HAMILTON HYDRO INC.

RESPONSE TO

ONTARIO ENERGY BOARD
STAFF DISCUSSION PAPER

REVIEW OF FURTHER EFFICIENCIES IN THE ELECTRICITY DISTRIBUTION SECTOR

SUBMITTED FEBRUARY 16, 2004

RESPONSE TO OEB STAFF'S REVIEW OF FURTHER EFFICIENCIES IN THE ELECTRICTY DISTRIBUTION SECTOR

Introduction

On January 21, 2004 the Ontario Energy Board issued to stakeholders a notice to review further efficiencies in Ontario's electricity distribution sector. In particular, the Board's objective is to consider "if further efficiencies are available, and if so, how to achieve them".

Hamilton Hydro Inc. believes strongly that further efficiencies are available in the rationalization of the electricity distribution sector. Hamilton Hydro Inc. has first hand experience in that efficiencies and benefits are to be had post consolidation. In response to OEB Staff's Discussion Paper, Hamilton Hydro Inc. would like to share its experience post amalgamation and present its views on how future consolidations should occur in this sector as well as related issues that need further considerations.

Hamilton Hydro Experience

On July 1, 2000, the five municipal electric utilities in the new City of Hamilton (Ancaster, Dundas, Flamborough, Hamilton, Stoney Creek) merged to form Hamilton Hydro.

This was a legislated amalgamation involving one large LDC (Hamilton Hydro Electric System) and four smaller LDCs. The amalgamation effort was very successful, was completed in one year with little to no political interference.

The resultant utility was financially stronger, improved service and reliability to its entire customer base, while reducing controllable expenses.

Benefits post amalgamation included:

- A 24 hour – 7 day a week control centre with trouble crews on shift ready to be dispatched. In most cases this meant that customers could enjoy response times within 30 minutes of reporting any service related problems as opposed to relying on after-hour call in of service crews that typically requires 1 to 2 hours to respond at the customer's site.

- One common billing centre. Hamilton Hydro's billing system was market ready and has performed reliably throughout the various regulatory changes that have occurred since. These costs would have had to be borne by five (5) utilities as opposed to the one amalgamated entity. Further, amalgamated Hamilton Hydro has also been able to provide water billing services to the City of Hamilton, at competitive rates, further reducing operating expenses for its electricity customer base.

- Common engineering and record systems. All paper records of the former separate utilities were digitized to permit for automated mapping, design and facilities management through utility computer applications. In addition to leverage existing engineering design groups the digitized format enabled field crews to provide safer, more reliable and timely locate and construction related information to contractors and developers in the field.

- Cost reductions. Annual recurring savings of $3.3 million achieved representing a 10% to 15% reduction in operating expenses.

The results have been impressive:

1. Dominion Bond Rating Services ranked Hamilton Hydro the lowest cost LDC in Ontario (DBRS, Canadian Gas and Electricity Distribution Utilities, June 2001).

2. S&P rated Hamilton Hydro parent, Hamilton Utilities Corporation A+ (stable) in 2002, among one of the highest rating of any utility in North America. Currently rated A (stable) post Bill 210, which is the highest rating in the industry for our sector.

3. In 2002 Hamilton Hydro set its own all time best performance record for reliability tracking an average outage duration of just 34 minutes per customer an exceptional result not only in Ontario but across Canada for an electric distribution utility.

Hamilton Hydro believes that consolidations coupled with sound fiscal management can result in similar savings and benefits to other utilities. Further efficiencies in the distributor sector are not only intuitive but also factual as documented by Hamilton Hydro's experience.

Consideration and Issues for Discussion

1. Further Consolidations

Any regulatory action towards industry consolidations should occur within an operating framework of principles that are generally understood and accepted by the industry, inspire investor confidence, and are in the best interests of the customer. With this in mind Hamilton Hydro Inc. is proposing these principles for the Board to consider:

Principle #1 **Rationalization of the distribution sector should occur on a voluntary basis permitting economic and service related objectives to drive the process.**

Since the introduction of the Electricity Competition Act, 1998 all LDCs have been incorporated and have established their own financial arrangements and structures that need to be taken into account so that shareholder value is fairly recognized upon acquisition, divestiture, or amalgamation and that the customer's interests are represented as well. Voluntary consolidation is the best method to achieve this.

Principal #2 **Any consolidation must result in a net benefit to customers in either improved service or a reduction in operating costs.**

While the economic imperative to maximize shareholder value is paramount it should be balanced with the interests of the customer to derive a sustainable model for the industry.

Principle #3 **Any entity, existing or newly created, must demonstrate its long term financial viability by being able to attract capital on a competitive basis as a condition of license.**

In the interests of customers a pro-active approach is required to ensure that re-investments can occur as required to maintain service levels and that rates of return on equity are sufficient enough to attract capital if required.

Principle #4 **All fees and budgets related to regulatory process (OEB) and market compliance (IMO) should reflect actual cost to perform service and not be based on customer base of the utility.**

Too many fees and rates exist in the current system that continue to encourage and support the existence of smaller utilities that would otherwise not be in a position to exist if not for these subsidies. All entities should bear their own full costs to participate in regulatory hearings and filings as well as other market compliance requirements. Differential rates based on size are discriminatory and provide false economies.

Principle #5 **As a financial inducement towards consolidating, utilities must be able to avail themselves of the financial benefits of the consolidations, for a defined period of time, to enable the entity to recover any integration costs, rate harmonization, or transaction risks.**

Integration costs will exist between two separate entities and are a necessary precursor to achieving operating savings. Information systems need to be replaced, employee separation costs need to be taken into account, etc. Further, valuations of two or more utilities with disparate rates will result in differing valuations based on current and future cash flow expectations. Permitting flexibility in retaining financial benefits post consolidation will increase the number of parties interested in consolidating as well as providing more options towards a rate harmonization strategy that will benefit both customers and shareholders in the long term. A reasonable period of time for benefits to be retained would be five years. Consolidating entities would be exempt from any productivity adjustments to their rate structures under a PBR framework of regulation for the defined time period.

Principle #6 **Hydro One's distribution assets in urbanized areas contiguous to existing LDCs serving similar urbanized areas must divest or consolidate with a contiguous utility if:**

i) an LDC requests to consolidate, and
ii) the new entity to be created is of greater financial viability, or
iii) customer value (price or service) is enhanced.

Hydro One's largely rural distribution system surrounds municipally owned distribution assets in a manner that has been categorized as a "Swiss cheese" landscape. This structure is a barrier to further consolidations. Hydro One's core competency should be in operating a transmission system. Hydro One may also be best positioned to service rural distribution lines that overlap with rural transmission lines for efficiency reasons. Hydro One, however, is not best suited to serve customers in an urbanized environment. The evidence is quite clear that these customers would benefit from being consolidated within an existing higher density urban utility and provide the utility the opportunity to further achieve greater efficiencies.

Principle #7 **New embedded distributors should not be permitted within an existing distributors service area.**

Consolidation of the sector has been proven to result in efficiencies and savings. Application for a distributor license, currently before the OEB, to permit an embedded distributor to be created with an existing service territory of an LDC would only serve to further fragment an already fragmented sector, potentially undermine the financial viability of the affected LDC, and are likely lead to increased customer costs directly or indirectly. This is not in the best interest of the sector, shareholders and most importantly the customer.

2. Load Serving Entities (LSE)

Hamilton Hydro is of the opinion that distributors can play an important role in providing stability to the marketplace and foster an environment for investment in supply. Distributors should be permitted to arrange for long term supply contracts for low volume SSS customers. This would provide a degree of price stability to the least able group of customers who can manage or hedge this risk while establishing a framework of contracts enabling generators/developers to finance supply projects.

This model is not dissimilar to the natural gas sector. The natural gas utilities have a regulated price for system gas that is based on partially hedging its portfolio with supply contracts and partially settled at market prices. A variance account is established for any amounts over or under collected and price adjustment processes are in place with the OEB to permit these to balance over time.

Hamilton Hydro is not advocating that utilities actively trade energy contracts to hedge 100% of the price and volume risk within the supply requirements of SSS customers. This is not necessary and would require a very sophisticated energy trading function complete with its inherent financial risks. A more pragmatic approach would be to hedge only the portion of the utilities portfolio that is required for base load requirements. The remainder of the portfolio (the net amount) would continue to be purchased on spot prices and recovered through periodic adjustment, upwards or downwards. No balancing or trading issues result to mitigate financial loss since the entire contracted amounts fits safely within the requirements of the utility load and becomes a blended rate between fixed contract and spot prices. The OEB's role would be to ensure that a prudent portfolio strategy is approved and that the utility executes on this plan. In turn distributors would have to have sufficient assurances that recoveries for variance accounts would be permitted unequivocally to avoid credit rating downgrades or other serious negative financial impacts to the utility.

In most cases the conservative amount of utility load that can be hedged would be approximately 50%, on an annualized average, of the entire utility portfolio or supply requirements. The amount of energy that these contracts would represent across the Province is substantial and could serve to be an extremely important source of financing for power projects.

Unfortunately the majority of Ontario distributors today are too small to be able to implement this model. For those utilities that possess the scale and financial viability to implement and manage under a load serving entity model then they should be permitted to do so. The others will need to consolidate further to achieve this capability. The benefits to the Province of this model would be to secure development in generation and to provide price stability and mitigation to low volume customers.