SanZoe Consulting Inc.

September 21, 2007

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319, Suite 2700
2300 Yonge Street
26th Floor
Toronto, Ontario M4P 1E4

Dear Ms. Walli:

Re: 3rd Generation Incentive Regulation for Electricity Distributors

Board File No. EB-2007-0673

Comments on Staff Scoping Paper

As consultant for AMPCO, representing the large user customer class, I offer these comments on the Staff Scoping Paper.

Two factors strongly support the initiative for a multi-year rate setting mechanism. The distributor sector is fundamentally an asset management business, requiring a higher level of stability and certainty than less capital intensive operations might need. Moreover, effective involvement by customers in the regulatory process requires that the volume of rate hearings be held to a reasonable level.

As a general comment, the Paper is well thought through and appears to encompass most of the major issues. As it articulates an OEB objective to continue the pursuit of economic efficiency in the distributor sector, it deserves the full support of customers.

The suggested schedule is reasonably aggressive, reflecting the need for efficiency incentives to become part of the LDC business environment as soon as possible. Presentations at the workshop for this process and the related LDC cost comparator workshop tended to focus on areas where the model was incomplete or the data uncertain. These concerns ought to be reviewed, but should not become a rationale for slowing progress towards an initial regime that provides unambiguous incentives for performance improvements.

Comments on Principles:

1. **Balance of interests**

   This principle is well stated and accepted.

2. **Pursuit of economic efficiency.**

   The text of this principle appears to be narrowly focused on operational efficiency.

   LDCs are inherently capital intensive. From a management model perspective, they are usually categorized as asset management businesses. Much of the cost borne by customers is driven by past capital investment decisions. If the LDC plant is "gold-plated", the customers may be paying more than they should for service. On the other hand, an IRM framework must not incent harvesting of assets, which would place future customers at risk.

   Any IRM must speak to LDC performance in terms of how well it optimizes the mix of capital and OM&A spending, as well as how it maintains its asset base in good condition.

   Determining the performance of the LDC as an asset manager is difficult, as the technical aspects ("best practices") of utility asset management are steadily evolving. However, it should not be too difficult to establish some initial basic measures associated with good asset management, such as asset condition indices or system component performance. Other indicators, such as per-unit asset value data may also be useful.

   In sum, long term economic efficiency requires efficient capital investment and asset management as well as efficient execution of normal operational activities.

3. **Sustainability**

   The IRM framework should be adaptable to address both current perceived issues such as lost revenue from CDM and also potential future issues that may arise with experience and a changing business environment.

   Even the best designed framework is likely to incent some unanticipated behaviours, which the Board may wish to discourage or encourage. To this end, the framework should be sufficiently flexible to allow the introduction of new criteria or the removal of criteria that decline in importance.

4. **Rate Volatility**

   Minimizing rate volatility is important, but one principle should also be that, overall, rate variability across LDCs should reduce over time. Energy supply cost and reliability are important determinants of location choices by businesses. The current variability in rates for medium and large users provides locational incentives and disincentives that often do not seem justified on fundamentals.

Elements of an IRM Framework

Earnings Sharing Mechanisms

An earnings sharing mechanism (ESM) should be an important part of any IRM framework. Such mechanisms are routinely used in best practice contracts in industry, where the supplier and the customer benefit jointly from achievements in cost reduction. In Ontario, where most LDCs are owned in some respect by their customers, ESMs should be especially effective.

Suggestions recommending some certainty in relation to the acceptance of multi-year capital plans should be considered seriously. Consistent with the comments above on optimizing the mix of OM&A vs. capital and on efficient asset management, distributors logically require some confidence that prudent capital plans will be accepted and approved.

Lost revenue adjustment mechanisms should be symmetrical in effect for increased revenue as well. From a practical perspective, it can be very difficult to determine with high confidence whether a change in consumption is due to conservation, a shift in customer behaviour, forecast problems, or inaccurate weather normalization. To the extent a distributor is relieved of risk associated with reductions in individual consumption, it should also be commensurately relieved of benefits when per customer consumption exceeds forecast.

Distributor Diversity

Allowances for the effect on distributor performance of exogenous factors such as density, customer mix or geography should be kept to a minimum.

Factors that are within the control of management or the shareholder, such as the size of the utility, are not truly exogenous. Moreover, while the analysis of data in the LDC cost comparator initiative indicates that utility size is somewhat correlated with efficiency, the number of exceptions to the rule seem to further weaken arguments for a size related X-factor.

Many apparently exogenous factors are not fully outside of management's ability to address through adaptation and innovation.

In competitive industries, it is normal for companies with widely differing external business conditions to sell products at nearly identical prices. As an example, Algoma Steel (Small size, Northern Ontario), Dofasco (Medium Size, Southern Ontario) and Nippon Steel (Large Size, Japan), all supply product at comparable prices into the same general markets.

Diversity can present both opportunities and challenges to different organizations, but is not an insurmountable barrier to excellence.

Service Quality

Service quality measures are essential to an IRM and it is noted that a separate OEB process will consider this issue. Service quality is currently not measured consistently.

Even the nature of the measures used is different in both approach and calculation. For example, SAIDI, CAIDI and SAIFI attempt to measure both utility performance and customer experience in an objective manner, while direct customer satisfaction measures are both more subjective and more relevant to customers.

Aside from issues with respect to the measures to be used, it must also be recognized that perceived service quality is affected by exogenous factors. Major storms and local planning controversies can affect measures. Also, an aggressive catch-up program on maintenance or capital can drive an increase in outages. The point here is that, at its current state of development, standard SQI measures may not be as useful as we might hope.

If the IRM development process cannot easily develop and implement useful service quality metrics, a practical solution on the first application of IRM may be to accept current performance as acceptable and only provide a disincentive to significant deterioration.

Data Issues

The data and analysis used on the cost comparator study should be useful overall. Quality issues have been noted by several stakeholders and in our own analysis, so there will need to be some effort to resolve (cleanse) data that appear inconsistent or implausible. The probably does not need to be a large effort, but could focus on the more obvious problems. One solution for purposes of developing a framework may be to focus on a sample of distributors whose data seems relatively credible and clean, with few issues.

Other Issues

The working group may benefit from some discussion or direction early on with respect to the general approach for an IRM. For example, and IRM can direct incentives at reducing variability among distributors, gradually raising standards for all, or providing specific benchmark objectives in areas of concern. Most approaches may produce similar results over time, but it would be useful for development if the overall approach were defined early on.

The issue of audit should be addressed. Much of the data used in the cost comparator analysis is suspect and stakeholders have noted the risk that distributor cost reporting policies may influence KPI results. For incentives of any kind to work properly, some form of verification may be needed. This should be addressed in the working group.

Schedule

The proposed schedule seems quite workable at this time. However, AMPCO's and other intervenors' consulting resources are limited. It is possible that this process may at some point conflict with one or more of the several impending hearings for this fall. I would request that, if this occurs, Board staff be as flexible as possible in scheduling workshops during periods when oral hearings are in progress.

Prepared by:

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