SUBMISSION TO THE

ONTARIO ENERGY BOARD

from

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Chatham-Kent Hydro Inc ("CKH") appreciates the opportunity to provide their comments on the Ontario Energy Board ("OEB") Draft Staff Report "Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors" ("Report"). The submission from CKH is the first opportunity to provide comments on the Report and due to having short period of time to prepare for this submission it may not be a complete list of issues, therefore we are reserving the right to bring forward additional submissions or expand on the issues in this submission the next time we are given the opportunity to make a submission after we receive the updated version of this report on July 20, 2006.

COST OF CAPITAL

There are six main issues that CKH would like to provide comments on this portion of the Report.

1. One size fits all

   CKH is concerned with the proposal that will have all Local Distribution Companies (LDCs) have the same level of equity in their capital structure. This assumes that there is the same level of risk for a $50 million LDC as there is for $1,000 million LDC. CKH does not believe that this is the case. The Board's own experts also do not agree with the report as follows;

Dr Cannon's report of 1998 had recommended four separate capital structures based on size of rate base, which has been the basis for setting rates since 2001 in the electrical LDC sector in Ontario.

Rate Base	Debt	Equity
> $1.0 billion	65%	35%
$250 million - $1.0 billion	60%	40%
$100 million - $250 million	55%	45%
< $100 million	50%	50%

The most recent report titled "Calculating the Cost of Capital for LDCs in Ontario" by Dr Lazar and Dr Prisman recommend the following debt to equity split;

Rate Base excluding Working Capital	Debt	Equity
< $300 million	50%	50%
> $300 million	60%	40%

2. Gas Utilities Debt to Equity Split

The Report suggests that since the Gas Utilities in Ontario have 36% equity that the same equity component should be applied to the Electrical Utilities. CKH does not think this is appropriate. The Gas Utilities are very large utilities and therefore have a much different risk profile than the majority of Electrical Utilities. The Gas Utilities in their most recent rate applications have been requesting that the equity portion be increased to 40%

because they are finding it difficult to attract investment. The Board has recognized their position and have increased the equity portion from 35% to 36%. Therefore if the Gas Utilities are having difficulty attracting investment with a 36% equity, the majority of Electrical LDCs would find themselves in the same or worst position. With the significant investments that the Electrical LDCs will be required to make in smart meters this could impact our ability to meet the timing that the Minister of Energy has set out.

3. Change the risk profile of LDCs

The change in capital structure of this magnitude will change the risk profile of most LDCs. This will negatively impact the LDCs and then the customers by making it more difficult and costly to attract investments and new debt. This capital structure could impact the credit rating for CKH from Standard and Poor which would then make the prudential support that CKH has with the Independent Electricity System Operator (IESO) more costly.

4. Significant change in value of LDC

The significant change in the capital structure that is being proposed will have a significant change in the value of LDCs. An example of the net income follows;

	Current	Proposal
Equity	50%	36%
Rate Base	$50 million	$50 million
ROE %	9%	9%
ROE $	$2.25 million	$1.62 million
Difference		$0.63 million
NPV over 10 years		$3.9 million

The calculation above used 9% for the proposed ROE rather than the proposed 8.36% because CKH wanted to only highlight the reduction in value due to the change in the capital structure.

The value of the LDC will decrease by almost $4 million. This would be a significant impact to the shareholders.

5. Possible Transfer Tax Implication

If the equity portion is changed to 36% CKH and other LDCs should move their actual equity to this level. However if dividends are paid to the shareholders this magnitude, it may trigger the transfer tax for the following reasons;

- More than 5% of the assets would be removed from the LDC
- The equity would be less than the equity transferred into the LDC at the initial incorporation

If there is a transfer tax impact, the value to the shareholder has decreased much more than the $4 million example above. Therefore it is important the Board review the implications of the transfer tax with the Ministry of Finance.

6. Interest Rate on New Long Term Debt from Affiliates

The Report proposes that the new debt from affiliates would be at the riskless rate plus a transaction premium which would most likely be less than the market rate. This proposed interest rate would not reflect the true risk factor for the debt which would then reduce the likelihood that affiliates would lend funds. This would limit the sources for borrowing.

Recommendation for Cost of Capital

Taking into account the issues provided above CKH would like to make the following recommendations on the Cost of Capital;

- Capital structure should be updated to levels in Dr Lazar's and Dr Prisman's report, with one adjustment in that the ratio should be for the total rate base including working capital;

Rate Base including Working Capital	Debt	Equity
< $300 million	50%	50%
> $300 million	60%	40%

- The debt rate used for new affiliated debt should be at the market rate at the time of the transaction and should be fixed the term of the debt.

2ND GENERATION INCENTIVE REGULATION MECHANISM

CKH is concerned with two components of the2nd Generation Incentive Regulation Mechanism (IRM) proposal at this time.

1. Z Factor

CKH believes that there should be a Z factor component, currently the proposal does not include a Z factor. The Ontario Electricity Industry is continuing to change significantly and therefore there are a lot of costs that can be passed down to LDCs that are out of our control and therefore we should not take the risk on them.

There are can also be significant costs incurred due to severe weather, as was experienced by a number of LDCs a few winters ago.

CKH would also like to obtain clarification from the Board as to whether there is still the ability to apply for deferral accounts for costs out of our control. In the Decision for the Generic Issues in the 2006 Electricity Distribution Rates the Board approved the ability for LDCs to apply for deferral accounts when there are significant costs incurred that were out of their control. Is this option still available to all LDCs under the IRM? If not then the Z factor is much more critical and required in the IRM.

The Z factor should be for material items, and the materiality threshold should be set at 2% of distribution revenue requirement.

2. Productivity Factor

The proposal has the same productivity factor for all LDCs, CKH does not believe that this is fair treatment for all LDCs. All LDCs are at different stages of efficiency and therefore the efficiency factor proposed will have very different impacts.

Recommendation for 2nd Generation Incentive Rate Mechanism

CKH is recommending the following changes to the IRM;

- Board clarification on ability to apply for deferral accounts under the IRM term
- Z factor should be a feature of the IRM
- Materiality for Z factor should be set at 2% of the distribution revenue requirement
- Productivity factors should be based on each individual LDC