

14 Carlton Street
Toronto, Ontario
M5B 1K5

Telephone: 416.542.2572
Facsimile: 416.542.2776
rzebrowski@torontohydro.com



February 19, 2004

via facsimile to 416.440.7656 – Original to follow by mail

Peter H. O'Dell, Assistant Secretary
Ontario Energy Board
P.O. Box 2319, 26th Floor
2300 Yonge St
Toronto ON M4P 1E4

Dear Mr. O'Dell:

**Re: Review of Further Efficiencies in the Electricity Distribution Sector
OEB File No. RP-2004-0020**

Pursuant to the Board's letter dated February 11, 2004, attached is Toronto Hydro-Electric System Limited's (TH Electric System) written submission on the Board Staff discussion paper on the above-noted matter. Six (6) paper copies have been provided for your review, together with electronic copies in PDF and Word formats.

Please contact the undersigned for any questions or comments.

Yours truly,

"R. Zebrowski"

R. Zebrowski, Vice-President
Regulatory Services

att./acc

Copy: Dorothy Wilkinson, Ontario Energy Board

IN THE MATTER the *Ontario Energy Board Act, 1998*, S. O. 1998, c. 15, Schedule B of the *Energy Competition Act, 1998*, as amended; and

AND IN THE MATTER OF a Notice of a Consultation to Review Further Efficiencies in the Electricity Distribution Sector.

Ontario Energy Board File #: RP-2004-0020

Date: February 19, 2004

Ontario Energy Board File #: **RP-2004-0020**

Title of Proceeding: Notice of a Consultation to Review
Further Efficiencies in the Electricity
Distribution Sector.

Submitter's Name Toronto Hydro-Electric System Limited

Submitter's Address 14 Carlton Street

Toronto, Ontario

M5B 1K5

Submitter's Representative: R. Zebrowski, Vice President

Regulatory Services

Telephone: (416) 542-2572

Facsimile: (416) 542-2776

e-mail: rzebrowski@torontohydro.com;
regulatoryaffairs@torontohydro.com

Introduction and Summary

1. In response to a notice given by the Ontario Energy Board (“Board”) on January 21, 2004 of a Consultation to Review Further Efficiencies in the Electricity Distribution Sector, these are the written submissions of Toronto Hydro-Electric System Limited (“TH Electric System”).
2. In this context, TH Electric System has confined its remarks to the topic areas set out in the Board’s notice. Although the discussion set out below makes reference to Second Generation Performance Based Regulation (PBR), TH Electric System will reserve a full statement of its views on this topic until the Board calls for them in a separate proceeding.
3. TH Electric System takes the positions that i) PBR is the most practical mechanism to influence electricity distribution sector efficiency; ii) that the load serving entity role is best not assumed by electricity distributors; and iii) that appropriate rate making mechanisms should be introduced to address significant capital costs associated with technological innovations.

LDC Consolidation

4. TH Electric System believes that further consolidation of the electricity distribution sector is an important issue in the medium term, but does not presently regard it as a top priority relative to other current market issues (e.g., supply adequacy, standard supply issues, DSM).
5. TH Electric System acknowledges that further scale economies and cost reductions may be realized through rationalization and that regulatory efficiency would be promoted by a reduction in the number of separate entities that must be regulated.
6. However, even though cost savings could eventually be realized through substantial and immediate consolidation of municipalities and/or LDCs over the short term, TH Electric System takes the view that that such a consolidation effort would require a substantial infusion of resources in the short term, and could potentially create costs which might otherwise be avoided if rationalization were to occur in a more measured fashion.
7. For example, immediate consolidation could create transition costs such as employee termination costs, which could be smoothed were consolidation among utilities to take place over a longer time frame.
8. Such an approach would require strong incentives or direction from government.

PBR Drives Efficiencies

9. TH Electric System takes the view that a well-balanced system of Performance Based Regulation (PBR) can drive efficiencies in the electricity distribution sector, flexibly and effectively. PBR focuses on the desired end results of quality service at fair prices, and allows utilities to seek cost efficiencies through a variety of means, which could include consolidation among others.
10. In addition to outright consolidation, there are a number of other avenues available to utilities by which to achieve scale economies and other efficiencies, in those areas where they are available. PBR is a flexible approach to seeking efficiencies that would permit utilities to target functional areas within the organization, or to consolidate at the organizational level, depending on what is most advantageous in the circumstances.
11. TH Electric System has confidence that significant efficiencies within the overall distribution sector can be achieved under Second Generation PBR. While First Generation PBR has been marked by transitional difficulties and policy uncertainty in the industry as a whole, it is reasonable to expect that utilities can continue to improve their operations and cost structures under an updated and refined Second Generation PBR system. To date Ontario electric utility experience with PBR has been somewhat inconsistent due to an unstable regulatory environment arising from Bill 210 and the previously proposed Bill 100. TH Electric System believes that utilities need a period of regulatory

- stability around PBR to develop a culture that will allow them to focus on a continuous improvement approach that will become embedded in the business processes and systems of the utility. This will contribute to the ongoing attainment of efficiency improvements and effective service delivery.
12. Therefore, second generation PBR should be a logical and predictable progression from the current PBR regime.
13. Overall, TH Electric System submits that it is practical and cost effective to drive efficiencies in the sector through an improved system of PBR. PBR presents effective and appropriate incentives to utility managers to reduce costs while maintaining or improving customer service and reliability standards. It is reasonable to believe that in the absence of barriers to doing so, utility managers will seek and execute the most effective methods of efficiency improvement, potentially including consolidation, under such a system of incentives.
14. TH Electric System also takes the view that it is appropriate to recognize inherent differences in operating environments and service quality requirements that currently exist in different areas of the province, when considering how best to achieve improved efficiency for utilities. As is recognized in the OEB Staff Discussion Paper, it would be imprudent to seek cost reductions if the consequent impact on service quality outweighs the cost saving. Similarly, simple one-dimensional comparisons of dollar costs between utilities with different service requirements could lead to poor decisions and outcomes. Differing

reliability requirements provide an example in the sense that a load loss of a given magnitude could have very different social and commercial consequences depending on whether the loss takes place in a high density downtown core or in other urban areas

Existing Efficiency Barriers and Regulatory Reform

15. TH Electric System observes that in many instances significant capital investments are necessary to achieve further cost efficiencies and/or service quality standards. However, under the present PBR system, capital expenditures are added to ratebase only on the occasions of rebasing, which are several years apart. Prior to rebasing, utilities receive no compensation for depreciation costs or any return on these investments.
16. TH Electric System takes the position that this approach creates an untoward disincentive with respect to undertaking significant capital expenditures, which would otherwise be cost-justified or even strictly necessary. Therefore, TH Electric System urges the Board to investigate alternative methods of ratemaking under a general PBR system that would reduce or eliminate this disincentive.
17. TH Electric System also observes that the regulatory cost consequences of having a large number of distributors are not fully reflected in the OEB cost assessments that the Board levies against distributors. The Board may wish to consider whether a more cost-based or ‘user-pay’

approach to recovering its own costs could provide a meaningful incentive for utility consolidation while avoiding unfairness for utility customers.

Load Serving Entities

18. In its final report dated January, 2004, the Electricity Conservation and Supply Task Force (“ECSTF”) suggests that there is a need for parties to assume the role of acquiring electricity for consumers who do not contract with retail or wholesale suppliers but continue to purchase electricity from their local distribution utility.
19. The ECSTF suggests that initially, “parties who might be able to play this role include wholesalers, retailers, and subsidiaries of local distribution companies” (page 11, para. 11). However, the Task Force goes on to recommend that over time load serving entities could be local distribution companies, among other parties (page 28, para. 2).
20. TH Electric System recognizes the need to obtain, on behalf of consumers, reliable, affordable supply and agrees that this can be done effectively in an open market.
21. Accordingly, TH Electric System understands the need for the role of LSEs.
22. However, TH Electric System feels strongly that Ontario electricity distributors are not equipped to, and should not, assume the financial

- risks inherent in the LSE role. Power marketers or other entities that are appropriately structured and capitalized would be much better suited to assume the role of LSE.
23. TH Electric System believes that little customer value is added by combining the distribution function with the role of the LSE.
24. On the contrary, distribution rates could actually increase due to the inherently higher risk and associated costs of capital. TH Electric System believes that credit rating agencies would review and most likely lower their ratings of LDCs that undertook the significant new risks associated with the LSE function, other factors being held constant. Increased rates would be an undesirable outcome of the assumption of the LSE role by electric distribution utilities.
25. TH Electric System also observes the Board's objective "To facilitate the maintenance of a financially viable electricity industry". It would be inconsistent with this objective for the Board to require LDCs to assume the LSE role without making compensating changes to utility capital structures and rates of return.
26. In addition, TH Electric System believes that assuming the LSE function could have a further negative impact on the efficiency of LDCs in that attention will be diverted from their core business of providing distribution services.
27. For these reasons, TH Electric System believes it is inappropriate for electricity distributors to perform the role of Load Serving Entity.

However, should the Board find that it is appropriate for LDCs to perform this role, TH Electric System submits that this should be on a voluntary basis only and that LDCs not be required to perform the role of Load Serving Entity.

Technological Innovation

28. Electric distribution utilities have implemented SCADA and outage management systems as well as other tools that promote efficiency improvements. TH Electric System believes that any PBR regime should encourage, rather than discourage, the research, development and implementation of distribution automation systems and other technologies that can be reliably used by electric distribution utilities to improve efficiency.

Conclusion

29. TH Electric System appreciates the opportunity to participate in this consultation and commends the Board in taking a proactive approach to the matter of electric utility distribution efficiency.

R. Zebrowski, Vice-President
Regulatory Services