Ontario Energy Board

(Board File No. RP-2004-0020)

Response To:

Consultation To Review Further Efficiencies

In the

Electricity Distribution Sector

Submitted By:

Erie-Thames Power

Essex Power Corporation

&

Oncor Utility Solutions Canada Ltd.

February 18, 2004

Introduction…

Good morning – My name is Ray Tracey, President & CEO of Essex Power. I am joined by my business associates, Mr. Jeff Pettit, President and CEO of Erie-Thames Power and Mr. Kirk King, Director of Business Development, Oncor Utility Solutions Canada Ltd. On a combined basis, Essex Power and Erie-Thames Power provide distribution services to 40,000 customers in southwestern Ontario. Oncor currently supports 3.1 million electric customers internationally. On behalf of our customers, employees and our shareholders, we appreciate the opportunity to appear before the Board concerning this very important issue.

Our presentation will speak directly to our own corporate accomplishments in the distribution sector, and the evolution of both companies in the context of the key discussion points outlined in the Board discussion paper.

From the outset, the goal of both companies has been to become more efficient, while continuing to provide low distribution rates, quality service and value to our shareholders which we believe is consistent with the objectives set forth in the legislation of Bill 35. With this focus creating our perspective, we believe three key points are relevant to the considerations currently before the OEB:

> **The consideration of efficiency issues in the Ontario Distribution Market must be based on the actual performance of the LDC's.** Currently no consistent benchmarking practices exist in Ontario, and few entities are held accountable to performance standards, either internally or externally. Without such a focus, the OEB has little basis for new actions aimed at correcting inefficiencies, since it is unclear where those inefficiencies exist.
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> **Allowance for rate adjustments without accountability for performance only encourages further inefficiencies.** Without comparison to peer group norms, the OEB has limited ability to judge the efficacy of current rates, or the basis for adjustments.
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> **Given these foundational issues, the urgent issue is not regarding further consolidation, but rather at understanding the current performance of the market.** With this focus, the OEB can identify the sources for creating efficiency in the market, and drive additional value to the customers through targeted regulatory oversight.

On Issue of Further Consolidation…

We represent two companies that resulted from consolidation of 11 former Hydro Electric Commissions (HECs) in mid-2000 ranging in size from 400 to 9,200 customers. The creation of these companies lead to a 72% reduction in the number of utilities.

As a result, both of these companies, their senior managers, their boards of directors and their shareholders have direct experience in the issues and decisions required to facilitate and implement efficient Local Distribution Company (LDC) mergers.

Both of these companies were created following careful consideration by their shareholders of their strategic options, and both were created in good faith, pursuant to the letter and spirit of the Energy Competition Act and its regulations. We strongly believe that both companies are on the right path to meeting the Act's objectives.

Since the creation of these companies, we have completed the following:

- Separated the previously integrated public utility functions into separate corporations. A wires-related fixed asset corporation (LDC) and network services corporation required to support those assets.
- Harmonized rates in each of the service areas of Erie Thames and Essex Power creating an equal playing field for customers
- Developed a financial planning cycle to satisfy our shareholders asset requirements to ensure safe and reliable power is delivered to customers yet provide fair and equitable revenue streams as allowed under the legislation
- Began providing utility services to other utilities and to non-utility customers, augmenting the shareholder revenue received from LDC assets
- Established equity interests in non-LDC business enterprises to increase return
- Broadened the scope of contracting-out
- Created opportunities for scale by separating the Asset Management functions from the Network Services activities. While retaining our separate individual corporate identities, this has allowed us to take advantage of many different business solutions to achieve new efficiencies that were inhibited by our previous integrated utility model. Some of these advantages are: Shared IT systems or ASP solutions, performance based management processes based on 'best in class" Asset and Network services, contracting out services which we can not competitively provide to the Assets, shared expert resources and establishing new partnerships to achieve services from an increased scale perspective.

- Began paying cash streams to municipalities in accordance with original shareholder bargain.

While our current business structures originated in the initial consolidation efforts, the predominance of these business accomplishments were a result of our keen attention to the overall goals of low rates, service to customers, and value return to shareholders, not an outcome of the consolidation itself.

Additionally, our experience tells us that consolidations will not just "happen". The transfer tax holiday is necessary, but not a sufficient condition for consolidations involving only municipally-owned organizations. In fact, several significant conditions existed prior to the first round of utility consolidations. These conditions included:

- Municipal clear understanding of the utility's role as a potential source for steady long-term revenue and support for economic development objectives.

- Willingness of shareholders to create a shared identity based on more or less equal partnership (no one dominant participant).

- Market Rules introducing operational or reporting requirements beyond the capabilities of individual HEC's, either in functional complexity (i.e. settlement/metering requirements) or rules compliance (i.e. wholesale reconciliation and retail billing)

- Human resources succession planning issues, primarily related to top management retirements, with retiring incumbents keen to protect staff and community service levels.

- Opportunity to hand over management to emergent senior staff with a "can-do and will do" entrepreneurial attitudes.

While we believe that the above conditions will again be required prior to other significant consolidations, we also anticipate that additional conditions will need to be present, including:

- A more sophisticated management approach across the industry including a well understood, regulatory strategy.

- Greater confidence in the political, business, financial and regulatory environments facing utilities.

- Demand for boundary expansions based on true customer choice and competition.

- Regulatory reward (or punishment) for a LDC for being efficient (or inefficient) as compared to the peer group.

In summary, our experience shows that factors other than consolidation have created our business success in delivery of value to our customers and shareholders. Additionally, the elements required to encourage further consolidation in the market are both numerous and substantial in scope. It is our opinion that the OEB's attention is best directed to the effective management of the current LDC's by encouraging performance accountability and creating an environment for fair assessment of success across the utility market.

On The Issue of Incentives…

Incentives to increase efficiency need to be measured and rewarded by reference to quantitative performance standards. Currently, there are no such standards, no agreement on what should be measured, and no agreement as yet of even what constitutes "efficiency"(which can mean different things to the regulator than it does to a shareholder or customer). A management by objective type analysis can be conducted to determine what behaviour the utilities should adopt and identify the most appropriate way to encourage that behaviour. Such an analysis has not been completed by the OEB, and in fact, may be best suited to an objective third party assessment.

At present, our two organizations have retained third-party expertise, Oncor Utility Solutions Canada Ltd. to measure the "efficiency" of these organizations by reference to other utility organizations across North America with whom Oncor is familiar. The results are clear that both Erie Thames and Essex compare favorably in their overall operations and maintenance expenditures (OPEX) expenditures when compared to other North American investor owned utilities. The opportunity to gain further scale in addition to management identification and control is facilitated by improvements in people, processes and technology. The adoption of industry wide "best practices" in performance management, asset investment strategy, resource management and work management facilitates the next level of scale for the two organizations. Practices like common construction standards, common use of engineering, estimating and design systems as well as planning and scheduling tools create a system that readily allows the sharing of employees across boundaries. This flexibility is similar to the "plug-n-play" concept in computers, whereby employees rapidly become productive in any work environment in which they find themselves.

This strategic approach to work together, while still maintaining local control, has allowed both enterprises considerable flexibility in mitigating risk, improving quality and delivering on commitments to owners, customers, employees and regulators.

The introduction of competition into the distribution sector, which is the subject of Combined Proceeding RP-2003-0044, would drive cost savings and improvements in customer responsiveness, and as a result, would push LDCs toward consolidation or negotiations of sale or disposal of assets and customer bases for the purpose of protecting shareholder interests and achieving economies of scale where the business case supports the transaction. For this to effectively happen, each LDC has to be facing the same business pressures based on rates, customer service expectations and owner requirements.

The OEB should NOT be allowing rate increases to LDC's that are NOT performing to at least to some type of median performance level set for the industry. Substantial distribution rate increases were allowed as a result of Bill 35 to allow the owners to restructure equity, allow a rate of return and pay PILS on stranded debt.

Currently utilities are being allowed to increase rates for recovery on regulatory assets without first demonstrating they have prudently delivered benefits to their shareholders from the 2001-2002 rate increase which speaks to the issue of whether LDC's are being properly benchmarked and actually operating more efficiently!!!

On The Issue of Load Serving Entities…

The capability of Ontario distributors to take on the role of LSE (load serving entities) would be entirely dependent on the detailed requirements. The rules and regulations for default supply through a LSE are not currently known. It is very important that the role of an LSE be offered to LDC's under a set of conditions that allow the LDC to earn a fair return for the risk it takes in providing default supply. A standard power purchasing portfolio for default supply should be set by the OEB for a licensed LSE to manage accordingly. Full recovery of power procurement for default supply should be allowed when all rules are followed by the LSE. LSE's should be required to maintain a power purchasing portfolio, which contains "Green" Power, Heritage Power, long-term contracts for new capacity required for Ontario, DSM and other components, which represent the energy policies of the Province. LDC's should retain the ability to opt out of the LSE responsibility with written notice to the OEB and its obligation assigned to another licensed LSE.

On The Issue of Distribution System Planning….

Distribution system planning happens now, as a result of somewhat informal interaction between Hydro One and the municipal LDCs. The system works as we know it today. However, we believe that greater standardization of engineering and system component specifications could result in additional efficiency. Furthermore, the expansion, replacement or rehabilitation of the overall distribution system can be much better managed for the benefit to the system than is currently achieved. To encourage this cooperative planning approach, the Board may choose to facilitate the coordination of system planning consultations through one or more working groups. Without mandating planning or equipment requirements, the Board can facilitate the achievement of desired outcomes without consolidation of utilities or additional burden of regulatory oversight.

On The Issue of Technological Innovation….

Although we are not aware of any specific regulatory barriers discouraging the adoption of new technologies, the general uncertainty in the political, regulatory and financial environment mitigates the likelihood that investors will put capital at risk for fear of not realizing a return on their investment.

Our two companies have invested in asset management technologies for the purposes of driving cost savings and improving managerial accountability.

Our current business structures and processes are allowing our organizations to maximize on innovative technology and shared resource opportunities. We are currently utilizing these technologies and human resources over a customer base in the millions. This has allowed us to aggressively create new efficient business processes to maximize OPEX and CAPEX expenditures to the benefit of our customers and shareholders as well as allow us to competitively compete for new business opportunities.

Summary Remarks….

In summary, our position is that the Board should establish only clear quantitative performance standards to which all utilities must comply. In turn, it should be left up to each industry participant to demonstrate its compliance with the industry-wide performance standard.

Clearly defined performance standards, enforced fairly and reasonably, as opposed to an arbitrary program of utility consolidation will result in the further efficiencies the Board is seeking. We oppose consolidation for the sake of consolidation, and any action that simply spreads costs across a larger customer base without any demonstrated benefit.

Further, it is our view that the industry will mature with time, and consolidation will occur when the conditions precedent for this to occur have been established. The only barrier that has prevented our two companies from achieving further rationalization is the unfair playing field that has existed across LDCs where LDCs have not delivered on their commitments to shareholders by providing them with the revenue streams that have been including in their rates since 2001.

As the Board is undoubtedly aware, our industry is in transition. We have not yet witnessed the full benefit of our previous decisions, let alone the opportunities that rest ahead of us.

Thank you for the opportunity to present our views to you today.