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**BY COURIER AND E-MAIL**

Peter O'Dell  
Acting Board Secretary  
Ontario Energy Board  
P.O. Box 2319  
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Toronto, Ontario M4P 1E4

Dear Mr. O'Dell:

**Re: Ontario Energy Board 2006 Ratemaking Methodology Consultation  
(EDR 2006) – Written Submission of Hamilton Hydro Inc. and St.  
Catharines Hydro Utility Services Inc.**

**Introduction:**

We are counsel to Hamilton Hydro Inc. ("Hamilton Hydro") and St. Catharines Hydro Utility Services Inc. ("St. Catharines Hydro") in the above captioned matter. Hamilton Hydro and St. Catharines Hydro are the local electricity distribution companies (the "LDCs") that serve the approximately 226,000 business and residential electricity customers in Hamilton and St. Catharines. Hamilton Hydro and St. Catharines Hydro and their municipal shareholders are currently in discussions regarding the possible amalgamation of these utilities into a single LDC. Hamilton Hydro and St. Catharines Hydro made a joint presentation to the Ontario Energy Board's (the "Board's") informal consultation on the 2006 Electricity Distribution Ratemaking methodology on July 6, 2004. The comments below will serve to summarize and supplement that presentation.

In its letter of June 16, 2004, the Board announced that it is establishing a "policy development process to develop guidelines for the methodology to be used in setting May 1, 2006 rates." The Board's letter stated that the purpose of the informal consultation on July 6 and 7, 2004 is "to identify the various issues and to discuss which are suitable for generic consideration."

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## **Decisions on the 2006 Ratemaking Methodology May Affect the Hamilton - St. Catharines Hydro Amalgamation and Other LDC Amalgamations:**

In keeping with the purpose of this consultation, Hamilton Hydro and St. Catharines Hydro are not taking positions at this time on the various issues in the Board's list of potential issues. It is important, though, that the Board understand that the decisions it ultimately makes on the ratemaking methodology for 2006 and beyond may affect the potential amalgamation of Hamilton Hydro and St. Catharines Hydro, and the potential amalgamations of other Ontario LDCs. Our comments address two broad themes:

- First, the need for the Board to maintain its commitment to the PBR approach to ratemaking; to determine the type of PBR framework it intends to use going forward; and to limit the use of comparators and cohorts until the Board has determined its chosen PBR approach; and
- Second, the use of historical test years for establishing the rate base and revenue requirements for amalgamating utilities.

These themes are related, in that they both pertain to the ability of LDCs in general, and amalgamating LDCs in particular, to realize the benefits of increased efficiencies, whether as a result of the efforts of individual LDCs or the efficiencies that may result from LDC amalgamations.

## **PBR Benefits LDCs and Their Customers, and Encourages Amalgamations:**

The Board's Distribution Rate Handbook (the "Handbook") has governed LDC ratemaking since the Board assumed the ratemaking function from Ontario Hydro. Since their initial rate applications in 2000, Ontario's LDCs have had to comply with the Handbook in making their distribution rate applications. Chapter 2 of the Handbook provides an overview of the electricity distribution rate regulation framework, and in that chapter, the Board confirms the adoption of PBR as the rate regulation scheme for electricity distribution utilities in the Province of Ontario. The Board noted several attractive features of PBR:

- It provides strong incentives to the utilities to continue and expand their efforts to control cost, increase efficiency, and maintain service quality.
- It is expected to minimize the administrative burden.
- It should minimize the cost of regulation.

Other benefits of PBR identified by the Board were:

- It allows electricity distribution utilities the potential for greater returns, based on superior performance than would a traditional regulatory framework, such as cost-of-service regulation. It allows the utility to keep a portion of the rewards from innovation and provides a planning horizon for the term of the PBR plan, during which the mechanism for calculating price changes and earnings to be retained by the utility are fixed.

- Customers benefit from PBR through the prescribed productivity factor and from potential gains through increased efficiency. By creating incentives that normally accrue in a competitive market, PBR brings the benefits of competition, and preserves the important service quality standards.
- If the utility can reduce its costs by more than its prescribed productivity factor it can keep the cost savings in the form of higher operating profits. Thus, PBR provides strong incentives for utilities to find efficiencies in their operations.

In short, the Board has recognized that PBR benefits both LDCs and their customers. While the Handbook did not address this particular aspect of PBR, a PBR framework using a historical year for rebasing also promotes amalgamations; while there would be initial costs associated with the amalgamation (such as the costs of rationalizing redundant staff positions), shareholders of the amalgamating LDCs would ultimately have the opportunity to realize and keep (at least a portion of) the profits arising out of the efficiency gains achieved through the amalgamation.

In its original (March, 2000) version of the Handbook, the Board provided for the sharing of overearnings between LDCs and their customers, after the LDCs had recovered any deferred portion of their target Market Based Rate of Return. In that version of the Handbook, issued prior to the Minister's Directive of June 2000, LDCs would move to their maximum MBRR immediately, but could defer a portion of their MBRR to address inappropriate bill impacts. The revised Handbook, issued following the Board's Decision in its generic hearing on the Minister's Directive, provided for the phasing in of the MBRR in three equal increments and eliminated the deferral of portions of the target MBRR and the sharing of overearnings.

In their business planning models, and in reliance on the Board's position on ratemaking methodology as expressed in the Handbook, electric LDCs have anticipated and accepted a PBR environment. Under this environment, LDCs have assumed that any rebasing process would be based on actual results from a historical year as was done with first generation PBR.

Accordingly, the shareholders of the amalgamating LDCs would be incented by the ability to recover the efficiency gains realized through the amalgamation. Whether it would be all of those gains or some portion of them would depend on the approach adopted by the Board in the next generation of ratemaking. Presumably, amalgamation-related efficiency gains and cost savings would be treated in the same manner as other efficiency gains, as they are now.

**Future Test Years that Incorporate Efficiency Gains from Amalgamation, or the Wrong Choice of Historic Test Year, Can Act as a Disincentive to Amalgamations:**

From the Board's list of potential issues, it appears that the OEB could be moving toward a cost of service forward/future test year framework for distribution rate setting purposes – much in the same manner as is currently done in natural gas. In contrast to the PBR approach, typically under a cost of service future test year framework any efficiency gains achieved by the utility, whether individually or as a result of an amalgamation, would flow



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directly to the customer and very little benefit, if any at all, would flow to the utility and its shareholder. There could be a similar result if the Board were to choose a test year in which the amalgamated LDC had already realized cost savings.

For example, if two LDCs were to merge this year, there would be significant costs incurred by their shareholders in the short term (perhaps this year and next) in implementing the merger. These costs would likely be one-time charges in the nature of transition costs. Following that, it would be hoped that the merged entity's costs would be reduced. In making the initial decision in favour of the merger, the shareholders would have to be satisfied that the costs associated with the merger would be outweighed by the efficiency gains and cost savings resulting from it and available for recovery by the shareholders.

Merely "breaking even", that is, recovering transition costs and being able to recover the maximum statutory rate of return, may not be an incentive to merge, as the LDCs would conceivably be able to achieve that outcome individually. Worse, if the Board uses a future test year that factors all of the anticipated savings into lower rates, or if the Board, even in a PBR framework, mandates a historic test year in which the merged utility's costs have already been reduced, in turn leading to lower rates in that initial year of the PBR period, then the shareholders will have lost their transition costs and the benefits of cost savings from amalgamation, and will effectively have lower returns than they would have, had no amalgamation taken place. Even if the prospect of merely breaking even did not discourage potential mergers, the prospect of being behind where the shareholders would have been had they done nothing certainly would. If the Board were to adopt a sharing mechanism for LDCs in the next generation of ratemaking, then the abandonment of PBR, or a rigid approach to test years that discourages amalgamations, will have a tangible detrimental impact on the LDCs' customers. Even if LDCs were still permitted to keep all of their efficiency gains through the next generation of PBR, customers would still be negatively affected in future generations of ratemaking if the amalgamations do not take place.

### **The Choice of Ratemaking Methodology Should be Consistent with Government and Board Preferences**

It is our understanding that the Government and the OEB would prefer amalgamations to assist in achieving further efficiencies in the electric distribution sector. A cost of service framework would be inconsistent with this preference, as would an approach to the test year, even within a PBR framework, that leaves the amalgamated LDC with no realistic opportunities to meet a new productivity factor, let alone create overearnings.

We also note that, contrary to the benefits of PBR with respect to lower costs and reduced administrative burdens, the cost of service framework will be more intrusive and more time consuming for the LDCs and OEB staff. Many weeks of hearing time are spent by the Board on the few gas utilities in Ontario. It is not clear how the Board would manage a similar process for the over 90 electricity utilities in the province. This can only be detrimental to the LDC's consumer, by way of higher regulatory costs which that consumer will ultimately have to bear.



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If the Board's intention is not to abandon PBR but instead to determine LDCs' cost of service in order to set initial rates for 2nd generation PBR, then that might be acceptable. However, to promote amalgamations, the cost of service should be determined on the basis of a historical year in order to provide for sharing of the benefits of increased efficiencies between customers and LDC shareholders. While this is relevant to individual LDCs generally, it is particularly important to amalgamating LDCs in order that a significant incentive for amalgamation is maintained. There should also be some flexibility in the choice of test year, in order that the amalgamated utility will still have a realistic opportunity to meet its productivity factor and overearn. Hamilton Hydro and St. Catharines Hydro wish to stress that they are not advocating in this submission that customers not receive any share of the efficiency gains arising from the amalgamation. What they are advocating is that if the Board wishes to see further consolidation in the distribution sector, the Board must allow incentives for that consolidation to exist.

Finally, if the Board has not abandoned the PBR framework going forward, the use of 'Comparators and Cohorts' to assist in the prudence review of LDCs' costs might be appropriate, but this should not mean that the Board has already determined that benchmarking PBR will be the approach to second generation PBR. This is not the only PBR framework available, and benchmarking PBR may not be in the best interest of the industry. We do not intend to discuss the various PBR approaches today, but we suggest that the issue of the appropriate PBR framework to be used moving forward should be added to the Board's issues list.

### **Conclusions:**

In conclusion, Hamilton Hydro and St. Catharines Hydro recommend that:

- The Board declare that it remains committed to a PBR framework, and that the issue of the appropriate type of PBR framework be added to the issues list;
- That cost of service only be used to assist in setting initial rates for 2nd generation PBR;
- That the Board maintain its use of historical years for rebasing, for LDCs generally and amalgamating LDCs in particular, in order to preserve the current incentives to LDCs and their shareholders for the creation of efficiencies, both internally and, if possible, through amalgamations; and
- That the Board recognize that uncertainty with respect to an LDC's ability to recover the costs associated with mergers and of implementing merger-related efficiency initiatives as a result of an arbitrary test year could delay or suspend merger activity, which in turn will result in delays in the customer benefiting from such efficiency measures and initiatives. Accordingly, Hamilton Hydro and St. Catharines Hydro recommend that the Board allow for the possibility of flexibility in the choice of a test year, in order to ensure that amalgamating LDCs have a realistic opportunity to both achieve any mandatory productivity factor and create additional returns that will ultimately benefit the customer.



We thank the Board for the opportunity to make written submissions in this matter.

Yours very truly,  
**BORDEN LADNER GERVAIS LLP**

*Original signed by J. Mark Rodger*

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JMR/JCS/llv

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