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BY COURIER

September 21, 2007

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-200-0673 - 3rd Generation Incentive Regulation for Electricity Distributors – Hydro One Networks' Comments re Scoping Paper

As directed in the Board's letter of August 2, 2007, I am attaching three (3) paper copies Hydro One Networks' comments on the OEB Staff Scoping Paper. An electronic text-searchable Acrobat version is being provided by email to the Board Secretary email address.

Sincerely,

Susan Frank

Susan Frank

1 Introduction

Hydro One Networks Inc. ("Hydro One") welcomes the opportunity to comment on the OEB ("Board") Staff's Scoping Paper ("SSP") in respect of the development of the 3rd Generation Incentive Regulation ("3GIR") for electricity distributors as outlined in the Board's communication of August 2, 2007.

Hydro One's comments are provided in the form of (i) general comments that speak to the over-arching context associated with the intent to move to incentive regulation and also provide responses to questions asked in the covering memo to the SSP, and (ii) specific comments related to the principles.

2 General Comments

2.1 Context Observations

Hydro One supports the Board's effort to move forward with incentive regulation in the electricity distribution sector in Ontario and applauds the Board's effort in proposing to consult with the distribution industry and interested parties prior to developing a detailed 3GIR plan. The Board has clearly indicated by the issuance of the Scoping Paper that it is willing to consider broad input from stakeholders and that in so doing it is willing to listen to a variety of views, all of which should provide the necessary knowledge to develop a meaningful and enduring 3GIR plan that will benefit the Regulator, the Distribution customers and the LDCs. In this respect Hydro One expects the ultimate design to reflect sufficient flexibility to effectively address LDC-specific circumstances within the framework.

Hydro One supports the concept of multi-year incentive regulation because it has the potential to:

- Make the regulatory process more efficient.
- Provide incentives for the utility to improve performance, and
- Allow the benefits to be shared more equitably between the utility and its customers.

Therefore, in Hydro One's view, progression to incentive regulation has the potential to benefit all parties involved. That being so, achievement of this all-round success will require their commitment.

2.2 Objectives and Goals

Hydro One believes that the development of goals, end-state vision and objectives will be the most efficient first step to address the multitude of issues which must be addressed in the design of 3GIR.

Participants need explicit goals to clearly point to an end-state. Developing this approach requires a clear understanding of the circumstances which utilities will face over the next three to five years and which the Incentive Regulation ("IR") framework will have to address at the outset.

Hydro One notes that no single IR model which fits all circumstances has evolved as a result of the progress made elsewhere. Rather, in other jurisdictions which have adopted IR, the concepts and principles might be the same, but the format of regulatory control that is generally adopted, is that which best suits the particular local environment. Thus for example, service quality regulation has been a key topic in the regulation of the electricity distribution sector in Australia, whereas the focus of attention in the Netherlands and Norway has been on cost efficiency. Regulation in the UK appears to be moving its focus from cost efficiency to service quality in recent years.

Hydro One notes that the circumstances which the Ontario electricity distribution sector will face in the foreseeable future are driven by the demand-supply mix. The issues raised by Board Staff in the SSP largely reflect this and Hydro One agrees with them. Because of their importance, Hydro One believes that these should be considered major objectives in the development of the framework. In other words, distributors face the need for capital expenditures in relation to system maintenance, expansion and new connections, and this is a key area that must be examined. Furthermore, funding of CDM programs and the potential for declining revenues due to CDM and distributed generation ("DG") are also critical issues. Addressing these could comprise another objective of this process.

Choosing a format for incentive regulation then means adopting a process that focuses attention on those elements that need to be developed at the outset, so that the resulting model best reflects the circumstances in Ontario that are most likely to impact utilities in the next three to five years, as noted above. This suggests that attention could be focused on the development of a model for the more immediate future, but along evolutionary lines that would allow key lessons learned to be fed back and incremental improvements made, rather than a re-thinking of the whole concept at some later date.

2.3 An Integrated Work Plan

The IR framework should be developed in a stepped, integrated and orderly manner, each step addressing the most pressing needs envisioned in a given time frame before moving on to address the next set of pressing needs.

The transition from CoS regulation to Incentive regulation is not a one-time step. Experience from other jurisdictions which use performance based regulation suggests that these have adjusted continuously as lessons are learned. One cannot expect the approach taken to developing incentive regulation in Ontario to be any different. Clearly, the development of an enduring incentive regulatory model will take time and effort and there should not be any need to force a design to meet a compressed time schedule. Rather, there is a need to develop a plan of attack that will highlight the key milestones and objectives that must be achieved in the interest of meeting specific time-related requirements that help to establish an enduring model, one that will lend itself to evolutionary changes as adjustments are made over time to reflect key learning.

In this context, and while the Board is prepared to consider a broad range of issues at the outset of 3GIR, Hydro One suggests integrating this work with the concurrent proceedings on utility cost comparison[1] and service quality regulation.[2] These two undertakings will have an impact on distributor regulation and as such, it is important that questions which overlap between the three undertakings are not missed. Early integration of the priority components would help determine the design elements needed to initialize the use of 3GIR for the setting of 2009 distribution rates and ensure that all pertinent issues are addressed in an orderly fashion.

2.4 Responses to Staff Questions

2.4.1 Issues

The August 2nd, 2007 covering memo to the SSP asks "*Are there other key issues that should be considered (i.e. other than the necessary elements of the IRM framework, capital investment, lost revenue due to changes in electricity consumption, and distributor diversity?*

Lessons from the Natural Gas Industry

Lessons from natural gas proceedings which have been tempered to reflect industry differences will help avoid pitfalls and repeat missteps. Board Staff suggest in the SSP[3] and Hydro One agrees, that work on an IR framework for electricity could be informed by the similar (combined) proceeding currently underway on an incentive regulation framework for natural gas.[4] Hydro One nonetheless recommends that the eventual design of 3GIR must reflect the significant differences between natural gas and electricity distributors, such as:

- The considerable difference in treatment of profits and earnings between private and public shareholders. Electricity distributors generally are publicly owned utilities whose financial responsibilities are very much linked to the "public good" through the returns that they make to local or provincial governments.
- Practicality. As Board Staff note, electricity distributor diversity (and numbers) must be a consideration in the design of 3GIR, in contrast to the natural gas sector, which is characterized by two main relatively homogeneous distributors.

Other Issues for Consideration

Hydro One provides below, comments on a few other issues that it believes are worthy of

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[1] EB-2006-0268 – Comparison of Electricity Distributor Costs.
[2] RP 2003-0190, Service Quality Regulation for Electricity Distributors, as per the Board's letter of September 11, 2007 on coordination of this work with 3GIR and distributor cost comparison work underway.
[3] EB – 2007-0673, 3rd Generation Incentive Regulation for Electricity Distributors, Staff Scoping Paper, first full paragraph on page 2.
[4] EB-2007-0606 – Union Gas Ltd; Multi-year Incentive Rate Regulation for Natural Gas Utilities.
[4] EB-2007-0615 – Enbridge Gas Distribution Inc.; Incentive Regulation Plan.

consideration and that could assist the Board with respect to the development of IR for electricity distributors in Ontario.

i) Regulatory Oversight: The utility should produce the same type and amount of information that is necessary to support its case for recovery of prudently incurred costs and the setting of fair and reasonable rates.

The Board's objectives and the utilities' business remain the same under both forms of regulation. The only change is the "tool" with which the Board exercises its regulatory oversight. The move to multi-year incentive regulation, therefore, does not in any way diminish the level of regulatory oversight and neither should it require more detail than CoS regulation. In short, Hydro One believes that the benefits of a reduced annual CoS burden should not themselves be reduced through the imposition of additional requirements on utilities through incentive regulation.

ii) Flexibility of Regulatory Control: Flexibility in either the model or its parameters is needed.

A review of incentive regulatory models in other jurisdictions suggests that no one single model applies to regulation of the electricity distribution sector. The electricity distributors in Ontario are not homogeneous in size, scope of operations (e.g. service territory, vegetation, geography, and climate), customer mix, asset age, progress in efficiency improvements and so on. Therefore, the particular form of regulatory control to be developed in Ontario must recognize these issues and adopt a design with sufficient flexibility to accommodate the varied circumstances. This would suggest that a single model with prescribed parameters may not necessarily be a practical solution, and the potential use of both price cap and revenue cap frameworks should be explored (witness the previously mentioned current proceeding for natural gas, where Union Gas has submitted a price cap application for setting 2008 rates, whilst Enbridge has submitted a revenue cap).[5, 6] At minimum, a model which has the flexibility to include a variety of parameters that might help to reflect the varied utility circumstances, is needed.

iii) Service Quality Regulation: Service quality regulation should be included within the scope of 3GIR as soon as possible.

Hydro One notes that it is the Board’s intent to deal with this important topic in parallel, but separate from, this consultation.[7] Service quality is an integral part of performance based regulation in other jurisdictions, such as the UK and Australia, where this form of regulation is practiced. It seems sensible to include service quality within the incentive regulatory umbrella because a utility’s costs are largely driven by this. In other words, the distribution utility’s work programs reflect the work needed to maintain an acceptable level of service quality and this obviously translates to the costs the utility is expected to incur during a given

[5] EB-2007-0606 – Union Gas Ltd; Multi-year Incentive Rate Regulation for Natural Gas Utilities.
[6] EB-2007-0615 – Enbridge Gas Distribution Inc.; Incentive Regulation Plan.
[7] EB – 2007-0673, 3rd Generation Incentive Regulation for Electricity Distributors, Staff Scoping Paper, last paragraph on page 4.

price control period. Therefore service quality indicators provide the cost drivers that a utility must factor into its business planning. The linkage between service quality and costs incurred should form a foundation in any regulatory model, whether it is CoS or Incentive regulation. Hydro One is pleased to see that the Board is moving firmly ahead with addressing service quality regulation, and would encourage the Board to consider including this within the scope of development of incentive regulation at the earliest opportunity. Establishing service quality targets provides a clear and unambiguous signal to utilities in terms of what must be achieved and as such, helps to establish the appropriate work programs and strengthens the rationale for cost causality.

2.4.2 Potential Use of Information Developed to Date

The August 2nd, 2007 covering memo also asks "*How might the work done to date on comparative utility cost analysis be used in 3rd Generation IRM?*"

The status of the cost comparison referred to above is the subject of a separate proceeding.[8] Hydro One and other utilities have stated their observations and concerns in their respective submissions, particularly with respect to the applicability of the analysis in rate-setting.[9] While Hydro One believes that considerable work is still required to ensure the reliability and consistency of data between utilities, we nonetheless believe that it could be helpful now if used in aggregate form, that is, total annual costs (by which we mean total annual OM&A and annual Capital expenditures). Use at the aggregate level would ensure the least potential "skewing" of observations which could result from incompleteness or inconsistencies due to differences in definition or accounting practices across utilities. Use of this data would have two immediate benefits:

- It would enable the industry to start distinguishing between utilities (not for establishing a TFP analysis, but rather, for identifying the relative standing amongst utilities when viewed from this perspective.)
- It would help isolate best practices. The industry as a whole could benefit from identifying such practices and sharing the information on them. Doing so encourages the learning that leads to improvement.

As stated earlier, Hydro One believes that cost and performance comparison is an important and integral component in the evolution of incentive regulation in the electricity distribution sector. As regulation moves forward toward greater reliance on performance based regulation, the need for effective comparison of costs and benchmarking of utility performance is of paramount importance.

3 Commentary on Principles

Hydro One supports the principles in the SSP, and suggests that with some refinements, they could be strengthened. Economic regulation is the result of a number of outcomes that need

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[8] EB-2006-0268 – Comparison of Electricity Distributor Costs.
[9] *Ibid* – Hydro One Networks' Comments, June 26, 2007.

to be considered and balanced in order to ensure that customers are served at an appropriate level of service and charged a “fair and reasonable” rate, and we believe this balancing should be reflected in the principles driving the development of 3GIR.

Principle #1- The financial viability of the electricity distribution sector should continue to be balanced with the interests of consumers.

Hydro One suggests splitting this into two principles, focusing firstly on customers, then on the utilities, as follows:

> *Revised Principle #1 – The interests of customers with respect to price stability and the maintenance of service quality, reliability and adequacy should continue to be protected.*
>
> This revision focuses on customer needs only, and accordingly, includes consideration of their service needs and also, the need to minimize rate volatility (the Staff's Principle #4).
>
> As stated earlier, provision of service is a relevant cost driver which must be recognized in the 3GIR model, just as it would be in a Cost of Service model. In the absence of service quality regulation, there is a need to ensure that changing the framework of economic regulation will not adversely impact the provision of services to customers. The recognition that utilities must invest in order to maintain quality of service should be an explicit factor in the development of the incentive regulatory framework. The Board's resumption of work on this issue[10] is welcome and Hydro One again encourages the Board to integrate this into the scope of incentive regulation as soon as possible.
>
> With respect to rate volatility, Hydro One agrees that customers prefer to see stability in rates and charges and therefore rate volatility is a less desirable quality. Although some IR models in their basic form are more amenable to rate stability than others, Hydro One believes that there are adaptive mechanisms which can be used to smooth the rates which may result and recommends the development of such mechanisms, if needed.
>
> *New Principle #2 – A sustainable electricity distribution sector should continue to be promoted.*
>
> The Staff's stated Principle #1 could be interpreted to mean that a distributor's financial viability could be sacrificed to meet consumers’ interests, i.e. that financial viability could continue to be degraded as long as customers continued to receive electricity services at whatever cost. Hydro One does not believe that this is the essence of regulatory oversight, whatever the framework. In as much as the regulator exercises regulatory oversight to ensure that a utility charges “fair and reasonable” rates, this is not done in a manner that trades off financial viability with customer interests. Rather, the regulator considers the level of service that is required to meet customers’ needs and establishes “fair and reasonable” rates that may be charged. Under these conditions, customers may be required to pay higher rates because these reflect the costs that must

[10] RP 2003-0190, Service Quality Regulation for Electricity Distributors.

be incurred to provide the requisite level of service. Furthermore, financial viability is a rather narrow measure. Hydro One believes that pursuit of sustainability with its consideration of the distribution sector's overall health would be more appropriate. The concept also extends beyond consideration of the traditional electricity infrastructure to include CDM, Smart Meters and DG, and we believe, therefore, would be more acceptable to customers for that reason.

Principle #3 – The pursuit of economic efficiency should be encouraged.

It is not clear what is meant by "*greater economic efficiency*." Is the aim of 3GIR to lower prices and if so, which prices – distribution, total bill? And, furthermore, are these lower prices to come from improved operational efficiency, as the rationale to this principle in the SSP might suggest? What about the efficient use of Capital and the utility's choice of approaches which would best suit its financial and operating conditions? Hydro One is not being critical, merely suggesting that clearer definition is needed here.

Hydro One believes that regulatory efficiency for all participants also should be encouraged as an aspect of economic efficiency. Changing the form of regulation should not make the rate payers or the utility any worse off than they would have been under existing Cost of Service regulation. Therefore there is an expectation that changing the form of regulation will lead to greater efficiency and possibly a reduction in the regulatory burden without undermining the Board's regulatory oversight. Benefits of this improvement in efficiency must be realized by customers, the Board and the utilities.

Revised Principle #4 – The incentive regulation framework must be sustainable ***and sufficiently flexible to reflect utility circumstances.***

Hydro One supports the concept of a sustainable regulatory framework, which would allow a utility to focus on its business, implement new processes and realize the benefits of its efficiency improvements. Also, a sustainable approach provides the potential for an orderly process to evolve regulation towards a long-term goal which requires incremental adjustments without major interruptions and changes which impact negatively on a utility's ability to manage its business.

Hydro One notes that the rationale in support of this principle refers to the need for ensuring a "*..framework that may be uniformly applied (in terms of principles and methodology, but not necessarily the specific adjustments)…*". This appears to recognize the need for flexibility to deal with a wide range of distributor circumstances in Ontario. Hydro One fully supports recognizing this need and as such, feels that this ought to be elevated to the level of the principle. In this respect, Hydro One suggests the following addition in bold:

"*The incentive regulation framework must be sustainable* ***and sufficiently flexible to reflect utility circumstances.***

This change would also capture the thought that Ontario distributors are likely to encounter changes as a result of government legislation and regulations that mandate the provision of new services. As such, the regulatory models should be flexible to allow for the recovery of prudently incurred costs for these.

New Principle #5 -- Prudent investment should be encouraged.

The form of regulation should recognize those utilities which have an aging infrastructure that may require significant OM&A and Capital investments during the regulatory control period. Also, as noted previously, recognition of utilities' investments to continue with CDM, Smart Meters and DG, is needed. In respect of Principle #4, the regulatory framework should be sufficiently flexible to permit those utilities faced with these issues to adjust the rate base as appropriate during the control period to ensure they recover the necessary costs to finance this need.

4 In Summary

The development of incentive regulation promises more efficient regulation that should benefit the electricity utilities, their customers and the regulator. Hydro One appreciates and supports wholeheartedly the effort that the Board is marshalling for this undertaking.