sector in Ontario and if not what procedure will the Board follow to redress this matter? Does the Board plan to review the SQIs during the period of 2GIRM?