Ontario Energy Association

July 5, 2006

Peter O'Dell
Assistant Board Secretary
Ontario Energy Board
PO Box 2319, 27th Floor, 2300 Yonge Street
Toronto, ON
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Dear Mr. O'Dell,

Re: OEA Response to "*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)

The 160-member Ontario Energy Association (OEA) is Ontario's premier energy trade organization, representing firms and organizations involved in the transmission and distribution of natural gas, and the generation, transmission and distribution of electricity across the province. OEA members together employ about 32,000 Ontarians and last year accounted for about $34 billion in market revenues within the Ontario economy.

Ontario's Local Electricity Distribution Companies (LDCs) are an important part of the OEA membership. Correspondingly, the OEA has been an active participant in the ongoing consultations on developing an incentive-based regulatory structure for electricity LDCs. The OEA continues to support the principles underlying the Ontario Energy Board's "efficiency agenda" and, in particular, the intent behind the Incentive Regulation initiative. As we mentioned in our November 7th letter to the Chairman of the Board, Howard Wetston, LDCs are the primary interface with customers and, as a result, are well-positioned to bring the benefits of innovation directly to consumers. Incentive-based regulations are a key step in allowing LDCs to continue to operate as commercial entities by maximizing business efficiencies and seeking out further innovations.

Recognizing that this is just the first stage of ongoing consultations, we would still like to take this opportunity to provide some preliminary comments on behalf of our Utility Sector Committee members with regard to the recently released Draft Staff Report. We appreciate the time taken by Board staff to explain the proposals and look forward to ongoing participation in the consultations.

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While we appreciate that one of the primary goals is to minimize the cost of capital for the benefit of ratepayers, we would caution against moving too quickly or aggressively in implementing changes affecting the cost of capital. Factors such as capital structure and return on equity are core elements of any business operation. Given the diversity of business conditions faced by Ontario's electricity distributors, both historically and looking forward, it is important that any changes affecting cost of capital be implemented carefully, recognizing the different starting points of individual LDCs. Equally important is a recognition that Ontario's LDCs operate in broader commercial capital markets.

In our opinion, the draft proposals relating to return on equity and capital structure are indeed too aggressive and we would recommend additional analysis, with more attention to alternative methodologies for calculating the equity cost of capital, be undertaken to ensure fairness, creditworthiness and overall stability within the sector.

1) Return on Equity

Board staff have recommended a net Return on Equity range of 7.52-8.36%. This represents a significant change from the current level of 9%. As a recent report prepared by BMO Capital Markets (June 27, 2006) warns, the proposed range is "unsupportable and confiscatory…and likely violates the fair return standard, as established by Canada's Supreme Court and accepted by the National Energy Board in 1971." In line with this, we strongly agree that ROE must be comparable to the returns available on capital invested in other enterprises of comparable risk (i.e., the "comparable earnings standard") and must maintain the financial integrity of the enterprise and its ability to attract capital.

The current ROE, although comparable to other regulated utilities in Canada, is lower than similar regulated entities in the US - typically in the 10% to 12% range. Further reducing the ROE to the proposed range could have a material negative impact on cash flow-to-debt and interest coverage ratios which in turn could affect credit ratings and cost of debt.

Again, while we appreciate that the intent is to minimize the cost of capital, a change of this magnitude does not reflect a fair return on the equity invested by LDC shareholders. We note that Incentive Rate Mechanisms (IRMs) are an important regulatory tool to drive efficiency and promote longer-term business planning. As noted in Mark Lowry's earlier report (June 13, 2006), "A minimum condition is that the chief parties to the regulation, shareholders and customers, fare no worse under PBR than they would under traditional regulation (pg. 4)." We interpret this to mean that LDCs should not be subject to a punitive ROE, in hopes that incentive-related performance will ultimately allow the shareholder to earn a fair return on equity.

In light of these concerns, we strongly suggest that Board staff re-examine the evidentiary record in light of the precedents established by the Supreme Court of Canada, the National Energy Board, as well as other North American benchmarks.

2) Capital Structure

Board staff have proposed a "one-size-fits-all" approach to capital structure, where all LDCs would be forced to move towards a 60:40 debt-equity split (including a 4% allowance for preferred shares). Currently, a number of LDCs are operating with capital structures that more closely approximate a 50:50 ratio. As noted in the Draft Staff Report, Lazar and Prisman found no common view, from the financial markets perspective, on an appropriate capital structure and, correspondingly, recommend two groupings of LDCs for the purpose of establishing maximum debt-equity split. In rejecting this recommendation, Board staff argued that there is no evidence to suggest that a different size-based capital structure is required to ensure reasonable returns on investment or continued investment in infrastructure and, as a result, simply adopted the capital structure utilized for gas utilities.

We would emphasize that there are some important differences between the gas and electricity distribution sectors, notably with regard to the scale of operations and the ownership structure of individual companies, and the number of entities operating within each sector. As well, gas utilities had an opportunity to evolve over a longer period of time to their current capital structures.

Most importantly, however, both gas utilities and LDCs compete in the same global capital markets for debt and, therefore, any changes to capital structure that reduce revenue requirements and change interest coverage ratios could undermine an LDC's ability to attract debt at competitive rates. While simplicity is a laudable goal, it is important to recognize the impact of these changes, particularly for those utilities which are currently operating under significantly different capital structures from the proposal, and allow for a sufficiently long period of adjustment or, alternately, provide for different capital structures based on size.

In conclusion, the comments above reflect our Utility Sector Committee's initial concerns with regard to the cost of capital proposals, but do not undermine our support for the underlying need to develop incentive-based regulations in Ontario. We continue to encourage a regulatory approach that recognizes the government's strong commitment to ensuring that ratepayers pay the full cost of electricity production and supply.

To the extent that the proposals regarding cost of capital do not reflect current market conditions, we would strongly suggest a reconsideration to ensure that LDCs can continue to operate as commercial entities and maximize efficiencies. Over the long run, we believe this approach will benefit both the ratepayer *and* the shareholder!

We look forward to seeing further detail regarding the process by which the 2nd generation IRM and the subsequent re-basing will be applied, as well as the key aspects of 3rd generation IRM.

Sincerely,

Shane T. Pospisil

Shane T. Pospisil
President and CEO
Ontario Energy Association

cc:
David Civiero, Chair, Ontario Energy Association
David O'Brien, Vice-Chair, Ontario Energy Association
Rick Zebrowski, Chair, Utilities Sector Committee, Ontario Energy Association
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