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August 14, 2006

By email to BoardSec@oeb.gov.on.ca - original to follow by courier

Kirsten Walli, Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Multi-year Electricity Distribution Rate Setting Plan Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089)

The attached comments are filed in response to Board Staff's July 25, 2006 Discussion paper on the Cost of Capital and 2nd generation Incentive Regulation for Ontario's Electricity Distributors. These comments relate specifically to Board Staff's proposals on the Cost of Capital (EB-2006-0088) and are filed on behalf of the Coalition of Large Distributors (CLD) comprising Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc.

The requisite three copies of these comments are enclosed and electronic versions have been sent to you by email in searchable Adobe Acrobat (PDF) and Word.

In addition to these comments on the Cost of Capital, the CLD is filing today, under separate cover, an expert report prepared by Donald Carmichael, MBA.

Please direct any questions to the undersigned.

Sincerely,

Sardana

Pankaj Sardana
VP, Treasurer
Treasury, Rates and Regulatory Affairs

Copy: Coalition of Large Distributors
Donald Carmichael

Re:EB-2006-0088 (Cost of Capital) — Comments on Board Staff Discussion Paper — Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors, dated July 25, 2006

The Coalition of Large Distributors[1] ("CLD") is pleased to provide further comments on the Cost of Capital material contained in the OEB Staff's above-noted draft report. CLD intends to submit expert reports on the Board's Cost of Capital and IRM consultation by August 14th 2006.

Cost of Capital — Theory and Process

- CLD strongly reiterates its comments from it first submission that the current process envisioned in the staff paper (other "evidence" filed in August followed by a technical conference, to be followed by a draft code issued by the Board for comment) is not an appropriate way to deal with an issue as significant as this revenue element.
- While Board Staff's latest paper has more clearly defined some of the cost of capital ("CoC") details, CLD strongly feels that this issue is sufficiently important (and this has been acknowledged by Board Staff in its statement that CoC forms a significant portion of LDCs' revenue requirement) to be fully tested via a full hearing with a full testing of available evidence. This is particularly important in light of the significant departure in the methodology for setting equity returns from current practice, and particularly because Board Staff's proposed methodology is fraught with weak and untested assumptions.
- CLD points out that Board Staff has noted (p 9) that they have reviewed the theory and the regulatory practices in several key Canadian and US jurisdictions. In CLD's own scan of such practices, it seems clear that the setting of CoC has usually been done based on full evidentiary basis and via a hearing process.
- Board Staff has posed the question (p. 8) that investors should ask what return on investment would be required to invest in distribution utilities versus other investment

[1] Comprised of Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc.

opportunities. Board Staff goes on to posit that the answer to the question lies in satisfactorily addressing the degree of risk with distribution utility investments. CLD submits that a subtle, but important, dimension is not being addressed here. That is, if incorrect investment information is disseminated to begin with (say via improperly set ROEs), then incorrect investment choices will be made. In other words, when market mechanisms prevail, analyzing the relative riskiness of alternative investments will be the only decision rule left for investors. When market mechanisms are replaced by regulatory pronouncements without a full testing of evidence, then the potential for incorrect information exists, leading to inappropriate investment choices. Accordingly, by setting ROEs too low without a full testing of available methodologies, there is a real risk of under-investment in the distribution sector, or that incremental investment in the sector will come at a higher than necessary cost to ratepayers via higher borrowing rates.

- If ROE is set too low through this process, LDCs will likely still be able to access debt capital borrow to meet their funding needs, however, the cost of borrowing will be higher than otherwise, resulting in a higher, long-run cost to ratepayers. This aspect is important since many LDC's are faced with significant infrastructure spending to refurbish and maintain their distribution networks.
- CLD understands Board Staff's desire for a more efficient regulatory process, and points out that a hearing can be efficient if a clear set of issues is developed on which expert evidence can be submitted, and provides for full review (including testing of evidence in an oral hearing) on which the Board can make a decision. Accordingly, CLD urges Board Staff to reconsider its current process, in favour of that recommended in the foregoing comments.

Ontario Market Conditions and Risks to Electricity Distributors

- CLD points out that while Board Staff has summarized the history of CoC for LDCs, and go on to suggest that LDCs may face challenges in the future arising from government policy respecting the "culture of conservation" and "smart metering", the actual risks borne by LDCs in the interim period from 1999 to 2006 has not been mentioned. CLD submits that this history is equally important to recount because it is precisely the interference in LDCs' businesses that occurred during this period (and the probability of this re-occurring) that is motivating rating agencies and capital market analysts to suggest that recent levels of ROE and proposed ROEs are too low.

- CLD also submits that the 9.88% ROE granted to LDCs was effectively never achieved due to the rate freezes soon after market opening in 2002, and the attendant lower returns were fully borne by LDCs' shareholders or by the LDCs themselves.
- For Board Staff to now propose even lower ROEs, with a seemingly complete disregard for the impact that continuing political and regulatory risk has on LDCs' business is imprudent.

Approach and Components

- CLD agrees with Board Staff's view of the Board's objectives in setting a regulated cost of capital. Achieving an appropriate return that balances LDCs' ability to raise capital in the most efficient manner possible with just and reasonable rates for consumers is paramount.
- In Board Staff's previous draft report on this subject, CLD pointed out the technical shortcomings of using 15-year forward rates as the proxy for the risk-free rate.
- Board Staff has reiterated their preference for the determination of the risk-free rate using the zero coupon bond methodology (p12). They say that the appropriate risk-free rate for regulated utilities is a smoothed average of these curves. Board Staff does not say which curves would be averaged (though they imply using the 5-15 year curves, presumably in reference to the Lazar-Prisman paper).
- Board Staff also show these interest rates averaged over a rolling 6-year period. However, there is no analysis as to why the 5-15 year average is appropriate, nor why a rolling 6-year period is most appropriate. In fact, elsewhere in their paper, Board Staff acknowledge that utility assets are long-lived and thus should be costed at long-term rates. This suggests that using the 5-15 year average is inappropriate. It is also not in line with the current way in which the risk-free rate is determined, which approximates a forecast of 30-year bonds using a public forecast of 10-year bonds and adding a spread.

- CLD suggests that if Board Staff wishes to depart from the consensus forecast method (which admittedly is not ideal, especially using one month historical spreads to determine the forecast 10-30 year spread) then the implied 20-year or 30-year forward rate is the more appropriate, and the most recent (prior to the rate year) values are most reflective of the current estimate for the test year. As Board Staff has noted, distribution investments are typically made in long-lived assets (30-years plus). Accordingly, CLD would strongly urge that Board Staff settles on an appropriate long-term risk-free rate, and not pick the 15-year zero coupon forward rate simply because it is convenient to do so due to available data.
- While CLD agrees with Board Staff that there are many ways of incorporating risk into an appropriate cost of capital, and agrees that a risk premium that is imparted by financial markets is likely appropriate, CLD believes that it is inappropriate to apply an average risk premium from companies that trade to companies that do not trade as a proxy for their risk.
- With respect to updating the inputs to the formula, Board Staff should bear in mind that it is probable that the sample of companies selected for purposes of determining the "average Beta" will change on a year-to-year basis (say due to mergers and acquisitions, insolvencies, and other business conditions). It is unclear from Board Staff's report as to how changes to the original sample set will be dealt with.

Capital Structure

- CLD supports Board Staff's recommendation to change the debt:equity split to 60% debt: 40% equity. In Toronto Hydro Electric System Limited's case, for example, the change will provide a more optimal capital structure, and allow it to transact in capital markets with greater ease than it currently can. CLD also commends Board Staff for simplifying the equity component and for maintaining the flexibility of preferred share issuances.
- CLD also notes that for LDCs that currently have higher equity-to-debt ratios than the proposed 40% equity-to-60% debt may experience some difficulty with an immediate adjustment to Board Staff's proposed capital structure. In this case, CLD supports a phased approach to the new proposed capital structure for these LDCs.

Equity Risk Premium

- Turning to Board Staff's continued insistence on recommending only the use of the Capital Asset Pricing Model to determine the risk-free interest rate and the risk premium, CLD and other LDCs have pointed out the shortcomings of using only the CAPM as the only risk evaluation technique. Newmarket Hydro Ltd. has also correctly pointed out a logical flaw in the Lazar-Prisman methodology, but none of this seems to have been reflected in Board Staff's current report. CLD again strongly urges Board Staff to reconsider this position.
- It seems clear from the material contained in both reports that, Board Staff's insistence on using the CAPM stems from a convenient "Beta plug" which yields a desired Return on Equity number. CLD asserts that a different ROE number would result had a more rigorous testing of data (including an examination of other evaluation techniques) been carried out by Board Staff. It also seems clear that by proposing a range of Beta estimates, Board Staff can suggest that all possible risk premia have been captured. For Board Staff to use such a shortcut for an issue as important as CoC, and for one that has with far-reaching implications for LDCs' dealings in capital markets seems irresponsible.
- CLD would also like to point out that Board Staff has made some incorrect assumptions with respect to the Comparable Earnings method. First, and this is particularly true for public reporting issuers such as THESL and Hydro One, the post-Enron era has seen a marked <u>increase</u> in scrutiny of accounting earnings, not less. Accordingly, while admittedly manipulations of accounting numbers will likely not abate due to human nature, the rigour behind accounting earnings and their subsequent reporting has clearly improved. Secondly, and perhaps more importantly, Board Staff seems to have missed an important link between CE and CAPM. That is, the Beta of a company is effectively a mathematical representation of that company's risk, and reflects how the company's returns move relative to the market. Returns for the company are based on information disseminated by the company (and other sources) into the market. *The* critical piece of information disseminated by any company that trades is its quarterly earnings number, and forward looking earnings

guidance. For Board Staff to summarily dismiss the CE due to notions of accounting manipulation would then logically also extend to dismissing the use of the CAPM Beta.

- Similarly, Board Staff would be well advised to note, again particularly for companies with traded equity and debt, that there is an enormous amount of internal and external scrutiny on a company's cash flows and its weighted average cost of capital (i.e., a superb proxy for its discount rate). Therefore to suggest that this is far more uncertain than attempting to specify market-based parameters (for LDCs that have no securities trading in any market) again seems to be a convenient rationale for selecting an evaluation methodology that suits Board Staff's ends.
- To reiterate, CLD feels that the strengths and weaknesses of each evaluation methodology would best be explored in a full hearing. If Board Staff insists on selecting an evaluation methodology outside of a full hearing process, then CLD is of the view that the current process at least needs to accommodate an expanded technical conference period, whereby the merits and shortcomings of all available evaluations techniques are more fully debated.

Return on Equity Scenarios

- Board Staff has determined their preferred ROE scenario, and shown some others in Table 3 on page 16. CLD notes that the data used to develop this table has not been made available, and requests that Board Staff makes it available for greater transparency.
- There is also no analysis as to why the particular terms or samples were chosen. This needs to be explained and other possible alternatives explored.
- A new concept introduced in the current draft is the possibility of allowing for an incremental premium on new infrastructure investment of 50-150bp. CLD agrees that there is a need for significant investment in infrastructure, however, CLD believes that a premium on only new infrastructure investment is not the best way to proceed. In fact, the inherent risk of failure of older assets is higher than new assets, and investors would naturally require higher returns to invest in such assets. Additionally, it is unclear from Board Staff's proposal that the premium would last the life of the

investment. And it is submitted that applying a premium only to new investment beginning in 2007 fails to recognize that infrastructure investment has occurred already, and would treat new investment differently, when it should not. CLD submits that the right way to proceed is to price all invested capital – new and existing - at the rate appropriate for the risk of each company.

- With respect to annual ROE adjustments, The Lazar/Prisman model suggested annual ROE adjustments of 70 percent of the change in long-bonds (p47). CLD points out that there is no support or explanation for the proposed 70% adjustment. Board Staff is reminded that the Cannon methodology uses a 75% change.
- Board Staff has suggested that, once the 2007 ROE is determined, no changes will be made annually to the ROE calculations, but instead, the inflation index in the IRM will "take care" of underlying equity cost changes. There is no evidence showing that just and reasonable allowed returns will be met by changes in the inflation component of the IRM mechanism. CLD challenges Board Staff to demonstrate that this would be the case.
- Instead CLD believes that, starting in 2008 when the first LDCs rebase, the ROE should then be adjusted annually to reflect the current cost of capital, based on the existing Cannon methodology. There is no evidence at all to suggest that there should be any changes from the 75% capital structure.
- CLD would also point out that the period used to estimate Betas for all the companies in the sample set is highly subjective. CLD's analysis shows a higher levered average Beta over the 6-½-year period from 2000 to July 2006 for the "Electrics" in Board Staff's sample set (Source: Bloomberg). The point being that, setting a starting point for establishing the new base for the Equity Risk Premium is highly subjective. Again, CLD strongly urges Board staff to reconsider the use of the CAPM as the only basis for establishing the ERP.
- Comments submitted in response to Board Staff's previous draft report dated June 19, 2006, THESL pointed out that Board Staff had incorrectly reported the level of the ROE using Dr. Cannon's methodology for December 2005 data. Board Staff had reported an ROE of 8.36%, while evidence submitted (and also re-filed as part of THESL's comments to Board Staff's draft report) as part of THESL's 2006 EDR

process clearly noted that the correct ROE level using 2005 data should have been 8.65%.

- CLD points out that Appendix B in Board Staff's current report continues to show the ROE calculated using the Cannon methodology using December 2005 data as 8.36%. To reiterate, CLD notes that Board Staff, in calculating the ROE at 8.36% has not adopted the full Cannon methodology, which includes an inverse relationship between interest rates and the equity risk premium. With lower interest rates, the equity risk premium should have been increased. CLD submits therefore that, the Board Staff's calculation ought to be termed a partial Cannon methodology update.

Debt Rate

- Board Staff has stated that affiliated debt should be priced at the riskless rate plus a bond market spread (p 17). They accept the recommendation of their experts that the spread should be based on corporate A/BBB-to-government bond spread. One shortcoming of this approach is what is a "suitable" sample of corporate A/BBB bonds. CLD would propose that, for LDCs that have publicly traded debt, corporate spreads are typically readily available from banks' "bond desks", and that these LDCs could provide their own spreads for affiliated debt.
- CLD also requests that Board Staff clarify what is meant by new third party debt being issued at the actual rate. Logically, in a forward test year, there would be no "actual" new debt.
- CLD also points out that Board Staff's recommendations for the k-factor in the IRM does not allow for any changes in debt costs (p. 21).
- With respect to the short-term debt component, it seems that Board Staff has changed its view on the short-term debt component of the capital structure, and now believes that it should be deemed to be 8% of rate base, based on the Hydro One's recent lead/lag study. CLD submits that the experiences of Hydro One may not be indicative of the lead/lags for other LDC's, and basing the value on this amount — especially since it is significantly different from the currently allowed 15% — may not be appropriate. Instead CLD suggests that LDCs should have the option of providing their own lead/lag studies, the results of which would be more

representative than the study undertaken by Hydro One. Absent that, CLD believes that continuing with the current practice of determining the Working Capital Allowance at 15% of the LDC's cost of power plus controllable costs is an acceptable yardstick for the amount of short-term debt that could be required. This is particularly true since the currently methodology does not include (in some cases) onerous postings with the IESO for prudential requirements.

- In commenting on distributors' ability to access capital markets, Board Staff has challenged parties to demonstrate any difficulties LDC's have had in attracting capital. In CLD's view, Board Staff is not asking the appropriate question. The issue is not whether LDCs will have difficulty with attracting capital, but rather the cost at which that capital is placed in the capital markets. In Toronto Hydro's own case, its inaugural debt issue was placed at a spread of about 111 basis points over the equivalent government of Canada bonds in May 2003. Board Staff will recall that this was soon after Bill 210 and the regulatory and political risks that capital market participants perceived LDCs to be carrying. In the subsequent period as government and regulatory policy respecting LDCs began to be clarified, Toronto Hydro's spread "narrowed" to about 60 basis points over the equivalent government of Canada bonds. Accordingly, the point that needs to be focused on is the price at which capital can be attracted. CLD asserts that it is in all parties' interests to ensure the cheapest access to funds on an on-going basis while remaining just and reasonable.