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August 14, 2006

Ontario Energy Board
P.O. Box 2319
2300 Yonge Street 27th Floor
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Attention: Kirsten Walli, Board Secretary

Re: EB-2006-0088 and EB-2006-0089 - Comments on Board Staff Discussion Paper - Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors, dated July 25, 2006

The Board has requested comments on a Board Staff Discussion Paper dated July 25, 2006 ("Staff Paper") that identifies the current views of Staff on preferred options for cost of capital ("COC") and 2nd generation incentive regulation ("2nd Generation IRM"). The comments herein are prepared on behalf of the local distribution companies (LDCs) Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc., hereinafter collectively referred to as the "CLD". These comments relate specifically to the mechanisms being proposed for 2nd Generation IRM, and comments on COC will be filed separately. In addition to these comments, attached is an expert report titled "Incentive Creation as the Key To Incentive Regulation" prepared by Adonis Yatchew, Ph.D., on behalf of the CLD.

General form of 2nd Generation IRM

Board staff has described 2nd Generation IRM as being of a transitional nature. The CLD agrees with this characterization and would therefore expect that determinations for 2nd Generation IRM would not set precedence for 3rd Generation IRM.

The Staff Paper has proposed a price cap form of adjustment mechanism based on the following formula:

$$\%\Delta P = K + \%\,\Delta GDPIPI - X + Z$$

The comments following address each element of this formula.

- **Price Cap versus Revenue Cap**

While there are strengths and weaknesses to both a price cap and revenue cap mechanism, the CLD does not oppose the use of a price cap for 2nd Generation IRM. However, this should be in conjunction with a continued lost revenue adjustment mechanism (LRAM) for conservation and demand management (CDM). This is particularly important given the aggressive targets being planned for CDM as set out in the Minister of Energy's directive to the Ontario Power Authority (OPA).

- **Initial Rates**

Under incentive regulation the term ΔP refers to the change from initial rates, which are often represented as P_0**.** The assumption being made is that the current P_0 are correct. While it is acknowledged that changes cannot be made to initial rates prior to implementation of 2nd generation IRM on May 2007, it also has to be recognized that the 2006 EDR process that set initial rates was designed with numerous compromises for expediency. This should be a consideration when setting the productivity factor for this transitional period.

- **K Factor**

As stated previously, the CLD is filing separate comments on the specific issue of COC. The timing for implementation of any changes in COC also needs to be considered. The CLD recommends that the Board delay implementation of the K factor until 2008 when the first group of LDCs file new cost of service applications.

A more standard representation for incentive regulation than that in the Staff Paper would be: $P_1 = P_0 \times (1 + RPI - X + Z)$, in which a K factor is not included. The CLD is concerned that including the K factor in 2007 is essentially rebasing one element of the revenue requirement set through the 2006 EDR process without considering other utility specific factors. The CLD is therefore proposing that for 2007, 2nd generation be of the form $\%\Delta P = \%\ \Delta GDPIPI - X + Z$. The K factor would be added in 2008 to ensure that all LDCs, both those filing cost of service applications and those remaining on 2nd generation IRM, have the same COC.

- **Price Escalator**

The CLD would support the use of either CPI or GDP-IPI for the purposes of a price escalator in this transitional period of 2nd generation IRM. If the Board accepts the staff proposal and adopts the GDP-IPI, the CLD acknowledges that timing issues preclude the use of the Ontario measure. However, excluding escalators related to crude oil and natural gas is of concern since these factors affect many of an LDC's costs. For instance, an LDC likely operates one of the largest fleets in its community and fuel costs for operating this fleet have been escalating rapidly. Furthermore, frequently used materials such as aluminum conductor rely heavily on an energy intensive industry. These are examples of cost pressures from feedstock items such as crude oil and natural gas. Therefore, the CLD believes that, if the GDP-IPI is used as the price escalator, consideration must be given for price increases in crude oil and natural gas.

The CLD further notes that current collective agreements, which have a large impact on overall costs, include wage increases in the general range of 3% for 2007, providing additional evidence that inflationary pressures are greater than the 1.77% illustrated in the Staff Paper for the GDP-IPI.

- **Productivity Factor ("X Factor")**

The Staff Paper has proposed a relatively arbitrary 1% for the X factor during 2nd generation IRM. Staff has pointed out that 2nd generation IRM is transitional and therefore no calibration is proposed for the X factor to reflect the Ontario LDCs. The CLD acknowledges that developing X factors specific to Ontario LDCs in time for implementation by May 2007 would be a challenge and therefore accepts that a relatively arbitrary assessment must be made. However, in making that assessment the Board should consider some of the historical circumstances in Ontario.

The Ontario LDCs have been through a prolonged period of rate freezes. Most LDCs did not have any rate increases related to local operating costs between 1993 and 2006. During this period of time, LDCs have had to continually improve efficiencies to maintain operations. Certainly an examination of a simple measure such as OM&A per customer illustrates that this index has increased much less than the rate of inflation during this time even though LDCs have incurred many additional costs for new mandates such as retail and wholesale settlement and

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regulatory requirements. It is reasonable to assume that easily attained efficiency gains have already been extracted, making future gains more challenging. The CLD are not aware of other jurisdictions that could demonstrate a similar 13-year period of cost containment and therefore the relevance of external X factors is questionable.

Board staff has indicated that 2nd generation IRM without an X factor would "not create sufficient incentives to distributors for efficiency improvements". However, there is little evidence that an LDC can react to an IRM of such a transitional nature and short time period (some LDCs will only be subject to it for 1 year). Therefore the X factor simply becomes a somewhat subjective rollback of the inflation escalator.

For these reasons, the CLD recommends that a conservative approach be taken for the X factor under 2nd Generation IRM, without consideration of a stretch factor. It is recommended that the X factor be set to 0.7% for 2nd Generation IRM, reflective of acknowledged productivity trends without a stretch factor from Table 1 on page 55 of the June 13, 2006 report by the Pacific Economics Group ("PEG").

- **Z Factor**

The addition of a Z factor to an incentive regulation regime is intended to reduce the risks for a utility. As such, the CLD supports the Staff Paper's inclusion of a Z factor for 2nd generation IRM. However, the proposed limitations on its use are so restrictive that there is concern that this Z factor does not reduce the LDCs risk in any meaningful way. The CLD agrees that a Z factor should only be used infrequently, and only for issues of a material nature that are beyond the control of management. However, risk is only mitigated if an LDC is permitted to make its case for a Z factor before the Board on any issue. Of particular note are material bad debts. The Board has mandated rules for security deposits in the Distribution System Code ("DSC") that severely limit an LDC's ability to manage bad debts. (An LDC is under more stringent rules for prudential requirements with the IESO than it can require of a large commercial customer). If an LDC has followed these prescribed rules and suffers a material loss, the Board should be open to hearing this as a case for a Z factor. The Board is reminded of the $9.3 million loss experienced by the former Hamilton Hydro as a result of the insolvency of Stelco.

Smart Meters

The CLD agrees with the Staff Paper's proposal to increase the amount of funding for Smart Meters by $1 to the fixed distribution charge in 2007, provided that there continue to be variance accounts for Smart Meters.

Low Voltage ("LV") Charges

As part of the 2006 EDR, LDCs having embedded delivery points with Hydro One Networks ("HONI") were permitted to include new LV charges in their revenue requirement. The amounts included were based on estimates since HONI had not yet implemented these charges. LDCs were also required to set up variance accounts to track the difference between the estimated amount included in rates and the actual charges from HONI. For cases in which an LDC has a material difference between estimates and actuals, an adjustment to rates would be appropriate to prevent a large accumulation in a variance account requiring future disposition. This could be treated as a Z factor.

Capital Escalator

Absent in the Staff Paper is an escalator for increases in capital, other than for Smart Meters. This may lead to LDCs deferring necessary investments in distribution assets until the next cost of service application. As noted in the Staff Paper, Board staff has recently issued a proposal paper on minimum filing requirements for electricity transmission and distribution rate applications. The CLD suggest that providing LDCs an option at their next cost of service application of filing a multi-year capital plan would help mitigate this issue. An LDC could file a cost of service application for 2008 inclusive of a capital plan for 2009 and 2010 so that a capital escalator could be determined. As a result, an LDC would be without a capital escalator only for 2007.

Application of the Price Cap Index

The CLD supports the proposal in the Staff Paper to apply the proposed price cap index uniformly across all customer classes and to both the fixed and volumetric rates. The description of how the mechanical adjustment will be achieved appears appropriate, but as with any rate-setting methodologies there can be unforeseen complications. Members of the CLD would be pleased to volunteer to test out any models that may be developed.

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Summary

Thank-you for this opportunity to provide comments on the Staff Paper. The CLD intends to participate actively in future technical conferences and clarify any points at that time. Any questions about these comments can be directed to the undersigned at 613-738-5499 ext 527 or lynneanderson@hydroottawa.com.

Respectfully filed on behalf of the CLD

Lynne Anderson
Director, Regulatory Services