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Ontario

BY E-MAIL

October 17, 2016

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Lakefront Utilities Inc.
2017 Distribution Rate Application
OEB Staff Submission
OEB File No. EB-2016-0089

In accordance with Procedural Order No. 3, please find attached OEB staff's submission for Lakefront Utilities Inc.'s 2017 cost of service application. This document is also being forwarded to Lakefront Utilities Inc. and to the Cobourg Taxpayers Association, the Vulnerable Energy Consumers Coalition, and Energy Probe Research Foundation.

Yours truly,

Original Signed By

Georgette Vlahos
Ontario Energy Board staff – Case Manager EB-2016-0089

Encl.

2017 ELECTRICITY DISTRIBUTION RATES

Lakefront Utilities Inc.

EB-2016-0089

OEB STAFF SUBMISSION

October 17, 2016

INTRODUCTION

Lakefront Utilities Inc. (Lakefront Utilities) filed an application with the Ontario Energy Board (OEB) on April 29, 2016 seeking approval for changes to the rates that Lakefront Utilities charges for electricity distribution, to be effective January 1, 2017. The OEB issued an approved issues list for this proceeding on August 19, 2016. A settlement conference was held on August 22 and 23, 2016 and Lakefront Utilities filed a settlement proposal setting out an agreement between all the parties to the proceeding on September 21, 2016. The parties to the settlement proposal are Lakefront Utilities and the following approved intervenors in the proceeding: the Cobourg Taxpayers Association (CTA), the Vulnerable Energy Consumers Coalition (VECC), and Energy Probe Research Foundation (EP).

The settlement proposal represents a comprehensive partial settlement. The single issue that was not settled is Lakefront Utilities' proposed long-term debt rate for its affiliated debt.

On October 6, 2016, the OEB issued a Decision on the Partial Settlement Agreement and Procedural Order No.3. In that document, the OEB accepted the settlement proposal between the parties and the parties' request to hear the unsettled issue by way of written hearing. Pursuant to Procedural Order No. 3, OEB staff's submission on the unsettled issue is set out below.

Long Term Debt Rate

As part of its application, Lakefront Utilities indicated it has three long term debt instruments[1] (one promissory note and two loans). Lakefront Utilities proposed to apply the OEB's deemed long term debt rate of 4.54% to all three debt instruments:

[1] EB-2016-0089, Lakefront Utilities' Interrogatory Responses, Page 149

	Description	Lender	Affiliated / Third Party	Date	Term	Principal	Rate
1	Note Payable	Town of Cobourg	Affiliated	09/12/2006	NA (On Demand)	$ 7,000,000	7.25%
2	Loan	Infrastructure Ontario	Affiliated	10/01/2012	15 years	$ 1,225,224	3.38%
3	Loan	Infrastructure Ontario	Affiliated	09/03/2013	15 years	$ 1,457,461	4.03%
	Total Debt					$ 9,682,685	4.54%
							Proposed

In its interrogatories, OEB staff noted that the OEB's policy on long-term debt requires the use of actual rates to each of the debt instruments subject to certain conditions (e.g. taking into account whether the lender is affiliated or third party). In this case, OEB staff noted that the two Infrastructure Ontario loans are third-party loans with fixed rates and fixed terms, and would therefore attract, for rate-setting purposes, actual rates of 3.38% and 4.03% respectively. The promissory note to the Town of Cobourg is affiliated debt, with a fixed rate but with no fixed term. Because its rate is above the OEB's ceiling, it would attract the OEB's current deemed long-term debt rate of 4.54% rather than the actual rate of 7.25%.

The OEB's current Cost of Capital Report makes it clear that, while reliance is made on the actual (embedded) cost of debt for the portfolio of debt instruments of a regulated utility, the OEB's deemed long-term debt rate will act as the ceiling on the allowed interest rate for debt under certain circumstances. These circumstances include affiliated debt (to ensure that the arrangement appears to be "at arm's length") and for debt without a specific term (or maturity). Variable rate debt or new debt for which no reasonable forecast may be available also falls under these criteria. The September 12th, 2006 promissory note meets these criteria:

- It is affiliated debt
- It has no specified term or maturity, but is payable on demand or on order of the lender (the Town of Cobourg)

In accordance with current OEB policies on the Cost of Capital, the current deemed debt rate would be the maximum allowed for recovery as part of the OEB-approved revenue requirement with respect to this debt. While Lakefront Utilities may pay interest at 7.25% to its municipal shareholders, it would not recoup that amount in interest in distribution rates as long as the 7.25% was above the OEB's current deemed interest rate. The OEB could determine a rate lower than the current deemed long-term debt rate, but there would have to be specific evidence supporting such a rate.

In response to interrogatory 5-Staff-53 c), Lakefront Utilities agreed with analysis conducted by OEB staff indicating that the applicable debt rate should be applied to each debt instrument individually and not how it was initially proposed by Lakefront Utilities. This would result in a current weighted average cost of long-term debt of 4.32%. Lakefront Utilities also agreed to update its long-term debt rate when the OEB issues the updated Cost of Capital parameters applicable to 2017.

OEB staff submits that Lakefront Utilities' updated proposal of a weighted average cost of debt of 4.32%, to be updated when the OEB issues the new cost of capital parameters, is consistent with OEB policy on the Cost of Capital.

Negotiate New Promissory Note

Notwithstanding the above, the parties to this proceeding were unable to agree on the amended proposal for Lakefront Utilities' long-term debt rate. OEB staff notes that the issue raised in interrogatories and follow up questions to the applicant concerns whether the utility should replace the $7,000,000 debt with debt from third-party lenders at an even lower rate. As indicated in its response to pre-ADR clarification questions from the CTA, Lakefront Utilities' position is that the Town of Cobourg long-term note is a legally binding document and although Lakefront Utilities may have interest in negotiating a lower rate or paying it off entirely with another market rate, it is ultimately up to the Town of Cobourg to accept that proposition due to the nature of the Promissory Note[2].

OEB staff notes the lack of specificity in the terms and conditions of the Promissory Note filed in the appendix to Exhibit 5. It is unclear whether the current promissory note is callable by Lakefront Utilities, or only by the lender (i.e. The Town of Cobourg). The note is explicitly labeled as being a "Promissory Note" (as opposed to a Demand Note). However, except in the situation of default, the only reference to repayment terms is at the beginning:

[2] EB-2016-0089, Pre-ADR Clarification Responses, 5-CTA-15, Page 9

> FOR VALUE RECEIVED, Lakefront Utilities Inc. (the “Borrower”) promises to pay on demand to or to the order of The Corporation of the Town of Cobourg (the “Lender”) … [emphasis added]

OEB staff submits it is unclear whether this is really a demand note, whereby only the lender can demand repayment of the principal outside of default, or whether it is a promissory note, where either party can initiate repayment of principal or can negotiate an agreement for repayment.

There is nothing specific in the promissory note that adds further to this.

Lakefront Utilities may be paying higher interest than otherwise would be the case if it negotiated a lower rate with the Town or if it replaced the note with a new debt instrument at a market-based rate. But all else being equal, Lakefront Utilities’ actual return on equity is lower as a result of the current note parameters. It is the utility’s shareholder which bears the impact of paying interest on the promissory note at a higher-than-market-based rate. Ratepayers are protected by the OEB’s policy described above.

While there may be valid reasons indicating that the utility could attempt to replace the $7,000,000 debt with debt from third-party lenders, there may also be benefits to Lakefront Utilities from the current promissory note conditions. For example, not having to re-pay the original principal means that the utility may avoid raising debt as frequently, and thus reducing transaction costs. This is a management decision, and for the utility and its shareholder to decide whether to re-negotiate or replace debt. There are many instances where utilities have monetized or replaced original municipal debt, but there are equally many situations where the affiliated debt remains in place - so long as the amounts recovered in rates are consistent with the OEB’s policy and practice with respect to the cost of capital.

OEB staff submits that Lakefront Utilities’ long-term debt rate as amended in 5-Staff-53 c) (i.e. 4.32%), and specifically its proposed treatment of the affiliated debt, conforms to the OEB’s policies on the cost of capital. OEB staff also notes that Lakefront Utilities long-term debt should be revised upon issuance of the OEB’s cost of capital parameters applicable for 2017 rates, as already acknowledged by Lakefront Utilities.

All of which is respectfully submitted