RP-2004-0020
Ontario Energy Board Consultation on Further Efficiencies in the LDC Sector
Submission of Guelph Hydro-Electric Systems Inc.
February 20, 2004

Introduction:

Guelph Hydro-Electric Systems Inc. ("Guelph Hydro") wishes to make a brief written submission to the Ontario Energy Board's (the "OEB's") consultation on further efficiencies in the electricity distribution sector at this time. Guelph Hydro may make further submissions as this consultation continues, and trusts that there will be further opportunities for written and/or oral submissions. For the time being, though, Guelph Hydro has not been in a position to develop and present a detailed position on the restructuring of Ontario's electricity distribution sector in the seven business days since the release of the OEB discussion paper prepared for this consultation. Aside from the practical difficulties of Guelph Hydro's management not being able to report to its Board of Directors on this issue in the few days since the discussion paper was released, the challenges currently facing the distribution sector do not lend themselves to quick, simple solutions. Any consideration of further restructuring in this sector must be undertaken carefully and thoughtfully, with a clear understanding of the challenges currently facing the sector, in order that the Provincial Government and the Regulator do not compound the existing problems in the sector or create new ones by ill-conceived restructuring initiatives.

Guelph Hydro has organized its comments according to certain themes; some correspond to matters raised in the discussion paper, and others are outside of its scope. Guelph Hydro trusts that these comments will be of assistance to the OEB, and looks forward to further opportunities to comment during what Guelph Hydro anticipates will be a thorough consultation process.

1. Insufficient Incentives to Foster Consolidation:

The authors of the discussion paper suggest that "The most obvious approach to furthering efficiency through exploiting scale economies is through industry consolidation."[1] This may or may not be the case (the discussion paper does not substantiate the assertion), and the list of 21 jurisdictions with the average number of customers served per distributor[2] shown in the discussion paper provides no guidance as to minimum efficient scale. The authors suggest that "Empirical estimates of LDC minimum efficient scale range from 20,000 customers on up."[3] Even if it is the case, Guelph Hydro is of the view that mandatory consolidation in the sector is not the answer. Instead, the Government and the OEB must create an environment that encourages voluntary consolidation initiatives. Guelph Hydro believes that various circumstances are preventing further consolidation in the sector. Among them are the following:

(a) Lack of Full Market Based Rate of Return

Four years after the release of the first version of the OEB's Electricity Distribution Rate Handbook, and close to 6½ years after the Government stated that "in reviewing local

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[1] Discussion Paper – Electricity Distribution Efficiencies, dated February 10, 2004, at p.8
[2] Discussion Paper – Electricity Distribution Efficiencies, dated February 10, 2004, at p.19
[3] Discussion Paper – Electricity Distribution Efficiencies, dated February 10, 2004 at p. 19

distribution tariffs, the Ontario Energy Board would be expected to make an appropriate allowance for a normal rate of return",[4] distributors are still not earning their target Market Based Rates of Return. The new Government's Minister of Energy announced in November, 2003 that LDCs would be permitted to apply for rate adjustments that would enable them to recover the final ⅓ increment of the Market Based Rates of Return that they elected in their initial rate applications in 2001, but even then, the first year's incremental revenue increase is to be dedicated to demand side management initiatives, so that LDCs will not be earning their anticipated 9.88% regulatory return (or such lower rate of return that may have been declared in the LDCs initial rate application) until 2006 at the earliest. In light of the Province's record of changing the rules applicable to the distribution sector in response to stakeholder concerns, it may be the case that even this new timetable is not immutable. This contributes to the uncertainty surrounding the valuation of distribution utilities, which in turn discourages parties from considering further consolidation.

(b) Uncertainty as to the OEB's Principles on Service Area Amendments

In March, 2003, in response to 9 service area amendment applications, the OEB initiated a Combined Proceeding on Service Area Amendments (RP-2003-0044). In December, 2003, the OEB heard expert evidence and final argument on the "principles" portion of the proceeding. Among the issues to be determined by the OEB in that proceeding are the appropriateness of overlapping service areas in which contiguous distributors would "compete" for customers, and the appropriateness of the creation of new "embedded distributors" that would effectively carve holes into existing service areas by establishing a multitude of discontiguous service areas, each consisting of a multi-unit building or a plan of subdivision; establish their own distribution rates through the OEB; and pay a charge for the use of the "incumbent" distributor's system. Guelph Hydro is of the view, consistent with policy documents dating back to the Macdonald Committee Report, and as current as the Discussion Paper[5], that electricity distribution remains a monopoly activity, and that introducing new discontiguous embedded distributors will erode the efficiency of the sector as a whole. In addition, the prospect of the loss of customers due to competition in distribution, whether through overlapping service areas or the fragmenting of existing service areas through the injection of new embedded distributors, will adversely affect the valuation of LDCs and interfere with efforts at consolidation in the sector. As the authors of the Discussion Paper wrote, "Unit cost tends to decline as the number of customers increases, all other things being equal (including size of service area, load factor, etc.).[6] If these forms of "competition" in distribution reduce customer numbers in incumbent LDCs, then this will increase unit costs, thereby reducing efficiency. Accordingly, the OEB must be clear in that the introduction of "competition" into the natural monopoly of electricity distribution will not be permitted.

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[4] Direction for Change: Charting a Course for Competitive Electricity and Jobs in Ontario, November, 1997

[5] Discussion Paper Electricity Distribution Efficiencies, February 10, 2004, at p. 17 – "Because electricity distribution companies are natural monopolies, the Act [the *Energy Corporation Act, 1998*] gives the Ontario Energy Board (OEB) responsibility for regulating distribution rates."

[6] Discussion Paper – Electricity Distribution Efficiencies, February 10, 2004, at p.10

(c) Uncertainty of Outcomes of Rebasing for Second Generation PBR

Second generation PBR was to have begun this year. It was then postponed by the OEB to March, 2005. It is now scheduled to begin in 2006, as a result of the former Government's enactment of Bill 210. Until LDCs can understand what the rules will be for second generation PBR, and the relationship between the new rules and their projected revenues, LDC valuation will be uncertain.

(d) Outstanding Recovery of Transition Costs and Other Regulatory Assets

Guelph Hydro appreciates the steps that the Minister has taken to enable LDCs to begin recovering their outstanding regulatory assets. LDCs would otherwise have been waiting until 2006 to begin recovering them, notwithstanding that significant amounts of money were spent by the distribution sector over two years ago to prepare for market opening in 2002, with the expectation that these transition costs would be recoverable as part of the normal LDC rate adjustments shortly after market opening. To date, however, the recovery of the first 25% of distributors' regulatory assets, which is being addressed by the OEB in rate adjustment orders to be effective on March 1, 2004 for implementation April 1, 2004, is based on the balances in four "Primary" Retail Settlement Variance Accounts. These balances have not been subjected to the OEB's "prudence" test, nor would it be necessary to do so, as these accounts simply reflect differences between prices and charges paid by LDCs in the wholesale market, and those charged to their customers. However, other accounts, containing large balances, relate to transition costs and extraordinary items ("Z factors"), to which the OEB's prudence test (as well as the other Z factor- and transition cost-related tests set out in the OEB's Distribution Rate Handbook) will be particularly relevant. It is difficult to determine the value of potential consolidation partners (and of one's own LDC) where it remains unclear, almost two years after market opening, whether the OEB will consider the costs incurred in preparing for the new market structure as having been prudently incurred.

Guelph Hydro shares the concerns of the authors of the Discussion Paper regarding,

> "regulatory rules that create a bias against technological innovation and risk-taking, such as the asymmetrical treatment of innovations with uncertain benefits (for example - rebasing rates to reflect the benefit of successful cost saving initiatives in rates combined with cost disallowances when cost saving initiatives are not successful)"[7]

Distributors must not be penalized for reasonable future attempts to innovate. Similarly, though, LDCs should not be penalized for having incurred significant transition and extraordinary event costs in preparing for the new market, through unreasonably restrictive definitions of prudence, or overly restrictive applications of the other tests applicable to transition costs and Z factors. This will reduce, or perhaps worse, render uncertain, the value of the corporations, and will reduce shareholder willingness to consider consolidation.

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[7] Discussion Paper, at p.13

(e) The Effects of Downloading Additional Responsibilities onto LDCs

In addition to transition costs, incurred as a result of the Province's restructuring of the electricity sector, that have been carried by distributors for several years, other factors resulting from steps taken by the Province, the OEB and the IMO may be increasing uncertainty and putting shareholder value (and inclination to consider consolidation) at risk. Among them are the following:

- LDCs have lost the ability of the former hydro commissions to have electricity-related account arrears added to the property tax rolls of the corresponding municipality;

- despite the loss of this historical ability to mitigate against account defaults, the OEB has adopted recent amendments to the Distribution System Code that further restrict LDCs' abilities to take and retain security deposits. This is of particular concern given that LDCs must not only bear the risk of loss of their distribution revenues as a result of an account default, but they are also required to pay the IMO for the electricity commodity, transmission and all other charges imposed by the IMO, before they are collected from the customer. If the LDC is not paid by the customer, the LDC is at risk of losing five to seven times the amount that would remain with the LDC on account of distribution. A default by a large use customer can be catastrophic for a distributor, and this cannot reasonably be described as being part of the business risk that should be borne by an LDC; and

- the IMO's Market Rules impose high prudential requirements on LDCs.

In effect, LDCs are seeing their creditworthiness affected on both ends of their supply chain – on the one end, the IMO maintains unreasonably high prudential requirements for LDCs. On the other, the applicable legislation has removed a traditional source of security against account defaults, and the OEB has prevented LDCs from taking what they consider to be appropriate measures to secure against those defaults.

The authors of the Discussion Paper note that:

> "Also, a prerequisite for entering into the risk mitigating contracts discussed above is a high standard of credit worthiness. Some LDCs may not currently be able to reach this standard acting on their own. This raises the question of whether further consolidation or joint venturing would be required for these LDCs to get started in the load serving entity role."

Guelph Hydro acknowledges that there may be some LDCs that will not meet a creditworthiness threshold should there be a move toward load serving entities. However, LDCs should not be placed in that position as a result of legislation and/or regulatory policies that impose unreasonably high security requirements on them while at the same time preventing them from acting in a commercially reasonable manner in respect of account defaults, in spite of their natural person status as Ontario *Business Corporations Act*. The risk of huge exposures in the event of account defaults will increase the risks associated with further consolidation in the LDC sector.

2. Shareholder Issues:

Those LDCs that have not already been subject to consolidation remain owned by their incorporating municipal shareholders. Under the *Electricity Act, 1998*, municipalities were required to incorporate their municipal electric utilities under the OBCA by October, 2000. The year 2000 was a municipal election year in Ontario, and the incoming municipal councils that year did not always share the views of the outgoing councils on fundamental issues such as whether to hold or sell their utilities or, if holding them, on whether to operate them on a for-profit or a not-for-profit basis. The outgoing councils had often spent a year or more considering these questions and restructuring their utilities.

It is now early 2004, and once again, the councils of the shareholder municipalities have changed, and have only recently taken office following the November, 2003 municipal elections. New councillors will require time to learn the businesses of their LDCs and affiliate corporations before they can begin to revisit the fundamental question of sale vs. retention. This suggests that the March 2003 – March 2005 transfer tax window established by the previous Government, already almost one-half over, will likely not provide adequate time for shareholders to make their decisions on consolidation-related issues. This is particularly true in light of the ongoing policy uncertainties, both at the Provincial Government and the OEB levels, with respect to the distribution sector. The rate freeze of Bill 210 and the new Government's determination to bring sweeping new electricity-related legislation in the coming months will not inspire confidence in the creation of a stable regulatory environment in the distribution sector in the near future. This lack of stability will make it more difficult for shareholders to consider radical changes in the structures of their LDCs.

Another shareholder-related issue affecting consolidation will be the political differences between communities, in addition to any internal political differences that may exist among the members of individual municipal councils. While these differences may not be insurmountable, they may take time to resolve, as councils that have already determined to hold their utilities may be reluctant to revisit their decisions.

Finally, having determined over three years ago that they wish to maintain local control over their utilities, shareholders may simply have no political desire for consolidation. In the absence of any new incentives to consider consolidation, and without stability in the sector, shareholders would likely prefer to keep jobs in their communities and maintain the LDC as a local asset.

3. Other Barriers to Consolidation

(a) Rate Harmonization

Consolidation of LDCs suggests that distribution rates of the consolidating LDCs will be harmonized, if not immediately, then eventually. While Hydro One Networks Inc. has not yet harmonized the rates of the many LDCs that it acquired in 2000 and 2001, its intention, expressed in its applications to the OEB for approval of the proposed transactions, was to harmonize the rates of the acquired utilities in the course of first generation PBR, for implementation with the commencement of second generation PBR. Consolidation through a merger or acquisition will not be attractive to a municipal shareholder whose taxpayers will experience electricity rate increases as a result of rate harmonization after the transaction.

(b) Labour Issues

Any consolidation will have to take into account the varying collective agreements between LDCs, and their employees. LDC's may have an interest in alternatives to consolidation as described below. However, the pursuit of options such as the creation of services affiliates through joint ventures may raise a number of labour relations issues related to contracting out or the sale of a business, with the possibility of triggering successor rights. The reality is that many collective agreements have limitations on contracting out by the LDC. These limitations, and related successor rights issues, must be addressed in the creation of any joint venture service entity.

4. Alternatives to Consolidation

If there is no conclusive evidence to support the notion that "bigger is better", or if it is unclear how much bigger is better, then the OEB is not in a position to make a determination on the optimal size of a distributor so as to achieve the greatest efficiency. Guelph Hydro suggests that in the current uncertain regulatory and business environment, the Board's focus may be better applied to the rationalization of distributor costs rather than the pursuit of consolidation.

While Guelph Hydro is not averse to the notion of consolidation, provided that it is approached on a voluntary basis, and that incentives exist, Guelph Hydro is concerned that the authors of the Discussion Paper, in their focus on consolidation as the key to efficiency, are ignoring other means of achieving efficiencies in the distribution sector.

In that regard, the OEB may wish to promote the expansion of distributors' current efforts to rationalize costs, including co-operation among LDCs through informal or formal arrangements, in areas such as procurement, billing and settlement, or the outsourcing of certain functions to third party providers who are able to spread those costs over larger customer bases, achieving similar, or greater efficiencies compared to those that might be achieved simply by combining a number of small utilities. An advantage of this approach is that these cooperative activities can be pursued now, prior to the completion of the large amount of study that would have to take place before an optimal utility size could be determined, and before it could be concluded that utilities must be consolidated to be efficient. A simplified regulatory regime, with a PBR mechanism that creates clear incentives for efficiency and disincentives for inefficiency will also rationalize costs, and may ultimately have the effect of encouraging consolidation, as those LDCs that cannot increase their efficiency are sold or amalgamated. The PBR mechanism currently does not operate in this way, as one of the effects of first generation PBR has been to penalize low-cost LDCs that entered the new regime operating efficiently, while high-cost LDCs have not been required to significantly reduce those costs.

5. LDCs as Load Serving Entities ("LSEs")

The discussion paper speaks to the concept of LDC's becoming LSE's as one outcome of a restructured electricity marketplace. Some commentators have noted that in order to act as LSEs, distributors must consolidate, as it is only large distributors that could provide the LSE function. The OEB may wish to consider in its deliberations on LSEs that municipal utilities co-operatively created a power procurement company (Enerconnect) several years ago to provide that LSE function. However, the market design adopted by the Government of the day precluded that entity from power procurement as distributors were required to purchase all of their power from the spot market. With an entity such as Enerconnect, Power procurement could be undertaken by LDCs by aggregating their loads, without the need to consolidate.

Guelph Hydro appreciates the opportunity to make this submission, and looks forward to the continuation of the consultation process.

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