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on

**Review of Further Efficiencies in the Electricity
Distribution Sector**

By

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Sub-Group Presentation to the Board Hearings on Efficiencies through Consolidation,
LSEs and the Delivery of DSM Programs

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Introduction

This presentation is being made by Aurora Hydro, Innisfil Hydro, Newmarket Hydro, North Bay Hydro, Orillia Power, Parry Sound Hydro, and Tay Hydro. For brevity call this group the Sub-Group. All are members of the Upper Canada Energy Alliance, the Alliance for short. The Sub-Group would like to thank the Board for allowing it this opportunity to make an oral presentation in response to the Board's initiative to undertake a consultation to review further efficiencies in the electricity distribution sector.

Discussion Paper

Regrettably the Board Staff's ("Staff") discussion paper arrived just a week before these hearings, however we have been able to add a few comments that reflect excerpts from the discussion paper.

Overall the discussion paper's scope and understanding of the issues is encouraging and the Sub-Group congratulates Staff on the balance it has achieved. Staff sensibly recognizes the trade offs involved in distribution restructuring. For example Staff recognizes that efficiencies are not simply cuts in service to lower costs, which have been the trademark of so many so-called efficiency and cost cutting exercises. Nevertheless the discussion paper is like a series of unnumbered dots connected to draw a picture of efficiencies through consolidation. The Sub-Group believes those dots can be connected in other ways to draw several other pictures and that efficiencies have been and can be achieved in other ways.

MEUs/LDCs

As I speak I will use the terms MEUs (Municipal Electric Utilities) and LDCs interchangeably both meaning more or less the same thing but MEUs generally implying pre Energy Competition Act ("ECA") entities and LDCs implying post ECA entities.

Origins of the Alliance

The Upper Canada Energy Alliance, as the name suggests, is a partnership formed between a number of Local Distribution Companies ("LDCs") that are diverse both geographically and numbers of customers served. The Alliance members are those of this Sub-Group and three other LDCs.

The Alliance started as a co-operative effort between MEUs in York Region. In 1997, with the prospect of dramatic changes in Ontario's electric sector on the horizon, the York Utilities turned their attention to the challenges and opportunities those changes would bring. The membership was expanded to utilities beyond York Region on the working assumption that LDCs would need to procure electricity. This was the formation of the Alliance.

Alliance RFI for Power Procurement

As part of investigating electricity procurement, the Alliance issued an RFI in 1998 to determine if the North American market was interested in selling electricity to such a group. The results

were overwhelming. Responses from almost all significant market participants at that time were received, including:

- American Electric Power
- PECO
- PacifiCorp
- Enron
- Williams Energy
- Ontario Power Generation
- Hydro Quebec

who were at that time eager to enter the Ontario electricity market and establish early adopter customer relations.

Alliance OPG Discount

As a consequence of this investigative process, the Alliance negotiated and received a discount on wholesale electricity by aggregating its supply from Ontario Power Generation before market opening, resulting in savings to members of almost 1% on Cost of Power.

Alliance Refocus and Accomplishments

When it became obvious that default consumers would be price takers in Ontario's spot electricity market the Alliance concentrated on the pursuit of joint purchasing and services savings for its members.

Currently, the Alliance operates its own wholesale settlement service that has been a success story, delivering wholesale settlement services to its members at 50% of the commercial pricing available at market opening.

Even with this significant discount, the Alliance has been able to enhance its services to members by adding participation in the Ontario Load Data Research Group, including the cost of required interval meter installations at no extra cost.

The Alliance routinely uses one representative at industry groups rather than requesting the attendance of multiple representatives. The Sub-Group members believe that shared services have as much potential if not more than consolidations because they preserve the identity and local contribution of LDCs while permitting choice of where the LDC wishes to seek economies through partnerships with others. Additionally it does not limit an LDC to one partnership. In fact a number of Sub-Group members are also partners in other shared service groups.

This Consultation

This Board consultation is about driving further efficiencies in the distribution of electricity, speculation on whether further consolidation would create these efficiencies and if in fact there would be additional benefits to consumers to be derived.

Is Bigger Better?

This is the “bigger is better” argument that has confronted Ontario’s LDCs for many years. From the early 90’s there were observations that Ontario’s over 300 MEUs, as they were then called, seemed like more than were necessary to serve the number of customers in the province and that in other jurisdictions the number was typically much lower.

The MEU Heritage

MEUs always agreed that their number was an anachronism but it was not the cause of high electricity rates. That was directly attributable to Ontario Hydro’s debt and dubious management practices. MEUs could never seem to get people to understand that they were not part of Ontario’s electricity problem, they were in fact part of Ontario’s electricity heritage and an Ontario success story that would have been a solid cornerstone on which to build a restructured electric ity industry.

MEU Characteristics

Many, the government of the day included, did not appreciate the unique aspects of Ontario’s LDCs. As not for profit entities with elected commissions they were virtually self-regulating through the lightest of touches from Ontario Hydro, they were fierce consumer advocates and they drove their own efficiencies through rivalries with their neighbouring communities. When new rates were needed, Belleville was not willing to admit it had to seek more than Trenton, nor would North Bay seek more than Sudbury, or Markham more than Vaughan.

Controllable Costs as a Proxy for Efficiency Measurement of LDCs

In pre re-regulation days a generally accepted rule of thumb for efficiency was an LDC’s Controllable Costs per customer. It wasn’t perfect because of service differences between LDCs, some provided more, some less and accounting practices, some transferred costs to capital rather than operations but many believed it was a reasonable proxy for efficiency.

Statistics over many years have shown that the size of MEUs in Ontario bears little relationship to Controllable Costs per customer. If lower Controllable Costs are accepted as approximating higher efficiency, the reasons were more attributable to the performance and culture of management and elected commissions and their high degree of personal and professional ethics in their roles as public servants and the competitive rivalry between communities than the size of the MEU. The MEA published Performance Management Ratios that assisted MEUs to compare their performance to others and create objective measures for improving efficiencies. What the Board may find even more remarkable is that this was all done voluntarily with no regulatory insistence. MEU participation was also voluntary and the incentive to improve was simple – no one wanted to be running the worst or most costly utility in Ontario. The Board could do worse than to look at why MEUs responded to such voluntary incentives to improve efficiency, why the performance management ratios worked and what was achieved as it designs its efficiency models for Ontario’s LDCs and particularly if it decides to proceed with PBR II.

Controllable Costs Statistics

The Alliance presented evidence on this subject to the Board at the 1998 hearings on Performance Based Regulation. The Alliance said that on average the Controllable Cost per customer for

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Ontario's LDCs was in the order of \$160 per customer and that for the more efficient utilities in the province, including a number of Alliance partners, it was in the \$120 to \$130 range. We also pointed out that the largest LDCs in the province had some of the highest Controllable Costs per Customer. Toronto Hydro was in the \$400 range and had amongst the highest electricity rates in the province and Hydro One was in the \$320 range. We further observed that typically Hydro One cited distance and density as its costs drivers yet its Administration costs, where billings systems, call centres and a one million customer base should provide economies of scale were \$90 per customer almost twice the average LDC at \$50 per customer. An example from the gas industry drives home the same point. The O&M cost for distributing gas in Kingston a utility with less than 30,000 customers is about \$100 per customer, almost the same as Union Gas a utility with 1.1 million customers.

Controllable Costs Post ECA

The Sub-Group has reviewed the trial balance sheets submitted to the Board by three small, three medium and three large LDCs and observes that the trend identified above continues. Controllable Costs per customer for small and medium LDCs are comparable if not lower than larger LDCs. The analysis also seems to demonstrate that Controllable Costs for all LDCs have increased because of the costs of complying with market readiness and regulatory rules. A table of the findings is attached.

What are Controllable Costs in Other Jurisdictions with Larger LDCs?

In 1998 when one Sub-Group partner took the then Minister of Energy to task for repeating the mantra that Ontario had more LDCs than the rest of Canada combined and asked him what it cost those LDCs to distribute electricity he said he didn't know. We saw that the forced municipal mergers in Toronto and other Ontario cities based on the assumption that costs would be lower did not in fact deliver the lower costs expected, just bigger cities.

We note that the discussion paper follows the same path of discussing the number of customers served by LDCs around the world but does not say what level of service is provided or at what the cost. While the paper cites statistics that demonstrate a range of sizes it is safe to say that the overarching theme is that most countries have larger LDCs than Ontario. We note that there is only one statistic from the US and none from the numerous jurisdictions with multiple LDC systems similar to Ontario.

LDC Size Without \$ Uni-Dimensional

To cite statistics that demonstrate only size seems to miss an important point that the discussion paper makes elsewhere - that efficiency is about the value of services and supplying comparable levels of those services at a competitive cost per customer. Without defining the levels of service and the costs to deliver those services the statistics are uni-dimensional.

PBR I Did Not Link Levels of Service and Controllable Costs

PBR I did not address this issue. LDCs started their journey to greater efficiencies from different points. LDCs with high costs and high rates were not distinguished from those with low costs and low rates. All were set the same targets and high cost LDCs were allowed to embed their high costs in their rate bases. Low cost LDCs that were already more efficient were required to find

further efficiencies. While the Board identified SQIs it did not fully define an expected level of LDC services or a reasonable rate for those services and allow some to bring their levels up or alternatively others to adjust their levels down. A simple example is meter reading. An LDC that reads meters and bills monthly has higher costs and arguably a higher level of service than one that reads meters and bills bi-monthly. Given the nature of the market it was conceivable that monthly meter reading and billing to consumers would have been valued and should have been considered as a standard but it wasn't. The bi-monthly LDC could not improve service without incurring higher costs for which there could be no compensation whereas the monthly read/bill LDC could have reduced service, lowered costs and increased profits with impunity.

Transition from Ontario Hydro to OEB Regulation

Many LDCs were surprised at the relationship with the new regulator. A comfortable, predictable process of regulation by Ontario Hydro was replaced with a sterner, more rigid regimen of a regulator that didn't seem to appreciate the unique heritage nature of LDCs or the reasons they exist. One size fits all codes, rules, regulations, reporting and filing requirements where the size seemed to be Hydro One or Toronto Hydro were onerous and a burden for many smaller LDCs. In fact LDCs understand this was reciprocal and that the Board had any equally arduous job regulating and dealing with the numbers of LDCs that has presently dwindled to just about 100.

LDCs Know Ontario's Electricity Consumers

LDCs' Main Street presence means they know their customers and electricity distribution better than many who have had such influence on electricity policy over the last ten years. It's too late now but if MEUs had been listened to, electricity restructuring might have run a different and more successful course. The Sub-Group respects the Board's process of hearings with oral and written submissions but suggests that this could be supplemented and enhanced by Board staff and members getting out and meeting LDCs and getting to know the business they are regulating at the grass roots level.

Since LDCs, especially the smaller and medium sized ones, operate in the communities they serve, the Sub-Group wonders if the same regulation necessary for robber baron monopolists is necessary for such municipally owned entities and whether some sort of asymmetrical and simpler lower cost regulation would be possible and offer reciprocal benefits to the Board and some regulated LDCs.

Post ECA LDCs Believe in Their Future

Despite all that has transpired many LDCs still believe in their contribution and value to their communities and have faith in what they are doing, what they have achieved and their future. LDCs that still exist, post ECA, do so because they believe they are viable in a restructured electricity industry, that they add service value to their communities by not relinquishing their independence yet delivering equivalent or enhanced monetary returns to their municipal shareholders than if they had been sold or merged.

LDCs as LSEs

Turning to another matter. The Board's Notice on this consultation discusses the notion of LDCs acting as load serving entities ("LSEs"). The Sub-Group experience in its late 1990's

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investigation into power procurement and the RFI process places it in a unique position with respect to an Ontario insight into this matter. It is worthy of note that, during this investigation, the Sub-Group, through a member utility, gained membership in the Northeast Power Coordinating Council to better understand wholesale power transactions and the reliability in an interconnected electric system. As such, we raise the following points for consideration in further deliberations on this point:

Definition of LSEs required

LSEs and their roles and responsibilities mean different things to different people and opinions on whether LDCs becoming LSEs and papers and presentations will vary based on the assumptions made. The Sub-Group will assume that an LSE means commodity purchase, supply to the default customer, a pass through rate and that the LDC takes no risk but is allowed some fixed price mark up for its involvement and to cover administrative costs. We expect that most, if not all LDC's should have more questions on this notion than there are answers. Once LSEs are defined, LDCs that may favour this role could well develop an aversion to it.

LDCs can procure electricity without consolidation

Power procurement for an LDC does not require consolidation. This was the initial premise for formation of the Alliance. We also note that ENERconnect was set up by the former Municipal Electric Association for the purpose of commodity purchasing and would have aggregated purchases for all sizes of LDCs with the intent of being the "LSE of choice".

More than one LSE and multiple pricing regimes?

The Notice for this consultation discusses LSEs in the plural. This indicates a digression from uniform pricing of the electricity commodity for default consumers. If LSEs are responsible for procurement, then each would require its own procurement portfolio and thus commodity pricing. Depending on the portfolio, the consumer price could vary significantly. This raises the question of how many LSEs there would be, as this would determine the number of pricing regimes, and the prudence requirements to ensure that contracts are fair to consumers. We suggest that the number and nature of LSEs be established without regard to LDCs, using criteria that place consumer and market impacts first and foremost.

Regulated default rate and procurement

Bill 4, Section 11 makes reference to default rate regimes being in accordance with government regulation. This is distinctly different from an electricity market that is competitive and the conditions under which the natural gas industry assembles its default supply portfolio. The Sub-Group notes that there may be a significant risk of an LSE not being able to assemble a prudent procurement portfolio that satisfied these regulations economically for consumers.

The Sub-Group LDCs believe they could assemble a prudent default supply portfolio, but only on the basis of a pass through in costs. LDC Boards and municipal owners are unlikely to want to accept the risk of volatile commodity prices that cannot be passed on to consumers. The impact of default supply on the cash flow of LDCs was an enormous burden in the short period prior to the passage of Bill 210. Thus, in an LSE role, LDCs

will reasonably expect compensation for providing procurement as part of default supply, creating additional costs for consumers.

LDCs as LSEs a conflict to retail

Multiple LSEs will create conflict with a retail market, causing it to weaken significantly.

LDCs as LSEs blur LDC costs

Default supply responsibilities have an impact on LDC costs. LSE responsibilities would have an even more significant impact that will blur true distribution costs and make LDC costs and efficiencies difficult to measure.

The roles, responsibilities and expectations of LSEs need to be crafted as part of any discussions on their number and the appropriate entity to fulfill these obligations.

LDCs as DSM Delivery Agents

Delivery of demand side management (“DSM”) programs by LDCs is also discussed in the Board’s Notice. There is a compelling argument that LDCs, with their exceptional community relationship, databases, and direct customer contact through billings are a natural choice for program delivery. Offsetting this are the issues of saving the distributor harmless from the economic impact of reduced system throughput, and ensuring adequate incentive to deliver effective programs.

Defining DSM

As with LSEs, without knowing the DSM programs to be delivered, it is difficult to discuss their delivery, or the appropriate entity to do it. The Sub-Group assumes that DSM programs in Ontario will be of three basic forms:

1. Behavior modification to have consumers use less electricity, particularly at times of peak provincial consumption
2. Agreed to restrictions on non-essential uses; and
3. Education

With the exception of (3), all forms use pricing signals to the consumer that inflict economic pain and reward. Readily available mechanisms in the electric industry include:

- Interval meters and spot market commodity rates
- Time of use meters and more than one daily commodity rate
- Escalating block commodity rates
- Programs of electricity metering, use auditing and process/commodity rate design for large commercial and industrial customers; and
- Point load controllers that can be remotely activated with a per use or per installation rate regimen.

DSM responsibilities need clarification to fit LDCs

Metering and commodity rate design are at the heart on any effective DSM program. While LDCs can fulfill the metering needs of a DSM program, we believe developing,

implementing and managing a myriad of commodity rate designs is a competitive market function. Similar to LSEs, the SubGroup suggests that the responsibilities and expectations of DSM programs need to be crafted as part of any discussions on the appropriate entity to fulfill these obligations.

Summary

In summary, the Sub-Group believes that consolidation should be enabled and encouraged but not contrived or forced. Available data suggests that any of the sizes of LDC that exist in Ontario can be efficient and sees no evidence that the existing large LDCs are more efficient. If in redesign of the market it appears that LDCs should act as LSEs or DSM delivery agents, small and medium sized LDCs could accomplish this through shared services. The caution and concern of the Sub-Group is that any of these new initiatives not be detrimental to the revenue streams that have now become part of and are relied upon for municipal funding. Concerns about the costs of delivering distribution services could be addressed through an easing and streamlining of the regulatory burden. The Sub-Group suggests that PBR I should be allowed to run its course and that the comments and observations the Board receives in these hearings be incorporated into PBR II.

Thank you for your time and patience.

Controllable Costs Post Energy Competition Act

	Average weighted controllable cost per customer for the group	Highest utility controllable cost per customer in the group	Lowest utility controllable cost per customer in the group
Utilities less than 10,000 customers	\$ 194.28	\$ 203.54	\$183.99
Utilities more than 10,000 customers less than 40,000	\$ 193.62	\$ 221.74	\$ 179.69
Utilities more than 40000 customers	\$ 219.30	\$ 256.66	\$ 195.68

Method selection

The 92 utilities in the Province of Ontario were divided into thirds. From each third, a sample of three was randomly chosen without statistical sampling techniques.

The thirds were divided into the following: 1/3 were utilities in the range of less than 10,000 customers, 1/3 were in the range of utilities with customer counts from 10,000 to 40,000 customer and 1/3 were utilities with greater than 40,000 customers.

Once the sample utilities were chosen, Audited Financial Statements were obtained for the years ending 2002, and 2001. Customer counts were obtained through the utility and through the Ontario Energy Board if the utility could not provide a count.

Controllable costs were defined as amounts listed on the Audited financial Statements as Billing and Collecting costs, Distribution, Engineering and General and Administrative costs. These Audited Expenditure line items amounts were added together then divided by the customer count to arrive at the controllable cost per customer.

It should be noted that these costs could differ between utility depending on different accounting treatments adopted by LDC's. There are consistent guidelines applicable to accounting treatments for LDC's therefore these differences in accounting treatments for certain expenditures should be immaterial.

Audited financial statements were chosen to provide financial information as these are released to the stakeholders to evaluate the stewardship of the LDC.