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June 26, 2007

via email – original to follow by mail

Ms. Kirsten Walli, Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

RE: **Comparison of Distributor Costs ("DCC")**
Consultation on Consultant's Report
Board File No.: EB-2006-0268

On April 27, 2007, the Board released for comment a report by Board staff's consultant, Pacific Economics Group ("PEG"), on a methodology for comparing electricity distributor costs (the "PEG Report"). This letter conveys the comments of the Coalition of Large Distributors ("CLD", consisting of Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited, and Veridian Connections Inc.).

The CLD acknowledges the need to develop a fair basis of comparison of distributor cost and performance levels. Generally, the CLD supports the direction of the work that has been undertaken by the Board and its consultant PEG as a constructive step forward. While the initial results obtained are preliminary and should be used with caution, the effort has also identified limitations of the analysis that PEG has expressly acknowledged. The CLD sees this as helpful in identifying the best course of further work.

Essentially, the CLD believes that while the current results have limited value in any quantitative application, the shortcomings that have been identified in the data and the analysis can be remedied and that the effort to do so can be fruitful over the medium term. The CLD recommends that the Board undertake a consultation process with the industry to further this effort, and in doing so that it maintain transparency with respect to both the process and the data being studied.

Comments on Specific Aspects of the PEG Report

The CLD retained a consultant to assist in the analysis of the PEG report and the CLD's detailed comments are contained in the attached document which the CLD prepared based on the consultant's input.

Summary of CLD Concerns

Data-related Concerns

The CLD is concerned that the historical basis of reporting by LDCs reflects legitimate variances in treatment that, while proper from GAAP, RRR and APH perspectives, do not support accurate inter-distributor cost comparisons. These variances in treatment have been documented in a variety of contexts prior to the current one. They include, for example, differences in cost categorization arising from differences in the location of certain functions (e.g., billing and collection) within or external to the LDC. Beyond differences in categorization with OM&A, differences will also arise based on whether or not capital related to a given function is within the LDC or is external to the LDC. In cases where the capital is held externally, the capital-related costs will be recognized as OM&A, which will thus appear to be exaggerated where the offsetting reduction in depreciation and return is excluded from the overall analysis.

The PEG report identifies that "One important problem with the OEB data is the questionable potential of available capital cost data." Consequently, the PEG benchmarking analysis was limited to OM&A data. The CLD proposes that the Board should undertake a consultation with LDCs and stakeholders to determine how the OEB data collection can be refined to provide, on a going forward basis, capital cost information that will support meaningful benchmarking.

Notwithstanding this lack of capital cost information, the CLD supports further development of the OEB benchmarking efforts. In the interests of making available OEB data useful for benchmarking comparisons, the CLD also proposes that the Board should consult with LDCs and stakeholders to determine well-defined, standard functional cost categories. In addition, the consultation could identify what, if any, adjustments might be necessary in individual cases in order to align reported OM&A data with the agreed-upon functional cost categories. For DCC purposes, LDCs would have the opportunity to make adjustments to OM&A expenditures that are deemed necessary to create a consistent cost comparison between LDCs, for example in instances where costs from one functional category such as billing and collection had been reported in the A&G category due to outsourcing.

This process could also partially compensate for distortions in capital cost data arising from corporate structure. For example, as a result of corporate structure or lease vs. own decisions, one LDC may have within their OM&A expenditures, amounts that are commonly found within depreciation, interest or allowed returns in other LDCs. An adjustment formula for the express purpose of benchmarking would make OM&A comparisons more meaningful and beneficial.

This opportunity to make adjustments for DCC purposes would be different than the affirmation that LDCs were required to undertake prior to the 2006 EDR process.

For DCC purposes, it would also be necessary to establish a consistent basis of reporting for other non-financial measures such as reliability and service quality, and system-description measures such as circuit kilometers.

Model-related Concerns

CLD has a number of concerns related to the modeling approach adopted by PEG. These are set out below.

1. Exclusion of capital and capital-related costs, together with capital vintage.

   PEG acknowledges, and CLD concurs, that capital costs, capital vintage, and substitution between capital and other inputs are very important factors in explaining and comparing LDC costs. CLD proposes that the Board should undertake industry consultation to determine a method for their inclusion in the DCC analytical framework. Until these factors are included, comparative results are likely to be significantly distorted.

2. Exclusion of service quality and reliability as explanatory variables.

   Utility costs vary directly, in both the short and long terms, with variations in these output levels i.e., services provided to customers. It is unreasonable to exclude these factors from the analysis and their omission is likely to cause significant distortions in results.

3. Inclusion of energy delivered as an explanatory variable.

   It is widely acknowledged that LDC costs (with the possible exception of losses) do not vary with incremental or decremental energy consumption by customers. Therefore the energy consumption variable should be excluded on an *a priori* basis since it lacks a theoretical underpinning. In addition, variations in customer mix among utilities will affect energy delivered per customer and therefore distort comparisons made on this basis. The fact that this variable appears to be statistically significant is most probably a result of using panel data on utility costs and throughput that vary tremendously in levels, and the correlation over this range of variation between customer numbers and energy throughput. The inclusion of this variable in the model represents model mis-specification rather than indicating a causal relationship between the variables.

4. Use of total costs rather than cost per customer.

   The use of total costs (even in log form) in the PEG model produces misleading parameter estimates and diagnostic statistics (for example, R^2 values), and in any case is irrelevant to the fundamental item of interest, which is cost per customer.

   From a statistical perspective, it is not possible to achieve good resolution on meaningful differences in cost per customer when analyzing *total* utility costs that vary tremendously across the range of utilities, since the variation in these costs is naturally and almost completely explained by the corresponding variation in customer numbers. In cases like these, a high R^2 value would be difficult *not* to achieve and is not indicative of good model quality with respect to the variable of interest, cost per customer.

   From a customer perspective, *total* utility costs are irrelevant. It is a matter of indifference for customers how many customers their utility serves: what is relevant is quality of service and cost per customer, i.e., the amount of their bill.

   The CLD takes the view that focusing on cost per customer is the preferred approach since it is better able to detect meaningful differences in utility costs, and can support direct analysis of explanatory variables like customer density, physical system descriptors like circuit kilometers and service quality levels, and as well can support flexible functional forms able to address issues like scale economies.

In pointing out these concerns, the CLD does not wish to impede or reverse the DCC effort; rather, it hopes to suggest constructive directions for the next steps in this process. The CLD anticipates that it will actively and responsibly contribute to this effort through a meaningful collaborative process with the Board and other stakeholders.

Yours truly, on behalf of the CLD,

[original signed by Anna-Christina Crespo for]

Colin McLorg, Manager
Regulatory Affairs