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BY E-MAIL AND WEB POSTING

November 21, 2008

To: All Participants in Consultation EB-2007-0673
All Licensed Electricity Distributors

Re: Further Consultation on Stretch Factor Rankings for 3rd Generation Incentive Regulation for Electricity Distributors Board File No. EB-2007-0673

On September 17, 2008 the Board issued its "Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors". In that Report, the Board stated its intention to undertake further work on the model it will use to assign stretch factors to distributors and to consult with stakeholders to identify whether it can improve the grouping approach and further reduce the potential for misclassification in the two OM&A benchmarking evaluations. The purpose of this letter is to initiate that consultation.

On July 22, 2008 the Board posted on its web site (at www.oeb.gov.on.ca) the results of OM&A benchmarking evaluations prepared by the Pacific Economics Group ("PEG") to divide electricity distributors into three efficiency "cohorts" supporting 3rd generation incentive regulation ("IR").

Today the Board posted a sensitivity analysis prepared by PEG regarding the efficiency cohorts that address three distributor characteristics. An overview of Board staff's work in support of PEG's analysis and of staff's proposal in relation to the treatment of low voltage charges is set out in an attachment to this letter.

Invitation to Comment

Participants are invited to provide written comments on Board staff's overview and proposal as well as on the results of PEG's sensitivity analysis. Specifically, the Board would be assisted by comments on the following:

- What changes, if any, to the model arising from the attached sensitivity analysis should the Board consider to further reduce the potential for misclassification?

Written comments received will be considered by the Board in its finalization of the Ontario electricity distributor efficiency ranking to set the membership of the three distributor groupings for stretch factor assignments for the 2009 rate year.

Written comments must be filed with the Board by **December 15, 2008** in accordance with the filing instructions set out below.

Cost Awards and Instructions on Filing Material with the Board

Cost awards will be available to eligible participants as set out in Table 1.

Table 1: Activities Eligible for Cost Awards

Activity	Total Eligible Hours per Eligible Participant
Written comments on Board staff's overview and proposal and on the results of PEG's sensitivity analysis.	Up to 10 hours

All filings in relation to this consultation must quote file number **EB-2007-0673** and include your name, address, telephone number and, where available, an e-mail address and fax number. Three paper copies and one electronic copy of each filing must be provided. Paper copies are to be addressed to the Board Secretary at the Board's mailing address set out above. The electronic copy must be in searchable/unrestricted PDF format, be submitted through the Board's web portal at www.errr.oeb.gov.on.ca and conform to the document naming conventions and document submission standards outlined in the RESS e-Filing Guides (available on the Board's website at www.oeb.gov.on.ca on the e-Filing Services web page). A user ID is required for filings through the web portal. If you do not have a user ID, please visit the Board's web site on the e-Filings Services web page and fill out a user ID password request. If the web portal is not available, the electronic copy may be submitted by e-mail to BoardSec@oeb.gov.on.ca. Participants that do not have internet access may file their electronic copy on diskette or CD.

Filings must be received by **4:45 pm** on the required date.

All materials related to this consultation will be posted on the "OEB Key Initiatives" portion of the Board's web site at www.oeb.gov.on.ca. The material will also be available for public inspection at the office of the Board during normal business hours.

If you have any questions regarding this consultation, please contact Bill Cowan at 416-440-7648 or Lisa Brickenden at 416-440-8113, or by e-mail at EDR@oeb.gov.on.ca. The Board's toll-free number is 1-888-632-6273, and the Market Operations Hotline is 416-440-7604.

Yours truly,

Original signed by

Kirsten Walli
Board Secretary

Attachment

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Attachment: Overview of Work Carried Out by Board Staff to Support Pacific Economics Group and Associated Proposal

On September 17, 2008 the Board issued its "Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors" (the "Supplemental Report"). In the Supplemental Report, the Board stated its intention to undertake further work on the model it will use to assign stretch factors to distributors and to consult with stakeholders to identify whether it can improve the grouping approach and further reduce the potential for misclassification in the two OM&A benchmarking evaluations.

Subsequent to the release of the Supplemental Report, Board staff carried out further work on the two OM&A benchmarking evaluations. Specifically, staff investigated with its consultant, the Pacific Economics Group ("PEG"), how these evaluations might:

- understate costs of distributors that are embedded within another distributor's service territory;
- overstate the costs of distributors that own transformation assets; and
- be sensitive to the Canadian Shield variable.

PEG discusses the issues of, low voltage ("LV") charges billed by Hydro One Networks Inc. ("Hydro One") to its embedded distributors, transformer ownership, and the Canadian Shield variable in their *Sensitivity Analysis on Efficiency Ranking and Cohorts for the 2009 Rate Year* which is now posted on the Board's website.

The following describes preliminary work that Board staff carried out in order to provide PEG with information to support the introduction of an LV charge proxy for embedded distributors into the model.

Proxy for Low Voltage Charges

LV charges appear in the Uniform System of Accounts as a component of the cost of power, and distributors are able to choose from two different methods under the Accounting Procedures Handbook for recording LV charges.

The main adjustment that staff asked PEG to make was to include an O&M cost proxy for LV charges billed by Hydro One to its embedded distributors. It should be noted that LV costs are not classified as OM&A and have been excluded from cost benchmarking to date. The rationale for adding the proxy is that an embedded distributor is charged by its host distributor for the costs of providing and maintaining certain LV assets (i.e., assets that operate at less than 50kV) for them. In the case of a small distributor, the LV charges could potentially be material and consequently this could affect the cohort rankings.

To improve the comparability of embedded distributors with those that own and operate all of their own assets less than 50kV, staff believes that some adjustments should be made to the data underlying the benchmarking evaluations. Specifically, the embedded distributors should have the O&M component of the LV charge included in their costs to be benchmarked, and the hosts' costs should be reduced by the same amount (assumed to be recovered from the embedded distributors).

$14.9 million of LV charges were recorded by embedded distributors for 2007 in their Electricity Reporting and Record Keeping Requirements filings. To confirm the information reported, staff contacted a number of the embedded distributors. Based on those inquiries, staff concluded that the information supporting the $14.9 million reported by distributors is not sufficient to reliably show what an embedded distributor was actually charged by its host distributor. This is largely because, as noted previously, distributors can choose from two different methods under the Accounting Procedures Handbook for recording LV charges. Several of the distributors contacted recommended that until this could be addressed, the reported information should not be used. Staff then contacted Hydro One and requested a list of distributors embedded in the Hydro One system that were billed by Hydro One in 2007 and the amounts for which they were billed. Staff received the information, marked as confidential, from Hydro One. The data indicates that Hydro One billed about $23 million to 70 embedded distributors in 2007.

Staff provided the Hydro One data to PEG on a confidential basis and asked PEG to carry out its analysis as described below. Staff believes that the results of PEG's work can be reviewed by interested stakeholders to provide meaningful comment on the analysis without having the detailed distributor-specific data.

To create a value suitable for PEG's use (i.e., a proxy), staff applied the following adjustments to the amounts billed by Hydro One to embedded distributors:

- An adjustment to isolate an O&M component of the LV amounts: The amount billed by Hydro One includes a component for capital cost recovery (i.e., the return of and return on capital employed, PILs/taxes and depreciation) which should be excluded when undertaking OM&A cost comparisons. Based on information filed by Hydro One in its 2006 electricity distribution rate ("EDR") proceeding (RP-2005-0020: EB-2005-0378), staff reasoned that only 26 percent of the LV charges should be included in the analysis. This percentage reflects the O&M portion of the revenue requirement contained in Hydro One's 2006 application evidence.[1]

[1] This percentage does not include an allocation of the administration portion of Hydro One's revenue requirement. Staff does not believe that Hydro One's administration costs to manage its

- A cost allocation adjustment: Staff's analysis revealed that the cost allocation factor[2] for Hydro One's LV customers[3], as filed in Hydro One's 2008 EDR application (EB-2007-0681), is 2.354. Staff believes that, in order to fairly estimate a proxy for what an embedded distributor's O&M costs might hypothetically have been had they owned and operated the facilities in question, this factor should also be applied to the billed LV amounts.

Staff asked PEG to test two LV charge O&M proxies based on the 2007 data provided by Hydro One:

- a proxy equal to the billed LV charges multiplied by 26%; and
- a proxy equal to the billed LV charges, multiplied by 26%, and then divided by 2.354.

For the purposes of the sensitivity analysis, staff instructed PEG to use the resulting LV charge O&M proxies for each of 2005, 2006, and 2007. Staff has not acquired three consecutive years of LV cost data. As a capacity-related charge, the LV charge amounts should be relatively stable from year to year and staff believes that this is sufficient for the purposes of investigating how the OM&A benchmarking evaluations might understate the costs of embedded distributors.

The details of the work carried out by PEG, and the resultant stretch factor rankings, are provided in PEG's analysis.

Board staff believes that the proxy equal to the billed LV charges, multiplied by 26%, and then divided by 2.354, most fairly represents the O&M costs that an embedded distributor might incur if it owned and operated the LV facilities in question. Consequently, staff proposes that the Board adopt the Ontario electricity distributor efficiency ranking reflected in Table 7 of PEG's results to set the membership of the three distributor groupings for purposes of stretch factor assignments for the 2009 rate year.

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extensive business in Ontario would be indicative of those that might be incurred by a smaller embedded distributor.

[2] Cost allocation factors reflect the relationship between the customer class revenue and the customer class total allocated costs (i.e., a "revenue-to-cost ratio").

[3] Hydro One's sub-transmission class includes embedded distributors and other customers.