

**Response of Direct Energy to Board Staff's Discussion Paper on the  
Review of Further Efficiencies in the Electricity Distribution Sector**

**February 19, 2004**

**RP-2004-0020**

**I. Introduction.**

Direct Energy is Canada's largest unregulated energy services retailer. With the completion of the pending acquisition of ATCO's customer base in Alberta, we will have over 5 million customers across North America. Our parent company, Centrica plc, has over 45 million energy and essential services customer relationships worldwide.

In Ontario, Direct Energy serves 1.9 million households, representing approximately half the provincial total. Those customers take 2.8 million energy and services products from us. Our products and services include: fixed price electricity and natural gas supply contracts; water heater rentals and servicing; heating, ventilation and air conditioning equipment sales, service and protection plans; plumbing protection plans; and home renovation/energy efficiency products and services.

Through Direct Energy Business Services, we provide integrated energy solutions including a comprehensive suite of energy supply and usage services to commercial customers, including load management services through either on-site or remote control of our customers' heating, cooling, lighting, refrigeration and other energy consuming operations.

Given this experience and knowledge of the electricity market, Direct Energy wishes to provide input into the Ontario Energy Board Staff Discussion Paper entitled *Review of Further Efficiencies in the Electricity Distribution Sector* (the *Discussion Paper*"), issued on February 10, 2004.

**II. Points for Discussion**

A. Efficiencies

The *Discussion Paper* reviews 3 different types of efficiency factors affecting the LDCs:

- i) Operational efficiency - related to the cost of providing service without materially impacting service levels.
- ii) Controllable structural efficiency – gains through restructuring (e.g. sharing of services, consolidation).
- iii) Uncontrollable structural efficiencies – related to output and customer density.

In the current market structure, LDCs provide a range of services to customers either directly or through an outsourcing arrangement with third parties. These include: ownership, operation and maintenance of the distribution network; metering and billing; customer care; system supply service. There is also a potential role for LDC's in the delivery of demand side management measures.

Direct Energy's position is that an analysis and definition of the roles and responsibilities of an LDC would strengthen the Board's analysis of efficiencies in the distribution sector. That analysis is missing from the *Report*. In particular, Direct Energy observes as follows:

- a) In considering how the efficiency of the LDC sector may be improved, a functional review at the activity level would greatly assist Board Staff and interested parties to identify the areas of inefficiency, the causes for such inefficiencies, and remedies that would eliminate or mitigate such inefficiencies.
- b) A functional review at the activity level approach would likely indicate that both the source of and best remedy for any inefficiency in one activity (such as the wires management) are very different from those in another activity (such as customer care). Accordingly, the economic and regulatory policies required to address any inefficiency in different activities would likely also be different.
- c) For example, an LDC might be efficient in comparison to its peers in one activity and not in another (for instance, the wires function versus billing and customer support). The competencies required across the two activities are different and there is little reason to believe that an LDC will be equally efficient across the two functional categories.

## B. Consolidation

Direct Energy supports further consolidation of LDCs. Such consolidation would promote business standardization and facilitate commercial transactions among market participants. For example, enhancing interface compatibility would reduce manual activities and minimize costs necessary to complete business transactions.

In particular, Direct Energy observes as follows:

- a) Through consolidation, further efficiencies based on scale economies may be achieved in distribution, especially in the case of LDCs whose service territories are contiguous or proximately located. Such consolidation could reduce capital costs, and operating and maintenance expenses.

- b) In contrast, consolidation of functions such as procurement, customer care and information technology is not constrained by geographical boundaries. The efficient scale of operations in these activities are likely to be larger than the efficient scale in the pure “wires” functions due to the ability to spread fixed costs over a larger customer base.
- c) Consolidation must be carefully managed and cautiously exercised such that detrimental impacts to IT infrastructure and data integrity are minimized.
- d) The Board should not mandate the scope or pace of consolidation. Those decisions should be left to the LDC managers and shareholders, acting on the basis of the efficiency incentives provided by an appropriate performance-based regulation framework.

C. Performance Based Regulation (PBR)

Direct Energy suggests that the best way to increase efficiencies in the distribution sector is by creating appropriate regulatory incentives for LDCs through performance-based regulation (PBR). In particular, Direct Energy notes as follows:

- a) Several years ago the OEB launched a process to develop a second-generation PBR mechanism. Such a mechanism has the potential to create efficiency incentives without requiring the OEB to oversee or dictate specific LDC management and investment decisions.
- b) The implementation of PBR mechanisms for the distribution function in other jurisdictions has produced significant benefits for customers. For example, in the U.K., prices paid by customers in the regulated distribution sector fell by approximately 30% over the period 1995 to 2000. Analysis performed for the UK regulator, Ofgem, suggests that UK distributors achieved a 3.2% average annual improvement in efficiency for the period 1998 to 2002, on top of previous efficiency improvements.

D. The Role of Load Serving Entities (LSEs)

The *Discussion Paper* refers to the suggestion, in the *Report of the Energy Conservation Supply Task Force*, that, over time, a number of commercial LSEs could assume the responsibility for the standard supply service function as described in that report.

If policymakers move in the direction of LSEs, Direct Energy's view is that LDCs, as regulated wires service providers, should not discharge that potential LSE function. There are a number of reasons for this position, as set out below:

- a) LDCs have not historically nor do they currently undertake a procurement function on behalf of their customers. Distribution utilities do not have an established core competency in respect of procurement of supply. Experience in other jurisdictions (such as the experience of several municipal utilities in the United States) suggests that substantial financial losses may be faced by municipalities and customers if municipal utilities, without fully developed procurement and risk management skills and systems, are required to procure power in wholesale markets.
- b) A regulated distribution utility participating in non-core functions increases shareholder risk and potentially increases its cost of capital.
- c) As noted in the *Discussion Paper*, some of the LDCs may not be creditworthy as counterparties in the energy market with little to offer as collateral without subjecting consumers to increased risk.
- d) Commercial entities, acting under ordinary business incentives, are better placed than regulated institutions, such as LDCs, to assume the role of LSEs. With established skills and knowledge entrenched in a market-based framework, they can assume the responsibility for managing commodity price risk.
- e) If shareholders of an LDC wish to participate in the market as an LSE, they should do so through an entity other than the LDC, subject to appropriate rules regarding affiliate transactions.
- f) The separation of the LDC and LSE functions would promote a level playing field between the LSE and other service providers and would mitigate any potential cross-subsidization between the distribution and the supply functions.
- g) Such a separation of the higher risk procurement function from the lower risk wires function would allow the aggregate level of risks faced by LDCs and their municipal government owners to be sharply reduced. This could have positive impacts on the cost of capital for LDCs and municipalities, and would allow LDCs to focus on their existing critical competencies in operating and expanding the distribution network for the benefit of customers.
- h) By limiting the LDCs to regulated distribution functions, the emphasis of these organizations can be focused on their key areas of responsibility: system reliability, system safety, and continued non-discriminatory access to the distribution system.

Direct Energy suggests that if the policymakers decide to pursue the LSE model, they should consider the advantages of making the LSEs responsible for customer care and

billing as well as procurement functions. Only LSEs with both: 1) significant experience in the wholesale market and 2) direct relationships with customers can effectively incorporate demand response and energy efficiency measures into their pricing and procurement decisions. In order to manage demand response measures and the procurement function effectively, the LSEs will need to understand the cost and reliability of demand response programs. They will also need to know the impact that such programs have on load curves. Consequently, LSEs will need to know customers' usage patterns and characteristics, and the effects that demand response measures have on consumption. This would in turn enable LSEs to define both peak-shaving opportunities and the avoided costs stemming from demand response programs. Confining LSEs to a simple wholesale procurement function would impair the implementation of these important policies.

### **III. Recommendations**

Based on the aforementioned discussions, Direct Energy provides the following recommendations:

- The OEB should conduct a functional review at the activity level to assist in identifying further potential efficiencies.
- Consolidation in the distribution sector should be encouraged.
- Further efficiencies can be achieved through Performance-Based Regulation.
- The “wires management ” function is qualitatively different from the “energy procurement/retail supply” function.
- LDCs should not fulfill any LSE function.

Direct Energy appreciates the opportunity to provide input to Board Staff regarding its *Review of Further Efficiencies in the Electricity Distribution Sector*.