**Aiken & Associates**
578 McNaughton Ave. West
Chatham, Ontario, N7L 4J6
Phone: (519) 351-8624
Fax: (519) 351-4331
E-mail: raiken@xcelco.on.ca

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Board Secretary
Ontario Energy Board
27th Floor
2300 Yonge Street
Toronto ON M4P 1E4

**Re: EB-2006-0088 (Cost of Capital) and EB-2006-0089 (2nd Generation IRM) – Written Comments of the London Property Management Association on Staff Discussion Paper dated July 25, 2006**

These are the comments on behalf of the London Property Management Association ("LPMA") on the Staff Discussion Paper dated July 25, 2006 on the Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. Three paper copies have been provided and an electronic copy has been e-mailed to the Board Secretary.

Section 2.3.1
The staff conclusion that they believe that there is a need for significant expansion of investment in electricity distribution infrastructure for maintaining, enhancing and expanding the infrastructure and that this poses additional risks as compared to natural gas distributors is not substantiated. What information is this conclusion based upon?

The statement is made that the proposal is for a thicker common equity than for the Ontario natural gas distributors. It would be helpful if the Staff report provided the Board approved common equity ratios for Union, Enbridge and NRG. It would also be useful to report the percentage of preferred shared for these utilities, along with their long term and short term debt components for comparison purposes to that proposed by Staff.

Section 2.3.3
Based on the ROE scenarios shown in Table 3 and the text following it, Staff appear to be supporting the methodology that currently results in an ROE of 8.37%. The comparison of the outcome from applying the existing Cannon methodology is shown in Appendix B. Appendix B shows the update using the Cannon methodology based on December 2005 data. This should be updated to reflect more recent information. For example, using data for July, 2006, the riskless rate of 4.45% would increase to 4.75%.

It is unclear how the 8.36% in the updated Cannon column in Appendix B is calculated. In particular, it is assumed that the 3.8 is the sum of the 3.3 market ERP plus the 0.5 transaction adjustment, but this is not spelled out. It is unclear where the figure of 0.11 comes from.

It is also not clear that the Canon method has been updated properly. If the methodology is updated in a manner consistent with that of the natural gas utilities (as illustrated on page 33 of Dr. Cannon's December, 1998 Discussion Paper), the net ROE would be as follows (based on the December, 2005 riskless rate of 4.45%):

| | | |
|---|---|---|
| Allowed ROE Test Year 1 | | 9.88% |
| Test Year 2 long-Canada forecast | 4.45% | |
| Test Year 1 long-Canada forecast | 6.00% | |
| Change in interest rates | -1.55% | |
| Adjustment Factor (0.75 to 1) | | -1.16% |
| ROE for Test Year 2 | | 8.72% |

It should be clearly stated why the adjustment factor is not applicable to the electric LDC's in the same manner as it is applicable to the gas LDC's.

It would be useful in Staff could provide the references to the Board decisions and/or orders where the 50 basis points implicit premium for floatation and transaction costs have been approved. Also, are there similar Board decisions and/or orders that included a different level?

It is unclear why any premium over and above the base ROE would be required for new infrastructure investment. What is the basis for Staff proposal? The Staff paper limits this new investment to upgrading and expansion investments. What about investment to replace existing infrastructure? This should be clarified.

It is assumed that the higher ROE on the new infrastructure investment would only apply to the common equity component of this additional capital investment. This should be clarified.

This proposal raises the question that if the upgrading and expansion requirements are driven by a certain customer or customer class, should the higher ROE be recovered in rates from all customers? From a cost causation perspective, this may not be appropriate.

The approach that the 8.37% return would apply to rate base as of 2006 and the premium rate to rate base added after than also appears to be somewhat simplistic. The 2006 rate base would gradually decline over future years as the capital assets depreciate beyond the 2006 level and some assets are likely to be removed from service and/or replaced with new assets. In other words, under the Staff proposal, only the net increase in rate base would attract the premium return. Is this the intent of the proposal?

<u>Section 3.2</u>

LPMA disagrees that one of the objectives of the second generation IRM is to drive efficiency improvements. This is not likely to occur given that the term of the plan ranges from 1 to 3 years, depending on when a utility re-bases. Further, the X-factor of 1.0% proposed by Board Staff is not adequate if this is indeed a goal of the second generation IRM. This is discussed more fully below.

LPMA is also concerned that the second generation IRM is to lay a foundation for the third generation IRM. The development of a third generation IRM should be the subject of a full hearing and should be developed from first principles.

Section 3.3.1

LPMA agrees that the proposed inflation proxy tracks changes in the market returns and cost of capital, including ROE. There is no need for any subsequent adjustments for ROE beyond 2007. This reflects the Board's previous finding in the RP-1999-0017 Decision with Reasons dated July 21, 2001 for a comprehensive PBR pan for Union Gas. At paragraph 2.368 of that Decision the board stated:

> *"The Board notes that the effect which inflation might have on the determination of a fair allowance for ROE is, to a significant extent, captured by annual changes in the GDDPPI component of the PCI. The impact of the differences in capital intensity between Union and industrial companies in general is captured in part through the appropriate determination of the input price differential. In the Board's judgment, the components of a fair ROE, which reflects the risks to which the utility is exposed, are captured under a PBR approach, to a large extent, through the application of an appropriate price cap escalator that includes the I-factor and the X-factor."*

LPMA does not agree, however, that the K-factor adjustment in 2007 should only be applied if the newly calculated ROE differs by more than 10 basis points from the 2006 Board-approved ROE of 9%. Given that the rates determined in 2007 could be the base rates for up to three years, reflecting the K-factor adjustment for 2007 regardless of the magnitude of the change if more fair for both the utility and ratepayers. As an example, a 10 basis point change in ROE for London Hydro is approximately $90,000. This is larger than the materiality threshold of 0.2% of distribution expenses, which is approximately $67,000.

With respect to the calculation of the K factors described in Appendix C, LPMA does not believe that it is appropriate to use an average of the adjustment factors. Given that Board Staff is proposing to use a "large" sample of utilities to calculate the averages, it would not much more work to calculate specific K factors for each utility for 2007 and 2008. LPMA does not believe that applying an average to each utility will result in just and reasonable rates for all utilities. Some utilities will benefit and others will suffer from this approach. Ratepayers will either pay more or less than if the specific utility adjustments were used.

As to the actual calculation of the K-factors, LPMA supports the proposed methodology, assuming the income and capital rates are updated to reflect the 2007 values. Taxes are discussed in more detail below.

Section 3.3.2

While the starting base of 2006 rates has been determined, LPMA strongly urges the Board to adjust the 2006 rates for the removal of the federal capital tax wich has been repealed as of January 1, 2006. This would be preferable to charging rates for up to 3 additional years that include a tax that is no longer applicable and recording this amount (including gross up for the I-X factor) to a variance account for rebate to customers. It should also be noted that this adjustment would only be needed for the larger utilities, as smaller LDC's would not have included any federal capital tax in their revenue requirement as a result of the $50 million exemption.

Section 3.3.4

The staff proposal would be based on the change in the level of the price index on a 4th quarter over 4th quarter basis. LPMA believes it would be better to base the change in the index on an annual over annual figure. The table below shows the impact of using the 4th quarter over 4th quarter calculation as compared to the annual index levels in calculating the percentage change over the 2001 through 2005 period.

| | Final Domestic Demand (Quarterly) V1997757 | | | Final Domestic Demand (Annual) V3860249 | |
|---|---|---|---|---|---|
| 2000 IV | 105.9 | | 2000 | 105 | |
| 2001 I | 106 | | | | |
| 2001 II | 106.9 | | | | |
| 2001 III | 107.1 | | | | |
| 2001 IV | 107.3 | 1.3% | 2001 | 106.8 | 1.7% |
| 2002 I | 108.1 | | | | |
| 2002 II | 108.8 | | | | |
| 2002 III | 109.7 | | | | |
| 2002 IV | 110.4 | 2.9% | 2002 | 109.3 | 2.3% |
| 2003 I | 110.8 | | | | |
| 2003 II | 110.3 | | | | |
| 2003 III | 111.3 | | | | |
| 2003 IV | 110.9 | 0.5% | 2003 | 110.8 | 1.4% |
| 2004 I | 111.6 | | | | |
| 2004 II | 112.7 | | | | |
| 2004 III | 112.8 | | | | |
| 2004 IV | 113 | 1.9% | 2004 | 112.5 | 1.5% |
| 2005 I | 113.7 | | | | |
| 2005 II | 114.6 | | | | |
| 2005 III | 115.1 | | | | |
| 2005 IV | 115.3 | 2.0% | 2005 | 114.7 | 2.0% |
| Average (5 years) | | 1.7% | | | 1.8% |

As the above table shows, the fourth quarter over fourth quarterly inflation figures range from 0.5% to 2.9%, while the increase in the annual figures range from 1.4% to 2.0%. Over this five year period, the average increases are virtually the same at 1.7% and 1.8%, respectively. What this illustrates is the volatility that is inherent in using the quarter to quarter approach. Given the desire for a stable environment, the use of the annual figures (which are available from Statistics Canada at the same time as the release of the 4th quarter data) is more reasonable.

It should also be noted that that the impact of revised data is greater when using quarterly data as compared to using annual data. The annual figure is the average of the four quarterly figures for the year, so any revision in the fourth quarter figure is moderated in the annual figure.

Section 3.3.5

It is not clear to LPMA where Board Staff get the 1% X factor from based on page 55 of the PEG Report. The average of all the X-factors shown in the table there that use a macroeconomic inflation measure (i.e. GDPPI and CPI) appears to be 1.16% and not 1.01%. Based on this, LPMA suggests the X-factor should be increased to 1.1% or 1.2%.

By accepting an X-factor in the 1.0% to 1.2% range, LPMA is in no way suggesting that this would be an appropriate level for a third generation mechanism. The X-factor for a longer term plan should include review of an input price differential (subject to the inflation factor used), historical productivity and a stretch factor (in lieu of an earnings sharing mechanism).

Section 3.3.6

LPMA accepts the use of Z factors for taxes. Taxes clearly meet the eligibility criteria shown in Table 4. However, LPMA does not believe it is appropriate to apply the materiality threshold to the tax changes. There are two good reasons for automatically adjusting rates for changes in tax rates. First, the Board has been concerned in the past that distributors were collecting more in taxes than they were required to actually pay. Nothing has changed to alter that concern. Second, under incentive regulation, Board Staff indicate that one of the goals is to drive efficiency improvements. As tax rates fall over the next few years (see below), the utilities could do nothing to improve efficiency and simply pocket the reduction in taxes payable. LPMA submits that this is inappropriate. Ratepayers should pay rates that reflect the expected tax rates, nothing more or less.

The following is brief overview of the tax changes that are currently known.

TAX CHANGES

This is a summary of corporate income and capital taxes as they are in the 2006 EDR model and the changes resulting from the most recent federal and provincial budget from earlier this year. Note that just because a tax change is proposed in the budget does not mean that it will actually come into effect when proposed. Similarly, future budgets may change the proposals or add new proposals. But here is what is currently on the horizon.

a) Provincial Capital Tax

The EDR model for 2006 uses a $10 million deduction to the net paid up capital (proxy is rate base) with a tax rate of 0.3%.

The most recent provincial budget increases the $10 million deduction to $12.5 million for 2007 and to $15 million in 2008 and beyond. In addition, the capital tax rate declines to 0.285% for both 2007 and 2008, to 0.225% in 2009, to 0.150% in 2010, to 0.075% in 2011 and is eliminated in 2012. The budget documents also indicate that if the fiscal position of the province allows it, the tax would be fully eliminated two years earlier, in 2010.

b) Federal Capital Tax (Large Corporations Tax)

The EDR model for 2006 uses a $50 million deduction to the net paid up capital (proxy is rate base) with a tax rate of 0.125%.

The tax has now been repealed as of January 1, 2006. As per the EDR Handbook, this tax saving will be booked into a deferral account. 2006 rates should be adjusted for the removal of this tax before any price cap index is applied. It should be noted that this will only affect large utility rates as small utilities with a rate base of less than $50 million would not have had any of this capital tax built into rates.

c) Provincial Corporate Income Tax

The EDR model for 2006 uses a tax rate of 5.50% for taxable income of less than $400,000 and 14.00% for taxable income in excess of this amount. There is also a Small Business Deduction Clawback rate of 4.67% for taxable income in excess of $400,000 and less than $1,128,519.

There are currently no changes proposed to these rates and thresholds.

d) Federal Corporate Income Tax

The EDR model for 2006 uses a tax rate of 12.00% for taxable income less than $300,000 and a tax rate of 21.00% for taxable income in excess of this amount. In addition, a corporate surtax of 1.12% is applied on all taxable income.

There are three categories of changes to the above from the federal budget. The first reduces the tax rate applicable to taxable income in excess of the small business threshold (currently $300,000). The tax rate declines from 21.0% in 2006 and 2007 to 20.5% in 2008, to 20.0% in 2009 and to 19.0% in 2010.

The second change is the elimination of the corporate surtax in 2008. The rate of 1.12% remains in place for 2006 and 2007.

The third change is a series of changes to the small business tax rates and threshold. The threshold increases from $300,000 to $400,000 effective January 1, 2007. The applicable tax rate falls from 12.0% in 2006 and 2007 to 11.5% in 2008 and to 11.0% for both 2009 and 2010.

e) Impact on Revenue Requirement

The impact on a particular utility revenue requirement will vary based on each individual circumstance, but could be significant.

The following analysis based on the tax model filed by London Hydro as part of the 2006 EDR filing and the changes provided above.

| | |
|---|---|
| Total Taxes Claimed by London Hydro for 2006: | $5.954 million |
| Reduction in 2007: | $0.166 million (or 2.8%) |
| Reduction in 2008: | $0.533 million (or 9.0%) |
| Reduction in 2009: | $0.751 million (or 12.6%) |
| Reduction in 2010: | $1.100 million (or 18.5%) |
| Reduction in 2010 (with full elimination of provincial capital tax) | $1.377 million (or 23.1%) |

London Hydro had a base revenue requirement of approximately $50.4 million. The above reductions as a percentage of this revenue requirement are as follows:

| 2007 | 2008 | 2009 | 2010 | 2010 (elimination) |
|---|---|---|---|---|
| 0.3% | 1.1% | 1.5% | 2.2% | 2.7% |

As the above illustrates, the change in taxes can be significant. LPMA urges the Board and Staff to ensure that such changes flow through to ratepayers.

Section 3.3.7

LPMA is concerned with the absence of any earnings sharing for over earnings over this period. The Z-factors proposed by Board Staff appear to be designed to favor the utilities with increases in expenses. It is unclear how ratepayers have equal protection against material cost decreases that would qualify as a Z-factor. It is not likely that utilities would bring forward such items that result in “refunds” to ratepayers and ratepayers do not have access to the information required to bring forward such circumstances to the Board.

LPMA submits that an earnings sharing mechanism that is asymmetric (i.e. only applies to over earnings) should be put in place to project rate payers. A deadband of 100 basis points over the ROE would provide utilities with incentives to become more efficient and pocket the first portion of any over earnings. Any earnings in excess of this deadband would be shared 50/50 between ratepayers and the company. The ROE to which the deadband would be applied should be that calculated each year in 2007 through 2009. This calculation will be done for those utilities that rebase in each of 2008 through 2009. This ensures consistency between those utilities that rebase and those that do not. For example, if the ROE for 2007 is 8.50% and changes to 8.75% in 2008, those utilities that rebase for 2008 will be allowed a return of 8.75%. Under the proposal above, a utility that does not rebase until after 2009 would be able to earn 8.75%, plus 1.00% or 9.75% before any earnings sharing would take place. In our view, this allows utilities to seek efficiency improvements and additional profits, while ensuring that excessive gains are shared with ratepayers.  This also eliminates gaming by utilities with respect to the timing of rebasing.

Section 3.3.8

While distributors may have been reporting their performance on SQI's since 2000, much if this information is not widely available and easily accessible by ratepayers.  LPMA submits that this information, including historical data, should be available on the OEB's website.  The public reporting of SQI's is critical to ensure transparency in the absence of full rate proceedings.

Section 3.3.9

To ensure transparency and to protect ratepayers, the LDC's should be required to file their financial information with the Board at the same level of USoA detail as was required to be submitted in the 2006 EDR applications.  Further, the Board should post this information on its website so that is easily accessible to all.

Section 4.1

In addition to determining which utilities should rebase in each of 2008, 2009 and 2010, LPMA believes that within each grouping for a particular year, the filings should be staggered throughout the year as much as possible.  The Board will need participation of intervenors to thoroughly review cost of service filings based on forward test years.  All parties would be stretched thin if all of the applications came in at the same time.

Further, LPMA believes that the Board should ensure that all utilities are aware of and prepared to meet the minimum filing requirements (including historical, bridge and test year data) that will be required.

If an over earnings sharing mechanism is put in place, LPMA submits that the selection of the utilities and when they rebase is less critical.  In the absence of such a mechanism, then the Board should require the utilities that have excess earnings to rebase first.

Sincerely,

*Randy Aiken*

Randy Aiken
Aiken & Associates
578 McNaughton Ave. West
Chatham, Ontario, N7L 4J6
Phone: (519) 351-8624
Fax: (519) 351-4331
E-mail: raiken@xcelco.on.ca