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File 15917

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, 27th Floor
Toronto, Ontario M4P 1E4

Re: Comments on Board Staff's May 6, 2008 Proposal on 3rd Generation Incentive Regulation for Electricity Distributors, 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 on going service quality, reliability and safety for Ontario consumers at a reasonable price. To this end, attached please find the PWU's comments on Board staff's May 6, 2008 proposal on 3rd Generation Incentive Regulation for electricity distributors. In addition, the PWU has retained Dr. Frank Cronin to provide comments which we submit along with our comments.

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

Yours very truly,
PALIARE ROLAND ROSENBERG ROTHSTEIN LLP

Richard P. Stephenson

RPS:lms

Encl.

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.
Sodexho 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

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"). On May 2, 2008 the Board posted a Board staff proposal on 3rd Generation IRM ("Proposal") for presentation at a May 6th stakeholder meeting, along with an invitation for stakeholder comments on the Proposal. In this submission the PWU provides its comments on the Proposal.

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 notes that nothing in Board staff's presentation on its Proposal changes the PWU's views presented in our April 15, 2008 submission on Board staff's discussion paper and as expressed by Dr. Cronin in his April 15, 2008 comments on PEG's report, *Calibrating Rate Indexing Mechanisms for Third Generation Incentive Regulation in Ontario.*

In its comments on the Discussion Paper the PWU shared its view that Board staff had 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. Unfortunately, Board staff's proposal fails to come through on several fronts.

<u>Long Term Vision on IR</u>

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 and falls short of setting a comprehensive long term vision and framework toward achieving such a vision, the Proposal makes no reference to a long term vision. As the PWU submitted in its comments on Board staff's scoping paper, in the absence of such a long term vision and a framework that gets us there, there is the danger that the Board will arbitrarily move from one regulatory mechanism to the next in the absence of gaining an understanding of the true impact of incentives set arbitrarily, on cost and service quality.

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.

Given Board staff's view expressed in the discussion paper of the industry specific IPI as the appropriate inflation factor, the proposal GDP-IPI approach on the inflation factor for 3rd Generation IRM is unexpected and in the PUW's view, undesirable. In its presentation on the Proposal Board staff notes that while all stakeholders support the IPI approach, stakeholders differed on the details. The issues on the details identified in Board staff's presentation include: the appropriate specific sub-indices; the weighting of sub-indices; and the calculation and smoothing of the capital sub-index. Stakeholders have provided the Board with their input and alternatives on these issues related to the IPI. In the PWU's view the error inherent in using the GDP-IPI rather than the IPI approach is far greater than the error inherent in the IPI implementation issues raised by the stakeholders. Most of all there is a Board approved precedent on the implementation of the IPI approach for 1st Generation PBR that Board staff can rely on. The use of this approach will avoid the sources of error associated with the application of GDP-IPI. This is especially so in the absence of data analysis that would allow for the correct determination of the Input Price Differential ("IPD") and Productivity Differential ("PD"), the factors used to correct for error in a GDP-IPI approach. In fact, the working group did not have any discussions on the derivation of IPD and PD as the apparent inclination was toward the IPI approach. Given Board staff's proposal on a GDP-IPI approach for 3rd Generation IRM, this is a significant gap in the working group's discussions.
In Dr. Cronin's presentation at the May 6th stakeholder meeting[1], he notes the following major problem with the use of the GDP-IPI:

[1] http://www.oeb.gov.on.ca/OEB/Industry+Relations/OEB+Key+Initiatives/3rd+Generation+Incentive+Regulation/3rd+Generation+Incentive+Regulation+-+Filings

- Share of capital in LDC costs (e.g. IPI) ranges from 45% (1st Gen) to 63% (PEG 3rd Gen) versus 15% to 17% in the GDP price index

- During periods of rapid change in financing costs, the GDP is seriously deficient in tracking interest rates

- Over the last 50 years there have been 10 interest rate cycles with trough-to-peak rate changes averaging 400 basis points over average period of 17 months.

- Rising inflation will force central banks to aggressively raise rates in the near term

- Likely funding gap of on-going capital projects with the GDP price index.

The risk of a trough-to-peak interest cycle over the course of 3rd Generation IR based on a GDP-IPI approach puts at risk on going service quality.

The PWU does not support the proposed use of the GDP-IPI. The PWU supports the use of the IPI as it provides a win-win approach for both distributors and consumers whereby the distributors have a reasonable opportunity to earn the allowed return while providing on going service quality, reliability and safety for its customers. The Board can rely on the IPI approach used in 1st Generation PBR with the capital sub-index smoothing approach proposed in Board staff's discussion paper. Over the term of 3rd Generation, discussions on the issues related to the IPI sub-indices can continue for consideration for future IR Generations.

<u>Productivity factors and stretch factors</u>

As submitted in our comments on the Board staff's discussion paper, the PWU repeats its disagreement with the approach of including the US utility database in the model used to derive TFP for Ontario distributors. The PWU also repeats its disagreement with the use of benchmarking based on O&M plus proxy capital costs given the significant non-fit of proxy capital costs with actual capital costs demonstrated by Dr. Cronin[2]. However, the PWU supports the base TFP of 0.88% for 3rd Generation IR as reasonable based on the TFP analysis conducted for 1st Generation PBR.

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[2]http://www.oeb.gov.on.ca/OEB/Industry+Relations/OEB+Key+Initiatives/3rd+Generation+Incentive+Regulation/3rd+Generation+Incentive+Regulation+-+Filings

Plan Term

On the term for 3rd Generation IR, slide 8 of Board staff's May 6th , 2008 presentation states that "Most stakeholders comment that 3 to 5 years seems reasonable; some prefer shorter term and a few prefer longer term". In the PWU's view, the term of an IR plan should be considered in terms of the plan parameters. The higher the risk associated with inherent error in plan parameters, the shorter the term. The stakeholder comments referenced by Board staff on the plan term were made in the absence of a proposal on the parameters for 3rd Generation IR. Therefore, they are not necessarily applicable to the Proposal.

With the error inherent in the Proposal, the PWU does not support a term in excess of 3 years. Three years of high risk years is sufficient to impact on-going service quality. This is especially so for the electricity distributors given the absence of a basis for the 2nd Generation rate adjustment.

Incremental Capital Module

In Board staff's May 15th, 2008 revised proposal on an incremental capital, Board staff proposes changes to:

- "the proposed materiality threshold for invoking the module; and
- the proposed scope for capital expenditures eligible for recovery through the module"

Board staff proposes a threshold for the average annual incremental CAPEX of 150% of the distributor's Board-approved depreciation expenses embedded in base rates. Board staff's proposal is in part based on the perfunctory analysis of "the total value associated with electricity distribution property, plant and equipment ["PP&E"] and depreciation for the past two years… ". Staff also notes that it "believes that 150% is appropriate in order to allow for the impact of inflation and to provide a cushion to ensure that only the most serious cases are considered".

The PWU notes that the analysis that contributed to the identification of the threshold level at 150% is based on the "total" value of PP&E and depreciation expense as a percent of gross PP&E for all distributors in the province. The proposal does not indicate whether the range of individual distributor's (i.e. distributor diversity) depreciation expenses as a percent of gross PP&E was reviewed and considered in determining the 150% threshold. While the proposal surmises that the 150% threshold would ensure that only the most serous cases are considered in the absence of an understanding of the range of levels of depreciation expenses as a percent of gross PP&E, the degree of hardship may be underestimated for some distributors.

Application filing requirements includes the following information that speaks to the 150% threshold: “An analysis demonstrating that the threshold test has been met and that the amounts will have a significant influence on the operation of the distributor”. To address this possible diversity amongst the distributors, the PWU recommends that Board staff provide opportunity for those distributors that do not meet the threshold to seek relief for incremental CAPEX upon demonstration that the amounts will have significant influence on the distributors’ operation. In the PWU’s view this concession is not only equitable, but results in a less onerous process for both the Board and the distributors compared to an off ramp application.