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July 5, 2006

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

Dear Mr. Zych:

Re: EB-2006-0088 Cost of Capital and EB-2006-0089 - Second Generation IRM

Guelph Hydro Electric Systems Inc. (GHESI) asserts that the form of regulation applied to LDCs is a critical factor in determining the long-term performance of the industry and, ultimately, the level of benefits delivered to customers. We are of the opinion that multi-year, incentive mechanisms (with the appropriate inflation adjustments and productivity offsets) better serve this outcome than annual cost-based reviews, which promote short-term distorted investment decisions. GHESI supports the OEB Staff concept of an incentive based mechanism; however, it would like to request that regular Cost of Service Rebasing be performed at some regular predetermined intervals (i.e. 3 – 5 years).

GHESI has the following comments regarding the OEB Draft Staff Report, dated June 19, 2006, Proposals for Cost of Capital and second Generation Incentive Regulation for Ontario's Electricity Distributors:

Guiding Objectives

2. Predictability and stability

To provide an environment where distributors and consumers are better able to plan and make decisions.

The Staff Proposal includes a substantial change in Debt Structure and ROE and an unexpected negative impact on revenue which seems at odds with the OEB's Guiding Objective of Predictability and Stability.

This change may alter the way that the financial community views the electricity distribution sector causing a tightening financial market at a time that the OEB is expecting LDCs to increase debt levels. The predictability and stability that the OEB seeks may not be achieved, but may well be eroded.

- 3. Promote economic efficiency by providing the appropriate pricing signals and a system of incentives for distributors to maintain an appropriate level of reliability and quality of service**

To create an environment where the distributor is encouraged to implement operating efficiencies, while being obliged to maintain appropriate and enforceable service quality standards.

At a time where LDCs will need to use their borrowing capacity to purchase and install smart meters this proposal erodes the LDCs net income which would be used to invest in infrastructure to maintain the level of reliability for its customers. We believe this proposal is at odds with the above objective.

LDCs have been delayed in initiating their smart metering programs as they were awaiting definitions of the AMI from the Ministry of Energy. As funds are spent, LDCs will require a mechanistic adjustment to recover the investment in smart meters and their associated operating and maintenance costs on a timely basis. In order to demonstrate the magnitude of this investment, the amount of investment required to install smart meters and the AMI infrastructure may be equal to the entire annual capital budget of an LDC. We expect this investment to occur over a three to four year period thus, the investment is material and needs to be recovered on a timely basis.

GHESE recommends that a better mechanism be established to recover the LDC investment in smart meters and associated AMI systems as they are installed. Recovery of these investments on a timely basis will free up borrowing capacity for LDCs to invest in their infrastructure.

- 4. Allow for the opportunity for distributors to earn a reasonable return on shareholder capital and to maintain their financial viability.**

This includes the ability to attract appropriate levels of investment.

GHESE maintains that LDCs must be recognized as For-Profit Businesses. The recent Supreme Court of Canada decision regarding *City of Calgary v. ATCO Gas and Pipelines Ltd, et al* upheld that LDCs are operating in accordance with their obligations to maximize the value of their shareholders investment. Regulation should be based on the core assumption that utility managers will act in the best interest of the company and shareholders and, as a result, will respond positively to steps that are taken that allow the shareholder to realize the value of investments made to improve company performance.

- 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.

GHESI would assert that establishing a common capital structure and incentive framework for all distributors is a minor barrier to consolidation within the electricity distribution sector.

The 33% Transfer Tax and the placement of a moratorium on Hydro One, by the Provincial Government, on the sale or acquisition of assets are major barriers to consolidation in the electricity distribution sector.

Imposing a common capital structure and incentive framework on all distributors would have a larger, ongoing, negative impact, far outweighing any benefits that may occur to the expectations of the purchasing and selling parties to any consolidation activity.

Cost of Capital

2.2.1 Capital Structure

GHESI disagrees with the OEB Staff Proposal that the appropriate capital structure for all distributors should be 36% common equity and 64% debt and has the following comments:

- No empirical evidence is available which supports one capital structure for all LDCs of such varying sizes
- Equating all electricity distributors to the regulated natural gas distributors is not recognizing the substantial difference in size between most of the local distribution companies (LDCs) and the major natural gas distributors.
- The OEB's expert advisors, Dr. Fred Lazar and Dr. Eli Prisman (L&P), state in their paper 'Calculating the Cost of Capital for LDCs in Ontario' on page 47 "Debt should consist of short-term and long-term debt following the practices of the credit rating agencies. We recommend that there be two groupings of LDCs for the purpose of establishing the maximum total debt to total debt plus equity proportions. For all LDCs with a rate base, excluding working capital allowances, of less than \$300 million, the maximum debt-equity split should be 50%/50%. For all LDCs with a rate base in excess of \$300 million, the maximum debt-equity split should be 60%/40%." GHESI concurs with L&P's recommendation of the two groupings of LDCs for the purpose of establishing the maximum total debt to total debt plus equity proportions, as described above.

2.2.1 Capital Structure – continued

- Dr. Cannon, the previous OEB expert advisor retained for Cost of Capital matters advised the OEB to adopt four capital structure groupings dependent on size. The OEB implemented this proposal and LDCs set up their capital structure, including third party debt, on this basis.

- Empirical Evidence, as shown on page 44 of (L&P)'s paper, illustrates that the "small" LDCs had an average debt ratio of less than 50%, and the "medium-small" LDCs had an average debt ratio of 50%. This empirical evidence further supports L&P's recommendations as noted above.
- Equating all electricity distributors to the regulated natural gas distributors is not recognizing that LDCs have had an obligation to serve and connect all customers and had to install plant whether it was profitable or not. Gas distributors have had the choice as to whether they install plant in any given area based on profitability and they do not service many areas that are serviced by LDCs.
- Regulated natural gas companies have had the opportunity to migrate to their current capital structure, this proposal does not allow this for the electricity distributors. In addition, the changes in capital structure proposed has the possibility of forcing an LDC into further borrowing to buy back their shares in order to achieve the regulated equity level. Such additional debt would erode the borrowing power of the LDC to invest in their infrastructure.
- Consideration needs to be given as to whether the substantial change in capital structure will adversely affect existing LDC Interest Coverage Bank Covenants and their ability to meet them in the future.
- If the change in debt structure causes the financial community to downgrade an LDC's credit rating, the Prudential amount required by the IESO may increase, thus, not only imposing a higher bank stamping fee, but may restrict an LDC's ability to further borrow.
- Many LDCs may not have the ability to borrow up to the 64% debt level, due to their smaller size and the financial community's view that an LDC is a less stable, more risky environment.

Based on the rationale provided above, GHESI believes that two groupings of LDCs, with the capital structure as proposed by L&P, for the purpose of establishing the maximum total debt to total debt plus equity proportions, is fair and equitable treatment to all LDCs.

2.2.2 Return on Equity (ROE)

GHESI does not agree with the Net ROE percentages as presented in the OEB Staff Proposal. GHESI asserts that a reduction of the current Net ROE rate is not appropriate, was unexpected by LDCs, and should remain at its current level.

- L&P document on page 18 of their paper, "Table 3: Awarded ROEs for Selected Canadian Utilities" some ROE awards made in other provinces during the past five years. Of note are the March 2006 Terasen Gas awards of 9.50% and 8.80% and the November 2005 ATCO TFO award of 8.93%. The current rate of 9.00% is consistent with decisions made by regulators in other provinces.

- L&P document on page 18 of their paper, “the awarded ROEs seem to be trending downwards over time. This reflects the downward trend in interest rates over this time period, a trend which continued into the second quarter of 2005.” The trend has been upward since that time. Of note is the Terasen Gas award of 9.15% in November 2003, which was reduced to 8.80% in the March 2006 award. The Ontario LDCs have already had their ROE reduced from 9.88% to 9.00%, and a further reduction would be inconsistent with adjustments made in other provinces.

GHESI asserts based on the rationale above that the current ROE of 9.00% should remain in place and any changes in ROE should be gradual and predictable.

2.2.3 Debt Rate – *Short Term Debt*

GHESI agrees that short-term debt should have a maximum allowable portion limited to the level of working capital. GHESI, however, asserts that the short-term maximum is a maximum amount only and should not necessarily cap the long-term debt portion. An LDC should be allowed to determine their short-term and long-term debt mix (adhering to the short-term maximum) in investing up to the maximum total debt percentage of rate base allowed by the OEB. This would allow the LDC to obtain the best borrowing rates which would ultimately benefit their customers.

Incentive Regulation

3.3.2 Term (up to 3 years) and Starting Base (2006 EDR)

The OEB Staff Proposal states that the starting base for the Generation IRM is the 2006 EDR. For LDCs that are historical year filers, this will be a starting base of 2004, with any applicable Tier 1 and 2 adjustments. If an LDC is a third tranche filer with Cost of Service Rebased in 2010 they will have rates based on 2004 until this time. The delay in recovering a return on the rate base for an extended period of time may result in rates that do not reflect the cost of providing service to their customers and further erode the LDCs net income. GHESI proposes that an adjustment mechanism, mechanistic in nature, for a specified limited number of adjustments, be implemented to move all historical year filers to a more current test year.

3.3.4 Price escalator: GDP-PI

GHESI asserts that the GDP-PI price escalator should be based on the national index and an Input Price Differential should also be implemented. Capital expenditure investments made by an LDC are most directly affected by changes in the cost of steel, aluminum, copper, the US dollar and wages. The price escalator adopted by the OEB should ensure that these items are taken into consideration in its calculation.

3.3.6 Contingencies and mid-term issues – Z-Factors

GHESI disagrees with the Staff proposal that the Second Generation IRM not provide for any Z-factors.

GHESI agrees that no pre-defined Z-factors be established, however, an LDC should be allowed to present and argue its case to the OEB in the future under a Second Generation Incentive Regime. Examples of Z-factors that may need to be presented to the OEB for inclusion in rates during the second Generation Incentive period are lumpy capital expenditures (i.e. LDC Transformer Station expenditures and Wholesale Metering Points (WMP's)) and costs based on the extreme nature of storms in a localized area. For example, GHESI's investment in WMP's may reach \$3-4 million to comply with market rules and we have no mechanism to collect this expense through distribution rates.

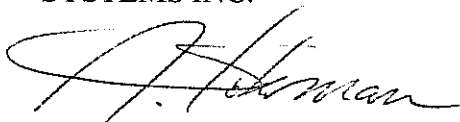
3.4 Looking Forward to Third Generation IRM

GHESI notes that the OEB does not state the next date at which an LDC may rebase its assets. Disclosure of this date(s) would lend predictability and stability to the industry.

If there are any questions, please contact me at (519) 837-4715, astokman@guelphhydro.com.

Yours sincerely,

GUELPH HYDRO ELECTRIC
SYSTEMS INC.



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