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# ELECTRICITY DISTRIBUTORS ASSOCIATION

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The Voice of Ontario's Electricity Distributors

EDA Response to  
Ontario Energy Board  
Staff Discussion Paper entitled:

## Review of Further Efficiencies in the Electricity Distribution Sector

February 19, 2004



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## 1. EDA Who We Are

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The Electricity Distributors Association (EDA) is in a unique position to comment on the consultation process concerning further efficiencies in the electricity distribution sector. The Association has a breadth of knowledge about the sector, and are intimately familiar with the players involved in distribution in the province. The EDA is the voice of Ontario's local electricity distributors. There are 95 privately and publicly-owned Local Distribution Companies (LDCs) in Ontario.

The EDA provides members with:

- Advocacy and representation in the legislative and regulatory environment and the electricity market in Ontario
- Up-to-date, expert analysis of relevant legislation and market rules, with a particular focus on regulation
- Networking opportunities for communication with professional and industry colleagues

The EDA focuses its resources and efforts on three core businesses: advocacy, information and analysis, and networking. We identify, manage, and articulate the significant issues and opportunities affecting member businesses and ensure a collective response to industry challenges.

### **Advocacy**

The Association champions and fosters an environment where electricity distribution companies can successfully achieve their individual business objectives with minimal, yet fair and effective regulation.

Through focused and intensive research, coupled with direct contact with members, government ministries, the Ontario Energy Board (OEB), the Independent Electricity Market Operator (IMO) and other bodies, the EDA's advocacy group thoroughly analyzes and proposes changes to the business environments of the province's LDCs.

### **Information and Analysis**

The EDA provides consistent, timely, credible and value-added communications. We don't just provide information, we provide analysis of the array of issues and legislative matters that LDCs just can't find anywhere else. The EDA provides members with up-to-date, expert analysis of relevant legislation and market rules, with a particular focus on regulation.

### **Networking**

The EDA has regular, innovative forums and networking opportunities for communication with professional and industry colleagues. This includes participation in such venues as Association Councils, Districts and industry-based taskforces.

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## 2. Introduction

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The search for increased efficiencies in the distribution sector is a very important issue and the EDA welcomes the opportunity to address it with full and meaningful consultations. The issue of efficiencies and specifically rationalization or amalgamation, has been percolating for some time in Ontario and further consideration of the issue warrants discussion. While the need for discussion is readily evident, all participants in Ontario's electricity distribution sector (policy makers, regulators, and distributors) must be careful not to rush to judgment in an effort to implement a particular business plan or policy vision without fully understanding the sector.

These consultations are an important first step. The EDA's participation in this process will ensure that any changes contemplated, as well as any adjustments to the status quo, are done in the best interests of local distributors.

The EDA is a welcome participant in the OEB led consultation, and has already begun its own consultation process that is looking at the current status of the distribution sector, the reasons for any change, and some suggested structures of what the sector might look like in an 'ideal' world. This includes all available options, from a structure model of one distributor, to a model that reflects the status quo.

The EDA began its consultation process in October 2003. The Association realized that by taking a proactive stance on the issues, the distribution sector would be prepared to actively participate in industry discussions which were likely to occur with government, the IMO, and the OEB. In order to provide solutions that were grounded in fact, had industry consensus, and would result in the desired benefits being achieved, we realized that the consultation process would likely take a number of months and that too much was at stake to rush to a decision.

We have established a research team to report its findings on the current state of the sector, and to suggest some alternatives. As their work wraps up, we will embark on an ambitious consultation process to solicit the input of our members. The EDA will be holding a LDC open forum as well as conducting EDA district meetings with our members in order to solicit input from all areas of the province.

Once the EDA has completed its internal consultation process, we would happy to share our thoughts in future steps in the OEB's consultation process. We anticipate that the paper will be completed in the spring of 2004.

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### 3. Conditions Precedent

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The EDA strongly believes that there must be the proper conditions precedent in place prior to any move towards rationalization within the distribution sector in Ontario.

First and foremost, there needs to be a clear definition of the roles of each of the market participants. If changes to the distribution sector are contemplated in the near future, prior to what is likely to be further market redesigns, the sector may be changed, or the status quo maintained to reflect a vision of the market that is outdated, only to force change again in the near future.

Ontario must also ensure that it has a clear regulatory environment, free from political interference, if it is to be certain that any future developments in the market will not be undone by decisions that are not in the best interest of that market.

Distribution companies have been particularly hard hit in recent years as a result of numerous policy changes. They have been asked to make significant investments with the understanding of not only recovering those investments, but also earning a rate of return that is sufficient to maintain and build on those assets. While the government's passage of Bill 4 certainly takes the distribution sector in a positive direction, the continued uncertainty as to what the next month or year will hold, makes investment in LDCs less certain.

The EDA believes that prior to any move on rationalization, all LDCs must be allowed the opportunity to earn the same rate of return (up to 9.88%) in order to ensure that no one LDC has an advantage over another in any rationalization talks. The EDA recognizes that for various reasons, municipal shareholders may desire a lower rate of return for different reasons such as economic development plans. Currently, each LDC is on a different financial footing depending on what rate of return the OEB set for them prior to the rate freeze as part of Bill 210.

The proper conditions precedent must be in place prior to any move on the part of the OEB or the government to initiate a rationalization plan in the distribution sector.

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## 4. Suggestions for the OEB's First Steps.

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As the OEB begins what is sure to be a long and difficult consultation process on the future of the distribution sector, it is important that time be spent on three critical steps in order to ensure that the process is both well defined and successful.

The OEB should first consider setting some guiding principles, determining a period of time for relevant fact gathering, and then dedicate some significant resources to the objective evaluation of information.

The consultation paper that was issued by OEB staff was designed to solicit the gathering of facts. The time frame given to provide feedback was not sufficient to comprehensively gather relevant and meaningful facts and the paper itself raises too many questions for it to be the basis of a fact gathering process (see section 9).

### Guiding Principles

The EDA believes that there are certain overarching principles that must be considered when discussing the potential for changes in the distribution sector. The OEB may be well served by establishing a set of principles so that all individuals and businesses understand what exactly it is that OEB hopes to achieve by conducting these consultations.

The setting of guiding principles ensures that Ontario does not engage in change for the sake of change, but rather to achieve some pre-determined goals. For many years in Ontario the distribution sector has anecdotally been referred to as inefficient and in need of change.

The electricity sector has gambled and lost numerous times in recent years on models that were tested and implemented in other jurisdictions, but did not work in Ontario. While the sector may indeed have to change, approaching a consultation of this importance without contemplating the need for it, may in fact lead to a negative outcome for all involved if it is not conducted within the parameters of some specific principles.

Without guiding principles, perspective may be lost.

### Gathering of Facts

Only after the guiding principles have been established can the OEB gather relevant facts to support the consultation process. Information gathering should not only focus on the facts for change, but also on the current structure.

The EDA anticipates being a willing participant through the entire consultation process and while the association is an eager participant in this first step, it is hopeful that subsequent steps will consider the question of timing. In order for this consultation to gather the relevant facts it is

critical that the OEB and other players spend some time evaluating the sector, and current policies that govern the sector, once they have been fully implemented and given time to mature.

As the EDA and the OEB know, the effects of recent turbulent times have had a detrimental effect on the distribution sector. Despite all of these troubling developments over the past number of years, the distribution sector and the players in it have continued to deliver safe and reliable electricity to their customers while operating without the planned regulated rate of return with which they were set up to operate.

The distribution sector in Ontario has not been given the chance to mature in the open market. In order for this consultation to be complete, the impact of a full rate of return for all LDCs, as well as the implementation of Performance Based Regulation (PBR), must be considered. Without these components, decisions to change the sector would not be based on an accurate understanding of what the sector looks like when functioning as designed.

### **Objective Evaluation of Information**

Once principles are set and information gathered, the objective evaluation can begin. Due to the nature of this consultation, the emphasis must be placed on the word *objective*. As mentioned above, there is a perception of the existence of biases among many industry players on all sides of this issue. These biases and beliefs, whether based in fact or not, must be taken into account, and where they exist they must be acknowledged, if the process is to be successful. There has already been some concern expressed that the consultation paper released by the Board's staff for this consultation strongly indicates a bias towards fewer utilities.

The EDA has asked for some clarification around some of the statements made in order to defuse this speculation (see section 9). If the facts are evaluated with a bias, the sector may be changed for the sake of change, or the status quo could be maintained for fear of change. It is only through this objective evaluation of the industry that relevant and meaningful decisions can be made.

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## 5. EDA's Suggested Guiding Principles

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As mentioned in section 4 above, the EDA strongly believes that as a first step the OEB should arrive at some principles under which sector changes might occur. The consultation process should stay within set parameters so that a perspective of the goals can be maintained.

The following is a list of principles that the EDA believes would be useful for the OEB. These principles have already received the approval of the EDA Board of Directors as a good basis for exploring the possibility of changes in the sector. As they have already received some type of validation from the distribution sector, they could serve the OEB well in their consultation process.

### **Primary Considerations:**

1. Any structural changes resulting from any distribution rationalization / consolidation must be accomplished on a voluntary basis.
2. Any proposed model must reduce operating costs to help minimize rate increases. In doing so, a proposed model will improve customer value by providing the best possible service or product at the lowest possible price.
3. Any proposed model must maintain or increase the level of service and reliability and realize improved planning synergies and asset management over smoothed, wider areas while optimizing distribution grids along natural electrical boundaries. In this way, the structure is enabled to optimize productivity gains from human and physical resources and encourage the adoption of best practices.
4. Any proposed model must promote a commercially oriented governance structure for distributors which, as a minimum is consistent with the OBCA and which incorporates evolving best practices and corporate governance.
5. Any proposed model must allow distributors to earn a rate of return sufficient to attract from commercial markets the capital required to allow distributors to reinvest in their systems to ensure that reliability is achieved.
6. Any proposed model must encompass a plan, supported by external funding, for meaningful customer and consumer education.



**Other Important Considerations:**

7. Any proposed model must ensure that there is an independent, consistent, efficient and light-handed Regulator free from political interference whose goal is to provide market certainty and stability.
8. Any proposed model must promote Performance-based Regulation (PBR) as the primary tool, administered by the independent regulator, to drive efficiencies and appropriate levels of service improvements within the sector.
9. Any proposed model must include rational rate reform using simple, common methodology (not arbitrary), implemented over time.
10. Any proposed model must promote Demand Side Management as an opportunity for distributors on a commercial basis.
11. Any proposed model must ensure a fair and consistent approach to customer fees.

**Transitional Considerations**

12. Any proposed model must design the management of commodity risk in such a way that results in distributors remaining creditworthy.
13. Any proposed model must cushion customers from rate volatility while still being market-based and stable over time.
14. Any proposed model must recognize that some form of subsidy will be required to offset delivery costs to some more costly-to-serve parts of the province.
15. Any proposed model must recognize that stranding of costs will occur and incorporate mechanisms to ensure it is not a barrier to restructuring.

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## 6. Rationale For Principles

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The EDA believes that the guiding principles we have articulated are a strong foundation for exploring changes to the distribution sector. They represent the broad consensus of our members and incorporate views from all sides of this issue.

The principles ensure that if changes are needed, they take place in a way that not only respects current operating principles and practices, but also does not require a top down or heavy handed approach which can lead to a situation that gets worse, not better, as we saw with Bill 210.

The principles also seek to address many of the concerns that the EDA and its members have with the current structure of the market. If there is a need to change the way that electricity is distributed in the province, then at the same time the EDA believes that it is incumbent on policy makers to address some of the inequities that exist with the current market structure that prevents distribution companies from realizing their full potential. For example, the EDA and its members believe that distribution companies should distribute electricity, and not be responsible for the commodity risk that in many cases imposes serious financial hardship on the LDC. One only has to look at the situation that Hamilton Hydro now finds itself in, as a result of the situation with Stelco, to see why this inequity must be addressed.

Addressing current concerns with the structure of the market as it now stands is paramount to the successful implementation of any distribution market changes. As noted above in section three, implementation of many of the envisioned market characteristics has yet to happen. If a true evaluation of the market is to be accomplished it is reasonable to expect that the market first be allowed to function as designed.

Many have pointed to the lack of voluntary consolidation or amalgamation in recent years as justification for a top down or heavy-handed approach to the distribution sector. While the sector did undergo rationalization in the early stages, in recent years there has been little change. The root causes may not be an unwillingness of LDCs to give up perceived power and status, but may actually be a symptom of a market that has not been allowed to flourish. It has been suggested that the many of the reasons for the lack of change are actually a result of too much change from the government and the regulator.

The use of the guiding principles listed above will ensure not only that any restructuring will maintain the best interest of all stakeholders, but also that current inequities are addressed. The EDA believes that it is only through the use of these or similar principles that the sector can thrive and continue to provide safe, reliable electricity to the customers of the province well into the future. Further, the EDA believes that distributors, and the distribution sector, are in the best position to determine the future of the sector.

## 7. Load Serving Entities

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While Load Serving Entities (LSEs) are not considered in the above-mentioned EDA consultation process, some of the same principles should apply. Specifically, if a LDC wishes to become a LSE or join with other distributors in a broader LSE, it should be able to do so. When determining if a LDC should or could serve as a LSE one should also consider the impact on credit ratings and other business considerations when applied to the distribution sector in its current form (i.e. lacking a full rate of return, responsibility for all charges on the bill, etc.).

Specifically, the EDA believes that embedded consumers who do not choose to be served by a retailer and who are not wholesale Market Participants (i.e. standard service supply customers) must be protected from price volatility via the provision of a standard service supply (“SSS”) offering that delivers stable, predictable prices that, over time, reflect the market price of electricity.

Part of the protection that SSS consumers deserve is assurance that the obligation to arrange for their supply has been assumed. Given a local distributor’s relationship of trust with customers which has developed over more than a century of service, the first right to assume the SSS obligation should be exercised by LDCs.

Where the local distributor, for whatever the reason, chooses not to exercise their right to assume this role within a reasonable period of time, a process, overseen by an agency of the government, such as the Ontario Energy Board, must exist to assign responsibility. This will ensure that protection is provided to consumers by another qualified and approved entity which could be another entity such as a LSE or LDC.

The government, market overseers and the distribution industry should work in partnership to ensure a stable transition to this consumer protection model, in a manner that reflects the needs and concerns of consumers, taxpayers, utilities and shareholders

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## 8. Demand Side Management

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The EDA supports a regulatory and policy framework that will, consistent with the recommendations of the Select Committee on Alternative Fuels, allow LDCs to receive appropriate and material commercial incentives for carrying out Demand Side Management (DSM) activities. In this context, LDCs carrying out DSM should be compensated upfront for their projected operating costs of the DSM programs and their projected lost distribution revenue caused by the associated reduction in sales volume. It should be noted that if an upfront cost recovery approach is not approved, LDCs would simply not be encouraged to proactively pursue DSM. Requiring LDCs to use a variance account to hold these DSM costs will also significantly reduce the incentives to carry out DSM activities, since significant cost variances, totaling over \$650 million, are already held by LDCs. In fact it is conceivable that many LDCs would not be able to carry out any DSM programs if the costs are not recoverable upfront due to their financial situation.

An upfront compensation program would require regulatory approval of the projected DSM expenditures and projected electricity reductions. The upfront compensation would under normal conditions be funded through a distribution rate adjustment. If the government is not prepared to incorporate financial compensation/incentives into rates before 2006, LDCs will require upfront compensation via some other mechanism, possibly through external funding from the government.

While LDCs would like the DSM compensation mechanism to be largely based on the same principles as used in the gas industry in Ontario, namely compensation for lost revenue and costs incurred, the differences in the industries structures must be recognized, and the mechanisms used for compensation should be tailored for each industry.

The unfortunate fact is that LDCs have over the past few years received mixed signals from regulators and policy-makers regarding their potential role in DSM. Bill 35, the Energy Competition Act, established restrictions on the business activities of distributors. LDCs could not carry out any business activity other than transmitting or distributing electricity. The Ontario Energy Board's (OEB) Electricity Distribution Rate Handbook stated distributors with current active DSM programs were encouraged to continue to offer their programs until such time that guidelines regarding the appropriate business activities of LDC and their role in DSM was established (p. 8-1). However, the Rate Handbook also stated that LDCs were not allowed to rent or sell hot water heaters, and as such most LDCs either sold their water heaters or transferred the water heaters to an affiliate.

Historically, the most prevalent DSM program run by distributors was water heater load control, and almost all LDCs discontinued their programs. Since the electricity commodity and transmission costs were to be a cost pass-through, LDCs had no incentive to incur any costs to maintain their DSM activities. Indeed, the OEB implemented a price cap performance based regulation that would have penalized distributors incurring any costs to promote DSM.

## 9. Next Steps – Clarification

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While the OEB staff paper makes several valid comments about the sector, it has been suggested by industry stakeholders that the consultation paper makes several broad statements that seem to indicate that some in-depth factual analysis has been completed, both within Ontario and in other jurisdictions. This type of information gathering would be very useful for the entire industry to study and digest.

The review of other jurisdictions should be considered and it is worth pointing out the OEB staff have clearly looked to other jurisdictions in order to assist us with our own concerns in Ontario. A discussion about why certain jurisdictions were chosen and others were not would be a worthwhile exercise.

Also worth noting, is the fact that there has not been an assessment done on how well the amalgamations (forced or voluntary) have worked out. Further research is required in subsequent steps in this consultation to determine if these amalgamations achieved efficiencies.

The paper has served its purpose of starting the debate on the issue at hand. The EDA looks forward to further steps in this consultation which will inevitably shed more light on the findings in the preparation of the paper and their applicability to the Ontario experience.

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## 10. Conclusion

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As stated at the outset, the EDA is pleased to have participated in this exercise. The EDA believes that this process should be allowed ample time and include full and meaningful consultation.

The EDA strongly believes that there needs to be a change in the regulatory and financial environment to ensure that the proper conditions precedent be in place to facilitate any desired changes in the distribution sector.

The Association also believes that in this first stage of the consultations, the OEB should first take the time to set some guiding principles, undertake some relevant fact gathering, and then conduct an objective evaluation of information. In order to assist the OEB in its fact finding stage, the EDA would like to offer to the Board members the opportunity to visit various LDCs in the province in order to see first hand the work of some of our members. With first hand experience, the OEB may better understand the day-to-day business operations of the distribution sector.

The EDA has articulated some guiding principles and we believe that these principles will ensure a fruitful consultation process. The EDA hopes that the OEB will take into consideration its position on both Load Serving Entities as well as Demand Side Management as we believe that our positions will not only lead to the successful implementation of these initiatives, but will also ensure that the distribution sector will be able to continue to provide its customers with safe and reliable electricity for years to come.

The EDA looks forward to working with the OEB on the next steps in the consultation process.