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BY COURIER

November 17, 2006

Ms. Kirsten Walli
Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON.
M4P 1E4

Dear Ms. Walli:

EB-2006-0267 – EDA LRAM Proposal for Electricity LDCs – Hydro One Networks' Comments

In response to the Ontario Energy Board letter issued November 2, 2006 regarding the Electricity Distributors Association LRAM proposal, Hydro One Networks Inc. is pleased to provide the attached comments.

As requested, we are enclosing seven (7) paper copies. The searchable Acrobat electronic version will be sent to boardsec@oeb.gov.on.ca

Sincerely,

Susan Frank

Susan Frank

Attach. (1)

IN THE MATTER OF a consultation by the Ontario Energy Board on the EDA proposal for a Revenue Stabilization Mechanism for Local Electricity Distributors

Board File No.: EB-2006-0267

The OEB (the Board) requested comments on the subject matter in relation to a number of questions posed in its November 2, 2006 memo to LDCs. Accordingly, Hydro One is pleased to respond to this request in the form of general comments and with responses to the specific questions posed by the Board.

General Comments

- Hydro One supports the EDA's position that the LRAM format that is used extensively by the Board in the regulation of CDM programs in the natural gas distribution sector for the purpose of maintaining revenue neutrality for the distributors is cumbersome and requires significant effort by the utilities to keep track of the performance of individual CDM programs to calculate the value of energy savings and hence revenue shortfall. Further, LRAM only captures the lost revenue impact of the utilities own CDM initiatives. This is particularly an issue for the electric utilities which are likely to experience a greater variety of CDM programs especially given OPA's expanded mandate for CDM programs and funding. LRAM simply will not capture all of these CDM activities. The LRAM is essentially a "bottom-up" approach at establishing revenue neutrality for programs delivered by the utilities.

- The proposal brought forward by the EDA's Consultant for a revenue stabilization mechanism (RSM), and endorsed by the EDA Board, is an alternative revenue matching mechanism that is seen as an aid to reduce the disincentives for the LDCs to pursue implementation of CDM programs in a simpler manner than is likely to be the case with LRAM. The RSM is a "top-down" approach at establishing revenue neutrality. As noted below in Hydro One's responses to Board's questions, the RSM by its very nature captures more than just the variances brought about by CDM activities.

- Ontario is increasingly moving forward with a focus on conservation and demand management to meet the directives set by the government for a conservation culture with respect to the use of electrical energy. In this respect the accountability for CDM targets and programs continues to shift away from the electricity distribution sector. The OPA has been charged with setting the targets and program for CDM province wide and has been allocated funding commensurate with this mandate. It is expected that the LDCs will continue to deliver the CDM programs set by the OPA because these entities are in the best position to do so. Therefore, given the OPA's lead accountability for setting provincial CDM targets and for administering the financing of the CDM programs designed to meet those targets, the need for LDCs accountability to drive CDM programs will be greatly diminished. As a result there should be reduced concern about the delivery of the programs by the LDCs in the electricity distribution sector or for there to be any potential for disincentives to do so. The matter of disincentives to CDM programs appears to be more a natural gas distribution issue.

- The LRAM and RSM methodologies rely on true-up adjustments to obtain revenue neutrality. The reliance on true-ups attests to the use of after the fact (past history) information which is inconsistent with the way utilities run their business, and is also inconsistent with the Board's proposals to move forward with incentive regulation.

- The nature of utilities business is "forward" looking and so utilities establish their business plans and work programs based on forecasts of customer demands. Equally so, the rate setting process utilizes this forward looking approach, i.e. the focus is on a future test year to set forward going rates. Furthermore, the Board has embarked on incentive regulation as a process for adjusting the rates for both the electric and natural gas distribution utilities. The very nature of incentive regulation is to rely on forecasts. Therefore, reliance on forecasts is a perspective that is shared by the utilities in running their business and by the Board in moving towards an incentive rate setting process.

- In summary, the electric utilities are not solely responsible for the consequences of the CDM programs and quite rightly should not be rewarded or penalized for the success or failure of these programs. The LRAM adjustment mechanism is complex, costly and subject to controversy and as such should be avoided in the context of CDM programs applied in electric distribution sector. It simply cannot capture the financial effects of conservation activity since there are parties beyond the utility undertaking CDM. Although the proposed RSM mechanism is an improvement on the LRAM concept its main disadvantage is that it is inconsistent with the Board's direction of moving to incentive regulation. The Board is proposing price cap regulation whereas the RSM is more akin to revenue cap regulation. As noted in Hydro One's response to Board's Question 1 below, it is not readily obvious how this revenue adjustment mechanism will work with the Board's proposal for price cap regulation. It seems that the two concepts are incompatible.

- Hydro One believes that a more effective way to move forward with the matter of revenue deficiency in conjunction with CDM program implementation is to develop appropriate adjustment mechanisms in the incentive regulatory model that reflect the nature of CDM as a province wide program, i.e. common to all utilities. For example, the Board may consider creating a "Z"- like equivalent factor that can be included in the price cap formula that would reflect the government's and OPA's CDM programs that are uniform for all LDCs. In this way the CDM-related adjustment factors would provide the necessary adjustment for utilities to balance the impact of CDM programs. This approach is entirely consistent with the nature of the adjustment mechanisms that are proposed for the price cap model which relies on the use of forecast indices, and could include annual adjustments to the CDM factor that would take into consideration any forward looking changes to CDM programs, just as will be done for the inflation factor. Therefore, Hydro One's proposed alternative is entirely consistent with the nature of incentive regulation which the Board proposes to adopt for the distribution sector in Ontario.

Response to Specific Questions

1. *What are the implications, advantages, and disadvantages of adopting the EDA's proposed approach?*

Hydro One response

Advantages

- The RSM attempts to achieve revenue neutrality through a "top down" approach. In this way the RSM appears to make the revenue recovered through rates consistent with the approved revenue requirement by accounting for most factors that may impact on revenue recovery. In this respect the RSM does not deal specifically with just CDM impacts.
- Another advantage of the EDA proposal is the apparent simplicity when compared to LRAM concept.

Disadvantages

- One disadvantage of the RSM proposal is that it requires "after the fact "adjustments to actual results, e.g. weather normalization, to calculate variances for the purpose of establishing true ups to revenues.

- Another potential disadvantage is that the RSM proposal is essentially a revenue adjustment mechanism whereas the Board proposes to move forward with price cap adjustment mechanisms. Therefore the proposal appears to be at odds with the Board direction for incentive regulation and it is not clear how it would work. Furthermore, the RSM proposal constitutes a "revenue freeze" which again appears to be contrary to the incentive plan being proposed by the Board for the LDCs. For example, under a price cap incentive model an LDC would have its revenue requirement approved as part of the rebasing process in the first year of the incentive plan. There would be no separate approvals of revenue requirements in the subsequent years of the incentive plan. The RSM approach calls for comparison of forecast and actual revenues to determine the true ups in which case the only forecast and approved revenue that could be used for comparisons is that in year 1 of the incentive plan.

- By looking at the differentials between forecast and actual revenues the proposed RSM methodology captures several potential factors, beyond weather and customer number adjustments, that could lead to a reduction in energy consumption and lower revenues. CDM is only one of the factors that impacts on energy consumption. The other impacts include customer consumption (reduction due to self generation which constitutes bypass), economy, and technology improvements to name but these few. All of these are generally accepted risks for the utility since these are inherent to the nature of its business. Therefore, the proposal to adjust revenues by "true ups" would remove all of these normal risks and as such could reduce the pressure on the LDC to be efficient in managing its business that involves acceptance of certain risks. This appears to be inconsistent with the direction in which the Board is moving with incentive regulation. Stated another way, revenue neutrality is contrary to the concept of incentive regulation.

Implications

- On the face of it the RSM appears to remove disincentive for enhancing performance of CDM programs by ensuring that utilities are kept whole for the loss of revenues due to more efficient and lower use of electrical energy. However, given the fact that electricity distributors no longer have the primary accountability for setting CDM targets or for funding the CDM programs, this may not be an important issue. It is expected that LDCs will implement the programs developed by the OPA, but overall the OPA has the major funding for CDM and the obligation to ensure that the CDM programs are delivered.

- In Hydro One's view the major implication with the proposal is that it acts as a disincentive for utilities to rely on forecasts. Rather it makes the utilities risk averse in that the RSM, and LRAM to some extent, create an expectation that the utility will recover its revenues no matter what. This is inconsistent with the nature of the utility business which contains elements of risks that are normal practise and which the utilities are expected to manage in the course of their business. The risk-averse approach is inconsistent with the nature of incentive regulation that the Board has embarked on for the electricity distributors.

2. *If the Board provided for a revenue stabilization mechanism for distributors, would it affect the distributors' risk? If so, how might it impact on the distributors' allowed ROE, and/or the design of an incentive regulation framework?*

Hydro One Response

- Experience from other jurisdictions suggests that regulators have not observed that the use of RSM-type mechanisms has had a material impact upon a distributor's risks that would necessitate a reduction in LDCs' allowed ROE. For example, upon implementation of an RSM for both Terasen Gas and Pacific Northern Gas, the BCUC made a modest 10 basis point reduction in each LDC's ROE. Subsequent to Terasen Gas' adoption of incentive regulation, the previous ROE reduction was eliminated (PNG is not subject to incentive regulation).

- An RSM must ensure any comparison between actual throughput vs. forecast throughput be made on a use per customer basis as is the case for Terasen and PNG, otherwise an LDC would be penalized for any customer growth.

3. *What are the implications of adopting the EDA's proposed approach if CDM programs, associated expenditures and program results are not reviewed and tested by the Board in the context of rate recovery?*

Hydro One Response

- The basic premise behind RSM is to move away from individual review of CDM projects because of the complexity of monitoring the variety of projects that will result in the electricity sector. However, simplification leads to loss of detail and this raises the issues as to how CDM tracking should be performed. Given that the nature of CDM is shifting from LDC centric to province-wide centric there is a lesser need to track individual CDM project performance that is the basis of LRAM approach Perhaps this is an opportunity to review this matter and change the focus to the aggregate approach that would be more consistent with the changing environment in both the OPA's responsibility for setting CDM targets and funding CDM program, and the Board's intended use of incentive regulation for electric distributors.

- In the future the OPA will identify and direct the implementation of CDM targets, and CDM programs to meet those targets, and will have the accountability for funding these programs. Therefore, it would seem appropriate that the Board also turn its attention to reviewing the OPA's programs, funding and tracking of program performance (i.e. at the provincial level) as it has the regulatory oversight to do so. In this respect the oversight of the delivery of CDM programs by the electric distributors is proportionally diminished and there is less need for tracking the performance of the CDM programs which are established province wide.

- Where utilities wish to embark on utility specific CDM programs and require incremental funding to do so then there may be need to track the performance of those programs but it is expected that this will be less frequent and at a much lower level given the OPA's accountability in this respect.

4. *There are two options set out on page 14 of the report. Do you think one, both, or neither are appropriate? Please provide a detailed explanation for your choice.*

Hydro One Response

- As stated previously both schemes suffer from shortcomings that in Hydro One's view suggest the need for an alternative approach.

- As noted above, RSM is a top down revenue true up approach that tends to neutralize risks that are normal to a utility's business. Promoting the use of such a technique is contrary to the nature of the distribution business and to the natural evolution of the regulatory compact which the Board is spearheading through the move towards incentive regulation. Rather than the removal of risks, the utilities should move forward with improving their risk management through improving their forecasting capability.

- The LRAM approach is inappropriate for the electricity distribution sector and, it simply does not work given the number/size of CDM players in each jurisdiction. The amount of time and effort required, and the high cost incurred in administering this concept is inconsistent with the small return that is achieved. The need for detailed forecasting, monitoring and reconciliation is burdensome to implement and can only measure LDC specific CDM programs, which is no longer the case given the move towards province wide CDM enforcement by the OPA.

5. *Are there alternative approaches to the EDA's proposal that the Board might consider for setting a lost revenue adjustment mechanism for CDM, including CDM funded by the OPA? If so, what do you think is the most appropriate approach? Please provide a detailed explanation for your proposed approach.*

Hydro One Response

- Hydro One's preferred alternative is to rely on forecasting as a means of managing the impact of CDM projects. In this way the utility accepts the targets set by the OPA. Associated with this would be some adjustment mechanism that could be included with incentive regulation formulae to reduce the impact of lower revenues due to reduced per capita consumption. For example, a "Z"- like factor that reflects the CDM targets set by the OPA and that are common for all utilities could be included in the price cap formula that the Board appears to want to move forward with in incentive regulation. This factor would have the same forward looking characteristics as the other adjustment factors in the price cap formula. Annual adjustments that reflect both changes in provincial targets and provincial actual CDM results would ensure that any changes to the expected CDM programs are captured in a going forward manner. In this respect it is expected that deviations from the targets set by the OPA will be relatively small.

- It is not expected that improvements in forecasting will create a perfect prediction, but rather that the improvements will reduce the bandwidth of uncertainty. There will continue to be differences in energy consumption from year to year. However, the nature of forecasting is such that the upside and downside differences around the forecast will even out over a period of time. The better the forecasting methodology the lower the upside and downside differences and the shorter the period of utility's exposure to over and under impacts.

- This approach does not preclude better or lesser than expected performance from CDM projects. In fact reliance on improved forecasting is neutral in this respect. There are no barriers to implementation of CDM programs.

- The general expectation is that the implementation of CDM programs designed by the OPA will not create sudden jumps in energy usage changes year over year. Rather the change will be gradually as the province moves forward with its culture change with respect to conservation of electricity energy.

- The approach put forward by Hydro One is entirely consistent with the nature of the distribution utility business. This is not a new revelation. Rather the focus has changed as utilities move into a new era where CDM is the norm rather than a new risk imposed on the LDCs and the accountability for setting the CDM targets and programs has shifted from the utilities to the OPA.