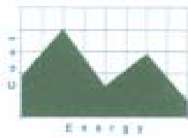

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Ontario Energy Board
Suite 2700
2300 Yonge Street
Toronto, Ontario
M4P 1E4
ATT: Mr. John Zych, Secretary

July 04, 2006
Dear Mr. Zych,

OEB Draft Staff Report: Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. (EB-2006-0088) and (EB-2006-0089)

In accordance with the OEB's E-mail and web postings of June 19, 2006 and June 29, 2006, the ECMI coalition (ECMI) submits its comments on Board staff's initial proposals for both the cost of capital and the 2nd Generation Incentive Regulation Mechanism (IRM), dated June 19 2006.

Three paper copies are enclosed and electronic copies in both Adobe Acrobat and Word have been sent this date by email to Boardsec@oeb.gov.on.ca.

Requested contact details are as follows:-
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President
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Respectfully submitted for the Board's consideration,

Original signed by R. White

Roger White
President

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ECMI Comments on OEB Draft Staff Report:
Proposals for Cost of Capital and 2nd Generation
Incentive Regulation for Ontario's Electricity Distributors.

1. **Capital Structure and Return on Equity (ROE) – General**
   Dr Booth's testimony (referenced on Page 7 of the Lazar and Prisman June 14 2006 report) which is relied on in the Lazar and Prisman report relates to an Ontario natural gas hearing. This testimony is not subject to cross-examination as it relates to the electricity market in Ontario and therefore should be disregarded as support for a uniform capital structure in the Ontario electricity market.
   Lazar & Prisman's recommendation on the bottom of Page 7 of the June 14, 2006 report starts with the apparent reliance on Professor Booth's argument, referenced in the penultimate paragraph on Page 7 and fails to recognise two underpinning points in Professor Booth's testimony. The first point being that the testimony related to a natural gas hearing on the Ontario natural gas distribution market which is quite different from the Ontario electricity distribution market. The second point that "*ROE regulated firms have minimal risk in Canada due to the high degree of regulatory protection*" assumes that regulation of electricity distributors in Ontario will be similarly "protected." In the same paragraph, the Lazar and Prisman report states that "P*rofessor Cannon had earlier reached a similar conclusion*" without recognising that Dr Cannon suggested a capital structure based on size to recognise the risk faced by smaller LDCs in the Ontario market.
   Similarly, in the same paragraph the Lazar and Prisman report states that "*DBRS has stated that it views regulation as a strength in assessing the credit risks of utilities since regulation assures financial stability and performance-based regulation shares future efficiencies*" but fails to recognize that that comment relates to "credit" or debt risk but not equity risk.

   > A fair cost of capital is the total cost of capital. The word "fair" does not permit the use of simply one universal number for debt cost when one wants to consider debt and **<u>independently</u>** the use of simply one universal number for equity when one wants to consider equity.

   This apparent desire to impose, contemporaneously, both a uniform capital structure and uniform risk premium on equity fails the fundamental test of fairness and the test of context of the evidence presented.

   The leap in the Lazar and Prisman report from the penultimate paragraph on Page 7 to the last paragraph on Page 7 through, in ECMI's view, the inappropriate use of the word "*Consequently*" implies a connectivity which is, in ECMI's view, simply not valid given the points raised in our previous paragraph above. This lack of validity is compounded by jumping from independent statements about debt and equity (see our previous explanation) to linking he word "*Consequently*" in the last paragraph on Page 7 to "*capital charge*" at the end of the same sentence. This latter jump magically combines independent debt comments with independent equity comments to reach what in ECMI's view is an unsupported cost of capital or "*capital charge*."

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Board Staff Proposal – Capital Structure

"Capital structure"
Staff proposes that the appropriate capital structure for distributors is 36% common equity (64% debt). In addition, distributors could include preferred shares as part of their capital structure to a maximum of 4%. In total this would then require 60% debt financing. From numerous sources, including Dr. Cannon's analysis and the work done by Lazar and Prisman, the general view of relative riskiness of electricity and natural gas distributors in other jurisdictions (primarily North America) is that ***there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario.*** *Therefore, staff is guided by the capital structure of the natural gas sector in Ontario with which the Board and financial markets are familiar. Natural gas distributors have a long history of financial stability and their current common equity share is about 36%."*
Ref Board Staff report page 8 (our emphasis)

As the Board staff's guiding objective number 6 is "*Establishing a common capital structure and incentive framework for all distributors*", then no one should be surprised by the Board's consultant's recommendations to adopt a single capital structure. However, this guiding principle does not require the return on equity premium to be common amongst all LDCs. While the PBR regime might be similar or common, the entry level risk premium on equity for a universal capital structure (debt / equity ratios) might be quite different.

Cost of Capital – not ROE
Both the Board's experts recognised size with respect to the cost of capital:-

Dr William Cannon presented a number of arguments for using size, based on assets, as the sole criterion for differentiating LDCs. Standard & Poor's has no minimum size criterion for any given rating level. However, size does turn out to be significantly correlated to its ratings. The reason: size often provides a measure of diversification, and /or affects competitive position. Small companies are, almost by definition, more concentrated in terms of product, number of customers, or geography. In effect, they lack some elements of diversification that can benefit larger companies. In addition, lack of financial flexibility is usually an important negative factor in the case of very small companies. Adverse developments that would simply be a setback for companies with greater resources could spell the end for companies with limited access to funds.
Ref: Page 5 "Calculating the Cost of Capital for LDCs in Ontario" Dr. Fred Lazar and Dr. Eli Prisman date June 14, 2006

a) "*Dr William Cannon presented a number of arguments for using size, based on assets, as the sole criterion for differentiating LDCs."* Dr Cannon recognised the additional risks associated with size through different capital structures (imputed debt & equity ratios).

b) The Lazar and Prisman report recognised that: "*Standard & Poor's has no minimum size criterion for any given rating level. However, size does turn out to be significantly correlated to its ratings. The reason: size often provides a measure of diversification, and /or affects competitive position. Small companies are, almost by definition, more concentrated in terms of product, number of customers, or geography. In effect, they lack some elements of diversification that can benefit larger companies. In addition, lack of financial flexibility is usually an important negative factor in the case of very small companies. Adverse developments that would simply be a setback for companies with greater resources could spell the end for companies with limited access to funds."* This clearly recognises size as an important cost of capital market consideration in that *"size does turn out to be significantly correlated to its ratings."*

There are two ways of recognising size implications:-

1. Dr Cannon chose capital structure to recognise size implications.

2. The alternative is to recognise size implications with a different risk premium for size if a universal capital structure (debt & equity ratios) is to be used.

One could say that LDC size does not matter with respect to debt cost but that debt cost may be based on different capital structures (debt & equity ratios). However, if a universal capital structure is imposed there is no evidence to suggest that size does not matter with respect to the cost of equity.

Similarly, if the capital structure is universally fixed at a higher level, it follows that the risk on the equity component of the LDC would increase. Therefore the risk premium should be larger for a smaller LDC to recognise the market response to equity requirements as opposed to debt requirements. While the cost of debt may be also universal in a regulated environment, there is generally a recognised risk premium on the equity part of capital structure.

However, Board staff in its proposal fails to recognise that size consideration has any merits in its statement: *"there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario"*
Ref; 2.2.1 Capital Structure Page 8

This statement is in conflict with the Board's own consultants on the cost of capital including Dr Cannon in previous proceedings and Drs Lazar and Prisman's report in the current proceeding.

The statement also ignores the fact that the OEB is a credible institution and its decisions have recognized size. To dismiss those decisions does regulation in Ontario a disservice. The province has LDC's ranging in size from a few hundred customers to in the million customer range. The exposure to regulatory cost risk faced by the small LDCs is disproportionately huge and potentially greater than any return on the rate base.

Further the statement appears to rely on the Ontario natural gas environment. The regulated natural gas industry in Ontario has few small natural gas distributors and those that exist may have unique customer characteristics which may fundamentally change the risk faced by the small gas distributor. The portability of the regulated natural gas Ontario experience into the Ontario electricity distribution market is not supported when size is dismissed as an important criterion.

These observations certainly support ECMI's perception of systemic bias on size identified under Point 4 below.

The statement *that "**there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario"*** fails to recognize that the OEB is a credible institution and its decisions have recognized size. To dismiss those decisions does regulation in Ontario a disservice. The province has LDC's ranging in size from a few hundred customers to in the million customer range. The exposure to regulatory cost risk faced by the small LDCs is disproportionately huge and potentially greater than any return on the rate base.

2. **Specific Debt Rates.**
   The proposals assume a market environment not a regulatory environment and assumed there would be automatic crossover in terms of the cost of debt for larger corporate (bonds). The Lazar and Prisman report proposals looked at an historical period when interest rates were relatively low and the cost of money (bond rates) were relatively stable and assumed a going forward relationship. Even if the conditions of the historic period considered remain stable over a longer term the market may not reflect the duration of the commitment that often underpins regulated entities' borrowings.

   Similarly, the staff proposal for long term debt is based on a bond comparison made with larger LDCs only. Smaller LDCs issue few if any bonds. Therefore the bond comparison is weighted heavily if not exclusively to larger companies.
   Ref: Section 2.2.3 Debt rate and Section 2.3 Table 4

   The staff proposal for short term debt section 2.3 Table 4 appears to presume that the Board's proposed interest rate on variance accounts will be adopted by the terminology "short-term" rate for variance and deferral accounts.
   Ref: Section 2.2.3 Debt rate and Section 2.3 Table 4

   The process initiated by the OEB is not complete as noted in the statement *"The Board is currently consulting on the appropriate rates for such accounts."*
   Section 2.2.3 Debt rate

   ECMI will not comment on short term debt costs until the aforementioned decision is rendered.

3. **Proposed Productivity Factor**
   The proposed productivity factor (stretch factor) of 1% of revenue (rates) in ECMI's view is too high. Capital items are regulated by code with the consequence that LDCs will have limited choices in how any capital cost reductions are achieved. For consideration, an LDC might have total allowed distribution revenue of $1million and

OM&A of about $650,000. In this case, the LDC would be required to realise a cost reduction of about 1.5% of OM&A. If this were repeated for 5 years, the consequential maintenance reductions which would be part of the 7.5% reduction could be significant. The Board Staff consultant recommended 0.5%. The leap to 1% in the Board Staff proposal is not consistent with the Ontario context.

4. **Economies of Scale**

The report's guiding objective 6 is:-

"6. ***Establishing a common capital structure and incentive framework for all distributors.*** *The objective is to avoid imposing barriers to consolidation within the electricity distribution sector."*

Ref: Page 5 of Draft Staff Report

This objective appears to assume that consolidation is a desirable process. The fact that it is included as one of the guiding objectives may reflect a systemic bias. Further, if there is an OEB bias in favour of consolidation, it should only be based on a specific, properly vetted Board policy in favour of consolidation. If there is a Board staff bias in favour of consolidation then this may be inappropriate as the OEB, in the absence of statute direction, has an obligation to not be biased when considering policy or applications.

"Economies of scale

It is generally accepted that there are economies of scale in electricity distribution. Thus, consolidation, especially among the smaller LDCs, is expected to lead to lower distribution costs. But mergers are not the only means by which the cost savings from economies of scale can be realized. Virtual utilities are an alternative to the outright sale of a LDC. That is, a LDC could outsource all of its operations to take advantage of any potential economies of scale, without the need for a change of ownership."

Ref: Page 5 "Calculating the Cost of Capital for LDCs in Ontario" Dr. Fred Lazar and Dr. Eli Prisman date June 14, 2006

Hydro One Networks Inc (HONI) in its evidence on Regulatory Assets made specific reference to "diseconomies of scale" which were present and a major contributing factor to the higher transition costs incurred by HONI. This is in apparent conflict with the assumption that consolidation is a desirable process and benefits customers by way of price.