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VIA E-MAIL AND WEB POSTING

April 27, 2006

To: All Licensed Electricity Distributors

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

Earlier this year, the Chair of the Ontario Energy Board announced that the Board has established a multi-year electricity distribution rate setting plan (the "Plan") for the years 2007 to 2010. The elements of the Plan and certain key milestones and associated tentative schedule are set out in the table attached as Appendix A to this letter.

The purpose of this letter is to describe the process that the Board intends to use in relation to two of the elements of the Plan: the review of the cost of capital and the development of a 2nd generation incentive regulation mechanism (the "2nd Generation IRM").

Overview of Project

The objectives of the Plan are: to provide greater regulatory certainty to distributors during 2007 to 2010 as several rate-related studies are carried out; to begin to drive efficiency improvements in the distribution sector; and to lay a foundation for the 3rd generation incentive regulation mechanism (the "3rd Generation IRM").

To achieve these objectives, the Board needs among other things to:

- confirm the cost of capital to be used in adjusting annual revenue requirements for 2007 and beyond; and
- establish a simple, practical and mechanistic incentive rate adjustment mechanism for the Plan period.

With respect to the cost of capital, the benchmark paper prepared for Board staff by Dr. William T. Cannon, dated December, 1998 and entitled "A Discussion Paper on the Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities", will be used as the point of departure. There will be a review of the economic and financial issues that are discussed in the paper as well as a broader examination of the risks faced by distributors.

With regard to the 2nd Generation IRM, the Board will examine the following: the method for determining, and the value for, a price escalator (price index) and a productivity performance standard (productivity factor); any boundaries for contingencies (including off ramps, z factors and variance accounting); the need for, and the appropriate form of, an earnings sharing mechanism; and suitable bridging to the 3rd Generation IRM. The term of (up to 3 years) and starting base (2006 EDR) for the 2nd Generation IRM have already been determined.

Important design criteria for this project will include consistency of approach across distributors, ease of implementation by distributors, and reasonable durability (some distributors will be subject to the 2nd Generation IRM for up to three years).

The Board's Approach

The Board will follow the process set out below for confirming the cost of capital to be used in adjusting annual revenue requirements for 2007 and beyond, and for establishing a simple, practical and mechanistic incentive rate adjustment mechanism for the Plan period.

Amendment to Electricity Distributor Licences

The Board will implement its cost of capital and 2nd Generation IRM determinations through an amendment to electricity distribution licence. The Board will shortly commence a proceeding on its own motion under section 74 of the *Ontario Energy Board Act, 1998* to amend the licence of each electricity distributor to stipulate that, in determining rates for the distributor, the Board will apply the methods or techniques set out in two new codes that will be developed as part of this project: a Productivity Code and a Cost of Capital Code. Interested parties will be invited to comment on the proposed licence amendments.

In tandem with the proceeding to amend electricity distributor licences, a process to develop the two new Codes will proceed as follows.

Phase I – Development of Mechanisms and Principles

Board staff will release proposals for both the cost of capital and 2nd Generation IRM in early June, 2006. The proposals will be based on research and analysis by external experts as well as the work of Board staff. The proposals will be

posted on the Board's web site and Board staff will then solicit stakeholder comment through a series of informal meetings in mid- to late- June.

Phase II – Code Development

Based on a consideration of Board staff's proposals and comments received from interested parties during Phase I, a proposed Cost of Capital Code and a proposed Productivity Code will be issued for comment by the Board in July, 2006 in accordance with the legislative requirements governing the issuance of codes. In light of the written representations received, the Board may propose changes to either or both of the proposed Codes.

Invitation to Participate and Cost Awards

The Board encourages participation in this process by interested parties.

Those interested in participating in the portion of this project that relates to the development of the two proposed Codes should indicate their interest in writing by letter addressed to the Board Secretary at the Board's mailing address set out above by **May 19, 2006**. Participation in the portion of this project that relates to the amendment of electricity distributor licences will be addressed separately.

Cost awards will be available to eligible persons under section 30 of the *Ontario Energy Board Act, 1998* in relation to their participation in the portion of this project that relates to the development of the two proposed Codes. The costs to be awarded will be recovered from all licensed electricity distributors based on their respective distribution revenues. Appendix B contains further details regarding cost awards for this project. Any person intending to request an award of costs must file with the Board a written submission to that effect by **May 19, 2006**. The submission must be addressed to the Board Secretary at the Board's mailing address set out above. Licensed electricity distributors will be provided with an opportunity to object to any of the requests for cost award eligibility, following which the Board will make a determination on the cost eligibility of the parties requesting an award of costs. The issue of cost awards in relation to the portion of this project that relates to the amendment of electricity distributor licences will be addressed separately.

Information related to this project, including the paper by Dr. Cannon referred to above and all filings to the Board in response to this letter, will be posted on the "Cost of Capital (**EB-2006-0088**) and 2nd Generation Incentive Regulation Mechanism (**EB-2006-0089**)" page of the "Key Initiatives & Consultations" portion of the Board's web site at www.oeb.gov.on.ca. The project information and filings will also be available for public inspection at the office of the Board during normal business hours.

All filings to the Board in relation to this project must quote file numbers **EB-2006-0088** (Cost of Capital) and **EB-2006-0089** (2nd Generation IRM) and include your name, address, telephone number and, where available, an e-mail address

and fax number. Five paper copies of each filing must be provided. The Board asks that interested parties make every effort to provide electronic copies of their filings, either on diskette or by e-mail to Boardsec@oeb.gov.on.ca. The electronic copy should be in searchable, unsecured Adobe Acrobat (PDF), if available, or in Word.

Yours truly,

A handwritten signature in black ink, appearing to read "P. O'Dell", written over a horizontal line.

Peter H. O'Dell
Assistant Board Secretary

Attachments: Appendix A – OEB's multi-year electricity distribution rate setting plan

Appendix B – Cost awards