May 20, 2008

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319, Suite 2700
2300 Yonge Street
Toronto, Ontario M4P 1E4

Dear Ms. Walli:

Re: Board File No. EB-2007-0673
3rd Generation Incentive Regulation for Electricity Distributors
Comments on Revised Staff Proposal for an Incremental Capital Module

I represent the Association of Major Power Consumers in Ontario on the working group for the above consultation. Attached please find an addendum to AMPCO's April 14, 2008 comments that I have prepared on the revised staff proposal.

Three paper copies have been sent by courier.

Yours truly,

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(for AMPCO)

Copy to:
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OEB File: EB-2007-0673

3rd Generation Incentive Regulation for Electricity Distributors
Comments on Revised Proposal for an
Incremental Capital Module

Introduction

The comments below are an addendum to AMPCO's previous comments submitted April 14, 2008. Board staff revised its proposal based on comments made by participants at a May 6, 2008 stakeholder meeting. These comments cover AMPCO's general perspective, as well as comments on the specifics of the staff proposal.

General Comments

In principle, an IRM should result in continuous improvement in the operation of the distribution sector, to the benefit of the ratepayer.

While good regulation should in theory produce results similar to efficient competition, it is hard to see in a practical way how the application of COS regulation can produce such results. So, a well designed IRM that mimics some of the incentives and threats of a competitive environment has appeal as an improved surrogate for competition.

This suggests that an IRM should produce some symmetry of risk and potential reward.

We are aware that distributors in general and Ontario distributors in particular, do not have a history of competitive pressure. This is, after all, a monopoly business. This observation is important, because it suggests that current information about productivity growth, whatever its accuracy, does not reflect an industry that is actively pursuing its *potential* for improvement.

In short, we believe the proposed TFP and stretch factors are only a very modest first step, necessary to establish the process and mechanisms of an effective IRM but probably also highly conservative.

Much of the discussion in the working group, presentations and stakeholder meetings has focused on including consideration of exceptional requirements, such as high levels of capital needs, or Z-factors such as major storms. To the extent that the mechanism allows these considerations, it reduces the business risk of an IRM for the distributor. Consistent with the principle that risk and reward should be symmetrical, access to risk-reducing modules should also reduce potential reward.

Overall, an IRM regime should act to discourage unnecessary recourse to special mechanisms and encourage utility management to use the discretion available to them to adapt to events.

Such disincentives for gaming, while providing access to special mechanisms when they are really needed, can help to address the issue of information rent that is present in all regulation.

Specific Comments

Use of GDP-IPI FDD vs. Industry specific IPI
We reluctantly concur with staff's proposal, accepting the limitations of the data that might support a distributor - specific IPI. In our April 14, 2008 commentary, we noted the common sources of inputs for distributors in both the USA and Canada, with relatively minor exceptions. In this light, we do not feel an input price differential is justified at this time.

TFP Growth (X Factor)
We continue to support Dr. Kaufmann's analysis and conclusion that 0.88% is the most reliable estimate of past long-term TFP trends in this industry. Dr. Kaufmann has taken considerable care in developing this estimate and, in our opinion; none of the alternative presentations have provided a more credible alternative.

Moreover, we note once again that past performance in a monopoly business environment is useful only in establishing a floor expectation for future TFP growth; if IRM is an effective competitive surrogate, utilities should be able to handily outperform this expectation.

Stretch Factors and Performance Cohorts
The use of three cohorts (1/6, 2/3, 1/6) is probably as good as the current state of the data can support, so this is a good approach for the first round.

There should be a means by which a utility can challenge its placement, but such challenges should place the evidentiary burden on the applicant and should include a requirement that the applicant's methodology be consistent with sound benchmarking practice and identify the impact of applying it's suggestions to the full LDC population.

The use of stretch factors of .25%, .50% and 0% is conservative, but acceptable for the first round of IRM-3.

We continue to believe that Ontario would be well served if individual distributors were able to select a higher stretch factor in return for an opportunity to achieve a higher ROE. This could perhaps be achieved by simply increasing the ROE dead band for such applicants.

Z-Factors
We concur that a single factor including both capital and expense, with a lower threshold, may be the most practical approach.

As with the concept of a capital module discussed later in this commentary, distributors that request Z-factor consideration should have a tighter dead band on ROE for triggering an ESM.

Term
The staff proposal for a four year term is logical in the current circumstance. As others have suggested, the Board should provide rates for the four year IRM term on rebasing, with the onus on the distributor or stakeholders to request a departure from IRM if they feel it is justified.

Off-Ramps
Under the existing law, off-ramps are legally available. However, application for review should be available to intervenors and other stakeholders as well as the utility, without requiring a special motion.

Special Capital Module
Without having specific knowledge, the justification for the 150% depreciation trigger seems about right. This may require a specific threshold for Hydro One, which depreciates assets more slowly than most distributors.

Managing access to the capital module and maintaining a strong evidentiary burden on the utility will be essential to minimizing customer risk and avoiding a "COS by other means" situation. The criteria provided by Board staff seem a good start, but there may be other suggestions that should also be considered. In particular, a capital smoothing test (average increase over IRM term) may be needed to ensure the proposed investments need to be handled via the capital module.

The guideline for access to this module should, as clearly as possible, define the terms "clearly non-discretionary". In our experience, utility management frequently exhibits discretion in excess of what it claims to have. For example, the past variances from plan that are revealed in many COS hearings suggest more flexibility than is often admitted.

Under current accounting practices, a utility with a large than normal capital program will inherently shift some resources away from OM&A activities and toward capital, producing an apparent but not real savings in OM&A expense. If the capital program or project is also one that itself replaces O&M activity, this effect is exaggerated.

In the process of requesting access to the capital module, the distributor should be required to identify these cost shifts in advance, so the appropriate stretch factor is maintained.

To reduce customer risk, access to the capital module should be tied to a narrower, asymmetric ROE dead band before an ESM is triggered. We would suggest that 50 basis points to trigger an ESM with 100% of excess earnings being returned to customers after a 200 basis point rise above approved ROE is appropriate, given the role of the capital module in reducing shareholder risk.

It can be correctly concluded from these comments that AMPCO has serious reservations around the use of a capital module, even while accepting its necessity on occasion. By constraining the opportunity to benefit unduly from use of a capital module and placing a

strong evidentiary burden on the applicant to establish the need, this module will hopefully only be used when it is really needed.

Earnings Sharing Mechanism
Staff proposal for a 200 point non-weather normalized asymmetric dead band in normal circumstances is reasonable.

However, for utilities willing to accept larger stretch factors than their cohort assignment suggests, a broader dead band should be considered.

For utilities requesting Z-factor consideration, the dead band should be narrowed to 100 points maximum.

Data
It is clear from many of the arguments and presentations that the OEB needs to build a foundation of good data for future use. This issue pervades many of the Board's policy initiatives.

It might be advisable for Board staff to initiate a comprehensive LDC data requirements review that includes the needs of all its policy and process initiatives.

Prepared for AMPCO by:

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