

December 8, 2006

Board Secretary
Ontario Energy Board
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Via email to boardsec@oeb.gov.on.ca and by courier

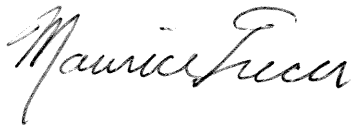
Dear Board Secretary:

Re: Comparison of Distributor Costs
Board File No.: EB-2006-0268

Enclosed are the comments of the Electricity Distributors Association in response to the Board's letter of November 24, 2006 on Comparison of Distributor Costs.

Please direct any questions or comments to Maurice Tucci at 905.265.5336 or at mtucci@eda-on.ca.

Yours truly,



Maurice Tucci
Senior Analyst

Encl.

EDA Submission on OEB Comparison of Distributor Costs EB-2006-0268

The Electricity Distributors Association (EDA) is the voice of Ontario's local distribution companies (LDCs). The EDA would like to provide the following comments on the questions in the memo dated November 24, 2006 on Comparison of Distributor Costs EB-2006-0268.

The EDA believes that the timeframe provided to prepare responses is very short and is not adequate to prepare a comprehensive response or to obtain adequate input from our members. The short timeframe has forced a compromise in our analysis. Members dealing with regulatory issues have expressed concerns on their ability to respond when they are dealing with a number of concurrent regulatory issues in December. There is a real concern that any regulatory decisions made, will be based on insufficient information.

Members also expressed many concerns with the comparability of the accounting data and the SQI data given the inconsistencies between LDC reporting practices. They noted that there is a need to review the data for consistency if it is intended to be used to compare distributors.

As a result, the comments provided are preliminary and further comments or amended responses and recommendations may be forthcoming from the EDA.

What is the objective of the Comparison of Distribution Costs Study?

- In developing cost causality studies one of the key issues is the need to balance accuracy and simplicity. While costs should preferably be accurately attributed, there is a cost associated with the higher degree of detail in measuring, tracking and attributing costs. Often this cost is related to a reduced simplicity in the whole process. The question of striking the right balance between accuracy and simplicity in a cost causality study has to be addressed in the framework of what the objective of the study is.
- For example, if the objective is only to develop a screening tool for deciding the tranches in which the utilities come forward for rebasing considerations, then we could possibly seek a simpler approach at the cost of lower accuracy in the study.
- However, if the study leads to the development of distribution rates, going forward, based on some form of benchmarking- a higher degree of detail and accuracy would be warranted. A higher degree of detail would be required as a logical consequence of the mandate to fix just and reasonable rates.
- How do we deal with the issue of data quality? If the objective is to use this study to inform the rate setting process in some way, we need higher quality data.
- A major issue for distributors has been whether all LDCs have interpreted the Uniform System of Accounts ("USofA") in the same manner. Consistency in USofA will be critical if it is to become the basis for the comparison analysis. Since the inception of the USofA, LDCs have been striving to ensure costs are allocated to the correct account, but until major reviews such as the 2006 EDR or the cost allocation process, the inconsistencies between LDCs actual coding of costs and what is dictated in the USofA may not have been apparent.
- As a result, if the 2002 to 2005 data is to be used in such a critical manner, LDCs should have the ability to review the data and reallocate (not change the total) if necessary to ensure

that the allocation of costs is as accurate as can be. If the Board does use Operations & Maintenance, Administration, Bad Debt and Amortization as the cost centers, LDCs should review that the split of costs reflects those categories.

- Impact of changes to GAAP. The study is likely to influence the development of the 3rd generation IRM (page 1) – a period beyond 2010, when the changes to GAAP to reflect the AcSB’s strategic move towards international financial reporting standards are implemented. It may be prudent to consider the likely impact of changes to GAAP on the USofA reporting.

Comments on Matters for Consideration by Interested Parties on page 2

Q1. Are the “cost centre” groupings of cost sufficiently useful for purposes of comparing distributors?

- To answer the question on whether the proposed “cost centre” groupings are sufficient for comparing distributors, the EDA will need to know, (a) the objective of this study in order to strike the right balance between accuracy and simplicity; and (b) a discussion on the preferred methodology for conducting this study. By providing a description of potential cost drivers, cost centres, etc. the Board Staff has already moved towards adopting a methodology.
- The EDA would like a working definition of “Cost Centres”. A key question is the level of aggregation required in the cost centre data for the purpose of comparison. Since some utilities outsource billing and collection, it would be preferable for the purpose of comparison to develop data related to unbundled services. If the aggregated (bundled) service cost such as O&M is chosen, then the fact that some utilities may have a lower cost as a result of outsourcing billing functions would tend to present inaccuracies in the aggregated data when used for comparison purposes.
- If the cost centres data are collected at a more granular level, i.e. at the unbundled service level, there may be an opportunity at a later date to aggregate the data subsequently. On the other hand if we begin with a higher level of aggregation, we may not be able to disaggregate that data subsequently.
- It seems that Capital expenses are not included in the data for the cost centres- clearly LDCs managers trade off the capital versus O&M costs in their decisions. The EDA questions whether the comparison of distribution cost will be accurate if capital costs are left out for the analysis.
- What is the purpose of using ‘cost centres’ in this study? One approach could be to use cost centres as comparators, perhaps as suggested by the Board staff. Another approach would be to, (a) to use cost centres for the purpose of aggregating the cost of providing distribution service(s); (b) identify cost drivers; and then using (c) clustering techniques to group LDCs for the purposes of comparison- and as a result of doing a statistical clustering we could use a broader range of comparators. It is unclear as to what is the approach being pursued by the Board staff- are we to assume that Cost centres would ultimately be used (unitized using cost drivers) for direct comparison? Or will the approach only be used to screen distributors and determine which should have their costs reviewed first.

Q2. Are the divisors used to unitize the costs (i.e., the physical quantities) reasonable drivers/determinants of cost behaviour for purposes of comparing distributor costs?

- With respect to whether the divisors used to unitize costs are reasonable, the answer again depends on what is the objective of this study. If the study is intended to be used in some form for determining rates in the future, then given the mandate to set just and reasonable rates, a higher degree of accuracy is needed. Reasonableness then becomes a question of balancing accuracy and simplicity. To be accurate what is required would be to identify a set of cost drivers as independent variables that explain the dependent variable, i.e. the cost centres. The set of cost drivers should significantly (statistically speaking) explain the cost centres or in other words provide a statistically significant exhaustible list of variables (cost drivers). Having determined such a list one can then review the cost drivers to examine if they are simple enough to be understandable. Judgement is then required to arrive at a list of cost drivers that are simple enough to understand and yet significant enough to impact the cost centres. In the present form, without an analytical support (such as the statistical significance of the cost drivers to explain the cost centres) any comments would be based on intuition. While an intuitive response may work for the purpose of developing a screening tool for rebasing, it would not serve the purpose of meeting rate setting requirements.

Q3. What are the matters/features useful to consider in establishing sub-groups of sufficiently similar distributors for purposes of comparing cost behaviours?

- The response to Question # 2 leads to a discussion on the choice of methodology for the study. One way would be to approach this analytically. An analytical approach could be to (as in the C&C report), (a) determine cost drivers through econometric models; then (b) determine cohorts with clustering methods; and then and ONLY then (c) determine comparators. Such an approach allows one to essentially bunch together LDCs as cohorts and once that is done, then one can choose any number of comparators to compare costs and that is because an analytical method (that is statistically significant) was used to group LDCs. In this method one does not have to decide on the comparators to use until one is finished with determining cohorts.
- If on the other hand decisions are made on the matters/features considered to be useful in grouping or clustering LDCs then one may be limiting the objectivity of the process. (See page 13 of C & C report of October 2005)

Q4. Are there additional data that should be acquired from distributors in order to improve the comparison process?

- For the purpose of comparison of utilities based on their cost it would be prudent to exclude factors that are beyond the management's control in controlling costs.
- One way to approach this issue is to identify a list (ideally an exhaustible list) of common characteristics (factors) of business context through an analytical method and then narrow that list to arrange a simple yet plausible list of common characteristics of business context.
- Providing additional data for comparison purposes (in response to this question) should not be based purely on intuition, as the resulting comparison between utilities could then be arbitrary.

Potential Cost Centres

Questions for Consideration by Interested Parties:

- 1) Are the proposed aggregations, or alternatively the 2006 EDR groupings, appropriate?

Please see response provided to Q1 above under Matters for Consideration.

The EDA notes that Board staff have chosen four high level cost centres due to their concern with the data recording inconsistencies apparent in more granular data sets. This demonstrates that the Board staff proposed approach has been compromised by the data inconsistency and work is required to improve consistency so that more granular data can be used with confidence in the future.

- 2) Should average labour costs be reported separately for comparison?

Firstly a decision is required on the level of aggregation in cost centre data. Should the data be bundled as suggested by staff or unbundled?

Secondly, consideration is needed on how factors (due to the given business context for an LDC) that are beyond the control of management are addressed?

If labour costs are reported for comparison purposes, then one needs to account for the differences in labour costs among geographic regions (e.g. labour costs in Northern Ontario could be different from the labour costs in Toronto).

- 3) Given difficulties with data comparability below the cost centre level of O&M and administration, should a lower level of granularity be considered? For example, billing separated from collection? Please suggest the lowest level of granularity based on the Uniform System of Accounts (USoA) that would be the most useful.

Please refer to the argument for striking the right balance between accuracy and simplicity above in Q1 Matters for Consideration.

Potential Cost Drivers

Questions for Consideration by Interested Parties:

- 4) Are the four cost drivers above the appropriate ones?
- 5) What other cost drivers should be considered?

- The issue of which cost drivers are appropriate is dependent on what is the objective of the study. If the study is intended to be used in some form for determining rates in the future,

then given the mandate to set just and reasonable rates, a higher degree of accuracy is required. Reasonableness is a question of balancing accuracy and simplicity.

- To be accurate what is needed is to identify a set of cost drivers as independent variables that explain the dependent variable, i.e. the cost centres. The set of cost drivers should significantly (statistically speaking) explain the cost centres or in other words provide a statistically significant exhaustible list of variables (cost drivers). Having determined such a list one can then review the cost drivers to examine if they are simple enough to be understandable. Judgement is then used to arrive at a list of cost drivers that are simple enough to understand and yet significant enough to impact the cost centres. In the present form, without an analytical support (such as the statistical significance of the cost drivers to explain the cost centres) any comments would be based on intuition. While an intuitive approach may work for the purpose of developing a screening tool for rebasing, it would not serve the purpose of meeting rate setting requirements.
- In order to determine whether the proposed cost drivers explain the proposed cost centres, one needs to carry out a statistical analysis. If the proposed costs drivers do not provide a statistically significant explanation of costs, this would then suggest that there is a need for more cost granularity and/or more or different cost drivers.
- EDA members believe more information needs to be provided on how the proposed cost drivers were chosen and whether they were based on a statistical approach.

6) Should different cost drivers be used for different cost centres? If so, which cost driver do you view as appropriate for which cost centre?

Please refer to the response provided to questions 4, 5 above. Ideally one should determine a set of cost drivers based on statistical techniques (that are statistically significant in explaining the dependent variable: the cost center) and then determine from that list for each cost center (a) a list of simple yet plausible list of cost drivers and (b) a list of cost drivers that could commonly be used to explain the different cost centers (c) determine the extent to which the list at (b) is a statistically significant in explaining all or most of the cost drivers.

Members have raised concerns on whether the proposed cost drivers are adequate even for use as a screening tool for rebasing. They note that number of customers may be an adequate cost driver for billing costs but would not be appropriate to explain distribution costs. Kilometres of road line and kilometres of circuit line explain different costs. More analysis and data collection may be required to identify the best cost drivers, even if it will only be used for screening.

Possible Grouping Characteristics

Questions for Consideration by Interested Parties:

7) Are the grouping factors proposed by staff appropriate?

Intuitively the proposed grouping factors appear acceptable, but grouping factors should be based on statistical or other analytical methods and only if these methods seem to suggest a

complex list of grouping characteristics, should one choose to restrict or limit the list to a set of factors for the sake of simplicity.

With respect to the proposed groupings, members raised questions on how the “degree of outsourcing and cost particulars” would be determined and measured.

8) Are there additional characteristics of utilities that should be considered for grouping distributors?

- For the purpose of comparison of utilities based on their cost, it would be prudent to exclude factors that are beyond the management’s control in controlling costs.
- One way to approach this issue is to identify a list (ideally an exhaustible list) of common characteristics (factors) of business context through an analytical method and then narrow that list to arrange a simple yet plausible list of common characteristics of business context.
- Providing additional data for comparison purposes (in response to this question) should not be based purely on intuition, as the resulting comparison between utilities could then be arbitrary.

Other Questions for Consideration by Interested Parties

Please consider the following additional questions:

9) Should external benchmarks established in other jurisdictions be considered in setting rates for Ontario distributors?

What are the similarities in the business context of LDCs to merit consideration of benchmarking costs from other jurisdictions. Board should not adopt a ‘selective’ approach when it comes to using comparative data from other jurisdictions. If the Board does not consider the comparison of cost of capital for Ontario LDCs with say the cost of capital for US to be a reasonable comparison, why should other distribution costs be compared for the purpose of setting rates?

10) Some SQI data is currently collected. How could consideration of service quality as a driver of O&M cost be improved?

Providing high quality reliable distribution service to customers comes at a cost. Intuitively providing high quality distribution service would suggest that there is an associated higher cost than for a lower level of distribution service. However, empirical analysis should establish the significance of the linkage between costs and quality indicators. Without the knowledge of the significance of the relationship between costs and SQIs it would be difficult to be able to comment.

Further there is a fundamental need to address whether or not the current SQI adequately indicate the level of service. Is the inherent reliability of the local distribution system adequately measured by SQI? There is a time lag between investments made to support reliability and the resulting long term improvement in reliability. One of the anomalies of SQI could be that a

distributor that has not kept up with investments for reliability could still demonstrate adequate SQI values in the short run, and values would not necessarily decline for several years. LDCs that have embraced long term reliability have spent more on their plant and infrastructure, and may be penalized if the improved long term reliability is not considered. An additional complicating factor is whether the reliability SQI figures have to be adjusted to reflect compounding factors such as local weather.

Members have expressed concerns that the current SQI data may also be inconsistent in how it has been reported and further work is required to improve the consistency.

11) In order to further the development of utility comparisons, what additional data should be collected from distributors, and why?

- For the purpose of comparison of utilities based on their cost, it would be prudent to exclude factors that are beyond the management's control in controlling costs.
- One way to approach this issue is to identify a list (ideally an exhaustible list) of common characteristics (factors) of business context through an analytical method and then narrow that list to arrange a simple yet plausible list of common characteristics of business context.
- Providing additional data for comparison purposes (in response to this question) should not be based purely on intuition, as the resulting comparison between utilities could then be arbitrary.

In conclusion, the EDA recommends that the Board choose cost centres and cost drivers based on a statistical approach. The EDA believes there is a need to review the accounting data and SQI data to achieve more consistency. The EDA recommends that the proposed comparison study using current unadjusted data should only be used as a screening tool for rebasing and that work begin on addressing data consistency for use in future cost comparison studies.

Additional Suggestions/Cautions brought forward by EDA members

EDA members have brought forward a few specific issues that were identified during the initial review of the proposed comparison. These specific issues are preliminary and should not be considered a comprehensive list of issues.

- Bad Debt Expense is impacted by factors beyond management control but is not adequately explained by any of the proposed cost drivers.

Comments on Groupings

- Account 6105 represents the Capital Tax paid and therefore it should not be grouped as an Administrative Cost. Please note that Capital Tax is a component of the PILS calculation.
- Amortization expense should be kept as a distinct and separate grouping and should not be included in any combined OM&A costs. This is important as amortization costs are not truly controllable in the same sense as other expenses because of their link to capital spending. A more meaningful exercise would be to review amortization expenses as they compare to capital spending. It is important to remember that in doing so, the net capital expenditures

(gross capital expenditures less capital contributions) should be used in order to analyze the true expenditures made by an LDC.

Comparability of Data

- For regulatory purposes, the 2005 Distribution Revenue includes revenues collected for the third tranche C&DM. Similarly, operating expenses may include a portion of costs related to the implementation of C&DM programs. As a result, Distribution Revenues and OM&A are overstated, resulting in an inflated net income. For the purpose of this comparison exercise, the operating costs are inflated by the C&DM spending which overstates the Administration costs. As LDCs are spending at different rates (over ~ 3 years) and types of costs (i.e. capital vs. expense), including these costs will cause a distortion of any LDC OM&A comparisons.