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BY COURIER

Ms. Kirsten Walli
Secretary
Ontario Energy Board
2300 Yonge Street
Suite 2700,
Toronto, ON.
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Dear Ms. Walli:

EB-2014-0138 – OEB Review of the Board’s Policies and Processes to Facilitate Electricity Distributor Efficiency: Service Area Amendments and Rate-Making Associated with Distributor Consolidation - Hydro One Networks’ Comments

Attached are two (2) paper copies of Hydro One Networks’ comments on the OEB Staff Discussion Paper.

Sincerely,

ORIGINAL SIGNED BY SUSAN FRANK

Susan Frank

**REVIEW OF THE BOARD'S POLICIES AND PROCESSES TO
FACILITATE ELECTRICITY DISTRIBUTOR EFFICIENCY:
SERVICE AREA AMENDMENTS AND RATE-MAKING
ASSOCIATED WITH DISTRIBUTOR CONSOLIDATION**

HYDRO ONE COMMENTS

Hydro One Networks Inc. (“Hydro One”) welcomes the opportunity to comment on the OEB (“Board”) Staff Discussion Paper (“SDP”) discussing the Board’s policies and processes to facilitate electricity distributor efficiency with respect to service area amendments and rate-making associated with distributor consolidation. The SDP, filed March 31, 2014, has been filed as EB-2014-0138.

Hydro One recognizes the benefits of this initiative and offers that the existing policies and associated guidelines and processes adequately address the concerns expressed by stakeholders with some suggested changes. The following comments have been provided to assist the Board in its review.

SERVICE AREA AMENDMENTS

Section 28 of the Ontario Electricity Act and the “Open for Competition” Approach

The SDP asks for comments on the benefits of an “open for competition” approach to un-serviced areas and how the Board would implement such an approach in light of Section 28 of the Ontario Electricity Act, 1998.

Section 28 of the Ontario Electricity Act, 1998 states:

A distributor shall connect a building to its distribution system if,
(a) the building lies along any of the lines of the distributor’s distribution system; and
(b) the owner, occupant or other person in charge of the building requests the connection in writing.

Hydro One does not support the “Open for Competition” approach for un-serviced areas for the following reasons:

(a) Decreased Economies of Scale and Operational Inefficiencies

The distribution of electricity is a natural monopoly with rates set by regulation. Distributors are licensed by the Ontario Energy Board (“the Board”), the regulator. As

described in the Board's findings in RP-2003-0044, *the ability of a customer to request connection under section 28 of the Electricity Act does not imply that competition must exist*. It is Hydro One's position that incorporating competition for an apparently *un-serviced* area dissipates the economies of scale and operational efficiencies that are achieved through contiguity and customer density that are fundamental to the operation of a natural monopoly.

(b) Inability to accurately produce/forecast long term Distribution System Plans

Introducing an "open for competition" approach for *un-serviced* areas would reduce the predictability of the regulatory environment and would ultimately impinge upon the system planning ability of any distributor. As suggested by Dr. Chamberlain, an expert witness in RP-2003-0044,

*"there is not an 'un-served' customer. While there may be physical areas that do not yet have service, there is an entire network upstream of that location which has been built to supply network distribution services to those areas...this is an integral part of a utility's planning process"*¹.

In accordance with the Board Filing Requirements for Electricity Distribution Rate Applications ("Filing Requirements"), distributors are required to file a Distribution System Plan ("DS Plan")². The DS Plan is a consolidation of a distributor's asset management process and capital expenditure plan with a 5 year long-term outlook.

"Filing DS Plans consistent with these requirements will ensure that the Board's expectations for a distributor's planning are met; namely, that the DS Plan optimizes investments and reflects regional and smart grid considerations; serves present and future customers (emphasis added); places a greater focus on delivering value for money; aligns the interests of the distributor with those of customers; and supports the achievement of public policy objectives".

The Board has recognized the benefit in a longer term approach to distribution system planning. Hydro One submits that the reference to *future customers* would be synonymous with what the SDP refers to as *un-serviced areas*. How can a distributor effectively develop a DS Plan to serve the future customers for whom it has built an upstream network to serve under an approach that renders those very customers vulnerable to competition? It is Hydro One's opinion that there is an inherent contradiction between the "open for competition" proposal and the overarching objective of protecting the provincial rate payer and the economic principles of a natural monopoly.

¹ RP-2003-0044, OEB Decision with Reasons, Section 3.2

² OEB Filing Requirements for Electricity Transmission and Distribution Applications – Chapter 5

(c) Diseconomies of contiguity

As described by the Board in its Decision with Reasons in RP-2003-0044, Dr. Yatchew, another expert witness in that case, stated that

“overlapping service areas or fragmentation of service areas through embedding would reduce overall economies of contiguity, density and scale. System planning would become less efficient and may be characterized by redundancies, competitive rushing to low cost, high density areas and avoidance of less dense areas with high service costs. This phenomenon is sometimes referred to as “cream skimming” or “cherry picking”³.

Hydro One agrees that this inevitable cherry picking tactic associated with the suggested “open for competition” approach will ultimately increase the proliferation of the existing checkerboard pattern⁴ that ultimately results in diseconomies of contiguity, in addition to lost economies of scale and density. The increased development of the checkerboard pattern throughout the Ontario distribution system is also detrimental to the Board’s regional planning initiative; with more entities to manage and more individualistic commercial drivers to appease, the development of regional plans becomes increasingly difficult.

Consideration for the Interest of the Incumbent Distributor and Their Ratepayers

As outlined in the SDP, and with respect to SAA applications since the combined proceeding,

“contested SAA applications have tended to arise in circumstances where the prospective customer is located in a portion of the Incumbent Distributor’s service area where service is not currently provided by that Distributor (referred to in this Discussion Paper as an “un-serviced area”). These cases have all involved new service to new customers, with emphasis being placed on an evaluation of the costs of connection. In each of these cases, the Board agreed with the Applicant Distributor that an extension to its service area to serve the new customers was appropriate.⁵

In short, the success rate so far, is 100% in favour of the Applicant Distributors. This track record has a corresponding impact on the remaining customers of the incumbent distributor. Hydro One, as the incumbent distributor for many of these contested applications has lost thousands of customers. Although, on a one-off basis, the materiality of the transfer may not cause any significant impacts on the remaining Hydro One customers, the aggregate of all these transfers certainly does. The first objective of

³ RP-2003-0044, OEB Decision with Reasons, Section 2.3

⁴ EB-2013-0187/EB-2013-0196/EB-2013-0198, Exhibit I, Tab 2, Schedule 2 Attachment 1

⁵ EB-2014-0138, Review of the Board’s Policies and Processes to Facilitate Electricity Distributor Efficiency: Service Area Amendments with Distributor Consolidation – Staff Discussion Paper, Page 7.

the OEB Act is to “to protect the interest of consumers with respect to prices, adequacy, reliability and quality of electricity of service⁶. The Board acknowledges this obligation in its RP-2003-0044 Decision with Reasons with the statement that it must

“consider the protection of the interests of other consumers in the proposed amendment area, the remaining customers of each utility, and the interests of electricity consumers throughout the province, over a time period that includes more than the short-term implications of any given action⁷”.

Hydro One recommends that the Board, in its determination of future service area amendments, and its application of its existing policies, guidelines and processes, give more credence to the impact these applications have on the remainder of the Incumbent Distributor’s customer base. Hydro One submits that this approach would be very similar to the Board’s Decision in Hydro Ottawa’s Motion to uphold the application of the principle of avoiding cross-subsidization with respect to long-term load transfers where the Board stated that a *higher quantum does not trigger the principle, nor does a de minimis amount justify not applying the principle⁸.*

Hydro One provides that there are additional examples of where the Board needs to verify the net-benefit and that no harm is caused to customers of both the Applicant and the Incumbent distributor. For instance, as described in EB-2007-0028, a potential transaction may entail the purchase or transfer of customers from a host utility like Hydro One by a contiguous utility that wishes to expand its service territory. An example of this situation can be illustrated through the ongoing proceeding between Hydro One and Horizon Utilities Corporation. In this type of case the resultant outcome is not a reduction in the number of utilities but rather a decision to effect the redistribution of costs with a potential for realization of long-run efficiencies. However, in Hydro One’s case, the loss of customers to an acquiring utility would mean that the sale of those customers at book value would result in Hydro One’s remaining customers having an increase in their distribution rates. The rate impact on remaining customers would be magnified to the extent the lost customers were over-contributing to the revenue pool. To ensure that “no harm” is felt by the remaining customers the price for the associated transaction assets must reflect not only the NBV of the assets but also the present value of the margin lost which in the case of these profitable close-to-urban customers would be a premium to book value.

Aligning Service Areas with Municipal Boundaries

The SDP requests feedback on whether the Board’s service area amendment policy should facilitate service area amendments that have the effect of aligning a distributor’s service area with municipal planning boundaries. Hydro One estimates that should the Board facilitate such a change, Hydro One could relinquish as many as an estimated 400,000 distribution customers. To note, in its most recent rate application, EB-2013-

⁶ Ontario Energy Board Act, 1998

⁷ RP-2003-0044, OEB Decision with Reasons, Section 2.2

⁸EB-2013-0308, Decision and Order on Motion to Review and Vary, Page 5

0416, fixed revenues represent 48% to 59% of the revenue requirement, based on residential rate class⁹. These fixed revenues cover the costs of direct fixed assets and common fixed assets. In a single service area amendment that involves a customer transfer, the direct assets to serve the customer such as poles and conductors, and the associated costs for those assets, would be transferred to the acquiring utility at net book value. However, the common fixed asset costs such as distribution stations, field business centres, customer care resources and IT infrastructure required to serve these customers would not be transferred. As such, proceeding with this suggested change that could reduce Hydro One's customer levels by 400,000 would create significant pressure on the rates of the remaining Hydro One customers. The resulting impact would be that the remaining fixed costs of the organization would now have to be spread over a much smaller customer base. In addition, such a change could lead to stranded assets. Consequently, with regards to the remaining Hydro One customers, Hydro One suggests that such a change would be contrary to the Board's objective to protect the interests of consumers and should not be pursued.

Hydro One understands and agrees with the Board's finding in RP-2003-0044 that *the efficient and optimized development of the distribution system is a higher value than the interests of any single operator within the system*¹⁰. This is intrinsic to the Board meeting its objectives. In so doing, Hydro One suggests that the Board should consider the conclusions of Dr. Yatchew in RP-2003-0044, that *any change in a distributor's service area should serve the public interest, clearly demonstrating that there are benefits to the distribution system as a whole*¹¹. Any change to the service area of any distributor, through a service area amendment application should not only illustrate no harm to the transitioned customers and the parties involved, but also clearly demonstrate benefits to the distribution system as a whole. Hydro One comments that a transition to an approach under current rules that would facilitate service amendments that have the effect of aligning a distributor's service area with municipal planning boundaries is counter-productive to this goal and is not in the public interest.

Conclusion

Hydro One submits that the Board's existing policies and associated guidelines and processes adequately address the concerns expressed with respect to service area amendments. However, in its determination of future service area amendments Hydro One recommends that the Board give more credence to the impact these applications have on the remainder of the Incumbent distributor's customers and that the Board verify that there are benefits to the distribution system as a whole.

⁹EB-2013-0416, Exhibit G1, Tab 4, Schedule 1, Table 3, Page 5.

¹⁰ RP-2003-0044, OEB Decision with Reasons

¹¹ Ibid, Section 3.2

MERGERS, AMALGAMATIONS, ACQUISITIONS AND DIVESTITURES – RATE ISSUES

With respect to rate issues associated with mergers, amalgamations, acquisitions and divestitures (“MAADs”) applications, Hydro One maintains that the Board’s existing policies, specifically the use of the well-established “no-harm” test, are appropriate. Hydro One recognizes, and is supportive of, the provincial government’s objectives of moving forward with distribution rationalization in Ontario as documented by the Distribution Sector Panel Review and the Drummond Report. The following comments have been provided to assist the Board in its review.

Defining the Default Deferral Rebasing Period

The SDP outlines that some distributors argued *allowing (distributors) to retain any achieved savings for a longer deferral period will provide encouragement to those that may be interested in pursuing consolidation opportunities*¹². Hydro One counters that increasing the default deferral period may encourage increased competition for consolidation, but it also encourages increased premiums at a time when controlling costs is critical to the industry. Such an approach would only increase market premiums to the benefit of selling shareholders and to the detriment of the industry as a whole. The drawback of such a change will also be experienced by the Ontario ratepayer as allowing longer deferral rebasing periods erodes the benefit of customers as they will not realize the savings that derive from reduced distributor revenue requirements that result from MAADs. Hydro One offers that recent consolidation examples, such as Hydro One’s acquisition of Norfolk Power Distribution Inc., illustrates that when natural consolidations occur between contiguous boundaries, the efficiency gains and savings necessary to enable the recovery of acquisition costs are feasible within the 5 year deferral period limit.

Hydro One also submits that the reduced regulatory predictability regarding well-defined service area boundaries would impact the anticipated future revenues that an entity can forecast, resulting in a negative impact to the market price of any utility. *“The market price of a utility company established between a willing buyer and a willing seller is informed by the anticipated future revenues that the purchased entity will generate”*¹³. As such, the suggested “open for competition” approach introduces unnecessary risk and uncertainty that could significantly impede consolidation.

¹² EB-2014-0138, Staff Discussion Paper, Page 13

¹³ EB-2013-0187/EB-2013-0196/EB-2013-0198, Procedural Order 8, Page 5.

Adjusting Rates to Reflect Capital Investments During the Rebasing Deferral Period – Balancing Ratepayer Protection and System Safety and Reliability

As outlined in the SDP, *distributors also indicated that while an extended rebasing period may allow for the recovery of costs, the treatment of capital investments during an extended incentive rate-making period may reduce the benefits of the extension...Their concern was that if capital additions cannot be incorporated into rate base, the shareholder's rate of return would diminish and there would be impact on financing for capital investments.* Hydro One suggests that the Board ought to consider overall electricity system safety and reliability concerns. If an Applicant can illustrate that the capital investments are necessary to maintain system safety and reliability then a mechanism for adjusting rates would be reasonable. Hydro One suggests that a practical starting point for establishing the criteria to determine such a mechanism would be the Incremental Capital Module elements that are specific to the 4th Generation IR Plan¹⁴ and adapted as required to address differences in rate-setting options.

Conclusions

Hydro One offers that the Board's 2007 Policy as well as the Board's findings in both RP-2003-0044 still hold in that the Board should review these MAAD applications through the lens of the "no-harm" test while bearing in mind that *the efficient and optimized development of the distribution system is a higher value than the interests of any single operator within the system*¹⁵.

As discussed earlier, consolidations may take a variety of forms and some level of uncertainty is generally accepted by parties that enter into MAAD applications. However, Hydro One submits that it is prudent that the Board continue to mitigate the regulatory uncertainty and consequential risks by determining MAAD applications on the basis it does today. This would include the use of the "no-harm" test and the 5 year limit on default deferral rebasing period which ultimately ensure the transaction is of "net-benefit" to the industry.

¹⁴ OEB Filing Requirements for Electricity Distribution Rate Application – Section 3.3.1

¹⁵ RP-2003-0044, OEB Decision with Reasons