February 18, 2004

SAME DAY COURIER

Mr. Paul Pudge
Assistant Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street
Toronto, ON M4P 1E4

Dear Mr. Pudge:

Re: RP-2004-0020, Consultation to Review Further Efficiencies in the Electricity Distribution Sector

Thank you for the opportunity to comment on the Board staff discussion paper entitled "*Review of Further Efficiencies in the Electricity Distribution Sector*". As requested, we have enclosed six paper copies and one Adobe Acrobat electronic version of this submission.

We have aligned our comments with the five points presented in the discussion paper:

1. **<u>Further Consolidation</u>**

   It is our view that there are significant untapped efficiencies to be derived in Ontario's electricity distribution sector. This view is based on our company's merger and acquisition experience over the past four years. During this time the operations of seven predecessor utilities were consolidated, with impressive operational savings and service improvements.

   Details of Veridian Corporation's experience in consolidating distributors are provided in the attached paper entitled "*Benefits of Utility Consolidation; Veridian Corporation Case Example*". As stated in this document, our company has already realized Operations, Maintenance and Administration (OM&A) savings of about $22 per customer per year due to our consolidation efforts. At the same time, we have leveraged our newfound economies of scale to provide higher levels of service to our customers. Examples of improved services include the expansion of Supervisory Control and Data Acquisition (SCADA) infrastructure, the provision of 24 hour Control Room support, and access to greater resources in the event of a catastrophic distribution system event.

We are strong advocates of further consolidation in the distribution sector. While we serve about 92,000 customers and are the seventh largest distributor in the province, it is clear to us that further efficiency gains can be achieved with greater scale. This is particularly true in the capital and labour intensive billing, settlement and customer care functions, and in areas of corporate administration.

Veridian is anxious to exploit opportunities for further efficiency gains. However, there are a number of serious impediments to renewed merger and acquisition activity. A few examples and our recommendations for remediation are as follow:

- Distribution Rate Inequities – Distribution rates in Ontario are based on each local distribution company's (LDC) 1999 cost structure. As a result, LDCs with an initial high cost structure have fared relatively well under the Board's Performance Based Rate (PBR) regime, while those with initial low cost structures have struggled to achieve even greater efficiencies. This unfair and inequitable rate treatment of LDCs makes high cost distributors less likely to entertain consolidation efforts.

  There are other rate inequities as well. For example, many smaller LDCs are fully embedded in Hydro One's distribution network, but do not currently pay 'low voltage' distribution charges to fully reflect the cost of electricity delivery to their local distribution networks. This makes meaningful comparisons between the distribution rates of LDCs impossible.

  It is our view that the Board's schedule for distribution rate reform should be rapidly advanced. We also believe that the Board should seriously consider a yardstick approach to the establishment of rates, to provide a greater incentive for high cost LDCs to find operational efficiencies.

- Transfer Tax On Surplus Assets – Under the current transfer tax regime, LDCs that dispense of surplus assets are subject to a 33% transfer tax on the proceeds of the sale. Since LDC consolidation will almost always result in surplus assets, this transfer tax penalizes merger and acquisition activity.

  This tax provision has had a direct impact on Veridian's consolidation experience. Our company was able to eliminate the need for one of its service and administration centres, and subsequently sold the property for about $3,000,000. One-third or about $1,000,000 of these proceeds had to be set aside for transfer tax. This reduced the value of the consolidation exercise to our shareholders, and makes further merger and acquisition efforts less attractive.

We recommend that the transfer tax regime be modified to exclude taxes on the sale of surplus assets, and that this change be made retroactive to the date that Bill 35 was enacted.

- Separation of Transmission and Distribution – As clearly shown in Figure 1, page 5 of the Board staff's discussion paper, the distribution assets of Hydro One are interspersed with those of other LDCs across the province. If rationalization of Ontario's distribution sector is to take place, Hydro One must be a willing and active participant. To date Hydro One has participated only as an acquirer, despite the fact that they have service areas that could be much more efficiently served by local distributors.

  We believe that Hydro One ought to be compelled to separate its distribution and transmission businesses. This would be particularly important if the Board were to pursue a yardstick rate regime. The combination of these two business lines presents opportunities to inequitably allocate shared costs. This may unjustly put downward pressure on the distribution rates of other distributors. In turn this could lead to the devaluation of the distribution assets of the province's LDCs, making them attractive acquisition targets for Hydro One. These economic drivers encourage the creation of one large distributor serving much of the province. This outcome would, in our view, limit the Board's ability to effectively apply yardstick rate and/or performance regulation.

  Regardless of the Board's intentions for yardstick regulation, the separation of Hydro One's distribution and transmission businesses would provide benefits. It would improve regulatory oversight of these two distinct business lines, and would give Hydro One the incentive to more fully participate in the rationalization of the distribution network.

The removal of these impediments to consolidation would contribute to renewed consolidation activity. However, there are additional proactive measures that could be taken by the Board and the Government of Ontario to hasten the consolidation process. First and foremost, we urge the Board to recommend that the Province of Ontario divest Hydro One distribution assets to LDCs that are willing to consolidate and create new, larger regional distribution companies. We also suggest that the divestment of Hydro One's distribution assets be at net book value. This would provide a strong incentive for consolidation and rationalization of distribution infrastructure. As an added benefit, the sale proceeds of this initiative could be used by the Government to reduce the stranded debt held by Ontario Electricity Financial Corporation.

We also urge the adoption of a 'cost of service based' approach to recovering the Board's costs from the utilities that it regulates. The current practice of assessing costs on the basis of utility load does not accurately reflect the cost of regulating individual utilities. The adoption of a cost based approach would encourage LDCs to consolidate to reduce their overall regulatory costs, which would in turn reduce demands on the Board's resources. Cost based assessments would also give LDCs an incentive to ensure that all applications brought before the Board are fully substantiated and, to the extent possible, supported by stakeholders.

2. Incentives

The current Performance Based Rates (PBR) regime does provide LDCs with an incentive to become more efficient. However, as explained in the prior section of this submission, the degree of this incentive varies based on a particular LDC's cost structure at the time that the current PBR term commenced. Therefore, in our view, the incentive is inappropriately and unfairly targeted.

We support a rapid transition to a form of yardstick rate regulation, under which LDCs with like customer densities and distribution system characteristics would charge a common distribution rate. While we understand that this type of rate regulation has its challenges and drawbacks as detailed in the Board staff's discussion paper, we believe it to be far preferable to the current basis for distribution rates. Yardstick rate regulation would provide a strong and clear incentive for high cost distributors to find efficiencies in their operations.

We also support changes in the way in which distribution system losses are dealt with. Currently the cost of these losses is passed through to customers by way of uplifted electricity charges. This limits the incentive for distributors to design, operate and maintain their distribution networks in a manner that reduces system losses. By assigning responsibility for distribution system losses to LDCs and permitting the cost of losses to be included in distribution rates, LDCs will be provided with an economic signal to invest in more energy efficient distribution apparatus.

3. **Load Serving Entities**

Verdian is a member of the Distributors' Electricity Efficiency Policy (DEEP) group, which has developed a separate position paper dealing with the issue of Load Serving Entities. We strongly support the positions of this group. However, in the interest of avoiding duplication, will not repeat these positions in this submission.

4. **Distribution System Planning**

Distribution system planning can be achieved among neighbouring distributors on a collaborative basis. This is how Ontario's distribution network has evolved to date. However, this exercise can be done in a much more efficient manner by larger regional LDCs.

Problems associated with the current planning environment are evident. Ownership of distribution infrastructure is highly fragmented, with many LDCs entirely or partially embedded within the distribution system of a host LDC. This structure means that LDCs must not only collaborate on planning matters, they must also coordinate system operations. The complexity of this coordination not only leads to inefficiencies, it also affects system reliability and customer accountability.

Veridian can attest to the impact of fragmented distribution system ownership. As an embedded distributor in some parts of our service area, we must frequently coordinate power restoration efforts with our host LDC. On many occasions power interruptions affecting many customers have been protracted due to ownership restrictions that limit our ability to deploy staff to repair known problems on our host's upstream distribution apparatus.

5. **Technological Innovation**

There are two primary obstacles to needed investment in technological innovation by LDCs. The first relates to the current rate regime. Simply put, under today's PBR plan distributors do not know how, if or when they will be able to recover capital investments through distribution rates. Consequently, such investments are constrained by the cost savings that they offer over the current PBR term. This has deferred investments in technology that could provide enhanced reliability, improved service or lower costs over the longer term.

This obstacle should be addressed through the implementation of a stable and long-term distribution rate structure, which would provide LDCs with the time needed to exploit the savings offered by investments in technology. We suggest that yardstick rate regulation with a six-year term would provide a strong incentive for the deployment of new technological solutions within Ontario's distribution sector.

The second obstacle to investments in technology is the limited scale of most LDCs in the province. Important technological solutions such as Geographic Information Systems (GIS) and Supervisory Control and Data Acquisition (SCADA) systems typically have very high fixed costs. These fixed costs must be spread over a large customer base if such systems are to be deployed in a cost-effective manner. The further consolidation of LDCs would provide the scale needed to extend the benefits of these technologies to a greater number of Ontario electricity consumers. Our recommendations for achieving such consolidation are provided under discussion point number one of this submission.

Once again, we thank you for the opportunity to comment on these important matters. If you have any questions or require clarification on any of the issues dealt with in this submission, please contact me at 905-427-9870, extension 2200. I can also be reached by email at jwiersma@veridian.on.ca.

Yours truly,

John Wiersma
President and CEO

c George Armstrong
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Benefits of Utility Consolidation

Veridian Corporation

Case Example

Submitted to:
Distribution Structure Analysis Research Team
Electricity Distributors Association
David Clark, CMA
Executive Vice President, Corporate Services
October 27, 2003

History

Veridian Corporation was incorporated in November of 1999, combining the operations of municipal electric utilities Pickering Hydro, Ajax Hydro and Clarington Hydro. Each of the municipalities transferring the assets of their utilities received shares equal to the book value of equity transferred to Veridian. None of the shareholders hold more than 50% of the shares of Veridian.

Veridian purchased utilities following incorporation, Uxbridge Hydro, Port Hope Hydro, and Brock Hydro and merged with Belleville Utilities. Veridian has successfully integrated the operation of these utilities ranging in size from 1,600 customers to 27,000 customers. The consolidated entity now serves over 91,000 customers.

Veridian Approach to Amalgamation

The three mainstay strategies within Veridian's Amalgamation initiatives have been:

1. Enhanced Shareholder Value through Improvement in Operational Cost Efficiencies
2. Improving Service Delivery to Customers
3. Maintaining Strong Customer and Employee Relationships

1.0 Improvement in Operational Efficiency

Amalgamation has contributed to significant operating expense savings. Savings achieved to date were quite easily derived. Staff attrition, elimination of duplication and sharing of resources all contributed to this first stage of cost reductions. Veridian estimates the savings achieved to date from the amalgamation at around $22 per customer per year, about 12% efficiency savings in OM&A. This is quite consistent with the 13% savings predicted in the Durham Region Study.

Veridian has significantly reduced staff, accomplished nearly entirely by attrition. Veridian's customer to employee ratio in 2003 improved to 606 customers per employee. This further confirms the validity of the findings within the Durham Region Study as the study had concluded that staff ratios would improve to 629 from 455.

Veridian anticipates further savings will be achieved through two additional stages. Stage 2 involves business restructuring initiatives. Veridian is completing the 2004 Budget and through these business restructuring initiatives, a further 10% reduction in costs have been identified for 2004.

Stage 3 involves reengineering work processes and practices. Veridian anticipates LDC savings of a further 10% through adopting best practices employed by best in class utilities or businesses and the advanced work management processes and systems they employ. These savings are anticipated to be identified and implemented within 2004. Overall the three stages of cost savings improvement are expected to generate 30% in cost per customer savings.

Examples of operational efficiency achieved to date

- Administrative Facilities
    - Disposal of Redundant Administrative Buildings
      Five of the eight administrative/operations buildings owned by the seven predecessor utilities were sold or not acquired at acquisition. Veridian operates now in only three owned administrative/operations centres and leases space at a more affordable cost from three buildings.

- Staff Reductions
    - Software improvements: Customer Care, Payroll, H/R, Accounts Payable, Purchasing/Requisitions and Finance have enabled staff reductions in each of these areas.
    - Fewer linemen - Consolidation of Service Areas (Pickering, Ajax, Uxbridge) and (Port Hope/Clarington). Consolidation of service crews and on-call linemen in these service areas. Field Supervisors supervise larger crew sizes.

- Resource Efficiencies
    - Inventory $5.9M to $3.1M (47% decrease!)
    - Partnerships based upon volume buying
    - Fleet
      Surplus bucket vehicles disposed. No new aerial fleet additions since 1999. There is still significant duplication of RBD devices assumed from the predecessor utilities that have yet to be rationalized.
    - IT – Consolidation of Customer Care, Billing, Finance, SCADA, Distribution Records Systems
    - Leveraging IT expertise of combined utility IT staff (as exampled by exceptionally low regulatory asset transition costs - $7/customer)
    - Increased budget detail and analysis – Activity Based Costing
    - Mechanic Garage Facility in two predecessor utilities consolidated into one and now services vehicles for four of the utilities that were previously contracted out.

- Union Administration
    - Eight Collective Agreements consolidated into one collective agreement. One set of negotiations, one union/management interface.

- Safety Administration
  - One safety officer for entire organization. Consistent approach to safety. Since Veridian's incorporation, President's safety award for 250,000 hours worked without a lost time injury on two different occasions and have just achieved 500,000 hours.

- Board Reporting
  - One Board of Directors instead of seven. Significant reduction in administrative time required for Board reporting.

- Regulatory Reporting
  - One Regulatory Affairs Manager for Veridian monitoring compliance and regulatory filing. Each of the predecessor utilities would have had the requirement for installing a regulatory function.

- Financial Statement Audits
  - One financial audit reduced from seven.

- Best Practices
  - There have been significant efficiencies achieved from adopting best practices of each of the amalgamated entities.

2.0 Service Delivery Enhancements

- SCADA operation extended to four of seven utilities without prior system control.
  - Increased number of remotely controlled/monitored field equipment.

- 24 Hour control centre operation
  - System reliability improvement
  - Efficiency dealing with Provincial Emergencies such as August 14 Blackout. Hydro One dealt with one operating authority rather than seven.
  - Enhanced safety – After hours emergency line work monitored.

- Customer Call Centre
  - Enhanced Customer Call Handling Software
  - Customer Care staff dedicated to answering customer calls
  - Improved quality of call response
  - Improved efficiency in call handling per Call Representative

- Development Standards
  - One consistent Conditions of Supply for all seven utilities.

- Better Design Coordination
  - Combination of adjacent service areas has lead to reduction in duplicated assets (i.e. Load Growth in Pickering/Ajax – one Veridian substation and one distribution circuit in boundary areas rather than one for Pickering and one for Ajax).

3.0 Maintaining Strong Customer and Employee Relationships

- Strong Municipal Support
  - "Power to make your community better" applies to each community served through Charitable Donations and Support of community initiatives.
  - Good business to be a strong community partner even if that municipality is not a shareholder.

- Harmonized approach to rate setting

- Union and Employees support consolidation
  - Employees and union support growth through consolidation
  - Morale is higher when there is a vision for the company
  - Team building and synergies develop from combining work forces

- Employees thrive from the challenge associated with consolidating.

- Employees can and do work safely even with the complexity and intricacies associated with combining operations. Veridian has achieved the E&USA Presidents award for 250,000 safe work hours twice and has just completed 500,000 safe work hours.