

April 14, 2008

VIA COURIER AND EMAIL

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
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Dear Ms. Walli:

Re: Comments on Board Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors and PEG's Report Calibrating Rate Indexing Mechanisms for Third Generation Incentive Regulation in Ontario (EB-2007-0673)

The Power Workers' Union ("PWU") represents a large portion of the employees working in Ontario's electricity industry and has the utmost interest in initiatives that impact the energy industry and the provision of on going service quality and reliability to customers. Attached please find a list of PWU employers.

The PWU is committed to participating in regulatory consultations and proceedings to contribute to the development of regulatory direction and policy that ensures ongoing service quality, reliability and safety at a reasonable price for Ontario customers. To this end, attached please find the PWU's submission on the February 28, 2008 Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors. In addition, the PWU has retained Dr. Frank Cronin to provide comments on Pacific Economics Group's (PEG) report entitled Calibrating Rate Indexing Mechanisms for Third Generation Incentive Regulation in Ontario. We submit Dr. Cronin's report along with our comments.

The attached material has been filed with the Board via *RESS* filing, and three paper copies are being forwarded via courier delivery.

HONORARY COUNSEL
Ian G. Scott, Q.C., O.C.
(1934 - 2006)

We hope you will find the PWU's comments useful.

Yours very truly,

PALIARE ROLAND ROSENBERG ROTHSTEIN LLP

Richard P. Stephenson

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List of PWU Employers

Atomic Energy of Canada Limited (Chalk River Laboratories)
Barrie Hydro
BPC District Energy Investments Limited Partnership
Brant County Power Incorporated
Brighton Beach Power Limited
Bruce Power Inc.
Corporation of the City of Dryden - Dryden Municipal Telephone
Corporation of the County of Brant
Electrical Safety Authority
EPCOR Calstock Power Plant
EPCOR Kapuskasing Power Plant
EPCOR Nipigon Power Plant
EPCOR Tunis Power Plant
Erie Thames Services Corporation
Great Lakes Power Limited
Grimsby Power Incorporated
Halton Hills Hydro Inc.
Hydro One Inc.
Independent Electricity System Operator
Inergi LP
Innisfil Hydro Distribution Systems Limited
Kenora Hydro Electric Corporation Ltd.
Kincardine Cable TV Ltd.
Kinectrics Inc.
Kitchener-Wilmot Hydro Inc.
Lake Superior Power (Brookfield Power)
London Hydro Incorporated
Middlesex Power Distribution Corporation
Milton Hydro Distribution Inc.
Mississagi Power Trust (Brookfield Power)
New Horizon System Solutions
Newmarket Hydro Ltd.
Norfolk Power Distribution Inc.
Nuclear Safety Solutions
Ontario Power Generation Inc.
Orangeville Hydro Limited
Portlands Energy Centre
PUC Services Inc.
Sioux Lookout Hydro Inc.
Sodexo Canada Ltd.
TransAlta Energy Corporation - O.H.S.C. Ottawa
Vertex Customer Management (Canada) Limited
Whitby Hydro Energy Services Corporation

EB-2007-0673

Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors

PWU Comments

Introduction

On August 2, 2007 the Ontario Energy Board (the "Board" or "OEB") initiated a consultation on the development of the principles and methodology for the 3rd generation incentive regulation mechanism ("IRM") for electricity distributors (EB-2007-0673) with the issue of Board staff's Scoping Paper on this matter. On February 28, 2008 the Board issued for comment Board *Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors* ("Discussion Paper") and a report prepared by PEG entitled *Calibrating Rate Indexing Mechanisms for Third Generation Incentive Regulation in Ontario* ("PEG Report").

In the PWU's view, Board staff has brought this consultation forward from the broadly based Scoping Paper to a more succinct set of issues that helps stakeholders' focus on essential issues that contribute to the development of 3rd Generation IRM as a step towards a sustainable long term IR framework for the Ontario electricity distributors.

The Power Workers' Union's ("PWU") interest in the development of a robust 3rd Generation IRM stems from our energy policy statement:

Reliable, secure, safe, environmentally sustainable and reasonably priced electricity supply and service, supported by a financially viable energy industry and skilled labour force is essential for the continued prosperity and social welfare of the people of Ontario. In minimizing environmental impacts, due consideration must be given to economic impacts and the efficiency and sustainability of all energy sources and existing assets. A stable business environment and predictable and fair regulatory framework will promote investment in technical innovation that results in efficiency gains.

The PWU's input on Board staff's questions set out in the Discussion Paper is provided in this submission. The PWU has retained expert consultant Dr. Frank Cronin to provide comments on the PEG Report and submits Dr. Cronin's report along with our comments.

A Long-term View of Incentive Regulation

While the Discussion Paper identifies the need for a long term view of incentive regulation (“IR”) and sets out principles to frame the long term view, it falls short of setting a long term vision and a framework toward achieving such a vision.

In Table 1 below, *IR Framework for Ontario Electricity Distributors Long-term Vision* the PWU illustrates milestones that would take the OEB’s regulation of the Ontario electricity distributors toward a long-term vision of a comprehensive and sustainable bifurcated IR framework. The IR framework envisioned is a comprehensive and flexible IR regime that internalizes service quality regulation, includes service quality indicators (“SQI”) incentives, and is a bifurcated IR regime with a benchmarking approach for LDCs for which peers can be identified and an “Input Price Index – Total Factor Productivity” (“IPI-TFP”) approach for those for which no peers are identified. The timelines used are for illustrative purposes and can provide a start point for stakeholder discussions.

1993 Cost of Service (“COS”)

The chart’s starting point is the distributors’ COS based rates approved by the former Ontario Hydro between 1993 and 1999. Most of the distributors chose to freeze their distribution rates when the Government froze Ontario Hydro’s electricity wholesale rates in 1993. As a result, distribution rate adjustments for the 1993 to 1999 period were rare.

The 2001 Board approved unbundled rates were based on the distributors’ historic rates that were in place in 1999 (i.e. not on rebased rates).

1st Generation Performance Based Regulation (“PBR”)

While 1st Generation PBR, an IPI-TFP approach, was intended to have a three year term, it was discontinued as a result of a Government imposed distribution rate freeze following only one PBR rate adjustment in 2002. The 1st Generation PBR framework established the annual PBR filing requirements as referenced in the Board’s Reporting and Record Keeping Requirements (“RRR”) for the electricity distributors with data requirements going back to 1998.

In addition PBR data was collected by Board staff in the development of 1st Generation PBR going back to 1972-1977 for capital costs. Operating data was collected from 1988-1997. This capital and operating data was intended for use as the basis for TFP analysis and in total cost benchmarking.

1st Generation PBR also established annual filings of service quality performance starting with 2000 information.

The IR milestones achieved with 1st Generation PBR therefore were:

- a. the introduction of SQIs;
- b. reporting of performance on SQIs;

- c. monitoring of service quality performance by the OEB;
- d. TFP and total cost studies for 1988-1997; and
- e. annual filings of PBR data to be used to update/expand the TFP research to help set parameters for subsequent IR plan(s) and for use in total cost benchmarking.

Bill 210, CDM/ROE Phase-in, and 2006 Historic Year COS

In 2002, as indicated above, Bill 210 imposed a rate freeze and in 2004 to 2005 there was the continuation of the phasing-in of the market-based return on equity ("ROE") through funding of conservation and demand management ("CDM") programs, and recovery of Regulatory Assets related to distributor Retail Market Readiness requirements. During this period filing of PBR data and reporting/monitoring of SQI continued.

A very small number of distributors chose to rebase their rates in 2006 with the remaining distributors taking the Board's historic year COS model-based approach for setting 2006 rates (i.e. no rate rebasing).

2nd Generation Rate Adjustment

2nd Generation IR was acknowledged to be a transitional mechanism that adjusts rates annually by "GDP-IPI – 1%" as a function of simplicity and transparency. During this 2007-2009 period, the distributors' rates are being rebased using COS, with the distributors divided into three tranches. The first tranche had rates rebased in 2007, the second tranche will have rates rebased in 2008 and the third tranche in 2009. The term of the 2nd Generation transition period therefore ranges from 1 to 3 years depending on the tranche that a distributor is in. Annual filing of PBR data and reporting/monitoring of SQI is on going during this period.

3rd Generation IR

From this point on, the framework is illustrative rather than historic.

Following rate rebasing the distributors will embark on 3rd Generation IR based on IPI-TFP. It is a transition plan that provides time to gather and review information and conduct comprehensive TFP and benchmarking analysis. In addition, it provides time to determine customer service expectations, establish consistency amongst distributors in SQI reporting and establish industry SQI standards. While comprehensive TFP and benchmarking analysis may not be

feasible within the timeline for implementation of 3rd Generation IR, the concept of the IPI-TFP approach is introduced as a transition step in the right direction towards the long term vision of the IR regime. Introduced in this plan is a module for incremental capital costs.

At the end of 3rd Generation IR, the distributors are rebased for 4th Generation IR. In this rebasing, SQI standards are internalized in the distributors' costs.

4th Generation IR

4th Generation IR is a comprehensive IR plan based on robust benchmarking and TFP analysis and includes incentives (penalties/rewards) for SQI. The distributors' terms will be assigned so that the distributors start on the benchmarking IR approach is synchronized. A benchmarking approach that has distributors within a common peer group out of phase would result in starting points that are inconsistent with the benchmarking assumptions and result in differing planning horizons for distributors within a common peer group.

Target Bifurcated IR Framework

Following rate rebasing, the framework reaches the long term vision of a bifurcated IR framework with a robust benchmarking approach for those distributors with peers and a comprehensive IPI-TFP approach for those that have no peers. Rate rebasing prior to the implementation of the bifurcated IR regime can be at a distributor's option given that distributors that had a one year 4th Generation IR term would only have had rates rebased in the previous year. In the benchmarking approach the distributors that form the frontiers set the benchmark for their respective peer group.

The Board will continue with the PBR data and SQI filing requirements and performs on going analysis in order to evaluate the effectiveness of the Board's IR framework.

The Discussion Paper states that the 1st Generation PBR data set (1988 to 1997) is not linked to the 2002-2006 data and that the linking data, 1998 to 2001 data, "would need to be collected from various sources and compiled into an appropriate form". The linking data is essential for the development of a sustainable and fair IR approach and the PWU encourages the Board to make the gathering of this data a key priority. As noted in the Discussion Paper, construction of a robust and reliable link between the 2002-2006 dataset and the 1st Generation PBR dataset would resolve a recurring issue related to the missing data that impedes standard empirical analysis. TFP analysis forms the basis for the determination of a transparent and fair efficiency incentive mechanism that supports rate sustainability and on going service quality for consumers in addition to the benefits resulting from efficiency gains.

Table 1: IR Framework for Ontario Electricity Distributors Long-term Vision

Regulatory Approach	☑ IR Milestones	Timeline
1993 COS Rates	<ul style="list-style-type: none"> ➤ For most distributors 1993 COS basis of rates until 2006 ➤ 1993 start of Ontario Hydro wholesale electricity rate freeze 	1993 – 2006
Rate Unbundling	<ul style="list-style-type: none"> ➤ For most distributors based on rates in place since 1993 Ontario Hydro electricity rate freeze ➤ Plus 1/3 of Market Adjusted Rate of Return (“MARR”) 	2001
1 st Generation PBR (IPI-TFP)	<ul style="list-style-type: none"> ☑ IR Milestone - Start of Annual PBR Data Filing (1998 first year data) ☑ IR Milestone - Start of Annual SQI Reporting ➤ TFP Studies (1988-1997) 	2002
Rate Freeze/CDM-ROE- Regulatory Assets Phase- in	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring 	2002-2005

Regulatory Approach	☑ IR Milestones	Timeline
2006 “COS Model”	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring ➤ Base Rates for 2nd Generation IR based on historic year for all but a small number of distributors i.e. not rate rebasing 	2006
2 nd Generation Rate Adjustment (GDP-IPI – 1%)	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring ➤ 1st Adjustment – 2007 ➤ 2nd Adjustment – 2008 ➤ 3rd Adjustment - 2009 	<p>2007 (1st Tranche term)</p> <p>2007-2008 (2nd Tranche term)</p> <p>2007-2009 (3rd Tranche term)</p>
2008/2009/2010 COS Rates	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring 	<p>2008 (1st Tranche COS)</p>
	<ul style="list-style-type: none"> ➤ Base Rates for 3rd Generation IR 	<p>2009 (2nd Tranche COS)</p>

Regulatory Approach	<input checked="" type="checkbox"/> IR Milestones	Timeline
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		2010 (3 rd Tranche COS)
	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring <input checked="" type="checkbox"/> Introduction of incremental capital cost module 	2009-2011 (1 st Tranche)
3 rd Generation IR (IPI-TFP) 3-year Plan Term	<ul style="list-style-type: none"> <input checked="" type="checkbox"/> Review Financial Reporting Consistency <input checked="" type="checkbox"/> Review SQI Reporting Consistency <input checked="" type="checkbox"/> Review of Rate Design <input checked="" type="checkbox"/> Assemble Data and Conduct Comprehensive TFP study <input checked="" type="checkbox"/> Assemble Data and Conduct Comprehensive Cost Benchmarking Study <input checked="" type="checkbox"/> Develop SQI Standards Study/Surveys 	20010-2012 (2 nd Tranche) 2011-2013 (3 rd Tranche)
2013/2014/2015 COS Rates	<ul style="list-style-type: none"> ➤ On going PBR Data Filing 	2012 (1 st Tranche)

Regulatory Approach	<input checked="" type="checkbox"/> IR Milestones	Timeline
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- On going SQI Reporting/Monitoring
2013
- Base Rates for 4th Generation IR (2nd Tranche)
 - Internalize SQI standards
- 2011 Update of Cost Benchmarking Study
2014 (3rd Tranche)
- 2011 Update of TFP study

Regulatory Approach	☑ IR Milestones	Timeline
4 th Generation IR (IPI-TFP)	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring ☑ Use 2011 Cost Benchmarking Study ☑ Use 2011 TFP Study ☑ Incentives for SQI 	<p>2013-2015 (1st Tranche)</p> <p>2014-2015 (2nd Tranche)</p>
3/2/1-Year Plan Term	<ul style="list-style-type: none"> ☑ Distribution Rate Design as per Board Decision ➤ Length of term brings distributors back to common timeline 	<p>2015 (3rd Tranche)</p>
2016 Rate Rebasing	<ul style="list-style-type: none"> ➤ On going PBR Data Filing ➤ On going SQI Reporting/Monitoring ➤ Base Rates for IR Framework Target ☑ 2016 Update of Cost Benchmarking Study ☑ 2016 Update of TFP study 	2016

Regulatory Approach	<input checked="" type="checkbox"/> IR Milestones	Timeline
Target	➤ On going PBR Data Filing	
	➤ On going SQI Reporting/Monitoring	
Bifurcated IR Framework:		Start 2017
▪ Benchmarking for LDCs with peers	<input checked="" type="checkbox"/> Use 2016 Cost Benchmarking Study	
	<input checked="" type="checkbox"/> Use 2016 TFP Study	
▪ IPI-TFP for one of a kind	➤ Incentives for SQI	

Issues and Options for 3rd Generation IR

Staff invites comments from stakeholders on the options noted above and on the option of maintaining the status quo vis-à-vis the Board's current LRAM for electricity distributors

The PWU agrees with Board staff and the Working Group that the current Lost Revenue Adjustment Mechanism ("LRAM") is appropriate until the completion of the Board's consultation on electricity distribution rate design given that related issues will be reviewed in that consultation.

Distributor Diversity

Core plan

The PWU agrees with Staff that a "core plan" approach with sufficient flexibility to handle changing and varied circumstances is desirable. Beyond this approach, the ability of a distributor to apply to the Board to have its rates set using an alternative approach provides sufficient backstop. However, where a "core plan" is not reasonably applicable to all distributors, it would be best to recognize distributor diversity and deal with it proactively rather than leaving it to a backstop that puts the distributor in the disadvantaged position of being out of

conformance with the Board's guidelines. An example of flexibility is the bifurcated IR framework illustrated in Table 1 above.

Board Staff suggest that a core IR plan approach would provide greater predictability that allows distributors and ratepayers better ability to plan. The PWU notes that, depending on what the "alternative approach" and "core IR plan" are, allowing distributors to use alternative approaches does not necessarily provide greater predictability. As an example, a multi-year COS approach can provide the distributor and ratepayer with greater certainty than a flawed core IR plan that is detrimental to a distributor's financial viability and its ability to maintain service quality for its customers. In this case a distributor's pursuance of an alternative approach to the core IR plan is to the benefit of its customers and its business viability.

Productivity factors and stretch factors

The PWU agrees that the TFP is the correct basis for the productivity factor. As noted in the Discussion Paper, the industry TFP provides the utility with an important external productivity benchmark. The Discussion Paper also notes that Ontario's electricity distributors are different from one another in many important ways including efficiency. The PWU agrees that conceptually TFP stretch factors can address distributor diversity. However, the PWU submits that the issue of unavailable data appears to preclude the appropriate application of stretch factors at this point in time.

The PWU does not agree with the methodology proposed in PEG's report for the determination of TFP intended to address the dilemma of the "unavailable" PBR data for 1998-2001. Specifically, the PWU does not agree with the inclusion of the US utility database in the model used to derive TFP for Ontario distributors. While we appreciate PEG's valiant effort of looking for an alternative to accommodate the paucity of the unavailable 1998-2001 data, in the PWU's view the circumstances of the US utilities, including their governance, are too divergent from the Ontario electricity distributors' to provide valid contributions to the determination of their TFP benchmark. The issues related to this approach are addressed by Dr. Cronin in his comments prepared for the PWU on PEG's report.

The PWU also does not agree with the use of benchmarking based on O&M rather than total cost in determining the distributors' efficiency ranking for the application of TFP stretch factors. Given the differences in capitalization policies between the distributors¹, benchmarking based on O&M is inappropriate and can

¹ EB-2007-0673. Transcript. Calibrating Rate Indexing Mechanisms for 3rd Generation Incentive Regulation for Electricity Distributors. Stakeholder Meeting March 26, 2008. Page 20, Lines 11-12.

result in allocative inefficiencies as distributors react to O&M benchmarking by moving costs from O&M to capital. The PWU is aware that PEG used the O&M benchmarking study because a total cost benchmarking study is not available. Had a total cost benchmarking study been available, the PWU accepts that PEG would undoubtedly have used the results of that study.

Inflation factor

The PWU supports the industry IPI as the inflation factor and agrees with the Discussion Paper that “industry specific measures better reflect the changes in input price trends for the distributor because they better reflect changes in materials prices, exchange rates, interest rates, amongst other things”. Since the industry IPI reflects cost pressures faced collectively by the distributors, its use provides a reasonable cost benchmark for the distributors.

Capital investment mechanisms

Based on discussions of the Working Group on 3rd Generation IRM (“Working Group”), the PWU agrees that “implementation of a capital investment mechanism is an important design consideration for 3rd Generation IRM to effectively reflect distributor diversity”. An example of a significant capital project that concerns some distributors and not others that came to light in the Working Group discussions is the construction of transformer stations.

Earnings sharing mechanism and off-ramps

The need for an earnings-sharing mechanism (“ESM”) or an off-ramp is very much dependent on the robustness of the IRM. As an example, given the critical short comings of the use of O&M rather than total cost benchmarking in the application of the stretch factors, if the Board adopted this approach, it is the PWU’s view that an ESM and an off-ramp would be required to mitigate the risk associated with this approach.

Menu approach

In the PWU’s view, in the absence of comprehensive cost benchmarking analysis, a menu approach best addresses distributor diversity. This approach allows utilities to select a TFP that is realistic for its circumstances that will mitigate the need to make irrational cost cuts that jeopardize on going service quality. At the same time, the ROE ceiling ensures that ratepayers benefit from the efficiency improvements.

The Discussion Paper states that “in practice setting the menu can be complex and controversial”. While developing the menu may be “complex”, as the Discussion Paper notes, the approach was part of Board Staff’s proposal for 1st

Generation PBR and therefore the Board has a precedent for the determination of a menu. With regard to “controversy”, the extent of controversy around the menu and the menu item that a distributor selects will undoubtedly be significantly less controversial than stretch factors that are based on a faulty benchmarking approach. Significantly, the PWU believes the menu approach has the distinct advantage of having built-in distributor “buy-in”. Since the distributors get to select a productivity factor that they consider to be achievable (and are rewarded for being more aggressive in doing so), it combats the problem of distributors, pressuring the regulator to make the productivity factor as low as possible.

Further PWU input on the use of a menu approach is provided in Dr. Cronin’s report.

Distributor choice of regulatory model

The Discussion Paper notes that in the Board’s July 23, 2007 *Report on Rate-making Associated with Distributor Consolidation* the Board states that it believes that it is neither practical nor appropriate to provide the distributors with a “basket of mechanisms” to choose from through its policy on rate-making associated with distributor consolidation. In particular the Board’s concern is policy that would be “counter to achieving a more predictable regulatory environment – for distributors and ratepayers”. In the PWU’s view, it would be contrary to this stated belief for the Board to propose a “basket of mechanisms” approach for 3rd Generation IRM.

Choice of IR plan term

Whether distributors should have choice on the term of the IR plan needs to be considered in the context of the Board’s vision for a long-term IR regime. At present the distributors’ rate regulation is out of phase with rates rebased either in 2008, 2009 or 2010. Accordingly, the first 3rd Generation IR rate adjustment will occur in 2009, 2010 or 2011 for distributors that will have their rates rebased in 2008, 2009 and 2010 respectively. Using the illustration of the PWU’s long term IR framework presented in Table 1 above, the long term goal is a bifurcated IR framework with a benchmarking approach for distributors with peers and an IPI-TFP approach for distributors without peers. If the distributors under the benchmark approach are out of phase, it is possible that benchmarks established in 2016, meant to apply to distributors rebased in 2017 would no longer be an appropriate benchmark in 2019. In addition, there is the issue of fairness between distributors within a common peer group related to the differences in planning horizons that the distributors would have around the benchmark. Using the illustration in Table 1, the Board would need to set the term for each distributor to make sure that distributors within a common peer group are back in-phase at the start of the benchmarking IRM. Should the Board decide to follow a framework that precludes 4th Generation IR and that goes straight from 3rd

Generation IR to a benchmarking approach for distributors with peers, the Board would need to set the appropriate 3rd Generation IR term for each distributor to ensure that rebasing is synchronized for the benchmarking approach.

Three Alternative Approaches that Address the Issues

Staff invites comments from stakeholders on the adaptation of a sliding scale like incentive mechanism in 3rd Generation IR. Specifically, if this kind of incentive were to be included how might it be designed and how would the Board know it has been designed “correctly”

As the PWU understands it, an Information Quality Incentive (“IQI”) is intended to incent utilities to include capital expenditure forecasts for a test year that can be reasonably achieved, thus mitigating any tendency a utility may have to over forecast capital expenditure in its rate application. It is also our understanding that this mechanism requires the Board to set a benchmark level of capital expenditure for each distributor against which the distributor’s forecast is assessed to determine the level of the incentive earned. It would be challenging for the Board to establish reasonable capital expenditure benchmarks given the well acknowledged “information asymmetry” between the regulator and regulated entity. As such there is significant risk that the Board’s benchmarks may inadvertently incent capital underinvestment. In turn, this puts at risk on going service quality, reliability and safety.

In any case, a distributor should have the flexibility to reduce its capital expenditure and increase maintenance efforts from the forecast levels when it is necessary to do so (e.g. delay in equipment delivery) or it comes to light that doing so is more efficient. The IQI would discourage a distributor from doing so. Therefore, the PWU does not support an IQI.

Staff invites comments from stakeholders on the three alternative approaches noted above, and on staff’s evaluation of them.

The three alternative approaches noted are:

- Comprehensive Multi-Year COS Approach (UK model, with use of benchmarks to establish COS)
- Hybrid Approach (OM&A under IR, and capital under COS)
- Comprehensive Price Cap Index Approach (total cost under IR)

It is the PWU’s understanding that the Board’s objective for rate regulation of the electricity distribution is IR. With regard to an IR approach the PWU supports a comprehensive cap mechanism for 3rd Generation IR. We do not support a hybrid IR approach. The PWU submits that a targeted OM&A IR plan provides

an inappropriate incentive to shift costs from O&M to capital. This is counter to IR's objective for efficiency improvement given that the incentive to shift costs from O&M to capital can result in decreased allocative efficiency. Allocative efficiency is addressed in an expert report filed by the PWU in our submission to the Board's consultation on *Comparison of Electricity Distributors Costs* (EB-2006-0268)².

It is apparent from both the Discussion Paper and PEG's Report that the correct derivation of TFP using the full compliment of PBR data filed with the Board will not be possible for the scheduled issuance of the Board Report on 3rd Generation IR. While the use of a comprehensive multi-year COS approach ought to be the default option to use until such time as TFP has been properly constructed, as the Discussion Paper notes, given the current lack of established benchmarks such as those used in the comprehensive multi-year COS approach in the UK, the implementation of this approach may not be practical.

The PWU agrees with Board staff that:

... in contrast to the UK and hybrid approaches, a comprehensive price cap index continues to be a relatively simple approach that will, along with the implementation of mandatory service quality requirements, provide balanced incentives for efficiency improvements and greater predictability to distributors and ratepayers. Proactively providing for an appropriate level of flexibility to complement the core plan in the form of some provision for incremental capital investment adjustments may contribute to the development of a more sustainable plan.

A proposal on a 3rd Generation IR approach, supported by the PWU, is provided by Dr. Cronin in Appendix A.

Elements of a Core Plan

Staff invites comments from stakeholders on the industry-specific IPI methodology, inputs and assumptions, including:

- ***the choice of sub-indexes;***
- ***the choice of the Labour Price Sub-Index and how well the Construction Union wage rate or the Wage adjustments for utilities in Canada can track changes in the labour prices or electricity distributors;***

²Comments by Francis J. Cronin In the matter of the Ontario Energy Board's Comparison of Distributor Costs Consultation on Consultant's Report (EB-2006-0268) On behalf of Power Workers' Union June 26, 2007.

http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_comparison-ontarioelectricitydistributorscosts.htm

- ***whether the volatility of industry-specific IPI should be limited and, if so, whether the use of a smoothed capital index is appropriate;***
- ***methods to annualize non annual series and to deal with revisions and series rebasing; and***
- ***primary and secondary preferences for alternative material, labour, and capital sub-indexes in the event of data termination.***

Capital Price Sub –Index

The PWU agrees with Board staff's COS approach described for the determination of the capital price sub-index as used in 1st Generation PBR:

- Risk free rate of return at the Government of Canada marketable bonds – average yield over 10 years.
- Depreciation rate of 5.67% used in 1st Generation PBR calculated using distributor specific data on level of capital stock and capital stock retirement;
- Use of the Electric Utility Construction Price Index (“EUCPI”) – Distribution Systems as reported by Statistics Canada as the acquisition price of capital

Labour Price Sub-Index

It is unfortunate that the distributor's line crew wage rate information filed with the Board as part of the distributors PBR information is no longer available, as it provides the actual labour price sub-index for the sector. Under this circumstance the PWU agrees with Board staff “that the *Construction Union Wage Cost Rate Index for Ontario* and the *Effective wage increase in base rates (or Wage Adjustment) for Utilities in Canada* could be good proxies of labour costs for Ontario distributors”. The PWU also agrees with Board staff that while the latter excludes data from small and medium companies (i.e. < 500 employees) it may be a good proxy because it reflects wage changes to a labour force with similar skills.

Materials Price Sub-Index

The PWU agrees with Board staff's suggestion of using the same Materials Price Sub-Index used in 1st Generation PBR: the All Finished Goods Industrial Producer Price Index ("IPPI") published by Statistics Canada.

Input Weights for Capital, Labour and Materials

The Discussion Paper states that cost shares used in 1st Generation are based on 1993 data and that an update of the calculation would be desirable. Therefore PEG calculated cost shares for capital and OM&A for 2002-2006. However, PEG in its report notes the limitations of the data, "particularly for capital costs" and states that it would typically conclude that the data are not sufficient to support their use in regulatory proceedings. Therefore, it would appear to the PWU that PEG's calculated cost shares do not provide an update of the calculations and it would be preferable to use the cost shares from 1st Generation PBR which were calculated based on in-depth analysis of capital costs.

Volatility in the IPI

The PWU agrees with the view of some of the members of the Working Group that commodity rates are adjusted several times annually based on "input price" and that some of these price changes could be several orders of magnitude greater than the annual change in the IPI related to volatility in the capital sub-index. The Discussion Paper states, and the PWU agrees, that the volatility in the smoothed capital sub-index is acceptable in light of the advantages of using the IPI. The PWU also agrees that smoothing of the capital sub-index using a three-year moving average is a better compromise than limiting the capital sub-index change to 50% of the actual change. The PWU agrees with PEG's assertion noted in the Discussion Paper that "counting only half of the calculated growth in the capital price in allowed inflation is more arbitrary than smoothing all capital input price changes over a multi-year period and, over time, is likely to under-estimate distributors for the growth in their actual input price inflation". The PWU notes that the Board's decision to limit the capital sub-index to 50% of the actual growth in 1st Generation PBR as a smoothing mechanism was not part of the original proposal based on the analysis conducted in the Board's consultation on 1st Generation PBR³.

Methods to annualize non annual series and to deal with revisions and series rebasing

The methods to annualize the non annual series to be used as the sources for the IPI sub-indices presented in Table 5 of the Discussion Paper, and the

³OEB Staff Proposed Draft Electric Distribution Rate Handbook. June 30, 1999.
<http://www.oeb.gov.on.ca/documents/cases/RP-1999-0034/handbook0.html>

illustrations on how the Board might deal with revisions and series rebasing provided in Appendix C to the Discussion Paper, all appear to be reasonable approaches.

Primary and secondary preferences for alternative material, labour, and capital sub-indexes in the event of data termination

The alternative sources of the IPI sub-indices presented in Table 5 of the Discussion Paper appear to be reasonable alternatives in the event that either Statistics Canada or the Bank of Canada or HRSDC stop the publication of the identified sub-indices over the course of the 3rd Generation IR plan.

In the PWU's view, it behooves the Board to proactively inform the parties that provide the sources for the IPI sub-indexes of the Board's requirement for the data. Possibly doing so will minimize a party's inclination to terminate the data reporting. Alternatively, the party may give the Board the option of receiving the data at an increased fee, in the case where the consideration of terminating data reporting is a lack of subscribers.

Staff invites comments from stakeholders on the use of the kind of menu approach described on page 36 of this paper. Specifically, if this kind of approach were adopted, how might it be designed, and how would the Board know it has been designed "correctly".

As indicated earlier in our submission, in the absence of robust comprehensive data for use in calibrating the productivity factor to address distributor diversity the PWU supports the use of a menu from which distributors can select the TFP-ROE that best reflects their circumstances.

Staff invites comments from stakeholders on PEG's proposed approach to deriving X-factors for 3rd Generation IR.

Dr. Cronin's comments provide the PWU's input on the derivation of the productivity factor for 3rd Generation IR.

Staff invites comments from stakeholders on the "incremental capital investment module" concept as described above. Staff also invites comments from stakeholders on the need to mitigate any risks associated with a capital investment module in the 3rd Generation IR mechanism. If some form of mitigation is considered necessary, staff invites views on an appropriate mechanism.

From the discussions of the Working Group and as noted in the Discussion Paper it is apparent to the PWU that there is the need for the optional provision for incremental capital investment in the 3rd Generation IRM. Delays in capital investment in the absence of an intra-term option for regulatory approval and pass through of incremental capital expenditures for growing capital demands may risk system reliability and ultimately result in higher costs. The PWU

therefore supports an optional modular approach to deal with incremental capital investment as a separate parameter in the IRM. While the Discussion Paper notes concern that this mechanism “could have the effect of interfering with the ability of IR to encourage distributors to seek efficiency improvements under the plan by undermining its comprehensiveness”, the PWU understands that the capital module would be included under the IRM and therefore would not undermine the comprehensiveness of the plan.

Staff invites comments from interested parties on whether capitalization as applied to cost of service rate setting is relevant to Z-factor treatment in incentive regulation rate setting, or whether this should be determined on a case-by-case basis?

The PWU is not aware that Z factors are intended to address unforeseen matters that are only temporary in nature.

With regard to the disposition of the Z factor, the June 30, 1999 *OEB Staff Proposed Draft Electric Distribution Rate Handbook* states the following:

In determining the disposition amount, the utility must consider whether the expenses have benefits for future periods or not. If they do not have benefits for future periods, the disposition amount should be designed to recover all of the expense by the end of the next rate period. If the expense has future benefits, it should be capitalized and the amortization amount brought into the balancing account(s)⁴.

While this paragraph is not in the final rate handbook or the 2006 Rate Handbook, neither of these two documents explicitly state whether capitalization as applied to COS rate setting is relevant or not to Z-factor treatment. Given that costs related to Z-factors may have benefits for future periods the PWU submits that capitalization of Z factors is relevant in IR.

To ensure that the burden on each class of customers is not unreasonable, the Board determined in the storm damage costs decision that Z-factor costs should be allocated between classes on the basis of distribution revenue. Staff invites comments from stakeholders as to whether this should be clarified in Appendix D as a general Z-factor rule.

The PWU assumes that Board staff is seeking comment on whether the allocation of Z-factor costs between classes on the basis of distribution revenue should be clarified in situations in which it is not possible to directly allocate costs or there is no alternative basis that merits consideration. The PWU agrees that such a clarification is worthwhile.

⁴ OEB Staff Proposed Draft Electric Distribution Rate Handbook. June 30, 1999. <http://www.oeb.gov.on.ca/documents/cases/RP-1999-0034/Chapter%204.pdf>

Staff invites comments from interested parties on whether one or more off ramps should be available to distributors in 3rd Generation IR and if so, what form they might take.

In the PWU's view, it is reasonable to include an off-ramp in an IR framework that lacks robustness, as a risk mitigation mechanism. However, in the absence of a concrete proposal on a 3rd Generation IRM it would be premature to comment on whether one or more off ramps should be included in the plan, or what form they might take.

In general terms, the PWU notes that while on the down side an off-ramp would address a distributor's concern related to financial hardship, on the upside, the Board's concern would be excessively high rate of returns. In the latter case, the Board needs to consider that a distributor will have put in place a business plan for the term of the IR plan around the IR mechanism. The need to abort its business plan as a result of an unexpected off-ramp may require the distributor to put on hold or cancel work projects. The disruption of the business plan can result in inefficiencies and risk deterioration of service quality, reliability and safety. Therefore, in including off-ramps, there needs to be clarity around the off-ramp mechanism. Multiple off-ramps on the upside or downside are likely to detract from clarity and result in an unexpected termination of the IR plan.

Staff invites comments from stakeholders on whether an ESM should be part of 3rd Generation IR and if so whether an asymmetric ESM as described above might be appropriate. If such a mechanism were to be implemented, what should the appropriate deadband be, if any, and should the 3rd Generation IR mechanism stretch factors be adjusted and how and by how much?

In the absence of a concrete proposal on 3rd Generation IR, the PWU notes that while a sharing mechanism may weaken the incentive for efficiency gains, if the IRM lacks robustness, the IRM would be required to mitigate risk related to the IRM in spite of its impact on the efficiency incentive. With regard to details on the ESM, we would need to consider a specific IRM proposal to provide comment.

Staff invites comments from stakeholders on the need for additional reporting requirements for 3rd Generation IR.

The current PBR data filing requirements as per section 12.4.4 of the 2000 version of the *Electricity Distribution Rate Handbook* provide complete information required to determine TFP as well as for benchmarking purposes. Together with the annual service quality performance filing requirements, these data should provide the reporting requirements for 3rd Generation IR.

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