June 30, 2006

Mr. John Zych, Secretary
Ontario Energy Board
PO Box 2319
2300 Yonge St, Suite 2700
Toronto, Ontario, M4P 1E4

Re: EB-2006-0088 (Cost of Capital) and EB-2006-0089 (2nd Generation IRM)

Given the complexity of the matter and its impact on LDCs, and in conjunction with the tight June 30th timeline, London Hydro anticipates that it will be providing more comments in the following weeks. However, London Hydro felt that it was important to initially comment on a few key components of the report that we believe will have unintended and severe consequence to many efficiently operated LDCs under this proposal.

London Hydro believes that the proposal and the supporting expert submission do not adequately address the unique and different risk profiles of the individual LDCs, that are largely influenced by applying current rate design (variable and fixed rates) to varying customer demographics of individual LDCs. This is largely evident in a comparison of LDC revenue generated per customer. When this analysis is performed you will note that there is a substantial variation in revenue generating capability for a given level of rate base; a reflection of customer demographics and rate design, and individual utility risk.

The acid test in determining if the proposal ("one size fits all capital structure based on rate base") can be fairly applied is to model the impact of it after assuming that the capital structure can be actually implemented by the LDC. If in fact that capital structure cannot be sustained by the LDC, it is an indication that either the cost structure of the LDC is excessive, or that using rate base as a sole determinant does not work. In the specific case of London Hydro, with one of the lowest operating cost structures in the industry, after implementation of the proposal and mirroring that capital structure in our financial results, our financial metrics are worsened considerably dropping our credit worthiness from A credit to a low BBB range. The interest coverage ratio plummets to below 1.5 times coverage. One of the key drivers to this result is that the customer demographic and individual risk profile of the Company produces very low revenue per

customer result, and the proposal does not adequately make that connection by solely employing rate base.

Accordingly, we contend that the above acid test fails and that the risk profile and methodology employed will be unfairly prejudicial to certain LDCs. The anticipated results as described above are inappropriate for a municipally owned and supported entity. We further contend that rate base cannot be used as the sole determinant and any risk assessment must be stratified across the industry to take into account further differences in size, demographics, commodity related risks and other risk determinants.

The risk profile of the average electric utility is influenced primarily by the size and diversity of the customer base. Larger utilities tend to have a higher degree of customer diversity and less revenue dependency and risk associated with a limited number of customers who consume a high percentage of the total utility load. Smaller utilities are more susceptible to revenue dependency and commodity risk associated with a limited number of key customers.

These risk factors that represent key metrics used by the majority of credit rating agencies contradict the Board Staff's conclusions that "there is no compelling evidence to suggest materially different risk profiles of electricity and natural gas distributors in Ontario".

The vast majority of approximately 90 electric utilities in Ontario have a rate base that is less than $150 million and a customer base that is less than 75,000. Board Staff's position is that these electric utilities should have the same risk profile and capital structure as Ontario gas distributors who consist essentially of 2 distributors who each have assets in excess of $4 billion and customer bases of well over 1,000,000. It is reasonable to conclude that the size and diversity of the customer bases associated with these 2 gas distributors will produce a risk profile that differs from the majority of electric utilities.

Dr. Lazar and Dr. Prisman have acknowledged this direct link between rate base size and risk in their recommendation to the Board that utilities with a rate base of less than $300 million (representing the majority of utilities in Ontario) should have a maximum debt-equity split of 50%/50%. Board Staff have rejected this recommendation in their proposal, without having provided any compelling evidence to support that decision.

A second area of concern warranting immediate comment and consideration is the competing objectives of the OEBs Multi-Year Electricity Distribution Rate Setting Plan and the decision of the Board dated November 1, 2004 from the 2006 EDR Issues Day – Volume 1 (RP-2004-0188) (see section 579 of transcript).

The transcript outlined above before G. Kaiser (Presiding Member and Vice Chair), P. Sommerville (Member) and C. Chaplin (Member), quotes the decision as follows;

"The Board was asked to confirm that LDCs will be permitted to rebase for 2008 rates. With respect to rebasing, the Board confirms that the setting of 2008 rates will involve rebasing for all utilities."

In the 2006 EDR process both interveners and LDCs expressed the need for rebasing in 2008 for all utilities, and extrapolating from the Boards decision, the presiding members agreed with this need.

London Hydro is aware of the tremendous strain on OEB staff during the rate application process and understands that a multi-year tiered rate application schedule will allow for a full and complete review of all rate applications, as well as allowing the Board to operate in a more efficient manner. The prospect of operating until April 30, 2010 with distribution rates based on a hybrid of 2004 / 2005 cost levels and 2002 / 2003 / 2004 consumption levels is inappropriate and unfair to all vested parties.

If it is deemed that the multi-year rate plan is the only appropriate regulatory model, London Hydro submits it may be appropriate to update the risk premiums to cover the rebasing risk associated with the 2009 & 2010 rebasing utilities.

In the "Draft Staff Report – Proposals for Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors" dated June 19, 2006, six (6) guiding objectives were listed on pages 4 & 5.

The change in philosophy from all utilities rebasing in 2008 (the EDR decision in November 2004) to the multi-year plan contradicts all stated objectives:

1) **Protect customers in relation to prices**
   - Customers served by LDCs that, for one reason or another, have a declining ratebase will contribute to a revenue requirement that is artificially high for the 2008 – 2010 time period.
   - Conversely, customers in service territories that have ratebases on the increase will be contributing to an artificially low revenue requirement.

2) **Predictability and stability**
   - Customers / LDCs / Stakeholders / Interveners / Investors, all require a predictable and stable environment, with respect to distribution rates.
   - All parties listed above, not to mention bond rating services, were expecting a rebasing for all utilities in 2008. A change from this philosophy will impact the financial outlook of the entire industry.

3) **Promote economic efficiency by providing the appropriate pricing signals and a system of incentives for distributors to maintain an appropriate level of quality service**
   - In order for LDCs to properly maintain appropriate and mandated service levels a rate of return is required on all assets.
   - It is acceptable and unavoidable to have a timing lag between the rebasing and the rate of return associated with capital investments, when utilizing a test-year approach to rate determination, however, London Hydro submits that a 5 to 6 year lag is unacceptable and inappropriate.

4) **Allow for the opportunity for distributors to earn a reasonable rate of return on shareholder capital and to maintain their financial viability.**
   - While it is important to update the rates of return to current market levels and it is important to utilize an accurate and appropriate capital structure, it is equally important to ensure that accurate and timely data is utilized in the determination of distribution rates. This is accomplished through regular rebasing initiatives.
   - Updating rates of return and capital structures without updating the cost levels that the returns are associated with, is analogous to utilizing a test-year rate approval mechanism and picking and choosing the "tier 1" adjustments that are favorable to LDCs; this of course was not permitted in the 2006 rate approval process.

5) **Minimize the time and cost of administering the framework**
   - Utilizing differing rebasing years may in fact muddy the waters of administration to the OEB.
   - Differing rate years may require differing risk premiums and drive differing return rates for LDCs in the 2nd or 3rd year of the multi-year rate setting program.

6) **Establishing a common capital structure and incentive framework for all distributors**
   - Common capital structures for like utilities is an admirable and achievable goal (please see comments above with respect to utility size and capital structure), however, the common structure should be utilized for common test-years.
   - By utilizing differing rebasing years, the comparability of LDCs is lost.

All of the above comments are respectfully submitted for your consideration.

If you require any further information, please contact me directly.

Sincerely,

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