London Hydro

June 18, 2007

Kirsten Walli, Board Secretary
Ontario Energy Board
PO Box 2319
2300 Yonge St, 27th Floor
Toronto, Ontario, M4P 1E4

**Re: EB-2006-0268 – Comparison of Distributor Costs
Consultation on Consultant's Report**

In accordance with the Board's instructions of April 27, 2007 we are providing three paper copies and one electronic copy of our comments on the Pacific Economics Group ("PEG") report "Benchmarking the Costs of Ontario Power Distributors".

General Comments

In a regulated natural monopoly environment, it is an essential exercise for Distributors to manage costs effectively and from the perspectives of the regulator, ratepayer and other stakeholders, it is necessary to ensure that the price paid for the services provided are just and reasonable. In the absence of a competitive marketplace, benchmarking tools can and should be employed to effectively evaluate the cost of services provided to the ratepayer.

Industry and peer group benchmarks, if properly developed and consistently applied, can provide significant benefits to the industry, the regulator, other stakeholders and the ratepayer. A well developed benchmark tool can be used to streamline the regulatory process, create incentives for distributors to improve their efficiency, and result in reduced rates and higher quality of service to customers.

The PEG Report

The PEG Report is an improvement over other simplified approaches to benchmarking. Statistical benchmarking is able to account for differences in "business conditions" or local environment, as well as for differences in decision making of utilities i.e. capital expenditure versus operating expenditure. However, as the authors of the PEG Report have clearly stated, the quality and completion of utility data are pre-requisites.

While it is yet to be determined how benchmarking will be used in the regulatory process, some potential applications are:

- To streamline the regulatory process by identifying rate submissions that may be "fast tracked" or to identify those warranting a detailed review.
- To inform utility management, ratepayers and other stakeholders of the reasonableness and comparability of the distributor's rates and costs versus other peer group utilities and the industry in general.
- As a tool to reward superior performance or to promote efficiencies and cost reductions in higher cost utilities.

Before benchmarking can be effectively applied, certain issues must be resolved.

1. Data Aggregation and Quality

   The PEG Report discusses certain inconsistencies in data reporting by utilities. It is important to ensure that data used is consistent among utilities. For now, we concur with the PEG Report that benchmarking of operating costs should be confined to the level of total OM&A expenses including all customer care, as well as plant related operational expenses. Variations in accounting and cost allocations at the detailed account level make benchmarking meaningless and misleading any level below total OM&A.

   The PEG Report suggests that there is a problem in the publicly available data as it does not sufficiently itemize the salary and wage content of net OM&A expenses. In the absence of a proper disclosure of outsourced functions versus those performed in-house, disclosure of salary and wage content in OM&A would be misleading. From a benchmarking perspective, a comparison of activity costs (billing, meter reading, line maintenance, etc) is more appropriate as it is not distorted by the methods (outsourcing vs. in-house) that management uses to accomplish those activities.

2. The PEG Methodology

   Assuming that the data consistency and quality will improve over time, we fully concur with the PEG proposal to use statistical benchmarking methodology over a simple benchmarking methodology. We concur with the recommendation made by the PEG in section 6.9.2 of the report, with the added emphasis on the use of a peer group for meaningful comparison. Unlike other jurisdictions that the PEG Report has referenced, the Ontario utilities, although larger in number, are much smaller and fragmented – some are so small that no amount of statistical correction can do justice in comparing their costs. On the other hand, we do not concur with the exclusion of the HONI from the benchmarking study. With all due respect, HONI does/should report all its distribution costs and more, the fact that it has several embedded utilities cannot make it a unique utility, especially when benchmarking the total OM&A expense in a statistical manner.

It is worth noting that statistical models are found to be robust, for the system R^2 is closer to 1 for both models (0.98 for Transcendental Log-Translog-Form) from and 0.977 for Double Log Form. We strongly recommend that if benchmarking was to be employed for the purpose of regulatory considerations, it should be a statistical analysis as proposed by the PEG and not simple unit cost benchmarking; moreover, the benchmarking should be used within the cohorts or peer group.

3. Scale Argument

The PEG Report makes a significant, yet in passing, comment on the benefits of scale of operation. The statement that "incremental scale economies are not exhausted until a level of output has been reached that is somewhat above the Ontario mean" is quite significant in that it shows that a large number of Ontario utilities are and would remain poor performers due to the lack of economies of scale. Moreover, it can also be interpreted that economies of scale are enjoyed by a few utilities which further strengthens the argument that a cohort or peer base benchmarking is meaningful rather than the industry wide.

Also, this further speaks to the fact that the utility industry in Ontario is extremely fragmented and some incentive should be created to defragment the industry so as to reach the level of output to the point where the scale benefits can be exhausted, and cost performance can be enhanced.

4. Other Comments on the PEG Report

- The proposed methodology accounts for all variances in business conditions of utilities.

- It is intriguing to note that the benchmarking tools have not been extensively used in North American regulations. The PEG Report gives a review of the use of benchmarking in the regulation of energy utilities in North America, Australia, New Zealand and Western Europe. In North America, benchmarking results have rarely had a national impact on rate design. However the U.S. regulators have developed sophisticated econometrics cost models, but the results of the studies have not been used in rate design.

  In Western Europe, benchmarking has played a much more significant role. For example, Britain's regulators have used benchmarking in determining the approval of revenue requirements in excess of their costs for those that are in the top quartile.

In Australia, regulators have initiated cost benchmarking studies using econometrics to compare the industry performance. However, in the states of New South Wales and Victoria there was much controversy over the methods, and in the end there was little or no impact from these studies on the final rate making decisions. The report states that the regulators have generally been dissatisfied with the outcome of benchmarking experiments and have not featured statistical benchmarking in subsequent proceedings.

- In models, labour price, number of customers, volume, line circuit length, as well as underground plant and ground conditions (Canadian Shield) were found to be statistically significant and meriting consideration for inclusion in the regression analysis. An interesting observation was the argument and contiguous territory; which in the case of Double Log analysis was just found to be marginally significant (T-statistic of $1.65 \approx 1.645$ for 90% confidence). This perhaps was due to the limited availability of such data.

- The PEG Report cites the percentage of residential versus commercial customers as another business condition affecting the cost (input prices); however, it is not clear from the model presented in the report if this was a statistically significant factor.

<u>Summary</u>

The PEG Report is a good start in the sense that it does validate the use of statistical benchmarking tools (instead of the simple unit cost comparison) to rank the performance of cohorts. The PEG Report however, also brings to light significant weaknesses of the Ontario data. Notwithstanding the fact that there are a relatively large number of utilities in Ontario, which ideally suits to the application of benchmarking tools, it must however be put to rigorous debate and testing before deploying it for regulatory purposes. As is evidenced in the report, other jurisdictions have used benchmarking to a mixed success. Of special mention is the experience of Australia, where in the states of New South Wales and Victoria the regulators have reportedly been dissatisfied with the outcome of benchmarking experiments. Moreover, in Europe where benchmarking has been used extensively, it seems that the application of benchmarking has been limited to appraisal or as a screening.

In light of the findings of the PEG Report, our recommendation is to further study the benchmarking tools and more specifically, follow the steps given below.

1. Continue to collect more data with well defined parameters and scope so as to improve the quality and consistency of the data sets.

2. Undertake to do more rigorous statistical benchmarking studies to:
   - Further validate the model, and
   - Determine a set of variables (business conditions) that have statistically significant impact on the performance.

3. Through an iterative process of Step 1 & Step 2 develop and adopt a suitable model with an acceptable set of business conditions.

4. Use the accepted model to rank relative performance of utilities.

5. Use the ranking to devise an incentive scheme to reward the good performers.

6. Update the model on a regular basis as the number and business conditions of utilities change over time.

Given the above process, we believe it will be more prudent to use the benchmarking methodology starting 2010-2012 rebasing period (or post 2008-2010 rate rebasing period).

All of the above comments are respectfully submitted for your consideration.

Sincerely,

Dave Williamson
Director, Finance and Regulatory Affairs
Phone: 519-661-5800 ext. 5745
Fax: 519-661-2596
Email: williamd@londonhydro.com