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May 16, 2008

Ontario Energy Board
P.O. Box 2319
2300 Yonge Street 27th Floor
Toronto, ON M4P 1E4

Attention: Kirsten Walli, Board Secretary

Re: EB-2007-0673 - 3rd Generation Incentive Regulation

By letter dated May 2, 2008, comments were sought comments from parties on the Board staff proposal for third Generation Incentive Regulation (3rd Generation IR). The Coalition of Large Distributors (CLD) - Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc.) and Hydro One Networks are pleased to provide comments. A copy of these files are being sent by electronic mail today and uploaded to the Board's Regulatory Electronic Submissions System (RESS). Hard copies of these comments will be sent on Tuesday, May 20, 2008.

Furthermore, Board staff issued a revised proposal for an optional capital module that would be part of the 3rd Generation IR plan. The CLD and Hydro One continue to evaluate this proposal and will file supplementary comments on May 20, 2008

If you have any questions about this material, please feel free to contact me at 613-738-5499 ext 527 or e-mail lynneanderson@hydroottawa.com.

Yours truly,

Lynne Anderson
Chief Regulatory Affairs and Government Relations Officer

On behalf of the CLD and Hydro One

EB-2007-0673
3rd Generation Incentive Regulation for Electricity Distributors
Coalition of Large Distributors and Hydro One Networks Comments
On May 6, 2008 Board Staff and PEG Proposals

1. INTRODUCTION

The Coalition of Large Distributors ("CLD") and Hydro One Networks ("Hydro One") is pleased to provide comments in respect of the Ontario Energy Board ("Board") Staff and Pacific Economics Group ("PEG") proposals outlined at the May 6th, 2008 stakeholder workshop[1]. These proposals entailed recommendations in respect of the core plan for 3rd Generation IRM ("3GIRM") process and recommendations in respect of the calibration of the rate indexing mechanism, i.e. setting the Productivity Factor, selecting the inflation index, earnings sharing mechanisms, off ramps, and other components.

As noted in our previous submissions and commentaries in response to Board Staff and PEG discussion papers on the subject matter, the CLD and Hydro One are supportive of the Board's effort to move forward with incentive regulation for the electricity distributors. The presentation brought forward by Board Staff at the May 6th stakeholder meeting further clarified the recommendations of the core plan and the indexing mechanism and generally the CLD and Hydro One view these recommendations forming a reasonable framework to start with on the path of 3GIRM. The CLD and Hydro One are in agreement with elements of the core plan and the flexibility of having options to depart from the core plan if circumstances require utilities to do so. We believe that the Board Staff proposal provides a reasonable balance in the elements selected, bar some key areas which are addressed in this submission, and that the form of the model will allow for future developments to be included as adjustments as experience and more information is gained on performance under this new regulatory regime.

Having said that, the CLD and Hydro One still have concerns in that the details surrounding the implementation of the proposed core plan are sketchy at this time and that significant work is still ahead in that respect. Nevertheless, the CLD and Hydro One accept the general form of the comprehensive price cap proposed by Board Staff and PEG and wish to focus our comments in three key areas, namely:

- The establishment of the Productivity Factor,
- The nature and implementation of the Capital Adjustment Module (to be filed as an addendum on May 20, 2008), and
- The implementation of the Earnings Sharing Mechanism.

Finally, the CLD and Hydro One would like to offer some thoughts on the next steps with the view of assisting the Board and Board Staff in the implementation of 3GIRM.

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[1] EB-2007-0673 – Development of 3rd Generation Incentive Regulation; Stakeholder Meeting, May 6, 2008

2. ESTABLISHMENT OF PRODUCTIVITY FACTOR

2.1 Total Factor Productivity

As noted in our previous submission[2] the CLD and Hydro One concur with PEG regarding the general choice of methodology for measuring industry average Total Factor Productivity ("TFP") growth. We also agree broadly with the use of the calculated industry-average historical TFP growth rate for determination of the X factor. However, we continue to believe that the TFP estimate developed and recommended by PEG may be unrealistic for Ontario's distributors since it is entirely reliant on data from US utilities and ignores the Ontario utility data. Although we agree with PEG that it is best to use a sufficiently long history of data to measure TFP growth for developing an X factor, and we recognize that reliable data in PEG's possession currently for Ontario LDCs is limited to the last five years, 2002 through 2006, we continue to believe that this limited, although very current, data does have relevance.

As discussed by Ms. Frayer in Section V of her affidavit in Appendix A to the CLD and Hydro One April 14th, 2008 submission, all indicators suggest that TFP growth is slowing down. This is of course not limited to Ontario (PEG's analysis of US utility TFP also exhibits slowdown) and therefore gives us confidence that such trends for Ontario over the 2002-2006 period are valid. As noted on page 17 of the Board Staff report[3], and discussed at length by Hydro One and CLD at the March 25th-26th 2008 workshops and the May 6th 2008 workshop, the utilities in Ontario have been under cost pressures due to price cap regimes or effective rate freezes for some time and therefore efficiency improvements have been made. 3GIRM will not be the first generation of price caps for Ontario utilities. More importantly, Ontario utilities are now embarking on a period of replacement of aging assets and demographical shifts in labour that are likely to show up in input increases without commensurate output increases. This slow down – and perhaps reversal - of TFP growth is already present, as indicated by PEG's analysis and observed by our consultant, Ms. Julia Frayer of London Economics International, and we anticipate that this will be a critical driver of utility business operations during the tenure of 3GIRM. An X factor that meets the Board's objective ratemaking criteria (financially viable, balanced, efficient, sustainable, and predictable) needs to consider such existing circumstances in determining a reasonable but effective productivity target.

The bottom-line is that PEG's recommendation for a 0.88% basic Total Factor Productivity for 3GIRM is too high, considering the operating experiences of the utilities and ignores verifiable and measurable recent trends in TFP growth in Ontario. If PEG's average TFP growth analysis for the long term period

[2] *Ibid*, CLD and Hydro One comments on Board Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's electricity Distributors, April 14, 2008
[3] *Ibid*, Board Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, February 28, 2008

1995-2006 was recalibrated with a more accurate analysis that includes data for Ontario for the period 2002-2006 (based on the methods and model applied by Ms. Frayer and described in Section V of her affidavit) in combination with estimates from PEG's own models (specifically model 2 and model 3) for 1995-2001, the annual average TFP estimate over the 1995-2006 period would fall in the range of 0.4% to 0.7%. We therefore recommend a basic X factor of 0.55% - the mid-point of this range. Such an X factor is also consistent with the findings presented by Prof. Adonis Yatchew on behalf of the Electricity Distributors Association (EDA) at the May 6th, 2008 workshop, as well as his testimony on behalf of the EDA submitted on April 14th 2008[4].

2.2 Stretch Factor

While the CLD and Hydro One agree with the concept of using a stretch factor to make a first approximation adjustment for differences in cost drivers among utilities as well as differences in achievable efficiency gains in the future, it is necessary to recognize that the design of such a factor is crucial to creating the appropriate incentives for utilities under an IRM. In all respects, the design of the stretch factor should be grounded in facts that appropriately reflect the trends in productivity changes that reflect the circumstances under which the utilities have and will be operating during the IRM. For example, the stretch factor needs to adequately measure and consider relative efficiency on a comprehensive basis, complementary with the intent of the IR mechanism under 3GIRM. The benchmarking analysis, on which PEG is partially relying on to determine peer groupings for its recommended stretch factors, does not meet such a standard. PEG's benchmarking analysis looks at partial productivity, and ignores the tradeoffs utilities make between capital and OM&A. There are other concerns as well, raised by members of the CLD and Hydro One in written comments in the benchmarking consultation, *Comparison of Electricity Distributor Costs* (EB-2006-0268).[5] For example, the choice of explanatory variables and model form may not be appropriate for all LDCs. PEG's econometric cost function, which underpins the benchmarking, uses only a handful of variables, and excludes factors that represent critical business drivers for some LDCs; for example, factors like customer mix, impact of merger and acquisitions, type of assets (high voltage versus low voltage, existence of own transmission substations, etc.). Additionally, it has recently been determined that incorrect data for kilowatt-hour (kWh) outputs were used for a number of utilities. Analysis of the PEG econometric benchmarking results, indicates that the use of a distributor's "throughput" kWh as opposed to kWh sold has a significant impact on the ranking for at least one utility, and possibly up to ten utilities. The change in ranking was significant enough to move that distributor's position from an average performing distributor to the significantly superior distributor group and as such, that utility would be assigned a lower

[4] *Ibid*, Presentation on behalf of the Electricity Distributors Association, Adonis Yatchew, Stakeholders Meeting, May 6, 2008
[5] Benchmarking the Costs of Ontario Power Distributors, March 20, 2008, Pacific Economics Group

stretch factor according to Board staff's most recent recommendation. Another analytical concern with the benchmarking relates to inconsistency in inputs employed with total factor productivity analysis produced in this proceeding. Furthermore, the results of PEG's analytics in the benchmarking analysis are conditioned on a number of pivotal assumptions, which have not been thoroughly tested or proven to be appropriate for all LDCs in Ontario. Therefore, any hypothesis tests or recommendations developed off such models are unlikely to be equally valid for all LDCs.

On an interim basis the CLD and Hydro One are not opposed to the use of peer groups to categorize utilities with similar kinds and degrees of exogenous cost drivers, in order to approximate a more thorough and exact analysis of cost driver differences. The use of such groupings would provide some measure of protection from the possibility that unjustified outcomes could be produced through inappropriate comparisons of utilities with very different sets of cost drivers. Again, it is crucial that the selection of peer groups reflect close similarities in costs drivers and not arbitrary and irrelevant features that do not have a demonstrable and sufficiently substantial connection to costs. Additionally, in a sector as heterogeneous as the electricity distribution sector, within any peer group established; there will remain a variety of utility specific productivity levels that may need to be further considered.

As explained by Ms. Frayer in Section V of her affidavit in Appendix A to the April 14th, 2008 CLD/Hydro One submission, a comprehensive approach, using multilateral TFP analysis, would be the most practical and accurate method for establishing an understanding of the diversity of performance between groups of firms, and determining group "diversity factors". Such an analysis has not been done to date for Ontario LDCs. PEG's benchmarking analysis is an analysis of only OM&A productivity, and therefore is likely to mis-classify firms, even across only three broad groupings now being recommended by PEG. A method, which is known in advance to be incorrect, should not be applied by the Board.

We prefer the use of "diversity" rather than "stretch" factors because we feel that the industry is not yet at a level of understanding of the relative status of productivity trends and achievements by all utilities in Ontario to adopt the concept of "stretching" performance. Such an approach can only come about after we have (1) gathered sufficient data and experience of performance under an incentive regime, (2) performed a rigorous analysis of productivity growth and the relative standing of utilities thereof, and, on the basis of the analysis, (3) determined whether we need to "stretch" performance targets or not above those that are set by the industry average measure of TFP growth. PEG rationalizes the use of stretch factors on the basis that utilities should be able to achieve accelerated productivity growth when moving from cost-of-service to incentive regulation. However, the electricity distributors in Ontario have not been on true cost-of-service regulation prior to the implementation of 3GIRM. Instead, distributors have been exposed to extended periods of price freezes related to local operating costs that ended only in 2006 when utilities were permitted to rebase their rates. There is no evidence to support the supposition that accelerated productivity growth is achievable at this time.

Therefore, given the status of analysis at this stage, the CLD and Hydro One recommend that the Board defer the use of stretch factors until such time as the comparison of utility costs has been completed taking into account capital costs and there is clear evidence on which to develop and target accelerated productivity growth with stretch factors.

3. CAPITAL INVESTMENT MODULE

Board staff proposal for 3rd Generation IR had initially included a proposal for an incremental capital module based on a threshold of 25% of a utility's *"capital budget reflected in base rates"*[6]. In response to comments received at the May 6th stakeholder meeting, Board staff released a revised proposal on May 15, 2008. The CLD and Hydro One are still evaluating this proposal and will file an addendum to this submission on May 20, 2008.

4. EARNING SHARING MECHANISM

Board Staff propose an asymmetric Earnings Sharing Mechanism ("ESM") with a 2% dead-band (or 200 basis points) above the calculated Return on Equity ("ROE")[7]. The ESM would be based on non-weather normalized earnings above the calculated ROE and the *"excess net cumulative amount over the plan term [would be] shared 50:50 at rebasing"*[8], i.e. at the end of the 4-year plan term.

In general the CLD and Hydro One do not support ESM because of its effects in diminishing incentives, particularly if the Board considers the inclusion of the Diversity (or Stretch) Factor in setting the X Factor for the electricity distributors in Ontario. If the Board proceeds with ESM, the CLD and Hydro One agree that the ESM should be assessed on a cumulative basis and should be evaluated vis-à-vis the allowed rate of return using the deemed capital structure. This approach will provide smoothing and greater rate stability compared to annual assessments. However, there are a number of other concerns with the Board Staff proposal that we discuss below.

There was considerable discussion at the May 6, 2008 Stakeholder Workshop to clarify the details as to how the earnings would be calculated to determine the level of over-earnings[9]. The CLD and Hydro One continue to be concerned with respect to understanding the details as to how the ESM would work.

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[6] EB-2007-0673, May 6, 2008 Stakeholder Meeting, Presentation by Board Staff, Slide 12
[7] Ibid Board Staff presentation at May 6, 2008 Stakeholder Meeting; Slide 11
[8] Ibid Board Staff presentation at May 6, 2008 Stakeholder Meeting; Slide 11
[9] Ibid Transcript, May 6, 2008 Stakeholder Meeting, pages 39-45

The major concern is in respect to the calculation of the earnings amounts in order to establish whether there are over-earnings during the IR term. The discussion at the Stakeholder Workshop attempted to clarify whether the calculation would be done in relation to the approved (at time of rebasing) ROE or the actual ROE on an annual basis. This remains unclear, other than that the deemed debt to equity ratio of 60:40 would be used in the calculation. The example provided by Board Staff at the Stakeholder Workshop included a column for "recalculated" return on equity. As discussed in Section 5.0 of this submission, there is no clear direction yet that cost of capital will be updated annually during 3GIRM. It is only appropriate to use the "recalculated" return for ESM if rates were also adjusted to reflect the recalculated ROE. Furthermore, the CLD and Hydro One have concerns about how the "net cumulative amount" of sharing is calculated.

On the matter of earnings calculations the CLD and Hydro One assume that audited annual financial statements would be used for the purpose of establishing the actual annual earnings. The issue then is what elements need to be identified and removed from the earnings because these are not part of the comprehensive price cap or would unduly impact the level of earnings that do not reflect efficiency gains and cost savings. For example, the CLD and Hydro One note that the annual earnings are not weather normalized so that there would be no accounting for lower profits due to weather effects. A further complication for some utilities may be a timing issue as a result of the difference between the fiscal year of utilities (mandated to be January to December) and the rate year set by the Board (May to April). Given the above concerns the CLD and Hydro One conclude that it is much more appropriate to employ a true cumulative ESM to smooth out annual differences, i.e. over the 4-year term any years under the 200 basis points limit are netted against years over the 200 basis points limit and the cumulative amount over the 200 basis points limit is then used to determine the shared amounts.

The CLD and Hydro One understand that issues pertaining to CDM will be dealt with outside the 3GIRM plan. For example, mechanisms such as LRAM and SSM, and fees from CDM programs sponsored by the Ontario Power Authority, would be dealt with outside of calculation of earnings amounts for ESM considerations, for those utilities making use of them. On the other hand capital CDM activities that have been included in rate base would be included in the ESM calculation. Furthermore, any affects to net income / earnings related to the recovery of regulatory assets from prior years should also be removed in determining the earnings to be shared.

Given the concerns expressed about how the ESM is calculated and to assist the Board in this matter, the CLD and Hydro One have prepared the following high-level example for ESM. The ESM will require calculation of the realized ROE, based on the earnings from financial statements. In order to do that, we need to first determine the appropriate balance sheet measure of equity. We agree with Board Staff that the deemed capital structure should be used. In addition, an adjusted rate base needs to be calculated for each year taking into account annual amortization and capital additions. On the basis of this adjusted rate base and a deemed equity share of 40%, a realized ROE figure can then be calculated for each year. The table on the next page illustrates that calculation.

The excess earnings (earnings above 200 basis points of the regulated rate of ROE) are tracked each year over the term of the IR on a cumulative basis and at the end of the IR term, if there are any over-earnings, then ratepayers would receive 50% of the cumulative over-earned amount. It is important for the negative effects of ESM be minimized, especially the reduced motivation for efficiency gains. An ESM that is operationalized on a cumulative basis would reduce some of these negative incentives, by allowing under-earnings in a given year within the IR term (due to the timing of capital additions, pace of efficiency gains or weather effects if earnings are not weather-normalized) to offset years of over-earnings

Example of ESM Calculation

	Regulated ROE updated for 3GIRM as deemed by Board	Actual Earnings from financial statements	Adjustments to earnings for CDM, regulatory assets etc.	Adjusted Earnings	Capital Expenditures	Amortization Expense	Calculated Rate Base	Calculated Equity	Earnings at 200 basis points above regulated ROE	Excess Earnings
	A (See Note)	B	C	D = B - C	E	F	G=prior year rate base + 1/2 year additions from prior year + 1/2 year additions from current year	H = G x 0.4	J = H x (A + 2%)	K = D - J
2008 (test year)	8.57%				56,767	37,783	545,806	218,322		
2009	8.90%	20,000	(1,000)	19,000	60,000	40,000	565,298	226,119	24,647	(5,647)
2010	9.10%	33,000	(1,500)	31,500	63,000	42,000	585,798	234,319	26,009	5,491
2011	9.20%	30,000	(750)	29,250	70,000	45,000	608,798	243,519	27,274	1,976
								Total overearnings to be shared		1,819
								Amount to customers (50%)		910

Note: The regulated rate of ROE would only be adjusted from the test year value if the Board determines that the cost of equity will be updated each year of the 3GIRM term.

5. OTHER CONCERNS

One important issue that was not included in the Board staff proposal is a discussion of cost of capital. To date it is the CLD and Hydro One's understanding that the Board does not propose to make any changes to the ROE during the IR term, though this has not been clearly stated. However, this assumption may need to be revisited in the light of potential for changes to interest rates as a result of the conditions affecting the financial markets and the economy in Canada and North America as a whole. The current level of interest rates is likely unsustainable for the IR plan term given that the actual rate levels are likely to increase from current levels. Consequently the Board may wish to reconsider the need to leave open the re-calculation of the utilities ROE, using the approved formula, in response to potential changes in interest rates. The CLD and Hydro One notes that in approving the settlement agreements for both the Union Gas and Enbridge Gas Distribution, the Board allowed for the annual calculation of ROE using the Board's approved ROE Formula which makes allowance for changes in interest rates[10, 11].

The CLD and Hydro One are also concerned about the potential impacts that may need to be addressed as utilities move to the International Financial Reporting Standards ("IFRS"), e.g. possible different treatment of regulatory assets and capital assets.

The CLD and Hydro One continue to be concerned with treatment of regulatory and legislative requirements during the term of 3GIRM that we raised in our April 14, 2008 commentary with respect to Board Staff discussion paper on 3GIRM[12]. The concerns around Smart Meters, the move to IFRS, anticipation of reforms in tax law, implications of formalizing Service Quality Regulation and others will require to be addressed in the context of automatic rate setting through the 3GIRM price cap mechanism. In this respect the CLD and Hydro One advocate the availability of variance accounts to assist with tracking of differences between revenues earned and costs incurred to manage these issues during the plan term.

6. IMPLEMENTATION ISSUES

The CLD and Hydro One note that the Board will consider all of the material submitted during this proceeding and render a decision around the middle of July 2008 and Board Staff will translate the decision into a model that will be issued in September 2008[13].

[10] *EB-2007-0606,* OEB Decision to approve Settlement Agreement for Union Gas, January 17, 2008
[11] *EB-2007-0615,* OEB Decision to approve Settlement Agreement for Enbridge Gas Distribution, February 11, 2008
[12] *EB-2007-0673*, CLD and Hydro One comments on Board Staff discussion paper, April 14, 2008, Section 7
[13] *Ibid,* Transcript, May 6, 2008 Stakeholder Meeting, page 5

There are many details that will need to be worked out in formulating the 3GIRM model. The CLD and Hydro One recommend that once the Board has rendered its decision utilities and Intervenors could work with Board Staff to develop the implementation steps and provide opportunity to test the model prior to its implementation for rate setting in 2009.