EDA

The Voice Of Ontario's Electricity Distributors

September 13, 2006

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

Via email to BoardSec@oeb.gov.on.ca and by courier

Dear Board Secretary:

Re: Presentation: Cost of Capital (EB-2006-0088) and 2nd Generation Incentive Regulation Mechanism (EB-2006-0089) Technical Conference September 18–22, 2006

The Electricity Distributors Association ("EDA") is the voice of Ontario's local distribution companies. Enclosed is a presentation prepared by the EDA and Christensen Associates Energy Consulting LLC for the Technical Conference scheduled September 18 – 22, 2006.

Please direct any questions or comments to Guru Kalyanraman at 905.265.5334 or at gkalyanraman@eda-on.ca.

Yours truly,

Guru Kalyanraman
Analyst

Encl.

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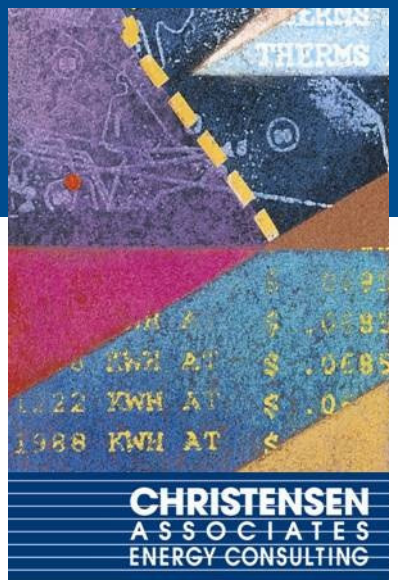
Rate of Return For Ontario's Electricity Distributors



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Before the Ontario Energy Board's Technical Conference

Toronto
September 18-20, 2006

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Introduction

- Objective: convey the positions of Ontario's distributors
  - importance of adequate returns to capital
    - the role of rate of return within regulatory governance, and its contribution to energy policy goals
  - recommendations for rate of return including capital structure and component cost rates
- Topics
  - PART I
    - cost of capital principles; guidelines and precedence
    - market context of Ontario Distributors
      - operating/regulatory constraints; cost of capital implications
    - Christensen Associate's study findings, analysis shortcomings, risks
  - PART II
    - address issues/questions raised by the Ontario Energy Board

Cost of Capital Principles

- Definition:
  - the cost (rate) of capital is the interest rate used to discount future cash flows, as expected
- Determining factors:
  - demand for capital (willingness to pay)
  - supply of capital (willingness to accept by investors)
  - expected inflation
  - perceptions of risks attending uncertain future cash flows
    - future market conditions (D/S for capital, inflation, events)
- Cost of capital as opportunity cost
  - financial markets allocate capital to highest valued use
  - market efficiency; absence of arbitrage

Guidelines and Precedence for Regulatory Governance

- Ontario Electricity Distributors are entitled to fair and reasonable rates
  - *capital attraction:* adequate returns so that capital can be obtained via conventional means
  - *comparable earnings:* rates of return equivalent to that of other investments of comparable risks
  - *financial integrity:* returns sufficient to sustain creditworthiness, so that capital can be raised when needed, and on favorable terms
- Longstanding precedence is at hand
  - *Bluefield Waterworks, Northwestern Utilities, British Columbia Electric Railway, Hope Natural Gas*

Ontario LDCs

- Market and regulatory context
  - near term requirements, limits
    - advanced metering
    - replacement of aging infrastructure
    - CDM capital expenditures
    - municipal mandates
    - Distribution System Code
- Broad range of operating size
  - capital indivisibility, lumpy investments
    - implications for raising capital
    - implications for capital structure
    - implication of size

Analytical Methods for Cost of Equity

- Alternative methods for determining equity return level are available. Cost of capital toolbox includes well-recognized approaches:
  - discounted cash flow
  - comparable earnings (market returns)
  - risk premium
  - CAPM
- Employ samples of comparable risk utilities (U.S. and Canada)
  - electric and gas utilities; comparable risk non-utilities
  - Canadian utilities listed with TSX

Recommendations

- Capital structure
  - observed, historical or pro forma capital structure
  - providing that the structure resides within an acceptable range (42% - 52% equity participation)
- Long- and short-term debt cost rates
  - L-T debt: utilize actual cost rate(s) of outstanding debt
    - determined on a yield to maturity basis at time of issue, providing that such rate approximates cost rates at the time of issue and accounting for risks
  - S-T debt:
    - include within regulatory capital structure
    - use observed cost rates, providing that the rates approximate the market cost rates for the relevant timeframe

Recommendations (2)

- Rate of return on equity, for Ontario distributors
  - authorized rate of return on equity should approach 11.0%
    - evidence regarding size-related equity risk premium:
      - smaller companies harbor comparatively high risks
      - CAPM does not fully capture risks associated with small companies
    - capital risks of electric services industry are below average risks
    - Size related premium should be adjusted through capital structure
- Ontario Energy Board should draw upon empirical evidence of U.S. capital markets to set authorized return levels
  - depth of market experience

Concluding Comments

- The Ontario Energy Board should consider the adoption of a more flexible approach
  - accommodation of unique business context and operations of individual LDCs
- Stability of regulatory governance is necessary
  - it is essential that changes be proposed under full information, and implemented in a deliberate and step-by-step fashion
  - impact of rate freeze

Issues Identified by the Board

Q.1 **Should the Board move off its current Cost of Capital method, as contained in the 2006 Distribution Rate Handbook?**

Response**:** The Board should adopt a more flexible approach.

Recommendation: use actual capital structure and debt cost rates of LDCs, providing that the structure and cost rates reside within an acceptable range, as set by the Board.

Reasoning:

- actual structure reflects unique LDC circumstances/experience alternatively the current structures
- capital structure of individual LDCs vary from time-to-time as a result of planned and unplanned business events:
  - new debt issues, where debt issues are somewhat indivisible
  - unexpected cost expenditures, perhaps involving capital resources
  - unexpected revenue shortfalls/high working capital requirements

Issues Identified by the Board (2)

Q.2 **i) What are the advantages and disadvantages to using a prescribed differentiated capital structures, based on size?**

ii) Are business risks of larger and smaller distributors converging or diverging?

Response**:**

i) ***advantages include:***

- sensible; conceptual logic
- as a general rule, smaller entities carry greater business risk than larger companies, other factors held constant

disadvantages include:

- break points between size classes are arbitrary and cannot be readily discerned
- because individual LDCs cannot match prescribed regulatory capital structure and debt rates, realized returns to capital cannot match regulator's WACC

ii) ***Further research is recommended***

Issues Identified by the Board (3)

Q.3 **Should the Board provide incentives for new infrastructure investment within the cost of capital methodology? How might this be done?**

Response**:** Board should consider incentives regarding infrastructure investment.

Recommendations:

i) authorize higher or blended ROE under conditions of high rates of infrastructure investment

- **Reasoning:** high levels of investment increase capital risks
  - incremental cost of new physical capital > embedded costs; thus, returns to capital likely to decline

or,

ii) implement regulatory mechanism to expedite recovery of infrastructure investment costs in revenue flows

- **Reasoning:** expedited cost recovery offsets higher capital risks by mitigation of potential, large shortfalls in revenues, operating income, and earnings

Issues Identified by the Board (4)

Q.4 **What are the implications if distributors relied solely on long-term debt to finance their businesses?**

Response**:** Such distributors are underwriting capital assets sub-optimally. Lending institutions would charge higher debt cost rates because of low interest coverage and high default risks. If such distributors pledge/indenture non-utility resources and assets, as surety for debt, property rights holders of other resources "wear" the default risks. We recommend inclusion of short term debt in overall capital structure for cash stability/short term financing needs.

Setting an LDC's WACC within an acceptable range obtains two results:

1: distribution wires services are properly priced, at least within the context of embedded costs.

2: the Board has satisfied its fair rate of return regulatory duty*

* the high capital risks implied by such behavior by an LDC may impinge upon service quality provided to electricity consumers

Issues Identified by the Board (5)

Q.5 **Should the Board use one or several methods to determine the ROE? What methods should be used?**

Response**:** The Board should use several methods including variations of discounted cash flow, risk premium, comparable earnings, and CAPM.

These methods should be applied by cost of capital experts that serve on a panel, organized by the Board. The panel should periodically provide the Board with ROE recommendations.

Individual LDCs and parties to rate proceedings before the Board should have rights to appeal the ROE recommendations of the Board's panel of experts.

The Board, in its discretion, should depart from the generic recommendations for individual LDCs.

Issues Identified by the Board (6)

Q.6 **Is there information from the financial community that there is a liquidity crisis and that distributors cannot raise money for capital projects?**

Response**:** The notion of liquidity should perhaps be interpreted as the quantity of funds that can be raised at various interest rates – essentially, a curve trading off capital quantities and cost rates where the position of the curve is determined by perceived capital risks. Under this interpretation, higher capital risks appear in the form of reduced interest coverage, the condition of ROE < cost of equity, and thin equity participation. Yet, distributors may still be able to raise necessary funds, but only on relatively costly terms.*

Recent reports, submitted to the OEB by stakeholders, by BMO Capital Markets and S&P recognize that the current Staff proposal may not attract investment in LDCs

- lending institutions typically look for specific covenants wrt interest coverage, debt to funded capital as a standard

*** Case in point is Public Service Company of New Hampshire (PSNH) during the early 1980s. CWIP was excluded from rate base while PSNH was financing a sizable share of Seabrook construction. With very low coverage and negative internal cash, PSNH was still able to raise long-term debt, though at a cost rates above 20%.**

Issues Identified by the Board (7)

Q.7 **Should the Board impose dividend restrictions?**

Response**:** The Board should not restrict or limit dividends.

Existing regulatory mechanisms are in place to address the issue:

1. dividend payouts are decided by Board of Directors who are mindful of their obligation under the Ontario Business Corporations Act to operate in the best commercial and fiduciary interests of the company.
2. the Board engages in on-going prudency review in setting cost of prices for distribution services, including compensation for labour and management.

Finally, the Board should not reach beyond its regulatory mandate and micro-manage the operating practices of distribution utilities.

Issues Identified by the Board (9)

Q.9 **Are there any implementation issues that have not been addressed?**

Response**:** Z factor for IRM: need not be pre-defined Z factors. Z factors should include lumpy capital expenditures, which are large in nature. Support Hydro One's proposal for a simple capital investment mechanism that removes the incentive to under-invest.

Working Capital Allowance: determination of amount for working capital allowance should involve further stakeholdering (as a separate initiative).

Impact of provincial regulation such as "Eligible Investments" O Reg 438/97 on the proposals for determination of cost of capital.