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Board Secretary
Ontario Energy Board
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**PWU Comments – Draft Staff Report - Proposals for Cost of Capital (EB-2006-0088) and 2nd Generation Incentive (EB-2006-0089) for Ontario's Electricity Distributors**

The Power Workers' Union ("PWU") represents a large portion of the employees working in Ontario's electricity industry and has utmost interest in regulatory proceedings that impact the energy industry and the provision of ongoing service quality and reliability to customers. Attached please find a list of PWU employers.

The PWU appreciates the opportunity to provide comment on the Draft Staff Report: Proposals for Cost of Capital ("CoC") and 2nd Generation Incentive Regulation ("IRM") for Ontario's Electricity Distributors (the "Draft Report").

It was unfortunate that there was no opportunity for stakeholders to review the Draft Report prior to the June 20th, 2006 Information Session on the Draft Report. Such an opportunity would have allowed parties to seek clarification on the proposals and resulted in an improved understanding on which to base comments.

The following are the PWU's comments on the Draft Report.

## 1. Cost of Capital

### 1.1 Board Staff Proposal

<u>ROE</u>

The risk free rate of return implicit in the existing ROE is based on a proxy of the forecast of the long Government of Canada bond yield for a test year. Board Staff's proposal is for the risk free rate to be set based on the average of the 5, 10 and 15-year forward rates for Government of Canada bonds. In the Board Staff's view the forward rates are a better indicator of the future costs of risk free capital.

The method used to establish the current equity risk premium is the equity risk premium test. As we understand it, Board Staff is proposing to determine the risk premium by measuring the distributor's risk using a factor knows as "beta" (β). The beta is described as "a measure of the relative riskiness of the firm of industry compared to the overall risk of the whole market over the riskless rate. The equity risk premium in this case is the product of the overall market risk and the distributor or industry beta".

Capital Structure

The deemed capital structures for distributors introduced with the Ontario Energy Board's first Electricity Distribution Rate Handbook in 2000 were determined according to the size of the distributor's rate base. The deemed capital structure for the smallest distributors, with rate base under $100 million, was set at 50% equity and 50% debt. The proportion of equity increases with the size of rate base, and the deemed capital structure for the largest distributors, with rate base greater than $1.0 billion, was set at 35% equity and 65% debt. The method used to derive the ROE and capital structure was developed by Dr. Cannon (the "Cannon method").

Board Staff is proposing a common deemed capital structure for all distributors of 36% common equity and 64% debt financing. The distributors have the option of including a maximum of 4% preferred shares, with 60% debt. According to Board Staff "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." The proposed capital structure is based on that of the natural gas distributors. In moving to the gas distributor's capital structure Board Staff is apparently guided by an objective for common structures and to minimize regulatory administration time and resources.

### 1.2 PWU Comments

The PWU notes that Board Staff's CoC proposal constitutes a profound change from the status quo, the potential impact of which should not be minimized in the Board Staff's consideration of its proposal.

ROE

The resulting ROE presented in the Appendix to the Draft Paper as determined by Dr. Fred Lazar and Dr. Eli Prisman, the Board Staff consultants on the CoC proposal, is a range of 5.78% to 7.02%. With the continuation of the practice of adding a 50 basis points allowance to the equity risk premium, the maximum of the range increases to 7.52% as indicated under the Board Staff proposal in the Appendix. This, as the Draft Paper points out, is a significant reduction from the original 9.88% ROE set out in the 2000 Rate Handbook. We note that it is also a significant reduction from the ROE of 9.00% set out in the 2006 Rate Handbook, and is significantly lower than the 8.36% that is derived using the existing method, the Cannon method.

The determination of the 2007 ROE using the proposed method will result in lower than expected 2007 revenue requirements for the distributors. Given that the distributors can be expected to have included ROE projections based on the existing methodology in their multi-year business plans and in carrying out their financial planning, the revenue shortfall can have a significant impact on their operations.

The difference in a 2007 ROE that would be based on the Board Staff's proposal and the 2006 ROE is largely a result of the change in the method used to determine the ROE rather than adjustments that reflect changes in economic/financial forecasts or the distributors' risk profile. While we assume the merits of the proposed method over the Cannon method is still up for debate, the PWU notes that any consideration of implementing the proposed method should take into account the impact of what may be a significant revenue drop from the distributors' planning assumptions. This would be especially onerous where a distributor's financial plan contemplates re-investment of its net income into its system. This proposal is counter to the stated objective of predictability and stability that is supposed to provide for an environment that allows distributors and consumers to better plan and make decisions. Therefore, mitigation of the significant regulatory risk related to the possible imminent implementation of such a significant change to the ROE must be considered in the Board Staff proposal.

It appears that the Board Staff proposal on the equity risk premium (“ERP”) is still at a very early stage of development and, in fact, Board Staff states that they are “undecided on the most appropriate way of estimating the ERP”. This leaves us with the impression that the proposed approach to the determination of the ERP is highly complex. While complexity should not be shunned to achieve robustness, Board Staff needs to consider the degree to which the complexity of deriving the ERP implicit in the CoC proposal is merited.

Capital Structure

The proposal to move all distributors to a deemed capital structure of 36% equity and 64% debt, or the alternative of 36% equity, a maximum of 4% preferred shares and 60% debt financing in 2008, would similarly negatively impact the revenue of distributors with rate bases of less than $1.0 billion. Mitigation of this revenue impact will also need to be considered in forwarding the proposal.

A lack of consideration of mitigating the negative revenue impacts of the CoC proposal can result in cost cuts that would compromise ongoing service quality and reliability. Such cost cuts may ultimately result in higher costs as the distributors catch up with the required maintenance and capital investment in future years.

## 2. 2nd Generation Incentive Regulation Mechanism

### 2.1 Board Staff Proposal

Board Staff is proposing a 2nd Generation Incentive Regulation Mechanism (IRM) for a term of up to three years with a first IRM distribution rate adjustment in 2007. The Board intends to stagger the review of the distributors’ rates by re-basing the rates of one third of the distributors in 2008, another third in 2009 and the remaining third in 2010. The term of the plan for a particular distributor would depend on the year in which its rates are re-based.

The initial rates for the IRM plan are the 2006 rates. The proposed IRM plan is a Price Cap mechanism that would adjust rates by: the Gross Domestic Product Price Index (“GDP-PI”) as the price escalator; a productivity factor (“X” factor) of 1%; and the ROE and cost of debt adjustment in 2007, and the adjustment to move the distributors to the proposed capital structure in 2008 (“K” factor). Service quality requirements would be made a condition of the Distribution System Code. Conservation and demand management (CDM) related costs would not be included in the IRM.

### 2.2 PWU Comments

K Factor

The K factor would be used to adjust rates in 2007 for the proposed ROE and debt rates only, and to adjust rates in 2008 for the proposed capital structure only. It is not clear whether, having made the CoC proposal related adjustments in 2007 and 2008, the K factor would be removed from the IRM formula for the 2009 rate adjustment. If the K factor remains part of the formula for 2009, the question is what it would adjust rates for in that year.

Term

In section 3.3.3 Board Staff indicates that there is no expectation that any distributors' rates will be re-based prior to implementing the IRM adjustments in 2007. We assume that this does not preclude the re-basing of rates for a distributor that identifies an essential need to do so in order to maintain its service quality and reliability and remain solvent, in an application to the Board.

Price Cap

Having been a party to the Board's 2006 Distribution Rates initiative and proceeding, the PWU agrees that the lack of a robust information base necessary to establish a yardstick approach precludes this approach for 2nd generation IRM.

Price Escalator GDP-IP

The PWU agrees with Board Staff that the GDP-IP tracks a set of goods and service that is more relevant to electricity distribution than the Consumer Price Index, which tracks consumer goods and services. However, we note Dr. Lowry's observation captured in the Draft Report that an industry-specific input price index ("IPI") tracks industry input price fluctuations better than an economy-wide measure such as the GDP-PI. As indicated in the Draft Report, the IPI avoids the significant gains and losses that result when a broad macroeconomic index is used to track a specific industry's input price inflation. The Draft Report correctly points out that electricity distribution and transmission are capital-intensive businesses that are therefore sensitive to changes in the cost of capital, and that the fluctuation in the cost of capital can differ from that of an economy wide measure over extended periods.

Board Staff indicates that they may review and refine where appropriate the IPI methodology employed in the Board's 1st Generation PBR for consideration in a 3rd Generation IRM. The GDP-IP is proposed as "less controversial and easier to implement over the next three years while a number of important rate-related studies are carried out". The PWU would like to point out that the implementation of the IPI would not necessarily require significant effort. The Board put in place an IPI adjustment mechanism in the First Generation PBR that the Board used in determining the IPI for 2002[1]. The PWU suggests that Board Staff consider using this mechanism to update the IPI for use as the price escalator in the 2nd Generation IRM plan.

Productivity Factor

With the proposed use of the GDP-IP as the price escalator, there is no way of assessing the incentive value of the proposed 1% productivity factor.

Board Staff states that the selection of the productivity factor for the 2nd Generation IRM is a function of simplicity and transparency. We question whether there is transparency when the productivity factor is set in the absence of any evidence on the distributors' productivity potential.

The PWU would like to point out that the Board Staff's proposed K adjustments are in fact productivity factors that would require the distributors to cut costs and find efficiencies to

[1] http://www.oeb.gov.on.ca/documents/backgrounder_ipi_210102.pdf

address the financial impacts of the proposed K factor. Therefore, we would suggest that in proposing the K factor the productivity factor is rendered superfluous and Board Staff should remove it from the IRM proposal.

Contingencies and Mid-Term Issues

Board Staff acknowledges the Board's conclusion in the Natural Gas Forum for the need to limit reliance on Z-factors in IRM to well-defined and well-justified cases only. Board Staff then goes on to state that given the varied and relatively short period of the 2nd generation IRM, Board Staff does not see the need for pre-defined Z-factors and the proposed IRM does not provide for a Z-factor. Nor does the proposed IRM provide for off-ramp provisions.

In the PWU's view, the need for Z-factors to accommodate extraordinary costs/events is in no way related to the term of an IRM plan. Occasion for the need of Z-factor treatment or to off-ramp can happen at any time as they are not in the control of the distributor. In addition, by definition, Z-factors are generally significant.

The proposal to keep CDM costs outside of the IRM is in fact Z-factor treatment.

The PWU recommends that Board Staff include a Z-factor provision in the IRM proposal as was provided for in the first Generation PBR plan. Distributors would be required to track the costs related to an approved Z-factor in a deferral account.

While the provision for a Z-factor can mitigate to a large degree the need for an off-ramp, there may be incidents where the significance of a Z-factor warrants an off-ramp.

Service Quality

The PWU is pleased with the Board Staff's recommendation that the Board resume its Service Quality Regulation ("SQR") review for the development of the Board's SQR regime. Service quality and reliability performance is what customers are paying for in their distribution rates and it is essential that distributors meet their customers' service expectations. It is key therefore, that stakeholders have the opportunity to review the distributors' service quality and reliability performance relative to the distributors' cost of service in a rates proceeding. To this end, given Board Staff's proposal to include the SQR requirements in the Distribution System Code, the PWU is concerned that the Board may find a distributor's service quality and reliability performance to be out of scope for a rate proceeding as it would be a DSC matter. As a result, the PWU recommends that the Board explicitly recognize that service quality and reliability performance remains a part of its rate review process under any IRM.

These are the comments of the PWU on the Draft Report. We hope you will consider them and that they are helpful in Board Staff's development of robust proposals on CoC and IRM.

Yours truly,

Don MacKinnon
President

**List of PWU Employers**

Atomic Energy of Canada Limited (Chalk River Laboratories)
Barrie Hydro
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brascan Power Corporation - Lake Superior Power Inc.
Brighton Beach Power Limited
Bruce Power Inc.
Corporation of the City of Dryden - Dryden Municipal Telephone
Corporation of the County of Brant
Electrical Safety Authority
Erie Thames Services Corporation
Goldman Hotels Inc. - Hockley Highlands Inn & Conference Centre
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
London Hydro Incorporated
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
Mississagi Power Trust
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Ontario Power Generation Inc.
Orangeville Hydro Limited
PUC Services Inc.
Sioux Lookout Hydro Inc.
Sodexho Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation