Ontario Energy Board
Review of Electric LDC Efficiency Issues

# Energy Probe's Recommendations on Efficiency Priorities for Electricity Distributors

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**Procedural Concerns**

Energy Probe has concerns about the process for the OEB's review of electric Local Distribution Companies (LDC) economic efficiency issues.

The OEB has not made clear the origin of its current enquiry. Has the Minister directed or otherwise encouraged the Board to enquire into the electric LDCs issue, particularly consolidation and expanding the scope of LDC responsibility to include contracting for power? Is the Board operating at arm's length?

The OEB could assist the parties participating in this review by explaining its hastiness in pursuing this review. The time allowed for participants to develop their presentations has impaired our ability to participate. The original schedule required written submissions filed with the Board only four business days after the publication of the OEB staff report. Interested parties were not informed in advance that we should be setting aside time during these four days to prepare a reply. The Board should recognize the limitations and inconvenience that it is unilaterally imposing on interested parties. A few days of preparation without prior notice is seriously in adequate to address the complex issues associated with LDC efficiency.

Public interest groups have been further disadvantaged by the absence of any means to recover their costs associated with participation in this process. I hope the Board will consider remedying this barrier to entry.

As of this morning, submissions received by the Board have not been published on the Board's web site. This lack of dissemination of received materials has further impaired Energy Probe's ability to be of assistance to the Board. Energy Probe encourages the Board to publish this submission and all other submissions it receives associated with this process.

## Prioritizing LDC Efficiency Issues

Energy Probe's overarching observation is that the OEB's review initiative on LDC efficiency appears to have been given undue priority in the OEB's regulatory program, and the Board staff discussion paper is not scoped to achieve the Board's stated efficiency enhancement objective.

As outlined in Energy Probe's recommendations on regulatory priority setting, submitted to the Board 2003 December 1,[1] Ontario's electric power system is faced with unprecedented challenges that directly threaten the security of supply of power to consumers. Ontario's power system is financially unstable due to factors like the continuing commodity rate freeze covering over half the overall market. Governance of the key elements of the power system is chaotic, like OPG operating with only an acting CEO.

In contrast to these negative conditions, since the passage of Bill 4 and the prospects for clearing their regulatory assets accounts, Ontario's LDCs appear to be relatively stable and capable of at least continuing the level of distribution service to consumers now provided.

Ontario's LDCs provide mission-critical services to the overall power system, including a playing a key role in emergency response and undertaking most customer billing. Any proposed changes to the policy environment in which LDCs operate should carefully plan how these critical functions will be maintained. Energy Probe notes that neither of these issues are addressed in the Board staff discussion paper.

## Efficiency Analysis Requires Data

The Board staff discussion paper identifies that the Board's objective "is to consider if further efficiencies are available, and if so, how to achieve them." However, the Board staff discussion paper presents no quantitative analysis of electricity LDC efficiency.

Any effort to enhance regulatory oversight of Ontario's electricity distributors must recognize that the core requirements for proper regulatory oversight of these LDCs are not currently in place. The LDCs do not have any regulatory approved baseline for their costs of serving their customers. Without such *cost of service* information, the best available information to compare the efficiency of the LDCs is existing rates. However, existing rates are a poor guide to cost, because many LDC did not have cost-based rates at the time the OEB's PBR Rate Handbook effectively froze their base rates. For example, at the time selected to index rates using the formula set out on the PBR Rate Handbook, Nepean Hydro had rates deliberately designed to reflect a negative return on equity for a time limited period. Nepean's rate design was appropriate in the institutional context that prevailed prior to the PBR Rate Handbook decision but the rates were not sustainable.

[1] http://www.energyprobe.org/energyprobe/index.cfm?DSP=content&ContentID=9046

There is no published reliability data or other Service Quality Indicator (SQI) data published that is suitable for comparing the performance of electric LDCs. LDCs are collecting some reliability data, but it is not clear that this data adequately captures the relevant reliability record. Similarly, the current regulatory construct does not encourage rational allocation and management of losses.

Energy Probe notes that none of these information deficiencies are mentioned in the Board staff report.

**Efficiency Review Focuses on Options that Would Reduce Efficiency**

Energy Probe is concerned by inclusion in the staff report of issues that threaten to impair efficiency of LDCs and the overall market or that are of second-order importance in achieving LDC efficiency gains. As indicated by the Board staff paper, the Board's apparent priorities appear to be first, converting LDCs into load serving entities responsible for procuring the power consumption requirements of consumers, and second, LDC consolidation.

The proposals to convert LDCs into load serving entities and to consolidate LDCs have their origin in the report of the Electricity Conservation and Supply Task Force.

**Credibility of the Electricity Conservation and Supply Task Force**

Supply-side interests overwhelmingly dominated the Electricity Conservation and Supply Task Force. Most of the members represented generators, transmitters, distributors, and suppliers to these entities. Not surprisingly, the recommendations of the Task Force would transfer most business risk associated with future investment in generation from producers to consumers.

There was no representation on the Task Force of the largest customer group, commercial and institutional customers.

The CEO of the IMO signed on to the report's final recommendations, notwithstanding that many of the recommendations promote central planning, directly contrary to the IMO's legal mandate to promote competition.

The Task Force's dismissal of the market design developed by the Ontario Market Design Committee in 1997-98 did not acknowledge that the international experience with competitive electricity markets has generally vindicated the market design concepts that the Task Force dismisses. For example, the Task Force's demonization of the spot market flies in the face of demonstrated public interest benefits in other jurisdictions from an active spot market. Indeed, some markets, like Norway, have substantial dependence on spot pricing, including particularly for residential service. The benefits of the spot market have been particularly evident where these markets have been highly "volatile", such as spot market in Norway, New Zealand, and South Australia.

Energy Probe suggests that the Electricity Conservation and Supply Task Force report is tainted by conflicted interests, ignorant of the international experience, and not a credible source of guidance on how to respond to Ontario's electricity crisis.

**LDCs as Load Serving Entities**

Converting LDCs into load serving entities responsible for entering into long-term contracts with generators on behalf of consumers would be a grave error. As demonstrated by instances as diverse as the nationalization of Central Gas Manitoba in 1999 due to that LDC becoming involved in commodity purchasing activities, to Ontario Hydro's failed non-utility generation program which developed stranded costs estimated in 1999 at $5.2 billion, to California's panicked state intervention in the electricity market whereby the government bought an estimated $20 billion (US) worth of power for $40 billion (US) by buying on long term contracts during the 2001 electricity crisis, LDCs would be exposed to substantial risk by entering into contracts on behalf of consumers. If prices drop below the contract price – for example if technological progress leads to the widespread adoption of fuel cells for cogeneration applications -- LDCs could be at risk. This risk is not recognized in the Board staff discussion paper.

Ontario's electric LDCs have no experience in power procurement under contract. It is difficult to imagine how LDC management would succeed in contracting for power. The Board staff discussion paper ignores the consequences of failure to appropriately contract for power.

Successful utility regulation requires that the regulator have the capacity to impose penalties on shareholders in the event that utility wrongdoing is determined to have happened. Accountability is achieved because penalties imposed on shareholders often results in changes in management. Two levels of government, rather than private shareholders, own most Ontario electric LDCs. This makes effective regulation of Ontario electric LDCs inherently difficult. Penalties imposed by the regulator on the Ontario LDCs are penalties borne by taxpayers, who have very limited means available to force changes in utility management. A governmental regulator overseeing governmental LDCs is already in a conflicted position. Expanding the scope of LDC responsibilities to include long-term power procurement will make the already difficult job of regulating the LDC virtually impossible.

**LDC Consolidation: Efficiency or Inefficiency?**

As indicated in our above noted submission to the OEB on priority setting, Energy Probe believes that the benefits and costs of the existing experience with LDC consolidation have not been publicly analyzed and therefore the lessons of this experience remain to be learned. The largest consolidation of LDCs since1998 was Hydro One's MEU buying spree – a business strategy that appears to have significantly reduced Hydro One's financial flexibility, reduced shareholder value, and failed to achieve any long term rate benefits for consumers. Energy Probe notes that all of Hydro One's buyouts were approved by the Ontario Energy Board.

Hydro One subsumes two substantially different businesses: transmission and distribution. Although the transmission business earns less revenue than distribution, transmission's share of Hydro One's profits is almost three times greater than its distribution business. The benefits of separating Hydro One into separate transmission and distribution companies was subject to scholarly attention by Littlechild and Yatchew, who concluded that continued retention of the two businesses within Hydro One will likely result in increased costs and significant disadvantages relating to price, regulation, and competition in Ontario's electricity sector.[2] There are many instances in Ontario where low cost LDCs, some with non-contiguous service territories, are adjacent to Hydro One distribution territories. On the face of it, there appears to be benefit to consumers of these LDCs taking over some of Hydro One's service region. We are not aware of any instances were Hydro One has allowed this type of rationalization.

The Ontario Energy Board should commission and publish economic research on the potential benefits and costs of separating Hydro One's transmission and distribution businesses, and allowing other distribution utilities to buy out sections of Hydro One's distribution territory where such mergers can yield efficiency gains.

A major determinant of overall efficiency is labour cost. Anecdotally, there are indications that the labour costs to serve customers served by at least some, perhaps many, utilities bought by Hydro One increased following the buyouts. The Ontario Energy Board should study the relative labour costs of distribution utilities with attention to the factors that contribute to efficiency in this area.

Aside from Hydro One, the next largest LDC in Ontario is Toronto Hydro. Toronto Hydro has among the highest distribution rates of any large urban utility in Ontario. There are many reasons why Toronto should be a low cost distributor relative to other LDCs, including high customer density and highly depreciated assets. High labour cost appears to be one driver of Toronto's relative inefficiency.

The experience with Hydro One and Toronto Hydro suggests that size is not an important determinant of efficiency.

However, the great range of distribution rates across Ontario suggests that there are substantial efficiencies to be gained. For example, Hamilton Hydro's residential distribution rate for a customer using 1000 kWh/month is about 17% lower than Guelph Hydro's rate.

The most reliable method of finding efficiencies in electricity distribution is for the regulator to administer rules that reward efficient operators with greater profits and

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[2] "Hydro One Transmission and Distribution: Should they remain combined or be separated?", S. Littlechild, A. Yatchew, May 2002.

inefficient operators with lesser or no profits. The regulator should also work to eliminate artificial or policy barriers that might prevent efficient operators from buying out inefficient operators. Consolidation should be market driven, not policy driven.

**Conclusion**

Consumer's primary interest in electricity distribution is efficiency. Efficient utilities will lead to lower overall costs in the long term. Energy Probe suggests that the OEB assemble appropriate data, analyze quantitatively the factors that drive distribution utility efficiency, and subject these results to public review.

Expanding the responsibilities of LDCs to include power procurement on long term contracts would not be in the public interest.

As illustrated by the poor financial results resulting from Hydro One's acquisition activities, non-market, fiat-driven consolidation is unlikely to be in the public interest. Any claim to the contrary must be subjected to thorough public scrutiny.