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File 15917

VIA COURIER AND EMAIL

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
27th Floor, 2300 Yonge Street
Toronto ON M4P 1E4

Dear Ms. Walli:

**Re: PWU Comments on Board Staff Scoping Paper – 3rd Generation
Incentive Regulation for Electricity Distributors, EB-2007-0673**

The PWU represents a large portion of the employees working in Ontario's electricity industry and has the utmost interest in regulatory proceedings that impact the energy industry and the provision of on going service quality, reliability and safety to customers. Attached please find a list of PWU employers.

The PWU is pleased that Board staff has selected our nominee, Judy Kwik, Senior Consultant, Elenchus Research Associates to participate on the 3rd Generation Incentive Regulation Stakeholder Working Group and provide Board staff with assistance on our behalf.

Attached please find the PWU's comments on the Ontario Energy Board Staff Scoping paper on 3rd Generation Incentive Regulation for Electricity Distributors. We have included three paper copies, and as well have forwarded an electronic copy to you via email.

We hope you will find our comments helpful.

Yours very truly,

PALIARE ROLAND ROSENBERG ROTHSTEIN LLP


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List of PWU Employers

Atomic Energy of Canada Limited (Chalk River Laboratories)
Barrie Hydro
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brighton Beach Power Limited
Bruce Power Inc.
Corporation of the City of Dryden - Dryden Municipal Telephone
Corporation of the County of Brant
Electrical Safety Authority
EPCOR Calstock Power Plant
EPCOR Kapuskasing Power Plant
EPCOR Nipigon Power Plant
EPCOR Tunis Power Plant
Erie Thames Services Corporation
Goldman Hotels Inc. - Hockley Highlands Inn & Conference Centre
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
Lake Superior Power (Brookfield Power)
London Hydro Incorporated
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
Mississagi Power Trust (Brookfield Power)
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Nuclear Safety Solutions
Ontario Power Generation Inc.
Orangeville Hydro Limited
PUC Services Inc.
Sioux Lookout Hydro Inc.
Sodexo Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation

EB-2007-0673

**Power Workers' Union
Comments on Board Staff Scoping Paper on
3rd Generation Incentive Regulation for
Electricity Distributors**

September 21, 2007

1. Introduction

By way of a notice issued on August 2, 2007 the Ontario Energy Board ("OEB" or "Board") initiated its consultation on the development of the principles and methodology for the third generation incentive regulation mechanism ("3rd Generation IRM") for electricity distributors. It is the Board's intent to first apply the 3rd Generation IRM in the 2009 rate year for those distributors whose rates will be rebased in 2008. The August 2, 2007 Board notice invited comments on Board Staff Scoping Paper on 3rd Generation IRM ("Scoping Paper") which sets out staff's proposals related to key issues to be considered in the consultation process. At present the electricity distributors are on 2nd Generation IRM, which the Scoping Paper describes as a "simple, practical and mechanistic price cap rate adjustment mechanism".

The following are the comments of the Power Workers' Union ("PWU") on the Scoping Paper. The PWU's comments stem from our energy policy statement:

Reliable, secure, safe, environmentally sustainable and reasonably priced electricity supply and service, supported by a financially viable energy industry and skilled labour force is essential for the continued prosperity and social welfare of the people of Ontario. In minimizing environmental impacts, due consideration must be given to economic impacts and the efficiency and sustainability of all energy sources and existing assets. A stable business environment and predictable and fair regulatory framework will promote investment in technical innovation that results in efficiency gains.

2. General Comments - OEB's Vision of a Long Term Regulatory Framework

The PWU believes that it is essential for the OEB to have a vision of a long-term regulatory framework for electricity distributors in order to achieve the Board's regulatory objective(s), consistent with the articulated principles. The lack of such a vision will result in the move from one arbitrary regulatory approach/mechanism to the next, as demonstrated by the current "simple, practical and mechanistic price cap rate adjustment mechanism" that is in place for 2nd Generation IRM. Such an approach, while addressing an objective of regulatory expediency, does not ensure on going financial sustainability for the distributors, nor rate stability and on going service quality performance for the consumers. As such it does not address objectives of regulatory effectiveness or efficiency.

The OEB's regulatory framework should provide the roadmap towards a construct of regulatory effectiveness. Such a framework must integrate service quality (including service quality and reliability, customer service and safety) and distribution system performance. This requires establishing the socially optimal level of service quality (e.g. through Willingness to Pay surveys) and the associated operation, maintenance and administration ("OM&A") and capital costs to reach such quality. If the OEB's long-term vision is an incentive regulation ("IR") framework, then IR mechanisms would be used to incent the distributors to efficiently meet the socially optimal level of service quality.

In a September 11, 2007 notice the Board indicated that it will be carrying out consultations on three matters that relate to incentive ratemaking over the next few months:

- the development of 3rd generation incentive regulation;
- a comparison of distributor costs; and
- a review of service quality regulation.

No doubt, these three elements are indispensable and critical building blocks for the Board's long-term vision. Unfortunately, despite acknowledging the important interrelationships among the above three matters, the notice indicates that the three initiatives will follow individual implementation plans. The PWU strongly submits that the

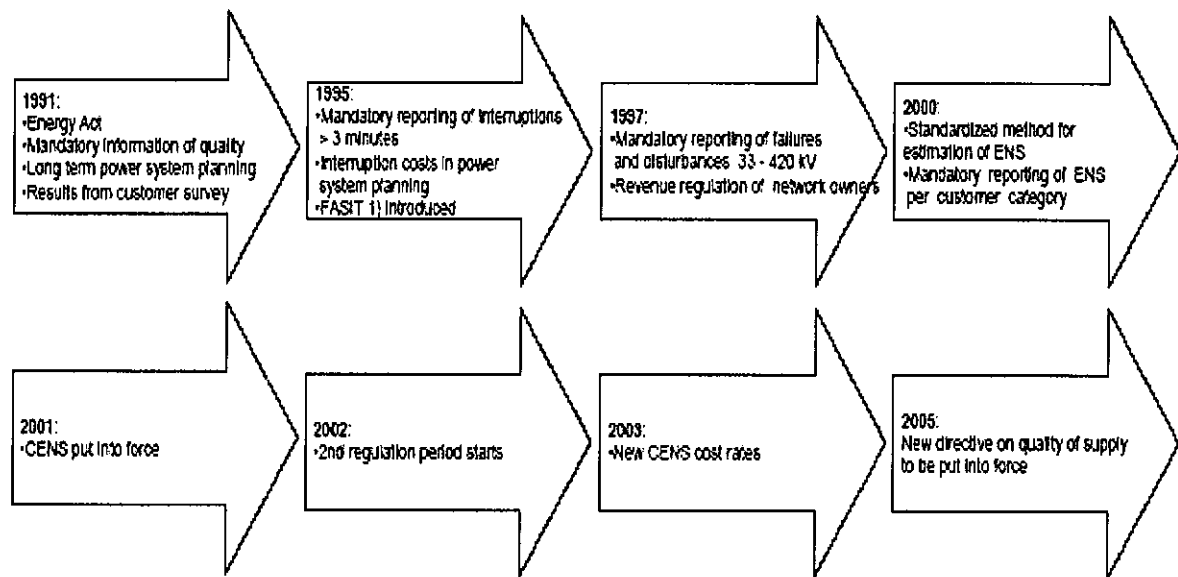
three matters must be considerations within a common regulatory framework and be implemented as a single initiative to provide the necessary balanced regulatory framework.

This consultation on 3rd Generation IRM provides the opportunity to develop a vision for the Board's long-term regulatory framework for electricity distributors that encompasses and incorporates all three matters. Should the regulatory framework envisioned require a longer period of time to attain than anticipated by the Board in its multi-year rate setting plan for the electricity distributors, the Board should take the time required to get the framework right. In the meantime the Board should follow the roadmap that will take it towards the construct of regulatory effectiveness.

An illustration of a roadmap towards an effective regulatory framework is the roadmap followed by the Norwegian ("NVE") in its regulation of the 200+ electricity distributors that it regulated at the time. Initially, the NVE set the rates based on cost of service for three years while gathering and assessing data and information on alternative regulatory designs upon which to proceed. Second, the NVE initiated a short IRM with a constant X factor for all distributors. Third, both temporal and cross section Data Envelopment Analysis ("DEA") benchmarking on total cost was used to identify the most efficient distributors and the rate of productivity growth. The NVE then implemented a five-year IR plan with both a constant and a variable X factor; the former to represent the growth of productivity among frontier LDCs and the latter to account for individual LDC's inefficiency. Recognizing the need for a phasing-in period, only about 40 percent of this inefficiency was expected to be eliminated during that upcoming five-year term. Fourth, at the start of the third IR term, the NVE introduced the concept of "cost of energy not supplied" ("CENS") within the IR framework to ensure appropriate service quality levels. CENS allows the NVE and LDCs to establish socially optimal levels of reliability and the correct operating and capital budgeting to reach these levels. Over the 1990's the NVE had collected data on reliability and examined approaches to incorporating this information into IR as illustrated in NVE's flow chart below (Figure 1). Norway's experience is described in more detail in the PWU's June 26, 2007 submission in the

Board's consultation on the comparison of distributor costs prepared on behalf of the PWU by our expert consultant, Dr. Frank Cronin¹.

Figure 1: Development of Quality of Supply Regulation in Norway



Source: Kjell Sand, Knut Samdal, Helge Seljeseth SINTEF Energy Research. Quality of Supply Regulation – Status and Trends.

It is well known that IR provides regulated utilities with different incentives than does cost of service with respect to profits, costs, and service quality. One study examined the effects of IR on OM&A expenses and service performance. Ter-Martirosyan (2002) examined the effects of IR on electricity distributors' OM&A and quality of service.² The author uses data from 1993 – 1999 from 78 major US electric utilities from 23 states. Ter-Martirosyan found that IR is associated with a reduction in OM&A expenditures. The author found that such reduced OM&A activities are associated with an increase in the average duration of outages per customer, System Average Interruption Duration Index (SAIDI). Importantly Ter-Martirosyan's analysis concludes that the incorporation of strict reliability standards with associated financial penalties in an IR plan can offset the tendency of IR plans without standards and penalties to imprudently cut critical OM&A activities.

¹ http://www.oeb.gov.on.ca/documents/cases/EB-2006-0268/pwu_peg-comments_200700704.pdf

² Ter-Martirosyan, A., "The Effects of Incentive Regulation on Quality of Service in Electricity Markets," Working Paper, 2002.

Ter-Martirosyan found that utilities with IR plans without standards reduced their expenditures throughout the time period of the analysis, falling by 37 percent. On the other hand, utilities with IR plans with standards and penalties increased their expenditures in every year of the analysis by 17 percent. The former utilities were found to have had a 64 percent increase in SAIDI and a 13 percent increase in System Average Interruption Frequency Index (SAIFI). The latter utilities were found to have 26 percent decrease in SAIDI and a 23 percent decrease in SAIFI.

The PWU believes that it is imperative that the Board explicitly incorporate service quality and reliability incentives within the IR framework. The issue of reliability and IR is discussed in more detail in the PWU's June 26, 2007 submission in the Board's consultation on the comparison of distributor costs prepared on behalf of the PWU by our expert consultant, Dr. Frank Cronin³.

3. Specific Comments – Scoping Paper

Below are the PWU's comments on the staff's proposals related to key issues to be considered in the consultation process.

Initiatives that May Affect Electricity Distribution Rate-making in the Coming Years

Among the initiatives identified in the Scoping Paper that may affect electricity distribution rate-making in the coming years are: cost allocation filings; distributors' conservation and demand management ("CDM") activities; distributed generation; developments in metering; review of distribution rate design; review of service quality indicators and standards; and the review of an IR framework for natural gas distributors currently underway.

In addition to the above, the PWU would submit that the outcome of the comparison of distributor costs initiative will have an intricate impact on electricity distribution rate making that cannot be implemented without consideration of impact on rate-making. In addition the Ontario Power Authority's initiative on Load Serving Entities ("LSE") and the

³ http://www.oeb.gov.on.ca/documents/cases/EB-2006-0268/pwu_peg-comments_200700704.pdf

Independent Electricity System Operator's initiative on a Day Ahead Market ("DAM") if implemented, and depending on how they are implemented, may have, at minimum, indirect impact on electricity distribution rate making.

Principles Underlying the Development of 3rd Generation IRM

The Scoping Paper states that:

Regulation that promotes economic efficiency in the energy sector ultimately serves the best interests of ratepayers, investors and the province as a whole. Incentive regulation, benchmarking and service quality standards are all tools that contribute to the advancement of that aim.

Building upon this foundation, Board staff believes that the Board's statutory responsibility is best fulfilled, and its statutory objectives in relation to electricity are best promoted, using multi-year rate-setting methodology that is designed on the basis of the following principles:

- 1. The financial viability of the electricity distribution sector should continue to be balanced with the interest of consumers...*
- 2. The pursuit of economic efficiency should be encouraged...*
- 3. The incentive regulation framework must be sustainable...*
- 4. Rate volatility should be minimized...*

The Scoping Paper goes on to state that:

In addition, the rate-setting methodology should be predictable, understood by all participants, and capable of implementation through a regulatory process that is efficient while at the same time addresses the concerns of interested parties and ensures openness and transparency. The costs of administering the methodology, including the costs imposed on all participants, should not exceed the benefits to be derived from the methodology.

While IR is a regulatory approach that applies incentives in the determination of just and reasonable rates, the Scoping Paper's discussion on principles underlying the development of 3rd Generation IRM, does not explicitly reference just and reasonable rates. Specifically, IR should encourage improvements in economic efficiency by providing appropriate pricing signals and a system of incentives to maintain a socially optimal level of reliability and quality of service. Specific articulation of this principle is missing from the Scoping Paper and should be incorporated.

In addition, and based on an examination of the Board's earlier articulation of principles for first generation performance based regulation ("PBR") *Ontario Energy Board Draft Policy on Performance Based Regulation*, October 2, 1998⁴, the following provisions, while in at least one case is identified as implicit in the principles set out in the Scoping Paper, should be set out explicitly:

- A provision for the fair allocation of benefits from greater efficiency between the utility/shareholder and the customers.
- A provision that addresses flexibility for the handling of changing and varied circumstances between distributors.
- A principle that facilitates the use of efficient processes within the IR framework.

Issues Regarding the Development of 3rd Generation IRM

The PWU agrees with topics identified in the Scoping Paper that need to be addressed in the consultation process:

- Necessary elements of an IRM framework.
- Capital investment.
- Lost revenue due to changes in electricity consumption.
- Distributor Diversity.

While we agree that the necessary elements of an IRM framework must be discussed, consistent with our general comments above, we see the elements of an IRM framework as considerations within a vision of the long-term regulatory framework: IR methods including the application of benchmarking approaches, service quality regulation, and a roadmap of how to attain the long-term regulatory vision.

⁴ http://www.oeb.gov.on.ca/documents/cases/RP-1999-0034/Draft_Policy.PDF

Approach and Overall Project Timeline

Board Staff proposes that:

.. this consultation involve consultation documents, adequate response periods, stakeholder consultation conferences, and the use of a stakeholder working group. Staff will also work with an expert consultant to carry out necessary supporting data analysis. Results of discussions and analysis with stakeholders will inform the Board's report on 3rd Generation IRM.

As indicated earlier in this submission, for this consultation to result in a balanced long-term IR framework, it is necessary for service quality regulation and benchmarking to be considered in the framework. The Board's September 11, 2007 notice sets out a timeline that incorporates the timelines for 3rd Generation IR, service quality regulation and comparison of distributors' costs as three separate initiatives. As such the Board's timeline does not include the time required for the integration of these three matters. Further, the Board presumes notice of code amendment for service quality regulation will be issued in January 2008 in the absence of any consideration of the current state of service quality regulation and its role in the rate setting process. The Board therefore should consider that its timeline may only get it on to the road map toward a long term target comprehensive IR framework.

In the PWU's view, it would be a serious error for the Board to complete the proposed processes without, at a minimum, merging the 3rd Generation IR and service quality regulation initiatives. The entire philosophy of IR is that the industry and customers are better served if LDCs are permitted to manage their businesses in pursuit of properly structured economic incentives. However, it simply cannot be said that the incentives given to LDCs are "properly structured" if their effect is to encourage LDCs to permit service quality and reliability to be degraded. Empirical evidence demonstrates that this tendency is effectively countered, not by prescriptive standards, but rather by financial penalties (and rewards) which force the LDCs to internalize the economic consequences to their customers of service quality and reliability degradation.

Critically, in order to hope to achieve optimal results, the economic incentives of IR must be carefully balanced with the economic incentives of service quality and reliability rewards and penalties. One cannot be determined in isolation from the other. They are

two sides of the same coin. They must be considered to be different aspects of an integrated whole, rather than discrete concepts.

As a result, the PWU urges the Board to merge its service quality regulation initiative into its 3rd Generation IR initiative, at the earliest possible opportunity.

These are the PWU's comments on the Scoping Paper on 3rd Generation Incentive Regulation for Electricity Distributors.