3240 Mavis Road
Mississauga, Ontario
L5C 3K1

Tel: (905) 566-2727
Fax (905) 566-2737

Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, Suite 2700
Toronto, ON M4P 1E4
Attn: Mr. P. O'Dell
Acting Board Secretary

July 5, 2006

Dear Mr. O'Dell

Re: EB-2006-0088
EB-2006-0089

Enersource Hydro Mississauga Inc. ("Enersource") is concerned that the proposals set out in the Board staff's June 19, 2006 Draft Staff Report – Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors with respect to Cost of Capital and Incentive Rate Making; will not result in just and reasonable rates. These comments are consistent with those provided under separate cover by Toronto Hydro Electricity Distribution Inc. on behalf of the Utilities. Furthermore, the proposals and the Code making process lack an appropriate level of transparency.

Enersource offers its perspective on the following issues:

1. Cost of Capital, including return on equity and capital structure;
2. Incentive Rate Making;
3. Related initiatives;
4. Next Steps; and
5. Process Issues.

Cost of Capital

Return on Equity

The proposal presented by OEB Staff recommends a cost of capital based on the actual debt rate and an allowed return on equity ranging from 7.52% to 8.36%. This recommendation is informed by a study prepared by Dr. Fred Lazar and Dr. Eli Prisman. The study utilizes a Capital Asset Pricing Model (CAPM) to determine an estimate of the appropriate rate of return for equity investments made in electricity distributors. The Draft Staff Report:

1. Recommends a flawed methodology and an inappropriate application of it;
2. Lacks objective assessment from the capital markets; and

3 Lacks transparency with respect to past OEB practice and the policies and practices of other regulators.

Attached as Appendix A to these comments is a report prepared by BMO Capital Markets (BMO), an organization knowledgeable in the Pipelines/Gas & Electrical utility equity markets. BMO's report was unsolicited and is provided as an independent and objective response to the OEB Staff's position paper. Pages 8 through 12 are referred to in these comments. Pages 9 and 10 of BMO's report identify the following eight specific problems with the Lazar and Prisman paper:

1. The 60 month study period for the determination of beta and market returns is too short;
2. In the determination of the key variables for the CAPM equation, the authors use different time periods, therefore comparing apples and oranges;
3. The forward rate is not an unbiased estimator of future expected rates;
4. The entities used as a proxy to determine the beta for Ontario electric distribution utilities are not comparable;
5. The study does not acknowledge that the TSX is not likely to meet the CAPM requirement for a diversified market portfolio;
6. Lazar and Prisman reject the use of other methods of determining the cost of equity, specifically the methods used by the equity markets to determine expected rates of returns;
7. Lazar and Prisman are unable to recreate or "reverse engineer" the beta on the current approved equity risk premium;
8. The Lazar Prisman study provides a risk range that is too wide to add incremental value to the equity rate of return discussion.

Of particular significance is the fact that Lazar and Prisman attempt to estimate an appropriate, market based rate of return for utilities utilizing a methodology that knowledgeable experts of utility securities and capital markets do not use. As BMO states on page 11 of its report, they use a Discounted Cash Flow approach. This methodology was not considered by Lazar and Prisman.

The proposed range of the allowed rate of return, from 7.52% to 8.36%, is unsupportable in BMO's opinion. In fact, BMO believes that this range is low enough to potentially violate the fair return standard, as established by Canada's Supreme Court and accepted by the National Energy Board in 1971.

It is important for the regulator to adhere to the tests stated in the Bluefield Water decision (Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia (1923)) and affirmed in the Hope Natural Gas decision (Federal Power Commission v. Hope Natural Gas Company (1944)):

> *"The return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital."*

This decision must be captured in the following tests of utility rates:

1. the utility has a reasonable opportunity to earn a rate of return equal to its cost of capital;
2. the utility has a reasonable opportunity to attract capital;
3. the utility has a reasonable opportunity to maintain its creditworthiness; and
4. the rate of return should be similar for other investments with similar risk.

In the OEB Staff's Draft Report, the methodologies utilized and the conclusions drawn are virtually all based upon the conclusions drawn in the Lazar Prisman report. It appears that the Staff did not rely on earlier studies conducted by other regulatory bodies in Canada, including:

1. National Energy Board's Fair Return proceeding Decision dated June 21, 2002;
2. Alberta Energy and Utilities Board Generic Cost of Capital Proceeding Decision dated July 2, 2004; and
3. British Columbia Utilities Commission's determination of Terasen Gas Inc. and Terasen Gas (Vancouver Island) Inc.'s appropriate rate of return Decision dated March 2, 2006.

Capital Structure

The Draft Staff Report recommends a deemed capital structure that is inappropriate. It is not related to a distributor's risk and lacks an objective assessment by the capital markets. OEB Staff have proposed a capital structure consisting of 36% common equity and 64% debt. Distributors may elect to include 4% of preferred share capital, thereby increasing the equity portion to 40% and reducing the debt portion to 60%. This structure is proposed to apply to all distributors, regardless of the size of rate base or other pertinent metrics.

The proposed common equity ratio is counter intuitive and contradicts the current Board policy. The staff paper does not provide the reasons supporting its assumption that all distributors can be equally well supported by rates set pursuant to a common capital structure and largely similar cost of debt and return on equity. The staff's analysis and methodology supporting its positions on the appropriate hypothetical capital structure should be consistent with past OEB proceedings that dealt with the issue (eg., E.B.R.O. 440).

Intuitively, the investment risk of the individual distributors varies. The staff paper suggests that the distributors risk profiles are not unlike those of the rate regulated gas distributors. The two large rate regulated gas distributors are acknowledged to be different. This difference is captured by the premium on the return on equity allowed to Union Gas Limited. While the staff paper proposes a range of allowed returns on equity it provides no guidance on how to quantify the minimum allowed rate of return or any premia for rate making purposes.

It is unlikely that equity markets would view a small electricity distributor (eg., one with 10,000 customers) in a similar risk category as a publicly traded gas distribution utility (with approximately 1,000,000 customers). An informed analysis of the investment risk of the electricity distributors would permit a similar distinction (eg., different customer composition and related risk profiles) that could be reflected in the allowed return on equity.

Incentive Rate Making

The distribution rates and distribution revenues resulting from the proposed adjustment mechanism will have an inherent arbitrariness and be loosely related to any distributor's cost of providing service. The staff's position paper proposes a rate adjustment mechanism whereas a revenue adjustment mechanism may be more appropriate. The proposed productivity factor and inflation adjustment, individually and in combination, merit re-examination. The proposed productivity factor may be improved by considering:

1. achieved productivity;
2. proposed investments;
3. the continuum of results; and
4. annual updates.

The proposed inflation adjustment, while simple, is not directly related to the costs incurred by distributors. The proposed k-factor will be designed to translate the proposed changes to the deemed capital structure and the maximum allowed return on capital into rates. It is necessary to analyze the implementation methodology before commenting on its fairness.

The staff paper contemplates a rate cap methodology. It relies on a formulaic determination of the maximum level of rate change based on two independent variables:

1. a price index; and
2. a productivity adjustment.

The output of the formula is applied to distribution rates, as determined under the cost of service methodology, to produce adjusted distribution rates. Those rates are similarly adjusted for several years.

The OEB has not provided policy direction or administrative rules on a Lost Revenue Adjustment Mechanism ("LRAM") or a Shared Savings Mechanism ("SSM") for electricity utilities. A revenue adjustment mechanism may partially relieve the need for an LRAM.

The Board's Cost Allocation Review is expected to elicit information on the presence and degree of cross-subsidization between customer classes. While the Board has not revealed its plan to act on this information it is not unreasonable to anticipate that the Board will seek to balance rates so that a just and reasonable return on equity is recovered from each customer class. The Cost Allocation Review findings may be more appropriately implemented under a revenue cap than under a rate cap.

The OEB has consistently adjusted rates since 1998. Adopting a revenue cap does not mean that the rate adjustment policy is abandoned, the rate adjustment policy could be applied differently (eg., the revenue adjustment cannot require changes to rates that are greater than a predetermined change). The Board could, for example, authorize a revenue cap mechanism and provide guidance on the reasonable level of rate change for individual customer classes. In light of the above noted advantages, a more fulsome analysis of rate adjustments versus revenue adjustments would be beneficial.

It is important to note that the GDP-IPI captures price changes in weights relevant to the economy and that neither the prices nor the weights are customized to the electricity distribution industry. It is also important to note that the proposed productivity adjustment has no theoretical or empirical rationale. The lack of direct causal link to electricity costs implies that the adjustment is arbitrary. As a result, the OEB cannot suggest that the resulting rates are 'just and reasonable' based on cost of service standards. All stakeholders will benefit from, and regulatory stability and transparency will be enhanced by, clearly stated tests of just and reasonableness.

Distributors that have not sought to be lowest cost providers are anticipated to be able to realize tremendous productivity gains. If productivity is thought of as a form of a learning curve then the inefficient distributor is best able to move through the most advantageous zone of the productivity curve, to realize preferred levels of net income and to appear to be the rational - or even preferred - investment opportunity. The distributor that has acted diligently in the past and already realized the majority of available productivity gains will be denied full access to the appropriate resources to continue to provide service to its customers. Distributors in Ontario have operated under a rate freeze and, as a result, some may have already implemented the majority of the productivity opportunities available through their current strategies.

All this suggests that a simple productivity factor is 0 and that a realistic productivity factor is informed by an individual assessment of each distributor's past productivity achievements combined with strategies to invest in new technologies.

The proposed rate adjustment mechanism will be relied on for rate making purposes for 1, 2 or 3 years, depending on which industry group the OEB assigns each distributor to. The proposed "bare bones" plan (i.e., an inflation factor and a productivity adjustment) is not fair of just for rate making for up to three years, particularly for those utilities with aggressive capital investment programs needed to maintain high reliability performance standards. Hence, it would be prudent for the OEB to implement other plan mechanisms (eg., off-ramps, z factors) for those distributors who will not be subject to rebasing until 2010.

<u>Related Initiatives</u>

The Staff's paper appears to adopt positions with little thought to their consistency with the other components of the regulatory framework. There is no attention paid to the utilities anticipated need to access capital on favourable terms in unprecedented amounts to support the government's Smart Meter initiative and the associated infrastructure. There is no discussion of the links between the implied risk incurred by the utility under

PBR and the appropriate return commensurate with those risks. There is no attention paid to the assumed ongoing need for utility provided CDM. There is no discussion of the implications of the Standard Offer Program for distributors' ongoing viability – a key aspect of investment risk.

Next Steps

It is assumed that complying with the proposed codes will be one component of the filing requirements supporting an application for distribution rates pursuant to section 78 of the Ontario Energy Board Act, 1998. It is suggested that the application filing guidelines permit the filing of financial scenarios, market based assessments of the applicant's risk, bond rating and credit rating agency reports, and projections of:

1 growth (eg., customers);
2 potential changes in credit ratings attributable to the proposed treatment of the cost of capital and capital structure for rate making purposes;
3 the need for capital;
4 the prevailing terms and conditions associated with the preferred source of capital (eg., maintenance of coverage ratios); and
5 the unique circumstances faced by the individual applicant.

Regardless of the parameters relied on for rate making purposes (eg., return on equity, productivity factor), a "one size fits all" Code cannot accommodate the operational and financial realities of all distributors in Ontario. Therefore, it is recommended that the proposed Codes provide an exemption process and sufficient latitude for management to cope with the risks, pressures and opportunities of an on-going business.

Process Issues

These comments are provided per the Board's schedule. That schedule has not provided sufficient time for significant comment. As a result, these comments do little more than identify some conceptual short comings of the paper. It is frustrating to receive a discussion paper on a key aspect of rate making on the same day as the topic is presented to the industry with 10 days (after a 2 day extension was provided) to comment. It is more frustrating to note that the expert discussion paper relied upon for the position paper is dated 6 days prior to the presentation. Nonetheless, it is encouraging that the staff plan provides for a second draft, expert evidence, a technical conference and another comment process.

Summary

The staff proposal does not demonstrably satisfy the test prescribed by the Bluefield decision. The potential unfairness or harm of the staff proposal has been identified and scoped by BMO Capital Markets utilities analyst. The staff proposal lacks a clear, comprehensive implementation plan that links compliance with the proposed codes to setting just and reasonable rates pursuant to an application under section 78 of the Ontario Energy Board Act, 1998. The process adhered to, thus far, also lacks transparency and does not provide the level of scrutiny and testing that a hearing would. The final plan must satisfy the legal tests, address transparency, permit exemptions, satisfy stakeholder expectations for regulatory certainty and be constructed in the context of the existing government policy, generation market considerations and the OEB's plans for other regulatory initiatives.

Thank you for the opportunity to comment on staff's Draft Staff Report – Proposals for Cost of Capital and 2^{nd} Generation Incentive Regulation for Ontario's Electricity Distributors. Enersource looks forward to the second draft of the report on July 20, 2006.

Sincerely

K. Litt
Regulatory Affairs Advisor

Encl.

cc L. Anderson, Hydro Ottawa Limited
G. Armstrong, Veridian Connections Inc.
P. Conboy, PowerStream Inc.
C. MacKenzie, Horizon Utilities Corporation
R. Zebrowski, Toronto Hydro-Electric System Limited