RP-2004-0188

IN THE MATTER OF the *Ontario Energy Board Act, 1998,* S.O. 1998, c. 15, Schedule B;

AND IN THE MATTER OF the preparation of handbook for Electricity distribution rate applications.

Submission of the Power Workers' Union (PWU)

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The following are the PWU's submissions on issues related to the Draft 2006 Electricity Distribution Rate Handbook (Draft Rate Handbook) which is Exhibit A.2 .

1 CHAPTER 3 – TEST YEAR AND ADJUSTMENTS

Tier 1 Adjustments: Distribution Expenses

Alternative 1: The relevant costs would include the following, which should be identified separately:

1. *LV recovery amounts approved by the Board in the Phase 2 regulatory asset review.*
2. *Proposed LV recovery amounts for the period January 2004 through May 2006.*
3. *Proposed Hydro One LV rates post-May 2006.*
4. *Wheeling charges in cases where there are no established rates in place.*

As items 1 and 2 are of a transitory nature, they would be recovered through a rate rider. As items 3 and 4 would represent adjustments of a more permanent nature, they would be recovered through base rates, unless the Board deems this to be a transmission service in the future.

Alternative 2: The relevant costs would include only those for which a Board decision has been made, approving their recovery. The recovery of any LV wheeling charges for which a Board decision has not been made by the application filling date is outside the scope of this proceeding.

The PWU supports Alternative 1. With regard to (1) and (2), delay in recovery of these amounts would increase retroactivity and utility risk. With regard to (3) and (4), if the development of such rates and charges is expected to slow down the 2006 approval process, at minimum the rate handbook should provide assurance that when such rates and charges have been developed distributors will be allowed to apply for rate adjustments to their rates schedule in 2006 to implement these rates and charges.

Non-routine/unusual Tier 1 Adjustments

Board staff has noted an inconsistency between Chapters 3 and 6. Chapter 3 prescribes removal of unusual 2004 bad debt expense as a Tier 1 adjustment, whereas Chapter 6 may allow full or partial recovery of unusual 2004 bad debt.

The PWU does not see an inconsistency between Chapter 3 and Chapter 6 with regard to bad debt. Chapter 3 deals with "non-routine/unusual" bad debt write-off associated with bankruptcy or equivalent of a major customer. Chapter 6 refers to disclosure of "material" bad debt occurrences. The PWU submits that not all "material" bad debt occurrences are considered by distributors to be "non-routine/unusual". As stated in the third paragraph of this section. However, to the extent that a distributor identifies a "material" bad debt occurrence that it considers to be "non-routine/unusual", it would then make a non-routine/unusual Tier 1 Adjustment.

Tier 1 Adjustments: Rate Base

Alternative 1: 6.) New transformer stations and directly-associated (e.g. feeders) with an in-service date of 2006 (half-rule).

The PWU agrees with Alternative 1 that section (6) should be included as a Tier 1 adjustment to Rate Base. The exclusion of this clause is likely to discourage investment in new transformer stations with in-service dates of 2006 which in turn will require catch-up in 2007. Delays in the installation of new transformer stations can put at risk service quality and reliability.

Option 2: Tier 2 Adjustments

Alternative 1: Tier 2 adjustments must not include any additional requests for hardship funding to address material degradation of the distribution system which may have occurred in prior periods, due to reduced revenue arising from the existence of the eligibility circumstances for the Tier 2 adjustments.

Alternative 2: Tier 2 adjustments may also include additional requests for hardship funding, which would be intended to address an identified material degradation of the distribution system resulting from the existence of one or both of the Tier 2 qualifying circumstances, as opposed to a normal on-going level of expense and investment. This is additional distribution expenses and capital expenditures related to prior years which the applicant believes is necessary to take corrective action for monies not spent in such prior years due to inadequate revenue as a result of the two circumstances outlined above. Any such amounts approved by the Board will be recovered with a rate rider to be in place for a period over which the corrective investments are to be undertaken.

The PWU agrees with the inclusion of Alternative 2 under Tier 2 Adjustments. If there are corrective measures that have been postponed as a result of inadequate revenue in prior years, disallowing such an adjustment for 2006 will not make the need for the corrective measure go away. In fact, it will likely drive the need for the corrective measure to a crisis point and impact system safety and service quality and reliability.

2 CHAPTER 4 – RATE BASE

4.1 Definition of Rate Base

The rate base used to determine the revenue requirement is defined as net fixed assets..

Alternative 1: at year-end

Alternative 2: calculated as an average of the balances at the beginning and the end of 2004

Net fixed assets used in the determination of 2006 rate base should be calculated according to Alternative 1. The net fixed assets used in the determination of the 2006 are 2004 net fixed assets. Generally it can be expected that rate base will have grown between 2004 and 2006. Using the 2004 year-end will more closely reflect the 2006 net fixed assets than the average of 2004 year-start and year-end net fixed assets.

4.4 Interest on Deferral Accounts and Construction Work in Progress (CWIP)

With regard to interest on CWIP, the PWU agrees with alternative 3 put forth by Mr. M.G. Matwichuk's[1] in his evidence filed by the Vulnerable Energy Consumers Coalition's (VECC): the use of an Allowance for Funds Used During Construction (AFUDC) using the Weighted Average Cost of Capital (WACC), or Interest During Construction (IDC) using long term debt cost. As indicated in reply evidence filed by the Coalition of Large Distributors (CLD):

> "The capitalization rate used by a utility should reflect the actual financing costs being incurred. The most appropriate rate for calculating the interest capitalization on CWIP is the company's WACC. Investments are made with the expectation that prudently incurred costs related to these investments will be recovered from the time incurred throughout such asset's service lives." [2]

With regard to interest on deferral accounts, the PWU agrees with the CLD that a shorter-term debt rate in cases where an annual clearing and recovery mechanism has been established as for the Ontario gas utilities, is appropriate. The PWU also agrees with the CLD that where a deferral account is of a longer-term nature (e.g. longer than one year) a longer-term rate is appropriate.

As pointed out by Counsel for CLD in his cross examination of Mr. Matwichuk[3], the Board's definition of long-term with regard to deferral accounts as stated in its RP-2004-0117, RP-2004-0118, RP-2004-0100, RP-2004-0069, RP-2004-0064 Decision with Reason is generally more than one year:

> "The Board's general practice however, is to authorize the recording of interest if the deferral accounts are considered to be long term in nature, generally more than one year. In our view, there is no reason to depart from this general approach."

Given this definition provided by the Board it would appear to be consistent that a longer-term rate is applicable to deferral accounts of longer-terms e.g. more than one-year.

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[1] RP-2004-0188. In the Matter of the 2006 Electricity Distribution Rate Handbook. Written Evidence of M. Greg Matwichuk on behalf of the Vulnerable Energy Consumers Coalition, December 13, 2004.

[2] RP-2004-0188. Response of the Coalition of Large Distributors to the Evidence of the Vulnerable Energy Consumer's Coalition Re; the Appropriate Interest Rate for Work in Progress and Deferral Accounts. Page 2, Lines 13-17.

[3] RP-2004-0188. Transcript Volume 3. Para 229-231.

3 CHAPTER 5 – COST OF CAPITAL

5.4 Working Capital Allowance

Working capital allowance (WCA) represents the estimated cash flow required by the distributor to be paid in advance of recovery. It is to be included in the calculation of the rate base upon which the distributor may earn a return.

Alternative 1: For 2006 rates, the allowance is calculated at 15% of the distribution cost of power, and other power supply expenses and controllable expenses. The general ledger accounts to be included in the working capital allowance are set out in Appendix B, Table B.2.

Alternative 2: The historical cost of power should be adjusted to better reflect the actual costs expected to be incurred. An adjustment is required to reflect upward pressure on electricity prices due to legislative initiatives that cause changes in electricity generation supply mix and supply availability.

In calculating the WCA, an adjustment to the cost of power and other power supply expenses is made, based upon a forecast of rates covering the rate period, prepared by the IMO, or other approved authority. This adjusted figure is used as the cost of power and other power supply components in the calculation.

Alternative 3: If the forecast cost of power is not available under Alternative 2, distributors will be permitted to track the difference between the estimated and the actual cost of power in a variance account. The variance will be used to calculate the dollar value of the return due to/from the distributor's customers.

Alternative 4: For 2006 rates, the working capital allowance is calculated as follows:

*[COP + 2004 Distribution Expenses with Adjustments (excluding depreciation)] * 15%*

Cost of power (COP) will be calculated in the model under COP and Contr. Expenses. COP is a function of wholesale kWh and kW volumes per customer class, multiplied by the class-specific rates for each component of the cost of power. The test year averages of kWh and kW per customer class are calculated on the Customer Demand Data page in the 2006 EDR Model, and are then adjusted for losses, where applicable, and linked to COP and Contr. Expenses.

2004 Distribution Expenses with Adjustments (excluding depreciation) will be derived from the Tab: Distribution Expenses with Adjustments, and linked to COP and Contr. Expenses.

The PWU supports Alternative 2. Of the alternatives put forth on the determination of the working capital component of rate base, Alternative 2 is the fairest option from both

a distributor and a customer perspective in that it is based on the actual price of electricity and therefore is reflects a true pass through. Should a forecast cost of power not be available, the PWU agrees that Alternative 3 is a suitable alternative to Alternative 2.

> *Whichever of the four alternatives above is selected by Board, an additional adjustment could be made:*
>
> *Additional Adjustment Alternative 1:*
>
> *The sum of the working capital accounts is to be reduced by the dollar value of customer security deposits. The result will be multiplied by the 15% allowance.*
>
> *Additional Adjustment Alternative 2:*
>
> *No adjustment for customer security deposits is made in the calculation of WCA.*

The PWU supports the Additional Adjustment Alternative 2. Security deposits are collected to mitigate the distributors risk associated with non-payment of account and must be available for refund any time a customer quits the system. It is not collected as a source of working capital and should not be treated as such in the regulatory framework.

4 CHAPTER 6 – DISTRIBUTION EXPENSES

6.2.5 Employee Total Compensation

> *2. Minimum Filing Requirements*
>
> *…*
>
> *Where there are three, or fewer, full-time equivalents (FTEs) in any category, the applicant may aggregate this category with the category to which it is most closely related. This higher level of aggregation may be continued, if required, to ensure that no category contains three, or fewer, FTEs.*
>
> *Guidelines for applicants with fewer than three employees*
>
> *Alternative 1: Where the total number of employees for a given applicant are two, or fewer, and the average total compensation per employee is less than $100,000, no employee compensation reporting shall be required under this section.*
>
> *Alternative 2: No specific filing guidelines for applicants having two, or fewer, employees. Minimum filing requirements outlined above to be applied to all applicants*

…

Additional Filing Requirements

Alternative 1: In addition to aggregated salary disclosure, total compensation for each distributor employee earning more than $100,000 per annum must be reported separately and individually.

Alternative 2: No additional filing requirements are necessary.

Of the alternatives on "Guidelines for applicants with fewer than three employees" the PWU supports Alternative 1 amended as follows:

> "Where the total number of employees for a given applicant are two, or fewer, no employee compensation reporting shall be required under this section."

Of the alternatives on "Additional Filing Requirements" the PWU supports Alternative 2.

The alternatives the PWU supports ensures that individuals' privacy with regard to their compensation level is protected. Employees of the electricity distribution companies are not civil servants or employees of Crown corporations for whom public accountability may require individual disclosure. Like the employees of the gas distribution companies, they are employees of commercial entities. The gas distribution companies are not expected to, and have not been required to disclose in the Ontario regulatory forum compensation levels of individual employees, regardless of the compensation level. The PWU believes that employees of the electricity industry should be treated with the same consideration and respect of privacy as their counterparts in the gas industry.

The PWU questions the need for compensation information at an individual level to establish prudence of compensation levels. Factors that impact individual compensation levels include consideration of an individual's experience, skill, responsibility and performance levels. Regulatory review at this level constitutes micromanagement and is inefficient.

6.2.7 Distribution Expenses Paid to Affiliates

Proposed Additional Filing Guidelines

Alternative 1:

- *actual costs of the affiliate, where cost-based pricing was used for services or goods provided by the affiliate to the applicant*
- *description of if and how the absence of a market was established before using cost-based pricing*

Alternative 2: No additional filing requirements are necessary

The PWU supports Alternative 2, no additional filing requirements. It is unlikely that the distribution company has the authority to require its affiliate to disclose its actual costs. Assuming that the affiliate provides services on a competitive basis, it is also unlikely that the affiliate would volunteer its cost information.

Additional Wording

Alternative 1: To help justify the reasonableness of amounts paid to affiliates for purposes of 2006 distribution rates, an applicant must provide a general explanation in Schedule 6-3 on how it followed the transfer pricing and shared service rules in the Affiliate Relationship Code.

Where an applicant failed to follow a material requirement in the Affiliate Relationship Code transfer pricing and shared services rules, it will face additional scrutiny of these expenses in its 2006 distribution rate application. In such cases, the Board will specifically review the reasonableness of allowing full recovery of the amounts paid in the given circumstances.

Alternative 2: Omit the above statement

The PWU supports Alternative 2 - as put forth by Consultant to the PWU on Issues Day[4]:

> "The review of prudence of cost is the main issue in the 2006 EDR process, regardless of whether these costs are in-house costs or costs for an affiliate transaction. Given that any review of affiliate rate – the ARC compliance in the 2006 EDR process will likely be the first of such reviews since the implementation of the ARC. There is a high likelihood that it will result in unreasonable delays in the rate-setting process as issues on the interpretation of the ARC arise. Therefore, the review of Affiliate Relationships Code compliance will result in unreasonable delays in the 2006 electricity distribution rate-setting process."

[4] RP-2004-0188. Issues Day Volume 1. Para 667-668.

In addition, as pointed out by Mr. M. Rodger, Counsel to Toronto Hydro, Aurora Hydro, Enwin Powerlines, Niagara Falls Hydro, and Brantford Power, the Board has a compliance function that deals with ARC compliance matters and so there "really is no need to duplicate the tools that are already available to the Board to carry out this function" [5].

The above position holds true for all distribution expenses paid to affiliates as well as distribution expenses incurred through sharing services with affiliates.

5 CHAPTER 7 - TAXES/PILLS

7.1.2 Principles Applicable to Specific Components of the Calculation

Although an expense may be non-recoverable or disallowed for regulatory purposes, the distributor may still be able to claim it in its actual tax returns filed, thus affecting the amount of tax payable in respect of the 2006 rate year.

Alternative 1: Sharing Tax Savings

*Fifty percent of the total amount of expenses non-recoverable/disallowed for regulatory purposes, but deductible for tax purposes, should be entered on line **XX** of the 2006 OEB Tax Model. This has the effect of sharing the tax savings generated by such expense equally between the ratepayers and the distributor.*

Alternative 2: 100% of Tax Savings to Ratepayers

*The total amount of expenses non-recoverable/disallowed for regulatory purposes, but deductible for tax purposes, should be entered on line **XX** of the 2006 OEB Tax Model. This has the effect of allocating all the tax savings generated by such expense to the ratepayers.*

Alternative 3: 100% of Tax Savings to Distributor

No adjustment shall be made in the 2006 OEB Tax Model for expenses non-recoverable/disallowed for regulatory purposes. This has the effect of allocating all the tax savings generated by such expense to the distributor.

With regard to the disposition of tax savings on disallowed expenses, the PWU supports Alternative 3, 100% of tax savings to distributor. The PWU agrees with the position put forth by Ms. Kathleen McShane in her evidence[6] prepared on behalf of the Coalition of Issue Three Distributors, that the Government's objective of maintaining a level playing

[5] RP-2004-0188. Issues Day Volume 1. Para 678.

[6] RP-2004-0188. Exhibit B.9. Report on the Disposition of Tax Savings on Disallowed Expenses. Submitted on behalf of The Coalition of Issue Three Distributors. Kathleen C. McShane, Senior Vice President, Foster Associates, Inc. January 12, 2005.

field and the principles of "benefits follow costs", "stand-alone" costs, and "no harm" principle, should be applied in the determination of who should receive the benefit of tax savings on disallowed expenses. In her evidence Ms. McShane demonstrates that in applying the Government's objective and the regulatory principles, 100% of the tax savings should be to the benefit of the distributor.

Analysis provided in Exhibit D.5.1[7] by Ms. McShane demonstrates how allocating the benefit of tax savings on disallowed expenses to the customers' results in a shortfall in the distributor's allowed return. If Ms. McShane's analysis is generally reflective of the views of financial analysts then, regardless of Dr. Mintz's[8] views on this issue, the allocation of the benefits of tax savings on disallowed expenses to customers can negatively impact a distributor's financial rating and viability, and in turn risk its ability to maintain system safety and service quality and reliability performance standards. Therefore, the PWU recommends that the Board implement Alternative 3: 100% savings to distributor.

6 CHAPTER 10 – RATES AND CHARGES

10.5 Update of Loss Adjustment Factor Reflecting System Losses Including Unaccounted–for Energy

Alternative 1: Variances in distribution system losses costs, including both variances in loss volumes (kWh) and variances in the electricity commodity cost per kWh will be either credited or debited to the XXX Variance Account in Accordance with the current practice. All distribution system losses cost variances, therefore, will be pass-through items.

Alternative 2: An amount, equal to the distributor's actual 2006 average annual electricity commodity cost per kWh times the loss volumes (kWh) originally projected and included in rates, will be calculated after the end of 2006. To the extent that this amount is greater or less than the dollar amount of distribution system losses costs used for 2006 rates, the difference will be either credited or debited to the XXX Variance Account. Only distribution system losses cost variances caused by electricity commodity cost variance, therefore, will be a pass-through item.

The PWU supports Alternative 2, assuming that the loss factor will be reset annually.

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[7] RP-2004-0188. Exhibit D.5.1. Illustrative Case provided by Ms. McShane Comparing Views with Dr. Mintz. K. McShane.

[8] RP-2004-0188. Exhibit B.3. Corporate Tax Adjustments and the Determination of Electricity Rates in Ontario. Jack M. Mintz, Deloitte & Touche Professor of Taxation, J.L. Rotman School of Management, University of Toronto and President and CEO, C.D. Howe Institute.

Section 10.5 of the Draft Rate Handbook includes provisions for departure from the 2006 loss factor adjustment based on a three-year average (2002, 2003, and 2004) in the event of specific events that impact the loss factor such as the loss or gain of large customers as follows:

> "If the applicant determines that specific information warrants a departure from that average (e.g. gain or loss of large customers), it must include in Schedule 10-5 a description of the change for the proposed methodology, with a detailed explanation and justification for the variance."

Given this provision, Alternative 2 provides the distributor with incentive to minimize distribution system losses while holding it harmless with regard to system loss costs related to the commodity cost variance as well as significant load changes not in their control. The latter consideration of load changes that are not in the distributor's control is essential to minimize the distributor's risk and ensure that the incentive to reduce line losses does not result in drastic measures that may compromise system safety.

10.6 Distributed Generation

> *Distributed generation (DG) is defined as, a merchant generator located within a distributor and connected directly to the distribution system to provide electricity to the distributor. This does not include a transmission-connected DG.*
>
> *Alternative 1: status quo: do not change the current process*
>
> *Alternative 2: The following methodology will be made available to, and will be used by, all distributors as an interim measure for the 2006 rates process. The issue will be examined more completely as part of the 2007 rate process.*

The PWU agrees with Alternative 1 with the addition of the clause that "the issue will be examined more completely as part of the 2007 rate process". In the view of the PWU this matter requires a thorough review of the cost/benefit and all possible consequences of the proposed methodologies in the context of the Distribution System Code rather than in a rate approval process.

7 CHAPTER 13 - RATE IMPACT MITIGATION

The PWU is concerned that mechanistic rate impact filing requirements based on thresholds may lead to mechanistic rate impact mitigation requirements, either through the deferral of work programs, the use of deferral accounts, or reduction of net income, in the absence of assessing the impact of doing so on utility financial viability, system

safety, and service quality and reliability performance standards in the short term and on a sustainable long term basis.

In cross examination by Counsel for the PWU on rate impact mitigation voluntarily undertaken by Hydro One in 2000, Mr. W.O. Harper of Econalysis Consulting Services (ECS), expert witness for the Vulnerable Energy Consumers Coalition (VECC) described the basis for Hydro One's rate impact mitigation as follows[9]:

> "I think they identified, say, a few areas where they felt it was possible to, sort of, defer, or reduce, the level of activity for a limited period of time, acknowledging that you couldn't have that lower level of activity for an extended period of time, but, for, sort of, a short period of time, you could have a reduced level of activity without impinging on, sort of, the reliability and service quality of the system. So I think, to some extent that took place. I think, to some extent, they were trying to focus on areas where they could reduce costs without having an impact on service reliability."

Mr. Harper's response illustrates the impact assessment conducted by Hydro One in determining its ability to mitigate rate impact. Similarly, in contemplating requiring a distributor to mitigate rate impact, the Board needs to assess the impact on the utility's financial viability, system safety and service quality and reliability performance both in the short term and on a sustained basis in the long-term. To this end, Mr. Harper agreed with PWU Counsel "that if the Board is considering a deferral in order to massage around a rate impact, that it should be explicitly mindful of the impact that that has on service quality and reliability performance indicators"[10].

The potential impacts of the three approaches to rate impact mitigation addressed in evidence and cross-examination are highlighted here. These approaches were: physical deferral; deferral accounts; and reduction of net income.

Physical Deferral

With regard to rate impact mitigation through the deferral of work (e.g. cost cutting), in his cross examination of Mr. Harper, PWU Counsel points out two ways in which service quality and reliability issues can manifest itself. The first is manifestation within the year where the decrease or cessation of an activity results in the "immediate, or almost immediate, decrease in response or service quality"[11]. The second arises where the expenditures relate to the utility's stewardship that requires sustained work with respect to the infrastructure of the utility where any degradation may not be immediately apparent[12]. In the case where an aging asset base is involved it may be the pace at

[9] RP-2004-0188. Transcript Volume 4. Para 573.
[10] Ibid. Para 628.
[11] Ibid. RP-2004-0188. Transcript Volume 4. Para 579.
[12] Ibid. Para 581.

which assets are upgraded or replaced[13]. As PWU Counsel put it, in this category "the actual diminution of service quality and reliability may not be manifested in any material way this year, it may be not even next year. But we know, as a matter of statistical certainty, it is going to show up at some point in time, unless something is done"[14]. Mr. Harper, expounded on this issue with the response that "if you continue to underfund the activity, at some point in time"…. "you know, the service quality will degrade" [15].

Further, Mr. Harper agreed with PWU Counsel that once costs go "out of the base budget, in effect, it is hard to bring it back into the base budget"[16].

Mr. Harper also agreed with PWU Counsel that both the distributor and the regulator need to be sensitive in engaging in physical deferrals that may be "superficially appealing" for those looking to reduce costs because there is no immediate service quality and reliability impact[17].

Mechanistic requirement for rate impact mitigation through cost cuts can result in physical deferral that results in the short-term and/or long-term and sustained system safety, and service quality and reliability.

Deferral Accounts

On rate impact mitigation using deferral accounts to phase in rate adjustments by deferring cost recovery to future years for the purpose of smoothening rates over time, Mr. Harper agreed with PWU Counsel that it is necessary to consider where rates might go in the future[18]. With the expected cost allocation exercise in 2007, the deferral of 2006 costs for recovery in future years might exacerbate the rate impacts created by the cost-allocation changes for some customer classes of individual distributors, and may result in problems with customer acceptability of recovery of the deferred costs in 2007 and 2008. In addition, the Board will be aware that its Smart Metering Implementation Plan[19] anticipates incremental increases in distribution rates related to smart metering starting in the first year of implementation possibly starting at $0.30 to $0.40 per month culminating at $3 to $4 per month at full implementation for 2010 and beyond.

In evidence prepared on behalf of Hydro One, PA Consulting Group (PA) states that "deferral accounts by definition create cost recovery risks that the capital markets factor

[13] Ibid. Para 583.
[14] Ibid. Para 585.
[15] Ibid. Para 586.
[16] Ibid. Para 589.
[17] Ibid. Para 587.
[18] Ibid. Para 598.
[19] Ontario Energy Board. Smart Meter Implementation Plan. Report of the Board to the Minister. January 26, 2005. Page 25, Para 1.

into risk assessment, and can potentially raise the distribution utility's cost of capital and thereby place upward pressure on distribution rates"[20].

Mechanistic requirement for rate impact mitigation through deferral accounts, therefore, can exacerbate rate impact issues in future years while risk associated with future recovery of costs can negatively impact utility financial viability and the sustained system safety, and service quality and reliability performance.

Net Income

In his cross of the ECS panel, Counsel for Schools suggested that one way distributors could lower costs is by reducing the profit that goes to the shareholder[21] and cites the phasing-in of the electricity distributors' market-based rate of return as a precedent for such an approach to rate mitigation[22].

Mr. Derek Hasbrouk, expert witness for Hydro One Networks Inc., comments on how, in market restructuring the credit worthiness of local distribution companies has been taken for granted. His response to a question posed by CMI on the impact of cost disallowance of distributors in California illustrates the potential negative impact of doing so:

> "It's interesting. I think, as the world and all of the -- in the various jurisdictions around the world that embarked on market restructuring set out upon this journey, the creditworthiness of local distribution companies, I think, was something that was just, sort of, taken for granted and assumed to be there. And what we've learned in California and elsewhere is that the market really depends on the creditworthiness of those entities which are large buyers in the wholesale marketplace, as well as entities that extend credit to all of the retail customers. That financial stability is an essential ingredient to a working marketplace, be it at the wholesale level or the retail level. And situations where that creditworthiness has been compromised, California being one example, the ability to extract the industry from those problems has been really, really difficult, in large measure because the thing we've instinctively counted on as being creditworthy, isn't, or became not creditworthy"[23]…
>
> "And that has created all sorts of complications, from the sort of institutions that California put in place to become a purchasing agent for

[20] RP-2004-0188. Exhibit B.8. In the matter of the 2006 Electric Distribution Rate Handbook. Evidence of PA Consulting Group. Derek HasBrouck and James Heidell. On behalf of Hydro One Networks, Inc. 10 January 2005. Page 1-2, Para 4, Lines 4-6.
[21] RP-2004-0188. Transcript Volume 4. Para 393.
[22] Ibid. Para 395.
[23] RP-2004-0188. Transcript Volume 4. Para 1230.

> power, the rather unattractive contracts that that agency, Water Resources, selected. And then the, sort of, stealth deferrals, frankly, that were talked about this morning of investments in the reliability and safety and customer service of the network that simply, on a very practical basis, have to be postponed by an entity that has no cash"[24].

In response to a question from the Board Panel Chair on whether the Board should order a utility that does not offer to lower its net-income level if that is "the only way to get the mitigation accomplished"[25] Mr. Harper responded as follows:

> "I think the Board would want to understand, before it did so, what the financial implications on that particular utility were of ordering a reduction, in terms of, what was its current financial soundness, if I can put it that way, and, sort of, it's level of financial viability"[26].

PWU's Position

In setting thresholds with regard to the requirement for the filing of rate impact information, the PWU strongly recommends that the Board resist the use of such information in a mechanistic process to establish the requirement for rate impact mitigation by the distributors. To meet its legislative objectives of maintaining a financially viable electricity industry and protecting the quality and reliability of electricity services, it is essential that the Board consider the impact of rate impact mitigation on each individual distributor's financial viability and in turn on the distributor's system safety and service quality and reliability performance.

As pointed out in PA's written evidence, the "rationale for rate adjustments will differ from utility-to-utility and from year-to-year and the OEB should retain sufficient flexibility for individual LDCs to address these issues"[27].

8 CHAPTER 17 - COMPARATORS AND COHORTS

The PWU submits that service quality performance needs to be included in any Comparators and Cohorts (C&C) mechanism that the Board might adopt as a screening

[24] Ibid. Para 1231.
[25] Ibid. Para 714
[26] Ibid. Para 715.
[27] RP-2004-0188. Exhibit B.8. In the matter of the 2006 Electric Distribution Rate Handbook. Evidence of PA Consulting Group. Derek HasBrouck and James Heidell. On behalf of Hydro One Networks, Inc. 10 January 2005. Page 1-3, Para 1, Lines 2-3.

tool in the processing of the electricity distributors' rate applications in order to permit "apples-to-apples" comparison of costs.

Consideration of service quality performance is missing from the study on a C&C mechanism conducted by Mr. Robert Camfield of Laurits R. Christensen Associates, Inc., Board Staff's expert witness on C&C mechanisms. Under cross examination by PWU Counsel, Mr. Camfield agreed that service quality performance is at least potentially a relevant factor if the C&C mechanism is to give the Board, Board Staff and intervening parties information on how a particular LDC is doing on a cost basis compared to other utilities[28]. Mr. Camfield indicated that service quality performance was not included in his retainer with Board Staff and that if it had been, he would have pursued the matter of service quality performance.

Dr. Mark Lawry, Hydro One's expert witness C&C mechanisms, stated that:

> "We find that with good data on service quality, that very often that is a statistically significant cost driver, and I would encourage that the data that's available on that here in the province be used in the benchmarking. And I when I say that, I don't mean just the reliability measures, it's worth looking at the various measures of customer-service quality, because there are considerable variations in the quality of those services[29]."

Both Mr. Camfield and Dr. Lawry, therefore, agree that service quality performance is, at least potentially an important consideration in the assessment of the distributors' costs.

While the Board has minimum standard performance guidelines for service quality indicators, including both customer service and service reliability indicators, from its participation on the Board's Service Quality Regulation ("SQR") Working Group that met in late 2003 through early 2004, the PWU is aware that there are significant issues with the interpretation of the service quality filing guidelines that accounts for substantial inconsistency in the filings among the distributors. To ensure consistency and robustness of the service quality performance filings the PWU submits that the review of the service quality indicators must be completed and its recommendations implemented. In the absence of the completion of the review and the implementation of resulting recommendations, as well as the establishment of the quality of the subsequent filings the Board cannot rely on the on-going service quality filings to provide a robust measure of service quality. The PWU has submitted a letter to the Board requesting a Board process for the review of service quality that will establish robustness to the service quality filings. A copy of the letter is attached.

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[28] RP-2004-018. Transcript Volume 6. Para 1066-1067.
[29] Ibid. Para 139.

The Board's establishment of utility cohorts, whether deliberately intended or not, and in spite of the Draft 2006 Rate Handbook's[30] contention that the intended use of the C&C mechanism is to screen applications to facilitate the review and assessment of the 2006 rate applications, takes on the aura of a benchmarking exercise none the less.

As such the use of the C&C mechanism put forth by Mr. Camfield in his evidence will pressure and incent utilities to move toward a cost benchmark that ignores service quality performance. The outcome of such benchmarking may be the deterioration of distribution service quality in the province.

It is the PWU's view that any form of screening or judgment of a utility's costs based on a C&C mechanism that ignores service quality performance will incent utilities that have higher than the average service quality performance of its cohorts and therefore higher costs compared to its cohorts to sacrifice service quality performance in order to reduce costs. Similarly, utilities with poor service quality performance whose costs compare favourably to those of its cohorts will be incented to forego investment in service quality performance.

Mr. Camfield states that "Inaccurate benchmarking methods can lead to assessments that are unfair to LDCs"[31]. In the PWU's view benchmarking/screening methods that preclude consideration of service quality are inaccurate benchmarking/screening methods that can lead to unfair assessments of LDCs.

To ensure that the Board applies its legislative objective of protecting the interests of consumers with respect to prices and the reliability and quality of electricity service in a balanced manner, the Board needs to establish robustness of its service quality indicator guidelines and consistency among the distributors' service quality performance filings. The Board should then include the service quality performance information as a factor in its C&C mechanism.

Rather than use a faulty C&C mechanism for screening/benchmarking the distributors, the PWU submits that the emphasis in the review process be based on a distributors historic performance.

9 CONSERVATION AND DEMAND MANAGEMENT

The PWU agrees with the view expressed by the various C&DM expert witnesses as expressed by Mr. Paul Chernik in his evidence filed on behalf of the Green Energy Coalition that:

[30] RP-2004-0188. Exhibit A.2. Ontario Energy Board 2006 Electricity Distribution Rate Handbook. Draft 2. 10 January 2005. Page 143.
[31] RP-2004-0188. 27 January 2005. Hearing Held at Toronto, Ontario. Transcript Volume 6. Para 463.

> "In order to encourage distribution utilities to implement energy-efficient programs, the ratemaking mechanism should at least remove financial disincentives, and provide the opportunity for some additional incentive to encourage the use of less-traditional resources. Some mechanisms that would help in achieving these goals are recovery of direct costs, recovery of lost revenues, and an explicit incentive mechanism." [32]

Cost Recovery

With regard to recovery of C&DM costs the PWU agrees with those parties that propose that the distributors ought to be assured recovery of prudently incurred costs through rates. The PWU also agrees that it is necessary for the Board to allow the distributors to set up Conservation Expenditures Variance Accounts (CEVA) to ensure that unspent budgeted C&DM expenditures are returned to the customers and that cost of continuing with successful programs above budgeted expenditures are recovered. As Mr. Chernik[33] puts forth in his evidence the CEVA should include carrying charges on C&DM capital investment. In addition as with all used and useful investments, C&DM capital investments should be reflected in rate base.

In his evidence, Mr. Chernik states that:

> "In the present environment of a rate freeze and considerable regulatory uncertainty, the Board should also strive to reduce utilities' concerns with cash flow and accrual of deferred assets, by allowing adjustment of rates to accommodate C&DM, and clearance of accounts, as frequently as any other rate adjustments are allowed".[34]

The PWU agrees with Mr. Chernik in this regard and as put forth by PWU Counsel with regard to the period of time that might elapse related to the back-end review of C&DM programs, the longer the period of time that elapses for clearance of accounts, the greater the element of rate retroactivity.[35]

Revenue Protection for Utility Conservation Impacts

The PWU agrees that the Board should allow a Lost Revenue Adjustment Mechanism (LRAM) for the distributors. Revenue shortfall resulting from their C&DM activities may result in distributors cutting activities related to system safety, and service quality and

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[32] PR-2004-0188. Exhibit C.2. Cost Recovery for Conservation and Demand-Management for Ontario Electric-Distribution Utilities. Paul Chernick. Resource Insight. December 20, 2004. On behalf of The Green Energy Coalition. Page 7, Para 6.
[33] PR-2004-0188. Exhibit C.2. Page 8, Para 3.
[34] RP-2004-0188. Exhibit C.2. Page 8, Para 2.
[35] RP-2004-0188. Transcript Volume 8, Para 396.

reliability that would not be consistent with the Board's legislated objective of protecting the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.

If the revenue shortfall results in lower return for the distributor, which can impact the distributor's financial rating, dissallowing an LRAM would be inconsistent with the Board's objective of facilitating the maintenance of a financially viable electricity industry.

To enhance certainty for the distributors, the Board should allow the distributors to incorporate C&DM kWh savings in the kWh volumes used in the determination of 2006 rate levels as well as a CEVA that covers the variance between forecast C&DM volumes incorporated in rates and actual C&DM volume savings.

Shareholder Incentive

The PWU agrees with those parties that believe incentives will enhance distributors' C&DM performance. The PWU submits that incentive should be pre-approved at the front-end, and that if the SSM is used, the avoided commodity cost should not be subject to true-up at the back-end. Front-end consultation and pre-approval of the incentive level provides the distributor with certainty on the incentive while ensuring customer acceptability. In addition, front-end approval will minimize back-end controversy that can delay the payout of the incentive, and take on increasing risk of retroactivity.

Consistent with the perspective put forth in his evidence prepared on behalf of the Canadian Energy Efficiency Alliance (CEEA), Mr. D. Heeney, indicated under cross examination by Pollution Probe that for the distributors' "comfort", the incentive rate should be pre-approved and should not be trued-up at the back-end[36].

Most parties that have put forth the Shared Savings Mechanism (SSM), propose the TRC as the basis for the incentive. The determination of TRC involves the calculation of avoided commodity costs and Hydro One Inc. indicates that:

> "Hydro One does not have any knowledge of or involvement with commodity based avoided costs, which are by far the largest component to be considered in the implementation of CDM initiatives"[37].

With the need for the distributors to file their 2006 rate applications by June, 2005 it is apparent that there is a good chance that the avoided commodity cost may not be available to the distributors in the preparation of their rate applications.

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[36] RP-2004-0188. Transcript Volume 11. Para 289.
[37] RP-2004-0188. Exhibit C.5. Reply Evidence of Hydro One Inc. Regarding Conservation and Demand Management Evidence Filings. Page 2, Para 6.

While the PWU agrees with the concept of an SSM based on the TRC, if there is little prospect of having an avoided commodity cost available for the pre-approval of the TRC for 2006, the Board should consider Mr. Heeney's proposed alternative of using a pre-approved incentive based on kWh savings as a pragmatic approach for 2006[38]. In the meantime, the Board should ensure that on-going avoided commodity costs are available for future use in a SSM starting in 2007.

If a TRC will be available to the distributors in the preparation of their rate applications then the PWU agrees with the CEEA that the TRC-based incentive rate should be pre-approved and should not be subject to true-up adjustments. Under cross by PWU Counsel with regard to a utility's upper level of profitability related to a SSM Mr. Goulding, expert witness to Board Staff indicated that from a regulatory perspective

> " ..you have come up with something that, at the end of the day, ratepayers feel comfortable with. So for any rate-making mechanism to be sustainable, it has also to be something that the ratepayers feel comfortable with"[39].

As put by PWU Counsel and agreed to by Mr. Goulding, the SSM incentive level would need to be "under the broad umbrella of public acceptability"[40].

When questioned by PWU Counsel whether the avoided commodity cost should be subject to true-up, given the potential for significant variance in the actual number compared to what might have been projected, Mr. Goulding indicated that from an incentive efficiency perspective a true-up should be done[41]. However Mr. Goulding goes on to say:

> "That being said, that issue of avoided generation costs is probably among the most challenging issues in the overall calculation of the TRC. And so I think that, if we're talking about a true-up on that particular element, we need to be very clear as to how we're defining it, prospectively and retrospectively, in order to do the true-up".[42]

It appears that Mr. Goulding's position that the avoided commodity costs should be subject to true-up is primarily conceptual while his caveat above points to the practical difficulty related to a true-up. Put another way, his position to true up reflects Mr. Goulding wearing an economist's hat while the challenges he expresses on the reality of implementing a true-up of avoided commodity cost reflects Mr. Goulding wearing a regulatory expert's hat.

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[38] RP-2004-0188. Transcript Volume 11. Para 82-83.
[39] RP-2004-0188. Transcript Volume 8. Para 383.
[40] RP-2004-0188. Transcript Volume 9. Para 384.
[41] Ibid. Para 408.
[42] Ibid. Para 409.

In the PWU's view a regulatory review process that results in the pre-approval of the TRC, including the avoided costs that are components of the TRC would ensure that the incentive rate applied at the time of incentive payout would be "under the umbrella of public acceptability". As such, the PWU believes that there should be no back-end true-up of the TRC.

Conservation Handbook

The PWU agrees with parties that the Board ought to provide a "Conservation Handbook" such as the "Energy Policy Manual" produced by the California Utility Public Commission referenced in CEEA's evidence[43].

The PWU believes that in approving C&DM programs and mechanisms the Board should not to do so solely at a high level, but also that the Board should provide rules, guidelines and assumptions to be applied in the development and evaluation of C&DM programs and mechanisms. Doing so will facilitate program development, screening, implementation and evaluation for the distributors, and will minimize the risk of programs going wrong.

While conceptually C&DM mechanisms such as the LRAM and SSM may be easy to buy into, Mr. A.J. Goulding agreed with PWU Counsel that it is of very significant importance that the rules be made very clear[44]. Mr. Goulding also agreed with PWU Counsel that not having clear rules in place in a "fashion which was sufficiently timely that the LDCs could actually use it to prepare their filings[45]" there is the "risk that the programs may be badly designed"[46].

In response to the Board Panel Chair on the necessity of a handbook Mr. Goulding indicated that the Board could issue a position paper "of a limited number of pages that would clearly set out the guidelines by which utilities would make their filings, make their calculations, and so forth"[47]. In the PWU's view a Board "position paper" would not be a regulatory instrument in the same vein as the Board's Electricity Distribution Rate Handbook. As PWU Counsel suggested to Mr. Goulding "if the Board thinks it's good policy to have a Rate Distribution Handbook for 2006 at all, that many of the very same considerations apply to having - - some form of a conservation handbook or set of rules with respect to CDM"[48].

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[43] RP-2004-0188. Exhibit C.6. Appendix A.
[44] RP-2004-0188 . Transcript Volume 8, Para 416-417.
[45] RP-2004-0188. Volume 9. Para 442.
[46] RP-2004-0188. Volume 9. Para 444.
[47] RP-2004-0188. Volume 9. Para 774.

[48] RP-2004-0188. Volume 9. Para 448.

The PWU is concerned that the Board may approve C&DM programs and mechanisms without considering clear rules and guidelines on program and mechanism. The rules and guidelines, such as those included in the recommendations of the 2006 EDR Conservation Working Group[49], should at minimum address:

1. A list and description of eligible C&DM programs
2. Program input assumptions.
3. Program eligibility guidelines.
4. Program and measure screening methods.
5. Default generation and transmission avoided cost values determination methods.
6. Determination of TRC including avoided costs.
7. Implementation of the Lost Revenue Adjustment Mechanism.
8. C&DM reporting requirements.

The absence of such rules and guidelines at the outset will result in significant uncertainty that may render any incentive for C&DM ineffective and risk badly designed programs that result in no net benefits.

Although having rules and guidelines may not avoid confrontation in the determination of final LRAM and SSM incentive levels, it will mitigate controversy, especially where the assumptions and methods were set forth in regulatory guidelines rather than in a stakeholders' settlement document. As such, clear rules and guidelines upfront will mitigate the need for regulatory resources both at the front-end in the review of utility C&DM programs, as well as at the back-end in the evaluation of program performance and the determination of LRAM and SSM amounts.

Finally, the PWU would suggest that consistent with having expeditious reviews of applications that meet the filing guidelines set out in the Distribution Rate Handbook, the review of C&DM programs filed according to the guidelines in a C&DM handbook will provide for the expeditious review of the C&DM programs.

Utility-Side of the Meter Conservation

The PWU agrees with Hydro One[50] that utility-side C&DM activities, as much as customer-side C&DM, require incentives to encourage distributors to "assign their

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49 RP-2004-0188. EXHIBIT NO. D.7.3: POLLUTION PROBE COMPENDIUM FOR CROSS-EXAMINATION

Exhibit X.X. Cross-Examination Reference Book on behalf of Pollution Probe. Tab. 4. Page 47-48.

50 RP-2004-0188. Exhibit C.5. Reply Evidence of Hydro One Inc. Regarding Conservation and Demand Management Evidence Filings. Page 1, Para 6.

limited resources" and turn their efforts to C&DM related activities. Mr. D. Heeney[51], expert witness to the Canadian Energy Efficiency Alliance, listed some initiatives that constrains the distributors' resources, including the smart metering initiative.

While Mr. Chernik contends that utility-side conservation activities are normal distribution activities and therefore should not require incentive mechanisms such as the SSM[52] although he does think that "utilities do respond to incentive structures, even in their traditional operations" [53]. In the PWU's view incentives would enhance utility-side C&DM beyond the utilities' existing performance standards.

C&DM Budget

Just as the general revenue requirement is a matter for each distributor to determine given their individual circumstance, the PWU submits that each distributor should determine their C&DM budget level according to its own circumstance to ensure cost effectiveness.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

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[51] RP-2004-0188. 4 February 2005. Hearing Held at Toronto, Ontario. Volume 11.
[52] RP-2004-1088. Transcript volume 9, Para 923.
[53] RP-2004-1088. Transcript volume 11. Para 236.