EB-2006-0088/89

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.

SUBMISSIONS

OF THE

SCHOOL ENERGY COALITION

1. The following are the School Energy Coalition ("SEC") submissions with respect to the Staff Report dated July 25, 2006 in this matter. To the extent that our comments continue to reflect our submissions of July 7, 2006 (the "Preliminary SEC Submissions") on the initial Staff Report, we have so indicated and have not duplicated our arguments in full.

2. ***Consultation Process.*** SEC continues to be pleased with the consultation process that the Board is employing for this initiative. Comments to the contrary by the Bank of Montreal ("The Coming Winter" – August 8, 2006) appear to us to be ill-informed and indicative of parties who have not participated actively in that consultation process. We will have more comments on that questionable BMO Report later in these submissions.

3. ***Transitional Rules.*** We note the emphasis in the Staff Report on these proposals being transitional in nature. In our view, these proposals must be assessed with that in mind. Once the Board has been through a full cost of service cycle for all LDCs (with all the additional information and analysis that implies), and in the meantime the industry has continued to consolidate and learn how to deal with their new business structure, we believe that the Board will be in a better position to develop a steady-state model. We guess that model will have a lower overall cost of capital, and higher productivity adjustments, for example, but we cannot really tell until the considerable additional information and understanding gleaned over the next four years is analysed.

4. ***Use of Licence Conditions and Code-making Power.*** We continue to have concern about the choice of licence conditions plus Codes to establish rates for LDCs over the next three years. We believe that, if the Board intends to proceed down that path, it should:

   a. Order that all quarterly utility filings should be publicly available and posted to the Board's website.
   b. Establish a stakeholder council to provide input on the Board when each quarterly filing is available.

Cost of Capital Issues

5. ***Introduction.*** In our review of the Staff Report, we have gone back to the 2006 EDR filings of the LDCs, and have selected (essentially at random) fifteen to review the base data for existing cost of capital. Attached as Schedule A to these submissions is a spreadsheet detailing the results of that analysis.

6. We note that this Cost of Capital Comparison is not intended to be a statistically valid sample (in fact, a proper study should include all LDCs), and it is clear that there are anomalies in the data. Further, it was not practical to include Hydro One, Toronto Hydro and Hydro Ottawa, all forward test year filers, and clearly those three would substantially impact the data.

7. That having been said, the data still represents fifteen LDCs with a combined rate base of more than $2 billion, and a combined service revenue requirement of more than $500 million. A review of the information presented allows one to suggest a few conclusions that may, when all data is considered, prove to be true:

a. The deemed debt rate appears to be a floor, not a standard. Only one utility – Orangeville – had an actual debt rate below that of the Board standard, and only one – London – had a rate which equalled the Board standard. In all thirteen other cases, the actual rate was much higher than the Board deemed rate.

b. On average, the actual debt rates are 68 basis points higher than the Board standard. This looks to be the case whether or not the debt is held by an affiliate or by arms-length third parties like banks.

c. While debt rates of larger utilities are generally lower than those of smaller utilities, the lowest rate of all in this sample is a small utility (Orangeville), while two of the larger ones (Horizon and Veridian) have relatively high rates.

d. The debt rate for Enersource, 6.44%, reflects a public issuance of bonds in 2001 at 6.27% that reflected not just the utility risk, but the higher risk associated with unregulated businesses. While this is listed as affiliate debt (presumably because it is back to back), and it is listed at a higher rate than the debt issued by the parent company, in fact it should probably be at a lower rate (perhaps 6.15% or so) since the utility is lower risk than the parent. This is but one example of anomalies in the data that should be addressed as staff moves forward in its analysis.

e. Most of the debt continues to be held by affiliates (almost always the municipality), apparently because of the high rate allowed. We note that the current new issue rates for publicly-traded municipal debt in Ontario are in the 5.00% to 5.50% range depending on size (and posted yields on existing debt are lower still), meaning that municipal holders of LDC debt are earning 150 to more than 200 basis points spread on that debt.

f. The total cost of capital for this sample is about 3.6% higher than the Board formula would produce. This is $7 million more in rates than would otherwise be the case.

g. When the debt rate, the return on equity, and the gross-up on the return are all added in, the total cost of capital is about 40% of the overall rates for these fifteen utilities. On average capital costs are just under 10% of rate base, but in fact range in this sample from 9.33% to 10.67%.

8. As we note in various places below, the Staff Report attempts to deal with some of the issues implicit in this data.

9. ***General Goals and Parameters.*** We continue to believe that the cost of capital experienced by the holders of LDC debt and equity should be a relevant criterion in setting the cost of capital of those LDCs. As we previously pointed out, the capital rules should ensure as much as possible that local municipalities are indifferent as to whether they provide the capital to their LDC, or the LDC acquires that capital in the marketplace. Control, of course, is a different thing, but in our view the fact that most LDC debt continues to be held by cash-strapped municipalities demonstrates that the rates allowed are too high.

10. The BMO Report goes on at some length on how the Staff Report misunderstands the obligation to give the investors a fair rate of return. With respect, it is BMO that misunderstands the policy imperative here. The Board's statutory mandate is to set just and reasonable rates. As a step in achieving that goal, the Board must ensure that the utility has access to sufficient capital to operate the distribution business safely, reliably, and efficiently. That in turn requires, as courts have long since determined, that the investors be granted a reasonable rate of return on their invested capital. In the Staff Report, Objective 1 is entirely correct. The Board's focus must be on just and reasonable rates. The cost of capital should be no more than is necessary to generate a reasonable rate of return.

11. In this context, it should be kept in mind that the current cost of capital, as shown in by way of example in Schedule A, is higher than is either necessary or consistent with the market. For Board Staff to seek to get the level closer to a market rate is, it is submitted, precisely what they should be doing.

12. We also note that the BMO Report refers more than once to the utility's need to "recover the cost of its capital". Again, with respect this misses the point. Where a utility issues capital on an arm's length basis to third parties in a market context, the market sets the cost of that capital. To our knowledge, no-one is debating whether in that situation the utility should be entitled to recover the actual cost of that capital.

13. The problem arises where the capital provider does not deal at arms length with the utility. In that case, a proxy for the market must be identified. Failing the establishment of a market price, the cost of capital is actually the affiliate's cost. In the case of a municipality as investor, that would likely be a debt rate of 5.00% or thereabouts, applied to all capital (debt and equity) supplied to the utility. Of course, the municipality's cost does not in fact have to be used, because market data is available. However, for BMO to bemoan the failure of the Board to allow LDCs to recover their cost of capital is just wrong. The Board's goal here is to identify the market cost of capital. Whether it will be recoverable is not an issue in this proceeding.

14. In passing, we note BMO's suggestion that the pressure to restructure as income trusts is evidence that municipalities want to get rid of their utility investments. This is not defensible. The pressure to use income trusts is because of the significant tax benefits available in that structure. What would be salient evidence would be if the municipalities were in fact trying to get rid of their LDC investments. In reality, not only is there no seller's market for utility investments, but the most recent acquisitions of utilities have been at a premium to book. The equity is valued at a premium because the market has established that a lower ROE is acceptable to utility investors.

15. ***Capital Structure.*** We agree with the Staff Report that fixing the same deemed capital structure for all LDCs is a good approach.

16. In our previous comments, we supported a debt/equity ratio of 65/35, the same as the gas utilities. The Staff Report stays with the 60/40 split it originally proposed. We accept that, as a transitional rule, 60/40 can be justified due to the capital needs of the LDCs over the next few years. However, we believe the Board should signal that moving to a 65/35 split is a goal for the future, so that utilities can plan for that eventuality.

17. We continue to be concerned about the pricing of preference shares. It is not clear to us why any LDC would include preference shares in its capital structure on the current proposals in the Staff Report. The result would be to reduce the effective return on equity.

18. We agree with the proposal in the Staff Report that short term debt be fixed at 8%, and with the rationale underlying that number.

19. ***Cost of Long Term Debt.*** The Staff Report's proposal on the cost of long term debt issued by LDCs continues to result in a current rate of 6.01%. We have commented on this in more detail in the Preliminary SEC Submissions. In short, a proposal that produces a result that is out of sync with the market should not be adopted. The whole point of this exercise is to establish the "fair market value" of the cost of various components of capital. We know that Toronto and others can issue debt at close to 5.00% in the public markets. Against this background, Dr. Cannon's methodology produces something closer to the market reality (5.15% to 5.60%), and should be preferred.

20. We note that the Staff Report assumes that LDCs will continue to act on their own in issuing long term debt, whether on the public markets or to their own municipal shareholders. We are familiar with the borrowing approach of Ontario's school boards through Ontario School Boards Financing Corporation (OSBFC). The seventy-two school boards, many of whom use OSBFC, present, like the LDCs, a mix of small and large entities with varying needs. None have a government guarantee. However, by borrowing through a common vehicle they get rates for their public debt not much more than 5.00%. Similar techniques have been tried

tried by LDCs prior to market opening, but that is not taking place today as far as we know. (It would be useful for LDCs to lead evidence before the Board explaining why that is the case, if it is.)

21. In our view, the Board should assume that prudently-operated LDCs will use all techniques available to ensure that the interest on their long term debt is as low as possible. This should mean an assumption that LDCs can borrow through common vehicles on the public markets, and in turn that should mean that the cost of capital should be lower as a result.

22. We have a serious concern with the proposal in the Staff Report that existing affiliate debt be allowed to continue at the current interest rates. This is a thorny issue, and one on which there are legitimate positions on both sides:

a. In principle, if a utility needs $50 million for new 30-year capital assets, and borrows that money from its shareholder on a fixed term basis at market rates, everything about that debt should match the market. For example, if the loan is a 30-year debt, not callable earlier, then an interest rate matching the 30-year market should be appropriate. That amount should continue to be recoverable from ratepayers for the entire 30 years, as long as it was equivalent to market at the time of issuance.

b. In practice, the shareholder controls the LDC, and as a result all debt, whether long or short term, is actually demand debt. Debtor and creditor can always agree to cause a repayment, whatever the terms actually say, and if the creditor controls the debtor, that means the creditor has the ability to cause repayment at any time.

c. But, this means that in practice if current interest rates are less than the original rate at the time of issue, the shareholder will leave the debt in place. However, if current interest rates are higher than the original rate, it is in the interests of the shareholder to cause the old debt to be repaid.

d. Given these facts, in our view existing affiliate debt should be repriced each year to reflect the current market rate for debt with that particular maturity. LDCs always have the option, of course, to borrow from arm's length third parties, in which case the rate at time of issue would continue to be recoverable in rates as long as the debt is outstanding and non-callable. If they elect to borrow from their shareholder or other affiliate, they should be required to follow an annual repricing rule so that the asymmetry noted above can be avoided.

e. We propose one exception to the above rule. We suggest that a utility should be able to borrow from an affiliate at a long term rate, and recover that rate throughout the period, if the borrowing cannot be prepaid without an order of the Board. Any utility that wishes to have this apply to existing affiliate debt should be required to reprice that debt at current market rates.

23. We note that, as shown in Schedule A, the continued application of old rates to existing affiliate debt is an important reason why the cost of capital being charged to ratepayers today is substantially in excess of market.

24. We agree with the comments in the Staff Report with respect to the lack of evidence that LDCs are capital constrained, and we believe the Board would be informed by expert evidence on the activities of the LDCs in the capital markets.

25. ***Cost of Short Term Debt.*** The Staff Report no longer (unless we missed it) contains a proposal on the interest rate for short term debt. We believe that the previous proposal – ie. to use the same rate as is approved for regulatory assets – is appropriate.

26. ***Cost of Preferred Equity.*** We continue to be concerned that the cost of preferred equity is not dealt with directly in the Staff Report.

27. ***Cost of Common Equity.*** We have supported the equity approach of Lazar and Prisman in the Preliminary SEC Submissions, and we continue to agree with it (still subject, of course, to our view of the riskless rate, set forth earlier).

28. Board Staff has, however, made three significant changes. First, the Staff Report now proposes that long-term assumptions be used for ROE. We agree in principle with that analysis and approach.

29. Second, the Staff Report proposes that the comparable group should be all rate-regulated companies. There is no empirical evidence supporting this, and in our view LDCs are more likely to share common risks with other electrics than with other rate regulated entities. This is especially true of telecom companies.

30. Third, the Staff Report proposes to add a premium of 50 to 150 basis points for new infrastructure investment. Aside from the fact that this proposal does not appear to have any analytical basis, nor is there any evidence showing that it is needed, we are concerned that such a step would invite gaming by the LDCs. It will, it appears to us, be important for them to shift as much capital to the "new" category as possible in order to increase their returns. When in the past the tax system has given incentives for new investment, such gaming has been rampant.

31. The tax incentives example raises another problem. Not only did companies try to characterize everything old as new, but as well the market for good used assets dried up, because the tax incentive skewed the business decision away from the most efficient choice, and toward the most tax efficient choice. The same may well happen here if this two-tier ROE is implemented.

32. We note that the Staff Report still does not lay any foundation for the 50 basis point transaction premium, although we have raised it in the Preliminary SEC Submissions.

Second Generation PBR Issues

33. ***Introduction.*** SEC continues to support long-term, formula-driven rates that guarantee rate increases of less than the rate of inflation. In general the approach in the Staff Report to transitional IR follows this same philosophy, and we agree with it. We do have some comments on the details. Because this is transitional, our comments are directed at balancing short-term efficiency, simplicity, and time management against the need to generate a close approximation of just and reasonable rates.

34. ***Initial Rebasing Year.*** We continue to be concerned that Toronto Hydro and Hydro One are not being asked to rebase in 2007. Other than that, and our comments on the selection of cohorts below, we agree with the Staff Report on the initial rebasing approach.

35. ***Use of GDPPI.*** We agree with the use of GDPPI as the base escalator, and while we disagreed in the past, we accept the conclusion of Board Staff that the final domestic demand number is the most appropriate.

36. ***Adjustment for Cost of Capital.*** We have three comments on the proposed K factor in the Staff Report.

37. First, in our view the choice of adjusting only for ROE in 2007, and then for debt in 2008, is not justified. Once the cost of capital is being adjusted to a more suitable level, it should be fully adjusted unless there is some compelling reason not to do so. Here, there is no improvement in efficiency, nor material reduction in complexity, by using the two-step approach. If the purpose of the two step adjustment is to ameliorate the impact on the LDCs, then in our view Board Staff should give numerical examples to show the rate/revenue impact, and demonstrate that some phasing in is required. Otherwise, the adjustment should take place in full in 2007.

38. Second, we have attempted to replicate the formula in Appendix C, and have been unable to produce consistently fair results. The reason, it seems to us, is that the formula assumes that a single number for a group of LDCs – a common "K factor" – is required in order to adjust rates during an IR period. We do not agree, and we think our Schedule A attached amply demonstrates this. In our view, once the Board has done steps 1 and 2 in Appendix C, it has the correct answer for the specific LDC, and should leave it at that.

39. Third, the formula appears to assume that the composite debt rate in 2006 will continue for 2007 and beyond, until rebasing. Perhaps the proposal adjusts for this elsewhere, but from our review it appears that the high debt rates allowed in 2006 are intended to continue. This is not appropriate, and if the Staff Report intends this to be the case, then we strongly disagree.

40. ***Productivity Factor.*** The Staff Report continues to propose a fixed productivity factor of 1%. We repeat the same two comments on this number that we had in the Preliminary SEC Submissions:

a. First, it appears to be generally low for utilities that have never been subject to regulatory scrutiny in the past.

b. Second, setting a fixed productivity factor for all LDCs will reward the most inefficient LDCs and penalize the most efficient. Without adjusting for the relative price levels of the LDCs (which is, in this case, a proxy for the existing efficiencies already built into their costs), any fixed productivity factor is too easy on the high priced LDCs, and too onerous for the low priced LDCs.

41. ***Relative Pricing Factor.*** The Staff Report rejects our previous proposal that the price cap contain an explicit adjustment based on the comparative costs of the LDCs relative to their peers. We continue to believe that this is a critical issue. Ratepayers do not understand why the Board allows some distributors to charge twice as much as others for the same service, and so far has taken no action to move away from this situation.

42. ***Z Factors and Off Ramps.*** The earlier Staff Report proposed Z factors for only smart meters and tax rates. The later Staff Report now proposes a set of criteria for a generic Z factor, eerily similar to the "non-routine and unusual adjustments" rule that bedevilled the 2006 rates process.

43. It is important here to repeat the principle we set forth in the Preliminary SEC Submissions. SEC is opposed to Z factors and off ramps, and believes that utilities under incentive regulation should see the revenue requirement generated by the formula as the budget within which they have to manage the utility, set priorities, and decide how best to spend a fixed amount of money. This fundamentally alters the ratemaking paradigm that a utility is entitled to recover their prudently incurred cost of service plus a reasonable return on invested capital. Instead, it proposes the paradigm that the utility should be granted a reasonable envelope, out of which it has to incur its cost of service, and then retain the amount left over as its return on invested capital. We agree that this is a better paradigm, which promotes more business-like management of the LDC.

44. The use of a generic Z factor is fundamentally incompatible with this type of "light-handed regulation". Instead of leaving the LDCs to get on with the job, this approach creates a built-in asymmetry in which the formula is the floor, and the LDC then looks for ways to increase their allowed rates through exceptions. Running an LDC becomes about adeptness at playing the regulatory game, rather than operational excellence.

45. We strongly disagree with this proposal. In place of the Board Staff proposal, we suggest that the Board adopt a rule that a factor that meets the tests in Table 4 of the Staff Report be allowed as a Z factor only if, in and of itself, it reduces the expected ROE for the shareholder by at least 250 basis points. The effect is that, if the ROE would otherwise drop to roughly the debt rate, the Board should review the impact to prevent deterioration of the LDC's financial position. Anything less than that should not, in our view, be tolerated if the Board wants an efficient IR process.

46. ***Selection of Cohorts.*** We would add "size" as a criterion for establishing cohorts, and we repeat our comments in the Preliminary SEC Submissions and above on the importance of considering relative rate levels in the Board's assessment of urgency.

Conclusion

47. In our view the Staff Report is a step in the right direction, and shows a careful understanding of the need to balance disparate interests. We have suggested a number of changes, but on balance believe that the Staff Report is a good foundation for the Board's decision making process.

All of which is respectfully submitted on behalf of the School Energy Coalition this 14th day of August, 2006.

SHIBLEY RIGHTON LLP

Per: ______________________
Jay Shepherd