Ontario Energy Board Hearings

RP-2004-0020

Review of Further Efficiencies in the Electricity Distribution Sector

A Joint Submission by Hydro Vaughan Distribution, Richmond Hill Hydro & Markham Hydro Distribution

February 18, 2004

Perspective

- We welcome the opportunity to provide input into the consultation process
- OEB is to be commended for its leadership and being receptive to stakeholders concerns
- Well written OEB discussion paper provides excellent framework to generate discussion of issues
- Important to allow enough time to have complete and well organized stakeholder input

Joint Submission

- Markham Hydro and Hydro Vaughan jointly own Richmond Hill Hydro, which has proven to be a successful partnership
- Represent 190,000 customers across the three distributors
- Contiguous utilities – high rate of customer and electricity load growth (5%+ over past number of years) with a mix of residential, commercial and industrial customers

Industry Direction

- The Macdonald Report and White Paper outlined several industry changes including further rationalization, pursuit of best practices and a cost competitive distribution sector
- LDCs were to be allowed to earn a commercial rate of return – 3rd step MARR required on current investment

Meeting of Large Distributors

- Ten of the largest distributors with 60%+ of the customer base across the province met just prior to OEB oral consultation to discuss further sector efficiencies
- Although the timing of release of the OEB discussion paper and oral presentations did not allow for a joint submission, considerable common ground was identified

Meeting of Large Distributors (cont'd)

- Strong support expressed for further voluntary consolidation
- Voluntary approach would be more effective in realizing synergies.

Support for Voluntary Consolidation

- Efficiencies expected across numerous functions through reduced duplication and economies of scale:
  - Call centre and customer service
  - Operations – line work, connections and emergency response
  - System planning and capital investments
  - Administration, systems, fleet and facilities

Controllable Structural Efficiency - Size

- Regulatory efficiencies will be realized through consolidation for regulatory agencies such as the OEB, IMO and the Ministry of Finance.
- Certain savings are only achieved through structural changes (ie: elimination of control room duplication)

Controllable Structural Efficiency – Size (cont'd)

- System Planning – savings through standardized equipment, avoided system costs and duplication. Better asset utilization resulting in an indefinite capital cost deferral
- Adequate scale also required to effectively resource regulatory rate design and stakeholder skill sets required of LDC sector in evolving Ontario market

Controllable Structural Efficiency – Size (cont'd)

- Minimum scale required to undertake new technological initiatives (e.g. DSM & DR)
- LSE risk implications to core LDC business must be considered. Proper regulatory framework needs to be in place if LDCs are going to be in this business
- Sufficient size may facilitate credit-rating status
- Larger LDC better able to handle risk management

Shared Services Model

- Wholesale settlements process delivered through our outsourced alliance (Upper Canada Energy Alliance) having 300,000 customers has significant cost benefits – but only one function

Shared Services Model (cont'd)

- Amalgamation should lead to more savings in other areas as opposed to what may be available under a shared and/or specialized services model. For example:
  – administrative overhead costs associated in consensus building/decision making in cost-sharing arrangements can erode business case of Shared Services Model

Synergy Characteristics

- Operational, planning and infrastructure investment synergies achieved more effectively through contiguous distributors
- Back office, administration and IT systems efficiencies achieved even when non-contiguous but efficiencies may diminish across greater distance.

Uncontrollable Structural Efficiency

- Increased load and higher density of contiguous service areas result in lower unit costs and allow for improved service
- High load and customer growth result in challenges that need to be closely managed.

Uncontrollable Structural Efficiency (cont'd)

- Benefit of high growth partly offset in the short-term by funding requirement for capital infrastructure investment and expansion. For example:
  - System planning and timing of capital investments
  - Regional road and infrastructure expansion

Transfer Tax

- Most consolidation occurred just prior to end of transfer tax exemption in November 2000.
- Could broaden to allow more private equity beyond 10% as most LDCs are leveraged to deemed capital structure

Transfer Tax (cont'd)

- In considering an amalgamation, a full understanding of the financial and operational implications of PBR II would be beneficial
- Current tax exemption window of spring 2005 may not be long enough for significant consolidation as larger deals require time for efficiency studies, due diligence and negotiations

Transition Costs - Barriers to Consolidation

- Transition costs and past investments are barriers to consolidation because:
  – they are not easily negotiated in amalgamations (capital infrastructure, systems, salary structures, outsourced contracts, etc.)
  – the transition to combined distributor (from 2 or more) requires additional one-time costs for workforce, systems, fleet and facilities integration
  – there is currently no mechanism to address these costs in the short-term to achieve the on-going savings

Government Should Facilitate

- Province owns considerable distribution assets and should take a direct role to facilitate consolidation in areas where significant rationalization and synergies can be realized.
- This would allow some LDCs to increase in size and achieve a minimum efficiency threshold

Need to Establish Stable Regulatory Framework

- Incentives to encourage efficiencies
  - Retain cost savings over period of time
  - Recover transition costs
- Need to advance rate reform process and initiate cost of service/cost allocation studies to establish rates that adequately reflect costs

Stable Regulatory Framework

- Define PBR II
  – Need to know the “rules” to assess rate, financial, customer and operational benefits arising from consolidation. What are the criteria?
    - Geography?
    - Density?
    - Growth rates?
  – LDCs with very high or very low growth factors should be considered in criteria.

Stable Regulatory Framework (cont'd)

- Benchmarking needs to address inherent system differences & issues but should also be used to drive improved performance
- Benchmarking needs to distinguish efficiency factors that are controllable or are beyond the control of the LDC.

Hydro Vaughan Distribution Inc. Richmond Hill Hydro Inc. Markham Hydro Distribution Inc.

Efficient Regulatory Framework

- While we are encouraged by the OEB's proactive approach to restructuring, we recommend the following changes to the MAAD application procedure:
  - Streamline application and review process to expedite consolidation
  - Clearly define regulatory expectations
  - OEB needs to dedicate sufficient resources

Efficient Regulatory Framework (cont'd)

- Need to establish fixed and appropriate timelines to act upon OEB applications, consultations, hearings, Minister's Directive, filings, submissions, etc.

Summary

- Need further consolidation to achieve operational and structural efficiencies
- Voluntary preferable
- Remove barriers to consolidation - ability to recover transition costs and past investments

Summary (cont'd)

- Incentives should be put in place to encourage consolidation
- Allow shareholders to share in efficiency gains
- Urgent need to provide regulatory certainty