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toronto hydro corporation

2005 February 14

Hand Delivered

John Zych, Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 26th Floor
Toronto, Ontario M4P 1E4

Dear Mr. Zych:

Re: RP-2004-0188: Submissions of Toronto Hydro in Argument

In accordance with Procedural Order No. 5, please find enclosed 8 printed copies and 1 PDF electronic copy of Toronto Hydro's submissions in argument in this proceeding. An electronic copy has also been sent by email to Mr. Ritchie.

Yours truly,

COLIN MCLORG
FOR

R. Zebrowski, Vice-President
Regulatory Services

encl.

RP-2004-0188: Electricity Distribution Rates

Submissions of Toronto Hydro–Electric System Limited

Introduction and General Remarks

1. Toronto Hydro–Electric System Limited ("Toronto Hydro") has participated actively in all phases of the RP-2004-0188 ("EDR") proceeding. Toronto Hydro submits that the subject matter of EDR is of great importance not only in the establishment of 2006 utility rates, but also as a starting point for future rate determination processes. Accordingly, it is important that the process by which the policies and practices applying to rate determination are established be one that is thorough and thoughtful. As with any set of founding principles, the outcome of the EDR process should be the result of careful preparation and sound construction.
2. Therefore, Toronto Hydro has very serious concerns around the process the Ontario Energy Board ("Board") has implemented to address this important area of policy development. Put simply, the EDR process has been unduly rushed, with the result that the quality of the final products (i.e., the 2006 Distribution Rate Handbook ("DRH") and the 2006 Electricity Distribution Rate Model ("EDRM")) may be seriously impaired.
3. Toronto Hydro observes that the stakeholder consultation process drew very heavily upon the limited resources of utilities and other stakeholders. While substantial progress was made, there were serious defects in that process. First, the scope of the undertaking was unduly large and attempted to address more issues than could practically be handled in the short time allowed.
4. Second, the working groups and sub-groups operated in relative isolation from each other. Even given oversight by the working group executive bodies, no time or process was devoted to the inter-relationships between issues, some of which are very significant. Toronto Hydro submits that the lack of attention paid to 'cross-over' issues specifically, and to the completeness and coherence of the DRH and EDRM generally, is likely to create implementation problems.
5. Third, the hurriedness of the working group consensus building process created confusion and dissatisfaction among stakeholders. In many

instances, the work of sub-groups consisting of subject matter experts produced consensus at that level which was later overturned at the executive level. Had the process been less rushed, there would have been an improved opportunity for communication and negotiation among the parties.

6. Fourth, the schedule for the EDR hearing and for subsequent argument and reply has been so compressed that it has precluded effective cooperation among stakeholders, even in instances where those stakeholders have long-established processes for such cooperation. Since cooperation has not been feasible due to the deadlines, the result has necessarily been an 'every man for himself' approach which has forced already scarce resources to be spread even more thinly, and has lowered the quality of input available to the Board.
7. Toronto Hydro observes that most utilities and many stakeholders have strictly limited resources available to devote to regulatory matters. In many instances, regulatory issues must be handled by staff that have multiple other duties that cannot be ignored or postponed. These include, for example, external reporting requirements and year-end accounting duties.
8. In addition, Toronto Hydro observes that throughout this process the Board itself has imposed many other deadlines that were to have been or must now be met by the same staff at very nearly the same time as the EDR deadlines, such as the filing of 2005 rate applications, and submissions to the Board in several other areas such as the Natural Gas Forum, RPP, Smart Meters, CCTA, and CDM applications and hearings. For Toronto Hydro specifically, there were also very detailed and time-consuming processes around Phase 2 Regulatory Assets and the complications that arose from the IMO (Ellesmere) billing error.
9. Toronto Hydro acknowledges that the Board has notified stakeholders of the scheduled dates for argument and reply. However, that notification has not created any additional time or resources to be used in addressing the need. It would be unreasonable for the Board to assume that simply knowing of a deadline enables a stakeholder to meet it effectively.
10. In the present situation, Toronto Hydro regrettably cannot anticipate that a satisfactory finished product will emerge from the RP-2004-0188 process. Therefore, Toronto Hydro urges the Board to establish a documented, transparent process to provide for the revisions and corrections that will likely be necessary in the DRH and EDRM. In

making this suggestion, Toronto Hydro is not advocating that the Board retrace steps that have already been taken. However, even as the hearing has unfolded there have been examples where the interpretation of the DRH has been unclear. In addition, there are several topics on which the DRH is silent, such as the treatment of CDM and smart metering assets, and the cost of power under RPP, which have distribution rate implications but which depend on external developments and policy decisions. These facts make it probable that the DRH and EDRM will require revision after the issuance of the RP-2004-0188 Decision.

11. In these circumstances, Toronto Hydro submits that the Board should adopt simpler approaches and filing requirements where possible in order to achieve a more timely and workable process.

12. Toronto Hydro further submits that it would be unreasonable and unfair to both utilities and other stakeholders to require rate applications to be based on draft versions of the DRH and EDRM that contain significant defects. Given that adequate time has not been devoted to testing and debugging these products, a substantial period may be required to bring them to a workable condition. Therefore, the Board should be preparing to augment its resources in order to process rate applications in less than 10 months, which is the lead time that the Board now appears to be reserving (i.e., applications filed July 4, 2005 for rates effective May 1, 2006).

Submissions by Rate Handbook Chapter and Topic

Chapter 3 – Test Year and Adjustments

Section 3.0 – Test Year and Adjustments (Disclosure of 2006 events)

13. Toronto Hydro cannot support alternative 1 since there is no definition of materiality or the other terms in the preamble. In fact, neither alternative is viable since the premise underlying the question is ill-defined and the conditions cannot be confirmed or disconfirmed as presently worded. In any case, disclosure requirements for events in 2006 should not apply to historical test year applications.

Section 3.2 – Rate Base Adjustments

14. Toronto Hydro gives qualified support to alternative 1 on the basis that it would better represent actual test year costs and investments.

However, Toronto Hydro has difficulty rationalizing why major capital investments with 2006 in-service dates should be restricted to transformer stations, since there could easily be other investments related to reliability or customer service that would be equally deserving of recovery through rates. This comment also applies to 2005 investments. In principle, Toronto Hydro supports adjustments for major capital expenditures (defined in reference to a materiality standard) without imposing the requirement for a full forward test year filing.

Section 3.2 – LV costs

15. Toronto Hydro endorses the inclusion of all relevant LV costs that can be reasonably quantified, despite the absence of a final Board decision in some instances. If there is uncertainty as to the exact level of costs, any variances could be posted to an appropriate RSV account.

Section 3.2 – Smart Meters and CDM

16. Toronto Hydro reserves the right to make submissions regarding the regulatory treatment of smart metering and CDM assets, and observes that while it will be necessary to make determinations in these areas, the Board has insufficient evidence before it to do so.

Section 3.2 – Non-routine Tier 1 Adjustments

17. Toronto Hydro submits that there are two distinct issues involved in this area, which should be considered separately. First, there is the question of the recoverability of any particular, material unusual cost (or cost reduction) occurring in 2004. Formerly such costs would or may have been treated as Z-factors, and the Board would decide such issues on a case-by-case basis.

18. The second issue is whether such unusual costs should form part of the basis of 2006 rates. Toronto Hydro accepts that material cost discrepancies that can reasonably be thought to be unlikely to recur should not form part of the basis for ongoing base rates (i.e., rates that should persist without a definite expiry, in contrast to rate elements dedicated to the recovery of specific costs and that should cease to exist after the recovery of those costs).

Chapter 4 – Rate Base

Section 4.1 – Definition of Rate Base

19. Toronto Hydro supports alternative 1 and the submissions of Hydro One with respect to the level of detail to be provided in applications. In particular, Toronto Hydro agrees that comparability of data at a highly detailed level, year over year or between utilities, is likely to be quite suspect and potentially misleading. Additionally, it would not be helpful to provide data at a level below that which is used for management purposes, since utilities would not be able to provide meaningful explanations of data at that level.

Section 4.1 –Rate Base Measurement Date

20. For any asset in rate base that was in service in 2004, Toronto Hydro supports alternative 1, i.e., 2004 year end measurement. For the purpose of 2006 rate setting, any (undepreciated) plant in service in 2004 will clearly be in service in 2006, and it is absurd to suggest that for historical plant, an average of 2004 balances should be used for rate setting purposes. Toronto Hydro accepts the half-year rule for plant additions in 2006, under the assumption that rate base will be reset in 2007 and 2008; otherwise, there would be an inadequate allowance for depreciation in ongoing rates.

Section 4.3 Capital Investments

21. Toronto Hydro supports alternative 2, on the basis that it depends simply on a percentage of net fixed assets and therefore would apply uniformly across utilities.

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

22. Toronto Hydro relies on the submission of the CLD.

Section 4.5 - Capitalization Policy

23. Toronto Hydro supports alternative 1.

Section 4.7 – Treatment of Capital Gains and Losses

24. Toronto Hydro observes that capital gains or losses are one-time phenomena, and consequently, any rate adjustment flowing from them must also be temporary (i.e., in the form of a rate rider).

25. Toronto Hydro does not believe that section 4.7.3 clearly sets out the practice to be followed and submits that it needs to be re-developed. In its present form it is unclear how to comply with this section.

Chapter 5 – Cost of Capital

Section 5.1 – Maximum Return on Equity

26. Toronto Hydro observes that the need for alternatives in this section flows from the long period between the date of filing and the effective date of new rates.

27. Toronto Hydro appreciates the need for current information when setting rates. However, from a planning perspective there is also a need for stability, and Toronto Hydro does not favour the work-around solution of establishing yet another variance account. On balance, Toronto Hydro does not support changes to established rates of equity and debt returns after applications have been filed, except where those changes are material (e.g., in excess of 50 basis points).

Section 5.2 – Debt Rate

28. Toronto Hydro supports alternative 2 and endorses Hydro One's submission on this topic.

Section 5.4 – Working Capital Allowance

29. None of the alternatives is entirely satisfactory to Toronto Hydro. Toronto Hydro takes the view that the 2006 forecast COP should underpin the WCA, and that in turn, the forecast COP should be a function of the best available price forecast and the same load quantities used to establish rates, adjusted as necessary for losses to bring those quantities back to the wholesale level.

30. Toronto Hydro does not support the inclusion of customer deposits in the calculation of the WCA. Customer deposits represent committed balances upon which utilities pay interest to customers, and the level of customer deposit balances is expected to decline with recent changes to the Distribution System Code. Therefore, customer deposits should not be considered a form of working capital.

31. Toronto Hydro submits that there should be recognition in the WCA of the costs of posting and maintaining IESO prudential requirements.

Chapter 6 – Distribution Expenses

Section 6.0 – Level of Account Detail

32. Toronto Hydro supports alternative 2, under which distribution expenses would be grouped or aggregated up to a meaningful level, for the same reasons that were set out under Section 4.1 in this document.

Section 6.2.1 – Insurance Expense

33. Toronto Hydro supports alternative 1, under which utilities could present evidence as to their reserves experience.

Section 6.2.2 – Bad Debt Expense

34. Please see comments re Section 3.2

Section 6.2.4 – Charitable Donations

35. Toronto Hydro takes the view that to the extent that charitable donations are not allowed in distribution rates, any benefits arising through tax deductibility of such donations should not be included in determining the utility revenue requirement.

Section 6.2.4 – Meals/travel and business entertainment expenses

36. Toronto Hydro supports alternative 1, under which utilities would not be required to file written policies (if they exist) in this area.

Section 6.2.5 – Employee Total Compensation – additional filing requirements

37. Toronto Hydro supports alternative 2, under which no reporting would be required for individual positions earning more that $100,000 annually.

Section 6.2.5 – Employee Total Compensation – incentive plans

38. Toronto Hydro supports alternative 1. Toronto Hydro rejects the premise of alternative 2, which is that incentive plans must necessarily benefit only ratepayers or only shareholders. Alternative 2 is not viable, since no criteria are specified for the determination of how benefits flow.

Section 6.2.7 – Distribution Expenses Paid to Affiliates

39. Toronto Hydro submits that affiliate relationships are adequately governed by the ARC. The minimum filing requirements as set out in this area are sufficient for rate review and rate setting purposes. Furthermore, the purpose of rate applications is not to test compliance

with the ARC. Toronto Hydro rejects additional filing requirements for 'actual costs' of affiliates as these are not adequately articulated and could involve the unwarranted release of commercially sensitive information.

Chapter 7 – Taxes / PILs

Section 7.1.1 – General Principles Underlying the 2006 Tax Calculation

40. The second issue on the OEB's approved Issues List was "Tax/PILs pass through versus true up methodology", ascribed to Toronto Hydro. More particularly, the question to be considered by the OEB was, "To what extent, if any, should differences between forecast taxes/PILs included in 2006 rates and actual taxes/PILs paid in respect of 2006 be trued-up after the fact, with excess refunded to ratepayers and shortfalls charged to ratepayers?"

41. In this regard, Toronto Hydro filed with the OEB the December 9, 2004 report of KPMG titled "Review of Proposed Methodologies for the Treatment of Taxes for Rate Setting Purposes" (the "KPMG Report"). The conclusions and recommendations of the KPMG Report are adopted by Toronto Hydro, and supported by Hamilton Hydro Inc., Hydro One Networks Inc., PowerStream Inc. and Veridian Connections Limited. A witness panel consisting of John Krukowski and Jonathan Erling of KPMG gave oral evidence at the January 17, 2005 session of the oral hearing in this proceeding. Mr. Krukowski is a tax partner in KPMG's Toronto office and a member of the KPMG power and utilities team. Mr. Erling is a director in the public infrastructure finance practice of KPMG, where he specializes in energy and utility economics, regulatory issues, statistics and forecasting. Both witnesses were qualified as experts.

42. No other written evidence was filed on this issue, nor did any witnesses other than those on the Toronto Hydro witness panel give any oral evidence on this issue. Toronto Hydro repeats and relies upon the written and oral evidence of the Toronto Hydro witness panel.

43. The Draft Handbook contains two alternative proposed treatments of PILs with respect to this issue: a "partial true-up, inclusive of tax rate/tax law/assessing policy changes and reassessments"; and a "100% Pass-Through/True-Up". Alternative 1, the partial true-up, is described as follows at p.69 of the Draft Handbook:

Each distributor shall establish a 2006 PILs/taxes variance account to capture the tax impact of the following differences:

- *any differences that result from a legislative or regulatory change to the tax rates or rules assumed in the 2006 OEB Tax Model*
- *any difference that results from a change in, or a disclosure of, a new assessing or administrative policy of the Federal or Provincial tax authorities, if the Board has declared that such new or modified assessing or administrative policy is a change of general application that should be treated as if it were a change in tax rules*
- *any difference in 2006 PILs that results from a tax re-assessment*
  - *received by the distributor after its 2006 rate application is filed, and before May 1, 2007*
  - *relating to any tax year ending prior to May 1, 2006*

Alternative 2 would provide for a true-up both for these "tax driven factors" and for "operations driven factors", which comprise situations in which the actual mix of types of expenses, capital expenditures and other components of the tax calculation differ from the forecast mix and type of those adjustments, or where actual earnings are more or less than forecasted earnings for the rate year.

44. As noted by Board Counsel, Ms. Lea, in her comments to the panel on Friday, February 4, 2005, "The full or partial true-up issue, which appears at pages 69 through 70, was - 71, I guess, yes, was discussed at the hearing. No one who appeared at the hearing appeared to be in favour of a full true-up."[1]

45. The Toronto Hydro evidence supports alternative 1.

46. The KPMG Report analyzed four options for the treatment of any differences between the taxes recovered by LDCs in 2006 distribution rates and the taxes actually paid by those LDCs:

Option 1: 100% Pass-Through/True-Up. Under this option, a variance account would be set up for 2006 taxes/PILs. Any variance between actual taxes and forecast taxes would be credited or debited to this account, and cleared to ratepayers in a subsequent year.

Option 2: 100% Asymmetrical Pass-Through/True-Up. This would use the same mechanism as the first position, but would only true up if taxes are less than forecast, so would only allow for a refund to ratepayers.

[1] Transcript Vol.11, at para. 951

Option 3: Partial True-Up. This position provides for a similar after-the-fact adjustment to taxes/PILs, but only to the extent that actual and forecast taxes differ due to changes in tax rates or rules.

Option 4: No True-Up. Under this model, taxes/PILs are forecast like any other expense, and that forecast amount is included in rates. Any variance between forecast and actual is enjoyed or borne, as the case may be, by the shareholder.

47. In the opinion of KPMG, as adopted by Toronto Hydro, projected PILs/taxes should not be subject to true-ups for any reason other than changes in tax rules or rates. Based on the KPMG analysis, KPMG concluded that Options 3 and 4 are both reasonable approaches for the treatment of tax variances under the 2006 rate setting process. Option 3 has some advantages relative to Option 4, since it reduces utility risk somewhat and seems somewhat fairer to both consumers and utility shareholders. In contrast, Options 1 and 2 entail significant disadvantages that KPMG believes make their use in the rate setting process inappropriate.

48. These options were considered and the KPMG Report was prepared before the Draft Handbook, in which the alternatives reduced to two, was issued. However, the witnesses subsequently reviewed those two alternatives in the draft Handbook and determined that the Draft Handbook's Alternative 1 most closely corresponds to KPMG Option 3, although that alternative represents a slight expansion of Option 3, with the addition of changes in tax policy and reassessments as grounds for true-ups. However, at p.15 of its Report, KPMG had already contemplated that Option 3 would include administrative policy changes by the Ministry of Revenue that would affect the calculation of PILs. In the course of their testimony,[2] the witness panel also confirmed that they had no concerns with the prospect of true-ups in the case of certain tax reassessments, as proposed in Alternative 1.

49. The KPMG Report and the evidence of the Toronto Hydro witness panel are clear, consistent, and uncontroverted, and Toronto Hydro need not repeat it here. However, Toronto Hydro does wish to emphasize the panel's conclusions as to the merits of KPMG Option 3/Draft Handbook Alternative 1. The comments of the witness panel can be found at paragraphs 156-164 of Vol. 1 of the Transcript of this hearing, and Toronto Hydro has summarized them as follows:

[2] Transcript Vol.1, at paras. 101-102

(a) Alternative 1 entails the lowest utility risk. It also ensures stable rates, yet retains an incentive for utilities to manage their revenues and expenses. This includes the incentive to look for tax savings.

(b) Alternative 1 is neutral with respect to consumer rates in the short run. The impact on the consumer, relative to option 1, can be either positive or negative. In the long run, however, option 3 may provide the lowest rates. The decrease in utility risk, particularly with respect to revenue and expense fluctuations that are not under the utilities' control, should serve to lower utilities' cost of capital. This will benefit consumers in the long run.

(c) Alternative 1 is just as appropriate for small utilities as for large, for the following reasons: This approach reduces utility risk. The effect of corporate taxes under the no true-up method is to act as a cushion against changes in revenue and expense from forecast. Shareholders feel only the after-tax impact of revenue and expense changes. This reduces the volatility of earnings relative to a scenario in which tax changes are fully passed through. Additionally, improvements in the model used to forecast PILs for rate-setting purposes should improve the accuracy of this model in forecasting actual taxes paid. Increasingly, tax variances should thus reflect only differences in revenues and expenses, for which, as outlined above, tax variances act as a cushion. Finally, utilities are not required to invest in tax strategies as a result of the adoption of this alternative. While utilities may have some incentive to explore tax avoidance strategies because they may be able to keep the tax savings, they do so at their own cost and risk. Utilities that do not pursue such strategies are no worse off. To the extent that their actual results approximate the regulatory income used to estimate PILs, their actual PILs should be approximately reflected in the rates that they collect. Accordingly, in our opinion, the conclusions and recommendations we are submitting to the OEB are applicable to all publicly owned LDCs in Ontario, regardless of their size.

50. In light of the foregoing, Toronto Hydro recommends that the OEB adopt Alternative 1, as set out in the Draft Handbook with respect to the treatment of PILs true-ups.

Section 7.1.2.2 – Non-recoverable and Disallowed Expenses

51. With respect to all cash outlay items, Toronto Hydro supports and relies upon the submission of the Coalition of Issue Three Distributors.

Section 7.1.2.4 – Sharing of Tax Exemptions

52. Toronto Hydro does not support the alternative to item (iii).

53. The federal LCT tax exemption should be pro-rated between distribution and other activities.

Section 7.1.2.8 – Interest deduction

54. Toronto Hydro supports alternative 1.

55. Interest deducted in computing the 2006 tax calculation should be the same as that allowed for recovery in the 2006 rates, as established in chapter 5 of the Handbook.

Section 7.1.2.15 – Placeholder: Impact of [C & DM] on PILs calculation

56. Toronto Hydro interprets the word missing from this heading to be 'C&DM'.

Chapter 10 – Rates and Charges

Section 10.5 - Update of Loss Adjustment Factor Reflecting System Losses including Unaccounted-for Energy

57. Toronto Hydro supports alternative 1. Losses are volatile and depend on conditions quite outside of a distributor's control. Providing an incentive for utilities to reduce losses can be better handled through the CDM initiatives. Putting distributors at risk for losses is not warranted.

Section 10.6 – Distributed Generation

58. Toronto Hydro supports alternative 1 (status quo) on the basis that the proposed changes will necessarily involve transfers of wealth and have long-term implications for the electricity system. Such changes require a proper forum for their determination, and that has not been provided by the EDR process.

Section 10.7 – Standby Charges

59. Toronto Hydro accepts the approach outlined in this section with the additional proviso that any reduction in the contracted standby capacity from nameplate ratings (for example, due to load shedding capability) must be supported by historical data documenting such a reduction.

Chapter 13 - Mitigation

Section 13.0 - Introduction

60. Toronto Hydro observes that there are few substantive proposals contained in this chapter. However, Toronto Hydro makes the following submissions.

61. The Board should distinguish three different focal points for rate mitigation: cost of service mitigation; rate design mitigation; and rate harmonization mitigation. (For simplicity in this discussion, changes in cost allocation are subsumed in the latter two categories.) Separable rate impacts can arise in each area and may in any given case combine to produce a variety of total impacts on differing specific customers.

62. The very process of reviewing in detail and approving a proposed cost of service, which the Board may modify from that initially submitted by a utility, is itself the process of total cost of service rate mitigation. Therefore, the Board should reject any preconceived rule limiting the change in the overall cost of service relative to a comparison year. The adoption of such a rule would make irrelevant the substantial effort undertaken by utilities, stakeholders, and the Board in preparing and reviewing a cost of service application. More importantly, it would also have the effect of pre-judging the merits of an application.

63. Having established a total revenue requirement, impacts can also arise as results of changes in cost allocation, rate design, and rate harmonization. Toronto Hydro accepts in principle the reasonableness of establishing rules or guidelines pertaining to the magnitude of tolerable intra- or inter-class impacts resulting from changes in rate design or from rate harmonization. Any such rules would need to balance competing objectives such as inter-customer equity, avoidance of rate shock, and equitable risk distribution.

64. However, for practical purposes the Board has limited the scope of those changes for 2006 EDR. Therefore, Toronto Hydro suggests that

the Board facilitate a full debate on these issues in the context of reviewing the impending cost allocation and cost of capital studies.

Chapter 14 – Comparators and Cohorts

Introduction

65. Three witnesses testified during the oral hearings with respect to Comparators and Cohorts. Robert Camfield, qualified as an expert "on the analysis of electric utility costs, including the identification of cost drivers, and the application of statistical cost estimation methods to utility data and utility comparison"[3], was retained by OEB staff to "determine whether a comparator and cohort system of comparing electricity LDCs could be used for screening applications in the 2006 rate application process."[4] Mr. Camfield's work apparently included a review of data filed by distributors in their RRR filings, a "proof of concept" exercise for a screening program for distributors' 2006 distribution rate applications, and the preparation of a report on the review and the outcome of the proof of concept exercise, all in a period of 12 days.

66. Dr. Mark Lowry, called as a witness by Hydro One, was qualified as an expert "on topics involving comparator and cohort, and benchmarking of LDCs, and general rate-making principles."[5] He was asked by Hydro One "to review the report that had been filed by Mr. Camfield in this case, and to provide [Dr. Lowry's] views and comments about his work, and, in general, about the topic of comparator and cohort benchmarking as it might apply in this particular circumstance."[6]

67. Thomas Adams, Executive Director of Energy Probe and a consultant with Borealis Energy Research Association, also gave evidence. He was not qualified as an expert in the areas of electricity utility cost analysis, comparators and cohorts, benchmarking or the other matters in respect of which Mr Camfield and Dr. Lowry gave evidence, but rather, "as an expert with respect to the Ontario electricity market."[7]

[3] Transcript Vol.6, at para.67
[4] Transcript Vol.6, at para.71
[5] Transcript Vol.7, at Para.52
[6] Transcript Vol.7, at Para.76
[7] Transcript Vol.10, at Para.771

68. Toronto Hydro does not intend to make extensive submissions on the econometric theory underlying the proposals set out in the various reports filed with the OEB. It is, however, of some concern to Toronto Hydro that the OEB is expected, at least by OEB Staff and presumably by a number of intervenors, to adopt a system of comparators and cohorts where the mechanism for the establishment of that system is not yet developed; and where the approach being proposed is either experimental, as acknowledged by Mr. Camfield,[8] or "highly experimental",[9] according to Dr. Lowry.

69. In addition, the statistical results in Mr. Camfield's 'proof of concept' appear to derive from the fact that the analysis was conducted on total utility costs, instead of on some normalized cost concept such as cost per customer. The fact that Toronto Hydro has different cost levels than a utility with 5,000 customers, and that customer numbers are 'statistically significant' in explaining that difference in total cost, can come as no surprise to the Board. Toronto Hydro questions whether an analysis based on cost levels is actually relevant, since two equally efficient utilities of different sizes will naturally have different cost levels, and that fact should be of no concern to the Board.

70. Nevertheless, Toronto Hydro acknowledges that both the Camfield and Lowry reports allow for the possibility of establishing a methodology for screening distribution rate applications, and that the OEB would be assisted by a tool that would enable it to reduce the burden of processing over 90 rate applications for 2006. It is not clear how relevant such a system would be to Toronto Hydro; as the largest municipally-owned distributor in Ontario, with approximately 670,000 customers, a 2006 rate application from Toronto Hydro will likely be subjected to additional scrutiny in any event. This was the case in the OEB's Regulatory Assets proceeding, in which Toronto Hydro was selected for an oral hearing notwithstanding that its transition cost claim, on a per-customer basis, was well below those of many smaller utilities.

71. Moreover, it is not clear that Toronto Hydro could be properly placed within a cohort, given that its size and the nature of its distribution system would not appear to lend themselves to ready comparisons. If the OEB determines that the 2006 rate applications are the appropriate time for such a screening mechanism, Toronto Hydro supports the evidence of Dr. Lowry, and wishes to emphasize Dr. Lowry's "overall

[8] Transcript Vol.7, at Paras. 545-548
[9] *Ibid.*

advice" as the OEB examines this technique.[10] It is directly relevant to Toronto Hydro's comments that follow, regarding a number of practical concerns that it submits must be addressed: First, what will the comparators and cohorts system be used for; and second, who should have access to the data being collected by the OEB for the purposes of screening the applications? Toronto Hydro has reproduced those comments here, for the OEB's reference:

> DR. LOWRY: Yes. I think that the Board has an understandable interest in using benchmarking in this application, because of the very large expansion in their regulatory responsibility that comes with trying to set rates for some 90 LDCs.
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> This is an approach to regulation that is used by regulators in some parts of the world, in particular, in Europe and in Latin America. It is to be noted, however, that this would probably be the first real application of benchmarking by a regulator in North America, and, also, it's relatively rare in Australia. So it's necessary to be cautious about this, but I think it's probably, on balance, worth your while to try something. But it has to be introduced with considerable care.
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> As my report points out, regulators, like utilities, are expected to have judgments that meet certain quality standards. And, if a utility was trying to decide on a new technology for, say, power distribution, they would have to think not only of how much money it would save them, but how it would affect the SAIDIs and the SAIFIs, and the other measures of the their quality. And I think the same thing applies here.
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> There is a possibility that a sloppy benchmarking method can lead to unfair and incorrect assessments of operating performance. And, in addition to the concern about unfairness, there can be a material increase in the operating risk of companies as a result of the application of benchmarking.
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> 84
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> MR. ROGERS: How would that be? How would that come about, Dr. Lowry?
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> DR. LOWRY: When the financial community sees that companies are subject to the risk of unfair cost disallowances, naturally, it can be of concern. And it would be a particularly large concern for -- in an application to the old capital cost. Imagine, for example, that, you know, investments that Toronto Hydro might make today could be subject to the decisions or the -- the decisions of some zealous benchmarker 30 years from now. That plainly does put the company at some risk.

The Use of the Comparators and Cohorts System

72. According to Board Counsel, "The Board confirmed on Issues Day that if the C&C mechanism is used, it would be used exclusively as a screening tool and not as a mechanism for the direct setting of rates for 2006."[11]

[10] Transcript Vol.7, at Paras.80-85
[11] Transcript Vol.11 at para.1003

73. This limited use of the data filed in the Comparators and Cohorts process was confirmed by the OEB staff witness, Mr. Camfield, at a number of points in his testimony, including the following exchange:[12]

MR. RODGER:	But it's certainly not your understanding or expectation that when these 95 rate applications come before them, and the Board is assessing the pros and cons, they wouldn't look at your mechanisms and say, Geez, this is an outlier or maybe we shouldn't approve or maybe we should qualify that. Because that's not the purpose of this mechanism in your view; is that correct?
MR. CAMFIELD:	That's correct.
…	
MR. RODGER:	So at no time were you asked to look at legitimacy of LDC costs as part of this review. Or to otherwise draw conclusions on --
MR. CAMFIELD:	That is correct. My retainer is to focus on cost assessment and not on judging or gauging -- attaching any, in your choice of words, legitimacy to costs.
MR. RODGER:	The costs are legitimate or the utility is efficient or inefficient, that's completely beyond the scope of your retainer.
MR. CAMFIELD:	That's correct.

74. Mr. Camfield also confirmed that he knows of no other utilities where the C&C method that he has proposed is used for screening rate applications, and acknowledged that if the C&C mechanism is not carefully employed, and appropriate data obtained to yield results, that there is a danger that utilities will be wrongly branded as being inefficient.[13]

75. In light of the experimental nature and the risks of the C&C approach, as acknowledged by the consultant who would be responsible for implementing it, Toronto Hydro submits that it is critical that the C&C mechanism, if used at all, be used solely as a screening tool, whereby the OEB would identify certain distributors for further scrutiny. This is consistent with the evidence of Dr. Lowry, as shown in the following exchange from Volume 8 of the Transcript:

MR. ROGERS:	Thank you.
	169
	Dr. Lowry, you started off, I think, this morning by saying that you thought that the Board's interest in this topic was appropriate. How do you see the Board and its Staff -- or this process using the results of the work that we've been talking about?

[12] For example, see Transcript Vol.6 at para.735
[13] Transcript Vol.6 at para.574

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DR. LOWRY: Well, there's been a lot of talk here about using this as a screening tool, and I think that that could well be appropriate under these circumstances. This is an experimental method, and it shouldn't be assumed, as we sit here today, that, as it's finally done, it's done well. It may not be, even though we have the best of intentions. And so it probably is best to use it as a screening tool.

171

But that's kind of a sensitive word. What do you mean by "a screening tool"? Because one definition of a screening tool is that you will decide who to do -- which companies should be subject to a detailed -- a more detailed, prudence-like review. And then, again, it could be used to not only do that, but to throw the benchmarking result in as evidence of impropriety. And that's really not using it as a screening tool.

172

So I think that, my own opinion, it could well be best to really use it as a screening tool and not -- and then proceed with a more traditional prudence review.

173

MR. ROGERS: Is it likely, based on your, obviously, quite extensive experience, that we will be able to develop this, if we -- if the Board decides to go ahead with it, that it will be possible to develop the technique with sufficient accuracy that it can be used for anything other than screening for 2006?

174

DR. LOWRY: I just don't have confidence about that at this point, and so I -- that's why I would recommend just using it, this time around, as a screening tool and gain some experience with it.

76. Even the Energy Probe evidence claims to propose "a benchmarking approach as a screening tool to facilitate a determination of just and reasonable rates for electric local distribution companies (LDCs) in 2006."[14]

77. However, while the OEB and the witnesses would appear to be in agreement as to the limited manner in which the C&C analysis would be used, Toronto Hydro is concerned that intervenors such as Energy Probe are in fact seeking to use the C&C process as more than a means of identifying utilities for further scrutiny in the 2006 rate application process. Toronto Hydro offers the following comments in this regard:

    a. Notwithstanding the quote from the introduction to the Energy Probe evidence in the preceding paragraph, Energy Probe advocates in its report the use of an efficiency frontier as a screening tool. Dr. Lowry described this method as comparing "each utility to what you think is the best practice in a given area." He addressed this in his testimony, at paragraphs 186 through 192 of Volume 8 of the Transcript. Dr. Lowry's evidence was that "if

[14] Exhibit B.11, at p.2

you're only going to use benchmarking as a screening tool there's no need to use a frontier standard. What you're looking for is like the worst 20 percent of the companies, and to do that you can compare -- you can have a standard of average efficiency for the industry just as easily as you could some sort of a frontier standard. Secondly, experience has shown that the -- to get an idea of what best practice is, it's very sensitive to anomalies in the data. And as we know from everything that's been said here, we definitely cannot guarantee there aren't going to be anomalies in the data for Ontario." Moreover, not only does one not know who is on the frontier, but the idea of a sustainable frontier is not possible – according to Dr. Lowry, no-one has ever devised a method for getting to a sustainable frontier. Based on his work in England, "the frontier is not a proper standard, it's not a workable standard and, in fact, OFGEM in its wisdom has abandoned that standard for this current round of benchmarking." In short, Dr. Lowry's evidence is that there is no use for the frontier approach where benchmarking is being used solely as a screening tool. Toronto Hydro is concerned that Energy Probe intends to move beyond the screening process to using the C&C process, however it may ultimately be designed, for the purpose of drawing conclusions as to the efficiency of Ontario's electricity distributors. This should raise concerns on the part of electricity distributors regarding the risks identified by Dr. Lowry

b. During the cross-examination of Dr. Lowry by Mr. Adams, the following exchange took place:[15]

MR. ADAMS:	Another comment you made in your testimony was that having used benchmarking techniques for screening purposes, once a utility finds itself identified for closer scrutiny and goes before the Board, I understood you to have recommended that the screening results be thrown out, not considered at the time that the cost-of-service review or more detailed scrutiny is applied. Did I understand that correctly?	564
DR. LOWRY:	Well, if they're not thrown out, then it's not my idea of screening; it's screening plus. I think it's really taking a bigger step towards using benchmarking in direct disallowance of costs -- eventually in direct disallowance of costs.	565
MR. ADAMS:	By recommending throwing it out, it sounds like you're inviting the Board to dispose of information that they might otherwise inform	

[15] Transcript Vol.7, at paras.563-566

themselves with in considering the full scope of the question of what are appropriate costs.

566

DR. LOWRY: Well, again, I'll say that, on the other hand, doing it differently than that, you're not really using it just as a screening tool, which the Board has cited several times is what this is all about.

Once again, Energy Probe appears to be attempting to move the data collection process beyond the simple determination of which utilities' 2006 rate applications should be subject to greater OEB scrutiny.

78. Significant risks to distributors can arise from using the C&C methodology as more than solely a screening tool for identifying utilities whose 2006 rate applications should be subjected to greater scrutiny, including risks of unfair and incorrect assessments of operating performance and material increase in the operating risk of companies as a result of the application of benchmarking. Toronto Hydro submits that the OEB must be vigilant in limiting the scope of the C&C process, both during the OEB staff screening activity and in the course of the proceedings that will follow.

The Confidentiality of the Comparators and Cohorts Data

79. Related to the issue of the limits that must be placed on the use of a C&C mechanism is the issue of the extent, if any, to which parties other than the OEB should have access to the C&C data. Toronto Hydro has a brief comment in this regard.

80. OEB staff have suggested a number of possible approaches to the confidentiality of the C&C analysis. The possibilities range from it being for use by Board Staff only to public disclosure on the Board's website.

81. Toronto Hydro submits that, in light of the risks associated with the potential misinterpretation or misrepresentation of the C&C data, as discussed by Dr. Lowry, the most appropriate treatment of the C&C analysis is that it be maintained in confidence by the OEB, in a manner similar to distributors' RRR filings. Once a distributor has been identified by OEB staff as having been selected for greater scrutiny in the application process, the distributor should have an opportunity to meet with staff, be advised as to the basis on which it was selected, and be given an opportunity to challenge that determination. The analysis should not, however, be available to the public. The release of the analysis will only serve to encourage its use for purposes beyond its

acknowledged intended purpose as a screening tool. This is of particular concern where, for example, as Mr. Sommerville has noted,[16] decisions on location may be made by industrial customers on the basis of benchmarking that is "embryonic." Toronto Hydro agrees with Mr. Sommerville's observation, at paragraph 915 of Volume 10 of the Transcript, that "I think you can have that input and dialogue without sharing the analytical output, this sort of first cut, if you like. You can still have that dialogue between the Board and the utility on that score, you can still avail yourself of that expertise and knowledge as to why this particular apparent anomaly may occur, you know. Thank you for your answer."

Conservation and Demand Management

82. Toronto Hydro generally supports the submissions of Hydro One in this area. Specifically, Toronto Hydro agrees on the necessity for revenue protection, and timely recovery of CDM expenditures. Also, Toronto Hydro sees as desirable the development of a simple incentive mechanism keyed to tangible customer and system benefits.

83. Toronto Hydro observes that utilities are at a very early stage of program implementation. The CLD utilities have focused their efforts thus far on program implementation, but recognize the need to develop monitoring and evaluation systems to enable more sophisticated cost benefit analysis of programs and reliable quantification of amounts related to LRAM- and SSM-type mechanisms.

84. Nevertheless, many essential aspects of these mechanisms specifically, and CDM policy generally, remain to be established. For example, the role and contribution of the OPA is not yet specifically known. There is no approved set of avoided costs. Future funding of CDM programs has not been determined.

85. Therefore, Toronto Hydro recommends that the Board adopt a simple, transitional type of approach at this stage. This approach would recognize that many utilities will not be positioned to propose 'Phase II' CDM programs (i.e., programs incremental to the established MBRR-funded programs) until 2007, since there will not be sufficient time or experience gained to do so by the filing date for 2006 rate applications.

[16] Transcript Vol.10, at paras.906-920

86. In the transitional phase, the Board should permit utilities to file *ex post* assessments of the load impacts of 2005 and 2006 CDM programs, for purposes of both the LRAM and SSM mechanisms. As soon as is practical, and ideally for 2007 programs, the utilities could file forecasts of program load impacts and program costs so that those impacts could be incorporated into the volumetric basis of rates. A similar approach could be taken with respect to Phase II program costs, such that those costs would begin to be recovered in the year they are incurred.

87. Once load impacts of CDM programs are known, it is straightforward to calculate the financial impacts for LRAM purposes. Toronto Hydro also proposes that the transitional SSM be a simple linear mechanism based on a fixed percentage of TRC net benefits, once the TRC parameters are known and approved by the Board.