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February 18, 2004

Ontario Energy Board
P.O. Box 2319
2300 Yonge Street 26th Floor
Toronto, ON M4P 1E4
Attention: Paul Pudge, Assistant Board Secretary

Re: RP-2004-0020– Consultation on Efficiencies in the Distribution Sector

In response the Board's letter of January 21, 2004 announcing a consultation on the electricity distribution structure, Hydro Ottawa has reviewed the staff report released on February 10th, 2004 and provides the following comments.

Staff Report

In general, the report provided a balanced view of the issues affecting efficiency in the distribution sector and opened up many areas for comment. Following is a discussion on the specific areas in which Board staff suggested comments be made.

<u>Section 6.1 Further Consolidation</u>

- Scale efficiencies already achieved

Hydro Ottawa has seen significant benefits from its consolidation, which occurred on November 2000. Hydro Ottawa, as the 3rd largest distributor in the province, has an improved access to capital. This allows investment in the kind of technology, such as geographic information systems (GIS), outage management and supervisory control and data acquisition (SCADA) that can provide the dual benefits of improving services to customers and reducing operating costs. One Distributor in the region also creates less confusion for customers. There is one set of conditions of service, one capital contribution policy for developers to understand, one operating entity to interact with the bulk electricity system and only one Distributor for the OEB to regulate. Many customers in the new City of Ottawa actually have rates that are lower now than they were 10 years ago, as a result of the amalgamation. The only confusion is for the 37,000 customers in the City of Ottawa not yet served by Hydro Ottawa. Further consolidation would alleviate this confusion.

Hydro Ottawa has used contractors for many years in areas where it is economically feasible. This has been for services such as meter reading and forestry, and also to meet short-term workload requirements.

Where possible, Hydro Ottawa has shared services, but this is difficult since there are no other large Distributors with a corporate presence in the vicinity.

Hydro Ottawa strongly feels that further consolidation in the distribution sector is now required. As a result of consolidations, the new larger Distributors will have improved access to both debt and equity financing. There will also be further benefits such as seen by Hydro Ottawa through the previous consolidation. This will result in lower overall distribution costs across the province. Hydro Ottawa is somewhat unique in that it is the only large Distributor in a somewhat geographically isolated area. Further consolidation cannot occur in this region without the separation of Hydro One assets from the provincial utility.

- Barriers and Incentives

The proliferation of smaller Distributors increases the overall costs of distribution across the province. Since some of these costs are indirect, they are not immediately obvious. This is a systemic problem that must be addressed. For instance, the OEB’s costs are shared based on the size of the Distributor and therefore larger Distributors pay a larger share, even though they may have no more interaction with the Board than a smaller Distributor. If smaller Distributors were required to pay the true costs, it might encourage further consolidations. There should be no special treatment for small Distributors.

The transfer tax holiday currently in effect is an important tool to assist with consolidation. Without this, consolidations would be much more difficult. An extension of the holiday to private sector companies could assist by providing more debt or equity financing.

The OEB’s process for approving Mergers, Acquisitions, Amalgamations and Divestitures (MAAD) needs to recognize the inherent benefits for the whole province of further consolidation, rather than looking only at the local impact. Applications for additional rate classes to assist with rate harmonization between urban and rural areas should be approved.

Section 6.2 Incentives

- Performance Based Regulation (PBR)

It is difficult to comment specifically about PBR in the absence of clear direction on how it will be implemented. However, it seems clear that with the constant changes faced by the distribution sector in the past few years, it is much too early to be considering yardsticking between Distributors for the setting of productivity factors. In addition, productivity factors cannot be considered in isolation of the IPI. The IPI set in 2002 fell far short of the true cost pressures experienced by Distributors as a result of inflation.

The highest priority of the Board must be the development of the mechanisms for determining revenue requirements and rate setting, for implementation in 2006. This uncertainty provides a major barrier to further consolidation of Distributors. Inequities or unusual conditions from the 1999 base year are still affecting the rates and revenues of Distributors today and must be addressed through a re-basing exercise based on the true cost of service.

- Detrimental effects of PBR on public

A hastily constructed PBR regime can result in serious ramifications for Distributors if mandated productivity factors do not recognize unique situations. The OEB's objective "To facilitate the maintenance of a financially viable electricity industry" is an important consideration. This objective is in the best interest of both shareholders and customers. If a Distributor does not have the necessary cashflow to fund reliability capital work as a result of PBR flaws, customers will be impacted.

- Other measures

The Board staff report had an excellent point in section 3.3 about the regulatory rules being a potential barrier to innovation if there are no rewards for a successful innovation and the costs for unsuccessful initiatives are disallowed. In order to take on the risks involved with new initiatives, there must be a reward mechanism in the regulatory rules. There needs to be symmetry in the regulatory environment such that Distributors can enjoy the upside of taking risk, not only the downside. It is also essential that the regulated return be commensurate with these risks.

Section 6.3 Load Serving Entities (LSE)

There will be significant risks inherent in the role of LSE that will have to be mitigated through strategies currently outside of the core competency of Distributors. Not only have Distributors not been involved in bilateral contracts or financial hedges to date, but activities undertaken in the past such as load forecasting would require much more rigour. Even at Hydro Ottawa's current size, it would be a challenge to manage this added risk, even if allowable regulated returns were increased appropriately. Further consolidation of Distributors would be a necessity to accommodate the required investment in risk management.

Section 6.4 Distribution System Planning

Hydro Ottawa has seen significant advantages in being able to undertake system planning across the new City of Ottawa. Transmission system planning completed with Hydro One Networks is also streamlined. Programs that improve efficiency, such as voltage conversion or system optimization, can be reviewed on a much broader basis. In the long-run, this will lead to a more efficient distribution system. One important consideration is that it can take many years, even decades, to see the full benefit. In Ottawa, there were 5 distinct distribution systems with distribution voltages including 4kV, 8kV, 12 kV, 13.2 kV, 27.6 kV, 44 kV and 115 kV. Since distribution systems are long-term assets, typically depreciated over 25 to 50 years, integration of previously distinct systems must be planned over many years.

Section 6.5 Technological Innovation

Hydro Ottawa is of sufficient size to have the capabilities and resources to achieve operational efficiencies through technological innovation. However, current cashflow limitations, resulting from the market rules and regulatory environment, severely limit the resources that can be allocated to new technologies. In addition, without a clear framework for PBRII it is not clear if Distributors will be rewarded for improved efficiency, therefore there is added risk in undertaking these investments. Under PBRI, Distributors that were the most lean and efficient in 1999 ended up with the lowest revenue and therefore had more difficulty achieving regulated returns when cost pressures of the new electricity market arose.

Other Considerations

One of the first issues that should be reviewed is the definition of a Distributor and distribution assets. There needs to be clear demarcation points between the bulk electricity system and the ownership of the local delivery plant. The unbundling of the electricity industry needs to be completed by having a entity to own and manage the bulk transmission system which is separate from the distribution sector. There also needs to be a clear process to streamline the wholesale delivery points to Distributors. Historical structures from the past have resulted in far more embedded delivery points than should be necessary. Hydro Ottawa currently has in excess of 90 wholesale metering points to manage, and the number will increase when redundant meters become a requirement.

Timing of Consultation

Hydro Ottawa agrees that this is an important topic for the Board to review, however the short timeline for considering this issue and preparing a response is of concern. In October 2003, the Board sought comments on the proposed priorities for 2003/2004. A consultation on distribution sector efficiency was not included in the priorities at that time so Distributors would not have been preparing for this discussion. Aspects of this consultation touch the core mandate of Distributors and therefore require in-depth review. Without sufficient time, a Distributor is unable to seek comments from its Board of Directors and can only do a cursory review with executive staff. In addition, while Distributors have been able to discuss shared positions informally with other Distributors, there was insufficient time to prepare joint submissions that could have streamlined the consultation. Hydro Ottawa strongly encourages the Board to set out a regulatory calendar that can provide stakeholders with advance notice of regulatory activities so there can be an effective planning of resources.

Thank-you for this opportunity to provide comments on the Board's consultation on distribution efficiency. If further information is required, please contact the undersigned at 613-738-5499 ext 527 or lynneanderson@hydroottawa.com.

Yours truly,

Lynne Anderson
Manager, Regulatory Affairs