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August 14, 2006

VIA E-MAIL

Kirsten Walli, Board Secretary
Ontario Energy Board
Suite 2701
2300 Yonge Street
Toronto ON M4P 1E4

Dear Ms. Walli:

Re: EB-2006-0088/EB 2006-0089

We are counsel to the Consumers Council of Canada. On behalf of our client, we attach hereto its Submissions on the Board Staff Discussion Paper on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors.

Yours very truly,

WeirFoulds LLP

Robert B. Warren

RBW/tm
Encl.
cc: Julie Girvan
Joan Huzar
919378.1

SUBMISSIONS OF THE CONSUMERS COUNCIL OF CANADA

TO THE ONTARIO ENERGY BOARD

RE: BOARD STAFF DISCUSSION PAPER
ON THE COST OF CAPITAL AND 2ND GENERATION INCENTIVE REGULATION
FOR ONTARIO'S ELECTRICITY DISTRIBUTORS

EB-2006-0088/EB-2006-0089

INTRODUCTION:

On April 27, 2006, the Ontario Energy Board ("Board") initiated consultations regarding the review of the cost of capital applicable to electricity distributors and the development of a 2nd Generation incentive regulation mechanism ("IRM") for setting distribution rates during the period 2007-2009 ("Rate Plan"). On July 25, 2006, Board Staff released a Discussion Paper addressing these two issues, identifying options and presenting its views on a number of preferred options ("Board Staff Paper").

On July 7, 2006, the Board commenced a parallel proceeding to amend the licences of electricity distributors to implement the new methods for setting rates that are developed as a part of this proceeding.

These are the submissions of the Consumers Council of Canada ("the Council") regarding options for incentive regulation and implementation. The Council has jointly sponsored the evidence of Dr. Laurence Booth regarding the cost of capital issue with the Vulnerable Energy Consumers Coalition ("VECC"), the Industrial Gas Users Association, and the London Property Management Association ("LPMA"). We will be filing that evidence under separate cover. In addition, the Council has been in consultation with both VECC and LPMA regarding common positions on the IRM and implementation issues.

Following some overview comments, the Council will set out its submissions addressing the issues in the same order as set out in the Board Staff Paper.

OVERVIEW:

The Council recognizes the challenges faced by the Board in regulating over 80 electric distribution companies (LDCs"). The Board must balance the need to ensure that rates are just and reasonable and based on the cost of providing distribution service with the need for regulatory efficiency. Accordingly, the Council supports the implementation of a multi-year transitional mechanism to set rates during the Rate Plan period.

It is important for the Board to acknowledge that most of Ontario's electric LDCs have not yet been subject to a cost of service review. It is essential, that, before moving to a 3rd Generation IRM, these LDCs be rebased on a cost of service basis. That is a critical component of the transitional proposals and the Board needs to make it clear that rebasing entails a full cost of service review.

The 2nd Generation IRM has been deemed by Board Staff as a transitional mechanism, pending the outcome of various studies and methodology reviews. Although the Council is generally supportive of the price cap mechanism proposed for the transitional period, in our view, the Board will need to undertake a comprehensive review of approaches to be applied beyond the Rate Plan period. Stakeholders must be given a full opportunity to make proposals to be used for setting rates beyond the transitional period. Acceptance of the price cap model for the years 2007-2009 should not be seen as acceptance of it beyond that period.

Board Staff has informed stakeholders that LDCs may file for exemptions from the Rate Plan. If the number of LDCs seeking exemptions is significant, the Rate Plan may not result in regulatory efficiency. The Council suggests that the Board seek input from the LDCs as to whether exemptions will be the exception or the norm. If exemptions are to

be the norm, the Board may want to revisit its approach to set rates in the 2007-2009 period.

INCENTIVE REGULATION:

Objectives of 2nd Generation IRM:

The Board Staff Paper states that the objectives of the IRM are to: provide regulatory certainty to distributors during the Rate Plan as several rate-related studies are carried out; drive efficiency improvements in the distribution sector; and lay the foundation for the 3rd Generation IRM. (p. 19). In addition, Board Staff has stated that the IRM is a transitional methodology that balances short-term efficiency, simplicity and time management to allow the Board to approve just and reasonable rates.

As noted above, the Council is generally supportive of the approach being advanced by Board Staff for the transitional Rate Plan period. From the Council's perspective what needs to be paramount is that through this process the Board, consistent with its statutory objectives, must protect the interests of consumers with respect to prices. In addition, the Board must ensure through this period the adequacy, reliability and quality of electricity service.

The Council is not convinced that the proposals, as set out by Board Staff, will drive efficiency improvements during the Rate Plan period. For some LDCs the IRM will only be applicable to one year. Such a limited term is not sufficient to incent LDCs to create efficiencies.

Annual Proxy Adjustment for Cost of Capital:

Board Staff's proposal is that rates be adjusted by an incentive formula that would include as one adjustment factor, recognition of changes to the existing capital structure and return on equity ("ROE"). Those distributors that will be rebased will have the

proposed cost of capital method applied to their revenue requirements. Until rates are rebased the adjustment factor would be applied to adjust their revenue requirements. (p. 20)

There will be two separate "K" factor adjustments to account for changes in ROE and capital structure from what is currently reflected in rates. The first will adjust rates in 2007 to reflect changes in the ROE if that change is more than 10 basis points from the approved 2006 ROE of 9%. For those that will not be rebased in 2008 the "K" factor would numerically approximate the adjustment necessary to move a distributor from its current capital structure to the proposed common structure. (p. 20)

The one exception is for distributors that selected an ROE of zero or something less than the 9% for 2006. Those distributors will be exempted from a K factor adjustment in 2007.

There will be four values for "K" depending upon current deemed capital structures. The Board Staff proposal does not allow for any changes in debt to be flowed through as K-factor adjustments. (Appendix C)

The Council accepts that the K- factor methodology is an appropriate approach with the following caveats. The proposal used four K factors depending upon the current capital structures. We believe it may be more appropriate to determine individual K factors for each LDC rather than attempting to group LDCs into four categories as individual K factors may vary significantly. In addition, LDCs that chose to apply for ROEs of less than 9% will be exempted from a K factor adjustment. These LDCs, to the extent they want to revisit their earlier decision regarding ROE should be permitted to seek return levels comparable to other LDCs.

Term and Starting Base:

The starting point for the IRM is 2006 rates. Board Staff does not accept the arguments advanced by some stakeholders that the 2007 rates should be adjusted to reflect three years of escalation. (p. 21)

Rebasing for all distributors will take place in either, 2008, 2009 or 2010. As noted above the Council accepts this approach as reasonable as long as rebasing entails a full cost of service review. In addition, the Council sees no need to adjust 2007 to reflect three years of escalation. 2006 rates were set on the basis that they were adequate for 2006. 2007 rates should be indexed using the 2006 rate levels.

Form:

Board Staff is proposing a price cap form of adjustment for setting rates for those LDCs that have not been rebased. (p. 22) The Council accepts that a price cap is appropriate as it represents a model that stakeholders are familiar with and is relatively simple to administer.

Price Escalator:

Board Staff is proposing that a GDP-IPI (Gross Domestic Product Implicit Price Index) as the inflation proxy for the 2nd Generation IRM. Board Staff is also proposing that the Canada GDP-IPI for final domestic demand be used as opposed to the Ontario value. The proposal will take 4th quarter GDP-IPI data for the rate adjustments. (p. 23)

The Council accepts the use of the Canada GDP-IPI as the inflation proxy for the 2nd Generation IRM. With respect to the use of 4th quarter data, the Council suggests it would be more appropriate to use the changes in the annual index instead, as those changes are likely to be more stable.

X-Factor:

Board Staff is proposing that distributors be subject to a 1% X-factor for the duration of the 2nd Generation IRM. The 1% number is based on the data provided by the Pacific Economics Group report. To the extent the 1% is representative of X factors typically employed in other jurisdictions the Council supports the use of it for the Rate Plan period.

Contingencies and Mid-Term Issues:

The Board Staff proposal sets out an allowance for Z-factors (adjustments during the plan) for unusual events beyond the control of management. Examples include changes in regulation, changes in accounting or tax rules, and natural disasters. In order for costs to be considered for recovery through a Z-factor Board Staff is proposing that the costs be subject to four tests: causation; materiality; inability of management to control, and prudence. The materiality threshold would be .2% of net fixed assets. Distributors will be required to submit evidence to substantiate that the costs that were incurred meet the four criteria outlined above. (pp. 27-28)

Board Staff is not proposing that the IRM will allow for “off-ramps”. (p. 28)

The Council accepts that the use of Z-factors is appropriate during an incentive regulation plan. However, the tests for determining whether Z-factors are appropriate must be clear and set out prior to the commencement of the plan. The onus will be on the LDCs to justify any Z-factor adjustments. The evidence provided in support of a Z-factor application must be thorough and subject to testing by the Board and intervenors prior to approval.

Consistent with the 2006 EDR process there should be an onus on the LDCs to bring forward Z-factors that may increase the revenue requirement or reduce it. In effect, the use of Z-factors must be symmetrical and should not be limited only to cost increases. An unusual event that results in cost decreases or revenue increases must be brought forward.

As noted below given the information asymmetry between the LDCs and its ratepayers the Council supports the use of an earnings sharing mechanism as a way to protect the interests of ratepayers during the plan.

The Council is supportive of the proposal to not set out any off-ramps that would be applicable during the Rate Plan period.

Earnings Sharing:

Board Staff does not propose that there will be any earnings sharing mechanism ("ESM") as a part of the 2nd Generation IRM plan. They cite one of the reasons for excluding an ESM is that an ESM is thought to reduce the distributor's efficiency incentives. (p. 28)

As noted above, the Council supports the use of an earnings sharing mechanism as a part of the 2nd Generation IRM. Ratepayers will not have access to full information regarding an LDCs financial results and will not have the same ability as LDCs to seek Z-factor relief. Accordingly, the use of an earnings sharing mechanism will provide a level of ratepayer protection during the plan. The Council supports an asymmetrical earnings sharing mechanism for over-earnings in excess of 100 basis points above the approved ROE. An asymmetrical mechanism is appropriate as LDCs will have the ability to apply for Z-factor relief if earnings are expected to be below the allowed ROE because of unforeseen circumstances.

Board Staff rejected the use of an earnings sharing mechanism in part because it may reduce the LDC's ability to achieve efficiencies during the Rate Plan. We do not believe that the plan will drive LDCs to create efficiency gains. Given the expectation that rebasing will occur for some LDCs in one year and others two years there is little incentive for them to invest in technologies and practices without an expectation that the benefits will flow to the shareholders.

Service Quality:

Distributors have been reporting on their performance on the service quality indicators (SQIs) that were prescribed by the 2006 EDR Handbook. Board Staff is recommending that the Board resume its service quality requirement (SQR) review and implement the resultant indicators and associated performance standards through an amendment to the Distribution System Code. This would make the SQR regime mandatory. (p. 29)

The Council supports Board Staff's recommendation that SQRs be developed, embedded in the Distribution System Code and deemed mandatory. In any incentive regulation model it is essential to ensure that safety, reliability and quality of service are not degraded during the course of the plan. The Council supports a process whereby the SQRs are finalized as soon as possible. The Council also urges the Board to make all SQR information publicly available, to assess adherence to the requirements and allow for comparisons among all of the LDCs.

Reporting and Data Requirements:

Board Staff is not proposing any additional reporting requirements for 2nd Generation IRM beyond those proposed for SQRs.(p. 30) The Council supports a mechanism whereby all annual financial results are publicly available on the Board's website. This will allow the Board and intervenors to assess the results and the extent to which the rate levels are appropriate.

IMPLEMENTATION:

The intent of the Board is to set out a multi-year electricity rate setting plan for the period 2007-2010. During that plan the Board intends to undertake a review of certain methodologies such as depreciation, cost of capital and rate design.

In 2007 rates will be set for distributors through a formulaic adjustment for the cost of capital and the incentive mechanism. Beginning in 2008 the Board will divide the distributor rate rebasing reviews into three yearly tranches rebasing 1/3 of the distributors in 2008, 1/3 in 2009 and 1/3 in 2010. (p. 32)

Determination of Rate Plan Groupings:

Board Staff will commence a study to design a process to select distributors for each year of rebasing. Criteria may include, but not be limited to the following:

- Comparator and cohort information screening (eg. costs and rates)
- Urgency of cost allocation issues
- Prior direction in a Board Decision
- Need and ability to implement new rate design
- Financial viability and realized earnings (e.g. significant over/under)

The Board will hold a stakeholder consultation on this design process and hopes to be able to announce the first grouping in March 2007, at a minimum, to be rebased in 2008. (p. 32)

The Council is of the view that the most contentious element of the Rate Plan will be the selection of the tranches. Some LDCs, those with higher earnings under an indexed approach, may prefer to be rebased in the third tranche. The Council believes that Board Staff has identified appropriate criteria to determine the tranches, but is also of the view that the stakeholder process envisioned to select the timing for each LDC must be transparent and balanced. The Board must consider the interests of the ratepayers and the LDC shareholders on an equal footing.

How Rate Adjustments Will Be Determined:

Under the Board Staff proposal the following items are to be excluded from the rate adjustment:

- Allowance for "smart meter" costs
- Conservation and demand management ("CDM") incremental spending
- Deferral and variance account balances
- Regulatory asset amounts
- Other rate adders

Board Staff is proposing that the price cap index be applied uniformly across all customer classes and to both the fixed monthly rate and the volumetric rate, including taxes. (p. 37)

With respect to smart meters recovery must be contingent on the actual costs incurred and an assessment of the prudence of those costs. There must be a clear accounting of the expenditures and how those costs are allocated to customers to allow for any true-up during the Rate Plan period. The Council suggests that the Board establish a working group to develop the guidelines applicable to recovery of the smart meter costs. Under the current mechanisms there is the potential for cross-subsidy to occur between rate classes. Cross-subsidies should be minimized to the extent possible.

With respect to CDM, the Council supports that the costs be dealt with separately from the 2nd Generation IRM. It remains unclear how any spending beyond the third tranche is to be dealt with and how the LDC's rates will be affected going forward by the Ontario Power Authority's ("OPA") expanded role to deliver and fund CDM. Once the OPA plans are clarified the Board should constitute a working group to determine how CDM costs are to be dealt with during the Rate Plan period.

The Council supports the Board Staff proposal to deal with any tax changes that occur during the plan period through the use of a Z-factor. The LDC shareholders or their ratepayers should not be subject to any gains or losses associated with these changes.

Given that tax changes are anticipated during the plan the Council supports an automatic pass-though of the impacts. Rather than relying on a materiality threshold to determine whether tax changes should be made we support a process that would have all LDCs incorporate the changes through a Z-factor approach.

With respect to deferral accounts the Council agrees with Board Staff that an incentive regulation scheme should limit reliance on the creation of new deferral accounts during the term of the plan to well-defined and well-justified cases only. The expectation is that applications for deferral accounts will be tied to the Z-factor approval process and assessed on a case by case basis.