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Ontario Energy Board

Report of the Board

on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors

December 20, 2006

(restaurants, stores, etc.) moving away, while larger distributors may operate in more diversified local economies and hence be better protected from a sector downturn.

The Board notes that load concentration risk, which was the primary focus of distributor concerns, is not necessarily related to distributor size. Horizon Utilities, Oakville Hydro and EnWin Powerlines are examples of mid-sized distributors with concentrated loads. As discussed previously, the four size-based categories have been in effect since industry restructuring and distribution rate unbundling. Based on changes to the sector over the last eight years and data from distributors' operations since 1999 the Board concludes that size is not a key determinant of, or proxy for, risk.

This conclusion is corroborated by the Board's examination of 2005 financial data filed by electricity distributors, which show that the distributors exhibit a variety of actual debt-equity structures. According to the data, about one quarter of the small distributors have leveraged themselves with debt to levels in excess of 50%. These distributors do not appear to be experiencing particular financing concerns as a result of this debt load.

A distributor, regardless of size, when planning and making decisions to manage its business risk, will organize its financing in line with its business needs.

The Board concludes that utility size no longer represents an accurate proxy for risk. As a result, there is no basis upon which ratepayers should be required to bear different costs, associated with different capital structures, on the basis of distributor size. The question the Board must ask is whether ratepayers of smaller distributors should pay higher rates than those of larger distributors because of a thicker equity component. For these reasons it is the Board's view, that for ratemaking purposes, a single capital structure for all distributors is appropriate.

To avoid the unintended consequences of transition causing gross mismatch between actual and deemed capital structure, the Board has determined that a staged implementation will be used. This is discussed in sub-section 4.1, below. In addition, if