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BY COURIER

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

**EB-2006-0268 - Comparison of Electricity Distributor Costs – Hydro One Networks' Comments**

Hydro One Networks Inc. (“Hydro One”) is pleased to provide comments on the Pacific Economics Group (“PEG”) report, which the Ontario Energy Board (“Board”) issued for comments on April 27, 2007<sup>1</sup>.

Hydro One’s comments comprise (1) general observations with respect to benchmarking, (2) specific comments that pertain to the PEG report, and (3) additional comments in response to the request listed on page 2 of the Board covering memo<sup>2</sup>. Hydro One’s commentary concludes with a summary section 4 that provides possible next steps in the evolution of benchmarking of the power distributors in Ontario.

**1.0 General Observations**

Hydro One is supportive of moving forward with the benchmarking of the power distribution sector in Ontario provided this is done in a consistent and transparent manner. The primary purpose and benefit of benchmarking is that it leads to the identification of best practices, which when implemented can help drive performance improvements and cost efficiencies. Benchmarking is also used in regulation as one of the tools for assessing the efficiency of the regulated entity.

Hydro One views benchmarking to include a much broader basket of elements that reflect the distributor’s business than just the comparison of respective costs. Examination of costs on their own will not be sufficiently informative to produce a comprehensive outcome. There must be appropriate

<sup>1</sup> Benchmarking the Costs of Ontario Power Distributors – PEG Report, 25 April, 2007

<sup>2</sup> Board memo, April 27, 2007, page 2.

linkages that inform how costs affect service performance and why costs may vary from utility to utility. Costs are incurred by utilities in providing distribution services and there are many elements that come into consideration in that respect. In addition to the more common elements such as number of customers served, the volume of electricity distributed and the length of distribution feeders used other elements including system design characteristics, age and condition of assets, back-up capability, customer/load growth, degree of automation, density, geography, voltage levels, customer mix, and load factors also exert their influence on the provision of service as measured by service quality targets and reliability standards. Put simply, all these considerations are influential in driving utility's costs and as such warrant consideration in a benchmarking analysis. Such a comprehensive approach yields a more balanced view of utility's performance vis-à-vis the peer set and therefore gives the Regulator and the Intervenor community more assurance of the appropriateness of results in supporting the long term sustainability of the business.

## **2.0 Specific Comments on PEG Report**

Hydro One wishes to focus its specific commentary on the following areas:

- (a) The use of appropriate comparators equating econometrics/statistics with benchmarking
- (b) The impact of excluding consideration of service levels and other performance metrics from the analysis
- (c) The impact of data consistency on the analysis
- (d) The impact of excluding capital expenditures from the analysis
- (e) Peer review of modelling approach used by PEG

The following provides a more detailed discussion of each of the key areas listed above.

### ***2.1 The Use of Appropriate Comparators***

As PEG rightly points out, Hydro One's characteristics (particularly in terms of operating scale) are vastly different from other Ontario distributors, and they are therefore without peers in the province. While we agree with PEG's reasons for excluding Hydro One from the current analysis, we disagree with their assertion that the ability to benchmark Hydro One will improve as additional years of data and better delivery data become available. The availability of data is not the issue as far as Hydro One is concerned – but rather its unique characteristics. For example, getting additional data will not address the fact that there are no other utilities in Ontario that are even remotely similar, and as such, it would be inappropriate to include Hydro One in any such analysis.

The arguments above notwithstanding, leaving out Ontario's largest utility is counterproductive from a regulatory point of view. Given Hydro One's operating scale and other demographic characteristics, it is important that their costs and performance be benchmarked in a separate exercise.

However, in order to do so, it is imperative to choose an appropriate peer group along with the appropriate factors for comparative purposes. Hydro One is by far the largest utility in the province of Ontario, and delivering electricity to almost 1.2 million homes and businesses across rural Ontario.

There is no other utility within Ontario that is even close in operating scale to Hydro One – the second largest utility (Toronto Hydro) has around half of Hydro One’s customers and serves a metropolitan area.

Any benchmarking exercise involving Hydro One will therefore need to include utilities from outside Ontario – for example, from other provinces within Canada, and from the United States.

## ***2.2 The Impact of Excluding Consideration of Service Levels and Other Performance Metrics***

In order to assess the overall performance of a utility, it is necessary to analyze its performance with regard to both cost and other measures of performance. Reporting only cost-based measures can provide an unbalanced view. For example, a utility that decides to spend a significant amount of money to deliver superior customer services or reliability in response to customer expectations will likely have higher OM&A expenditures than a utility that chooses to deliver a lower level of service. Comparing these two utilities on the basis of O&MA costs alone will be misleading, as it will not reflect the higher service levels attained by the first utility.

In the Distribution arena for utilities, non-cost performance measures fall into two broad categories: one relating to technical standards and operation of the power system; and the other, support and responsiveness to customer needs. The former may include measures of system reliability such as variations in power supply parameters (e.g. voltage and frequency) and measures relating to supply interruptions (e.g. number and duration of interruptions, as well as derived indexes such as SAIDI and SAIFI). On the customer service and responsiveness side, performance levels can be measured using indicators around complaints relating to metering and billing, response to consumers, time taken for providing new connections, etc.

In the paper, the term “benchmarking” is routinely used in a way that suggests a relatively narrow view of the term, focused almost entirely on statistics and measures, and even more narrowly on measures of cost. While this is accurate as a description of one element of “benchmarking”, it is also somewhat misleading in that it gives the impression that statistical cost modeling is synonymous with benchmarking. It is important to understand that benchmarking is a much broader concept, both in ratemaking for utilities and in general use. Benchmarking can be used to glean information about what the operating and service level achievements of best performers are – where performance is judged on the basis of a multitude of items – not just cost.

## ***2.3 The Impact of Data Consistency on Analysis***

With regard to the econometric modeling, PEG asserts that additional years of data will improve the robustness of their analyses. However, we believe that without tightening the rules around cost categorization, the additional years of data will not add much value. Specifically, a larger time series will not fix the flaws introduced through inconsistent data reporting practices.

In addition to inconsistencies in the data, PEG identifies areas where data are scant or missing entirely. Such areas include data on plant additions and data on power deliveries to other distributors. The latter

is particularly relevant to Hydro One. The robustness of results from the PEG model is dependent on the consistent definition of OM&A cost categories and the consistent application of capitalization rules – both of which are identified as areas of concern in the PEG report. As such, cost benchmarks derived from the current modeling exercise must be treated with caution.

#### ***2.4 The Impact of Excluding Capital Expenditures from Analysis***

Excluding capital from the analysis has potentially serious consequences. Specifically, the policies used by individual utilities for decisions regarding what should be treated as OM&A and what should be treated as capital investment can vary significantly. For example, two adjacent utilities, faced with replacing two poles and the span of wire between them, might make different decisions as to whether the project would be treated as OM&A or capital. Repeating the different decisions over and over during the course of the year would lead those two utilities to very different OM&A outcomes for the year, even if they carried out the same physical work during the year. This discrepancy wouldn't be dealt with at all in a model that only looks at the OM&A spending.

#### ***2.5 Peer Review of Modeling Approach Used by PEG***

We believe it would be beneficial for the underlying modeling approach used by PEG to be subject to a peer review, by academics or other consultants, at the time when the more complete models are being prepared for use. That would enable questions of the calculation process for the regression coefficients, as well as how the unit cost index was derived, to be explored and verified with other experts. Given the importance of the chosen method, this would appear to be a prudent step to take. For example, has interaction between the time variable and of the cost drivers been tested?

Research with other practitioners in econometrics have raised questions on the model, particularly the use of regression coefficients and asked for clear explanation of the derivation of the input price indexes. Therefore a more formal peer review of this modeling approach, by academics or other experts would be prudent.

### **3.0 Hydro One Response to Additional Comments Requested in Board Memo**

As noted in our commentary we support the use of benchmarking in contributing to a consistent and transparent decision making process. We have seen its use in other jurisdictions and applications and believe that more consistent and understandable decisions can be made using this approach.

With regard to the relative merits of the proposed methodologies, the comments provided in section 2 cover in detail most of the questions we have with regard to the PEG econometric study.

The “Board staff’s proposed benchmarking methodologies”<sup>3</sup> raises some different and interesting approaches and deserves further examination. We believe that the Board staff’s approach would be an

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<sup>3</sup> Benchmarking the Costs of Ontario Power Distributors – PEG Report, 25 April, 2007 Appendix B pages 74-75

effective first step in building a consistent and transparent benchmarking process while being conscious of our earlier comments on the quality of the data being used.

While econometrics may be considered for cost measures, we also need to incorporate methodologies for addressing reliability and statistical measures such as service quality.

#### **4.0 Summary**

Hydro One is supportive of moving forward with benchmarking of the power distribution sector in Ontario; in conjunction with further expert analysis and rigorous data compilations and reporting.

The Board is to be commended for initiating the study performed by PEG. The questions that we raised about the PEG report suggest more work is required. PEG analysis should be improved through the inclusion of: the use of appropriate comparators, the consideration of service levels and other performance metrics, the impact of data consistency on analysis, the impact of excluding capital expenditures from analysis and recommend further examination and peer review of this approach.

As noted in Hydro One's commentary above we believe there is much that still needs to be done. Hydro One would be pleased to assist the Board in the development of its benchmarking process by participating on OEB-led work groups with other interested parties.

Sincerely,

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Susan Frank