EB-2006-0268

IN THE MATTER OF a consultation by the Ontario Energy Board relating to a Comparison of the Costs of Electricity Distribution Companies.

SUBMISSIONS

OF THE

SCHOOL ENERGY COALITION

1. The following are the School Energy Coalition ("SEC") submissions with respect to the Report of Pacific Economics Group dated April 25, 2007 entitled "Benchmarking the Costs of Ontario Power Distributors" (the "Report").

2. Throughout these submissions, we have a number of comments and assertions that disagree with the Report, or highlight areas in which it does not, in our view, deal with all of the relevant issues as thoroughly as we would have liked. Despite these comments, our overall submission is that the Report is an excellent analysis, and adds a lot of value for the Board in its consideration of when and how to use benchmarking to improve the quality of electricity distribution rate regulation. If the Board were to adopt the conclusions of the Report without modification, in our view that would still be a significant step forward in the Board's ratemaking practices. Our comments seek to provide further improvements that would increase the value of benchmarking to the Board, but the Report already establishes a solid foundation.

3. In its letter dated April 27th, the Board asked parties to deal specifically with three questions in commenting on the Report:

   a. Uses of benchmarking in ratemaking;
   b. The different proposals of PEG and Board Staff; and
   c. Alternate proposals and their rationale

   These Submissions are structured using those three subject areas.

Benchmarking as a Ratemaking Tool

4. ***Use by the Utilities.*** Before considering how the Board might use this or other benchmarking activities in the ratemaking process, it is important to keep in mind that by far the most important use of this information is by the utilities themselves, to help them attain

or maintain their most efficient operational level. Some LDCs do this already, while others are new to this kind of standard-setting. The adoption by the Board of a clear and fair method of comparing operational efficiencies between utilities will help LDCs to identify problem areas and motivate staff and managers to address those problems.

5. We note that even the raw price comparisons between LDCs that have been published by the Board and parties in the last couple of years have engendered internal reactions by the utilities. For those at the lower end of the cost spectrum, we have seen not only pride in their achievements, but also a strong desire to maintain their position as a "low cost" LDC. At the other end of the price spectrum, we understand (although there is less open discussion about it), that these price comparisons have resulted in internal reviews of efficiencies to determine the reasons for the relatively high prices.

6. In our submission, any benchmarking standards published by the Board should be assessed to ensure that they can be used by LDCs for their internal purposes to reach the most efficient operating levels.

7. ***Existing Utility Benchmarking Data.*** Following along from the same premise, it is well known that the utilities and the EDA have extensive information on benchmarking they have done to date for operational purposes. In our submission, the Board should order that all utilities, and the EDA, file that material with the Board forthwith.

8. We readily understand that some utilities may object to such an order, on the grounds of confidentiality, or on the grounds that by making that information public the Board will create a chilling effect on voluntary utility benchmarking. Those may be legitimate concerns. We can't know at this point. Therefore, in order to ensure that those concerns, legitimate or otherwise, are respected, we believe that the Board should allow the initial filing of existing benchmarking information to be in confidence, until the Board has a chance to review the material. The Board will then be in a position to determine a) how helpful it may be, b) whether disclosing it may put a damper on utility benchmarking, c) whether the material appears to be confidential in nature, and d) what steps, if any, the Board should take in handling the information to maximize its value while avoiding these risks. The first step, however, is for the material to be filed, and we recommend that the Board so order.

9. ***Goals of the Ratemaking Process.*** In determining how benchmarking should be used in ratemaking, the Board must, in our view, be very clear as to the goals of the ratemaking process. This may seem like an obvious question, but we believe that when the Board reviews the submissions on the Report, it will be immediately apparent that some parties, including some utilities, have a quite different view of the goals of ratemaking than do other parties, including some ratepayer groups.

10. Consider the following two statements of the goals of ratemaking:

    a. In setting rates, the Board is ensuring that the LDC can collect in rates the amount it needs to run the utility according to the standards and goals established by its management and shareholders.

b. In setting rates, the Board is endeavouring to find the amount of money which is the least amount necessary, with efficient management, to run the utility properly and provide a reasonable rate of return to the shareholder.

In the former case, espoused by some LDCs, the utility tells the Board what it thinks it needs, and the Board reviews it to make sure the budget is not set unreasonably high. This is what many utilities expect from the cost of service model. In the latter case, the Board structures its ratemaking process so that all utilities are driven to be as efficient as possible, and are allowed rates that are sufficient only for an efficiently run utility. This is said by many to be the goal of incentive regulation.

11. Benchmarking has different uses depending on which model of ratemaking is accepted by the Board. It will be no surprise that SEC thinks the second model is the appropriate one, but in our view the key here is that the Board be clear in what it is trying to achieve in the ratemaking process, because that clarity will control how benchmarking is used most effectively.

12. ***Driving Efficiencies.*** In our view, and based on the belief that driving prices down to their lowest reasonable level is part of the Board's mandate and goal, benchmarking should be adopted as a method of putting assymmetrical pressure on utility costs and prices. Through a variety of techniques, including those discussed below, the Board should use benchmarking targets as a method of pushing costs and prices downward. This is in many respects exactly what the utilities use benchmarking for themselves, but when the Board does it achieving the result is less voluntary.

13. ***Average vs. Frontier Benchmarking.*** The first step in using benchmarking to drive efficiencies is to re-examine frontier cost and price levels. The Report, and the Board Staff approach, both start from the perhaps surprising premise that pushing utilities towards the average cost or price level is an appropriate goal. The Report, in fact, rejects frontier pricing almost summarily, devoting a couple of paragraphs to the subject and then dismissing it as if unworthy of consideration. This is true despite that fact that benchmarking to frontier costs is the norm in Britain, which has more experience with benchmarking in ratemaking than pretty well any other jurisdiction.

14. We note that average cost benchmarking is naturally assymmetrical as well. It is more intuitive for a regulator to limit the rate increases of a high cost LDC, for example, than it is for that same regulator to allow high rate increases for a low cost LDC. In the former case, there is at least in theory a problem that needs correcting. In the latter case, the utility has demonstrated that it can live with the lower cost, so there is no apparent reason to raise those costs. (Obviously there are exceptions, where badly run utilities have underspent to the detriment of service quality, asset condition, or other factors. Leaving those aside, there appears no justification for rewarding a low cost utility with a high increase.)

15. But frontier cost benchmarking acknowledges the true goal – getting costs to their lowest reasonable level. In principle, and after adjusting for exogenous variables, the lowest cost

LDC is closest to that goal, and therefore pushing all LDCs toward that level should be the regulator's goal.

16. For this reason, we would like to see the Board and/or its consultants embark on a more thorough review of the use of frontier costs in benchmarking in Ontario, and all of the variations that might make sense. For example, would it make sense for the Board to benchmark LDCs to the 25th percentile of their peer group, rather than the average, as a move toward frontier costs? Are there modifications of frontier costs that can shift them from single year (and potentially anomalous) standards to something more akin to a "lowest sustainable cost level"?

17. ***Analogy to the Competitive Marketplace.*** We note in considering this that Ontario, with its large number of LDCs, has a unique situation in which there is a funny sort of competitive market. Of course, they do not in fact compete with each other for customers, but utilities side by side or in very similar situations and close geographic proximity do offer the same service, according to the same standards, and under the same regulator. Where the resulting prices differ, the public will, and the regulator must, ask why that is the case, and if there is no good explanation adjust the prices so that they are equivalent to those that would prevail if they were competing for the same customers. Indeed, it has long been recognized that one of the roles of the Board is to be a proxy for competition in the marketplace.

18. But in a truly competitive market, do competitors move toward the frontier price, or the average price? The answer, of course, is neither. Some competitors will price their product too low, so will get market share but insufficient ROE. Other competitors will price their product too high, so will get a high gross margin but insufficient volume to have an acceptable ROE. As competitors respond to each other's pricing and market share, the lowest ones will increase, the highest ones will decrease, and the average will come down. Eventually, it is submitted, in a perfect (ie. theoretical) market the cost levels underlying prices will be what we have called, above the "lowest sustainable cost level".

19. In our view, the appropriate level to which an LDC should be benchmarked is the lowest cost level of a similar utility that maintains a sustainable level of high quality service. This means, logically, that the Board should throw out the low prices of utilities that, for example, don't spend sufficient money on system maintenance, or fail similar tests of proper long term utility operation. Having done that, though, the next highest cost level is, in our submission, the benchmark the Board should apply to other LDCs. Prima facie, each LDC could get to that level if they were as efficient as the most efficient LDC.

20. No-one thinks that every LDC should meet the full target immediately. This would be both unrealistic and unfair. Even in a competitive market, high cost providers will sometimes last for several years before they either get their costs down to the market standard, or they are forced out of the business. What is important, though, is that they do have to get there within a finite period of time, or the market will simply cut them off. So, too, the Board should establish clear targets based on benchmarking, and then step by step require LDCs to reach those targets over a period of years, failing which the high costs will eat into their ROE, not the pockets of the ratepayers.

21. ***Performance Standard vs. Diagnostic/Screening Tool.*** This in turn leads to what will be, for many, the most controversial recommendation of the Report, ie. use of benchmarking right now only for screening, without any direct or indirect impact on rates.

22. In our view, the Board has already had a form of benchmarking in use for screening. It was useful in that context (2006), but we need to move to a more rigorous approach. While we accept the notion that, in achieving tighter control over LDC costs, measured steps is a reasonable approach for the Board to take. But measured steps does not mean getting stuck with an approach (screening alone) that is too timid given the additional excellent work that has been done to date.

23. Further, screening does not have an obvious place in the current rate-making process. In the upcoming round of rate cases for electricity distributors, the format is already established, and for at least the first cut the timing of individual applications has been determined. What more could benchmarking add? If an LDC is coming in for a cost of service application, will it be looked a more thoroughly because it is a high cost utility? It would appear to us that all applications should be looked at thoroughly, and there are no circumstances in which the Board's view should be superficial.

24. Therefore, for both of these reasons we believe that benchmarking must have a more impactive role than screening alone.

25. ***Potential Rate Impacts of Benchmarking.*** It is submitted that there is a range of ways that the Board could use price or cost comparisons in the ratemaking process. At one extreme, of course, the Board could simply order that costs above a benchmark amount (or more than x% above that amount) are not allowable. This is the harshest of uses. At the other extreme, the Board could apply benchmarks only to rate changes year over year, and then only as a guideline or piece of evidentiary input, rather than having a direct operative effect on rates.

26. To our mind, and subject to our comments below on postage stamp rates, there is a reasonable progression, for which an example (this is not a proposal, but an example of the concept that, assisted by the input and evidence of others, could be implemented by the Board) is the following:

    a. In the current round of incentive regulation applications (ie. all those that are not cost of service), provide for a stretch factor in the X factor calculation that ranges from 0% to 3%. Utilities at a frontier cost level (the "lowest sustainable cost level" we have discussed earlier) would have a 0% stretch factor, and the factor would range upward to 3% for those at the highest cost level relative to their peers. The setting of the factor would not be totally formulaic, however. Either the utility or the ratepayers could seek an order altering the stretch factor level if the benchmarking formula produces a result that they can demonstrate is inappropriate.

    b. For those applying for cost of service under 2nd Generation PBR, the Board should require the applicant to file with them a detailed, multi-year plan to get their costs to the

frontier cost level. In our view, this should be an open-ended requirement, in the sense that the utility can propose a plan as long or as short as it feels is appropriate, but then must be prepared to justify it. The Board should consider and, if necessary, modify the plan during the cost of service application, and should set rates and annual adjustment factor consistent with the original or modified plan.

c. For those applying for cost of service under 3rd Generation PBR, the Board should determine whether the applicant is on track to get to frontier cost levels. If it is not, the Board should limit rates more directly to ensure that management is highly motivated to achieve the appropriate cost levels.

27. In our submission, a measured, step-by-step approach such as the above would give the LDCs both the time and the flexibility to introduce efficiencies into their operations, would allow them to maintain their individuality and local preferences, and yet would still give their ratepayers the benefit of an external test of reasonableness through the benchmarking process.

28. ***Postage Stamp Rates.*** All of the above proceeds from the assumption that different LDCs will charge different rates to their customers, driven, presumably, by their different cost structures. In our submission, it is not a given that rates for different LDCs should be different. As we have noted to the Board in submissions within other consultations, it is arguable that all customers in the province with the same use characteristics should pay the same amounts for electricity distribution. That is already true for transmission, and for the commodity. It is also true, in three broad geographic areas of the province, for gas distribution. A pooling approach, similar to that used for transmission, is also possible for distribution.

29. SEC does not believe that there is sufficient evidence before the Board for the Board, or any party, to form a rational conclusion on whether postage stamp rates for electricity distribution would be a suitable policy step. However, in the context of benchmarking what is clear is that any effect of benchmarking would have to be reconsidered if postage stamp rates were implemented. Since benchmarking would not affect rates from one location to the next, its operative effect might be to control the share of the pool that a particular utility was entitled to draw to cover their costs.

30. Note that there is an important difference here. Benchmarking in this context is not about fairness between ratepayers (since all ratepayers have the same rates anyway). Rather, it would be about fairness between utilities. Those utilities with more efficient management would, in a pooling system with revenues restricted through benchmarking, get higher returns on investment, relative to those utilities with less efficiencies. The way for an LDC to deliver higher ROE to its shareholder would be operational efficiency (competing with other Ontario LDCs to be the most efficient), rather than the current situation in which LDCs get higher ROE primarily by convincing the Board to increase rates to their customers.

31. It is submitted, therefore, that in considering the use of benchmarking the Board should take into account the possibility that benchmarking could enhance the viability of postage stamp rates and revenue pooling between Ontario LDCs.

32. ***Specific Recommendations.*** In summary, SEC recommends the following with respect to the use of benchmarking in ratemaking:

a. Any benchmarking standards published by the Board should be assessed to ensure that they can be used by LDCs for their internal purposes to reach the most efficient operating levels.

b. The Board should order that all utilities, and the EDA, file any existing benchmarking studies and data that they have with the Board forthwith, but the Board not release that to the public until it has reviewed it for value, impact, and confidentiality.

c. In reviewing how to use benchmarking, the Board should explicitly confirm that part of its goal in benchmarking is to influence LDCs to operate more efficiently.

d. The Board should, through expert advisors or otherwise, investigate frontier cost benchmarking with a view to developing a method of identifying the "lowest sustainable cost level" for a utility, which would then be the target level for an LDC.

e. Limiting the use of benchmarking to screening only should be rejected by the Board. The Board should instead implement a step-by-step approach, such as the example we have given in paragraph 26 above, in which benchmark information has an increasing influence over rates, over a period of years, until all LDCs are able through efficiencies to approach the frontier cost level.

f. In considering the use of benchmarking the Board should take into account the possibility that benchmarking could enhance the viability of postage stamp rates and revenue pooling between Ontario LDCs.

PEG vs. Board Staff Approaches

33. ***What Factors are Exogenous?*** One issue that dominates consideration of both the Report and the Board Staff approach is the question of what factors should be considered exogenous. In our view, the Board should consider each proposed exogenous factor and make a determination as to whether it is legitimately so treated.

34. Some factors will be obviously outside of the control of management. Customer density, for example, or physical topography, are only by the wildest stretch of the imagination within management's control. It is therefore legitimate to treat them as independent variables in an econometric model, or as factors determining the selection of peer groups.

35. Many other factors are not so obvious, such as:

a. Utility size (number of customers). On the one hand, current management is faced with a utility that has a particular customer base, and its efficiencies are limited by that apparently exogenous fact. On the other hand, the size of the utility may well be a political or business decision, in which economies of scale have been traded off for independence, or job security, or local autonomy, or any of a number of other non-financial benefits. Particularly where utility size is driven by a shareholder decision, it is reasonable to say that it should not be an independent variable. Any cost differentials driven by size are a choice the shareholder made, and the shareholder should bear the consequences (or benefits, for that matter) in ROE.

b. Asset condition. Again, current management has to deal with the assets as they exist today. The past cannot be changed. However, the current condition of assets reflects past decisions of management and/or shareholder. If ratepayers enjoyed low rates as a result of underspending on maintenance, for example, it may be fair to build the resulting higher costs today into rates. Conversely, if the current condition reflects a shareholder that wanted to maximize ROE, it would seem that this is not an exogenous factor, and the higher costs today should be reflected in ROE as well.

c. Labour costs and, in particular, union contracts. Much like asset condition, labour costs and union contracts are a reality today, but they are also in part a function of past management decisions. It may be reasonable to say to today's management that high labour costs are allowed now, but there must be a plan in place to bring them down to more reasonable levels. In so doing, it may be reasonable to divide the causes of high labour costs into factors that are truly exogenous (like regional wage disparities), and factors than can be controlled over time (like union contract terms).

36. In considering this part of the issue, we believe it is important to keep in mind that in a true competitive market there are very few exogenous factors as between competing suppliers. There are probably more in the case of LDCs (given that their businesses are tied to a particular geographic area), but each statement that "we can't do anything about that" should be scrutinized with some degree of skepticism.

37. ***The Special Problem of Hydro One.*** The other issue that is common between the Report and the Board Staff approach is the decision to treat Hydro One as "too special to benchmark".

38. This is, in our view, completely unacceptable. Hydro One is the largest LDC in the province, and there is no question that benchmarking its activities presents some challenges. However, it is also one of the highest cost service providers, and failing to use benchmarking to get those costs down is not fair to Hydro One's ratepayers. In the case of schools, for example, about 1,100 of the province's 5,000 schools get their electricity distribution from Hydro One. Are they to simply be ignored because it is difficult to benchmark Hydro One? That is, in our submission, unfair and inappropriate.

39. In fact, it would appear to us that benchmarking Hydro One does not have to be that complicated after all. Hydro One, as a distributor, is in fact an amalgam of very rural areas (for which there are peers), plus small and medium towns (for which there are also peers). It should not be difficult to determine the percentage of Hydro One costs associated with each type of franchise area, and compare those costs to their peers. Alternatively, Hydro One could be compared to a weighted formula "peer" comprised of the appropriate percentages of rural LDC efficiencies and small and medium town efficiencies. Developing a further reduction in target to recognize economies of scale is probably the biggest challenge, but in our view it is not suitable for either PEG or Board Staff to reject this option without even trying to establish a viable benchmarking model.

40. It is therefore submitted that the Board should, either through Board Staff or their external experts, develop a reasonable benchmarking standard for Hydro One that reflects its multiple franchise types.

41. ***Issues in the PEG Report.*** As we have noted above, the Report is an excellent first step in implementing disciplined benchmarking for Ontario LDCs. We therefore do not have any broadly based criticisms, although of course our general comments above do not at all times agree with PEG. We expect that other parties will focus on the details of the Report, and provide useful technical input, so we will not attempt to do a detailed critique. We offer, instead, the following comments on specific points of concern or question:

    a. It is not clear to us that the labour cost proxy used by PEG estimates properly. It may understate labour costs, but do so consistently. It would be useful if PEG looked into this to determine whether there is a problem, and if so whether it has any material impact on the model. It may not.

    b. We did not understand how PEG was unable to access information on power deliveries to embedded distributors. We would have thought this information was available to the Board in data on LV charges, or in the cost allocation filings that all LDCs have provided.

    c. Aside from Hydro One, on which we have commented above, one other utility (Oshawa) did not provide PEG with complete information. The Board should, in our view, require that the information needed be collected and provided.

    d. PEG has correctly identified the capital expenditures as an important aspect of benchmarking, but with particular calculation difficulties. What we did not see is an appropriate method capturing the interplay between capex and opex in the model presented. A better explanation is needed from PEG as to why the Total O&M data is useful/reliable despite the lack of a thorough control for capital spending levels.

42. ***Issues for the Board Staff Approach.*** As with the Report, it is not our intention here to provide a detailed critique of all aspects of the Board Staff approach. However, we do have the following comments which we hope are useful:

a. As noted earlier, there does not appear to be a clear justification for treating operating scale (ie. utility size) as an exogenous variable. In general, we believe this is probably not the case, and further that treating it as a "not our problem" explanation for cost differences has negative policy implications, e.g. as a barrier to industry consolidation.

b. On the other side, we agree with PEG that excluding customer density as a consideration in identifying peer groups is a weakness. If it is not to be included directly, some proxy to reflect the vary large differences in costs associated with density should be used.

Other Approaches to Consider

43. Both the Report and the Board Staff approach suffer from data integrity issues, and we agree with both PEG and Board Staff that steps need to be taken to improve the quality and reliability of data on which benchmarking is based.

44. That having been said, both use a bottom-up approach to cost comparisons, in which the very granularity exacerbates the data integrity problems. Both approaches start by trying to identify those factors that are both material and exogenous, to get to an "adjusted" cost level that effectively assumes that all other differences are the result of operational efficiencies (or the lack of them). The more specific factors are being applied, the more data must be sound in order to produce a reliable result.

45. ***Price Comparisons.*** On the other hand, it is also possible to use a top-down approach. One thing we know for sure is the actual prices being charged by each LDC. There are no data issues, and it is relatively easy to determine what a specific sample customer would pay for the same service to different distributors. This creates a solid foundation for diagnosis and analysis.

46. Once price differentials have been identified, the top-down approach then looks for reasons for those differences. In many cases, all of the exogenous factors will be the same as those found in the econometric model, for example, so the same data integrity issues will arise. However, that will not always be the case. In the case of any given LDC, the factors that are material may be fewer, and may be easier to calculate. It therefore may be possible in some cases to have more reliable results using a top-down approach than the more granular approach currently under consideration.

47. Of course, price comparisons also have the advantage that they tie directly to what the customers are paying, and in large part they mimic the effects of a competitive market (which is price rather than cost driven).

48. We recognize that price comparisons have their own challenges, and we are not proposing that the Board choose top-down benchmarking in place of econometric or similar bottom-up approaches. However, what we do believe is that the Board should use price comparisons as a further tool, both to be a reference point for the cost benchmarking, and to be a test of

whether planned efficiency measures (resulting from benchmarking) will achieve the desire results.

49. In the end, it is submitted that it is through price comparisons that the success of any benchmarking process is determined. If benchmarking is effective, each LDC should, after adjusting for exogenous factors, approach the frontier price level for the services being offered. If that is not happening, in our view the benchmarking is not working.

Conclusion

50. ***General.*** We appreciate having had the opportunity to provide input at this stage, and would like to continue to be involved going forward as the Board determines how to use benchmarking, and embarks on implementation of that process.

51. ***Costs.*** We hope that our input has been useful and we respectfully request recovery of our reasonably incurred costs of participating in this consultation.

All of which is respectfully submitted on behalf of the School Energy Coalition this 3rd day of July, 2007.

SHIBLEY RIGHTON LLP

Per: ______________________
Jay Shepherd