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BY COURIER

Ms. Kirsten Walli
Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON.
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Dear Ms. Walli:

EB-2007-0673 - Further Consultation on Stretch Factor Rankings for 3rd Generation Incentive Regulation for Electricity Distributors

Hydro One Networks Inc. ("Hydro One") is pleased to provide comments in respect of the Ontario Energy Board's ("the Board") communication of November 21, 2008 concerning further consultation on the 3rd Generation Incentive Regulation ("3GIRM") model. The Board's intent is to improve the model used to assign stretch factors to electricity distributors and to identify whether the grouping of distributors into the efficiency cohorts might be improved, reducing the potential for misclassification.

Hydro One has reviewed the Board Staff overview and the analysis performed by the Pacific Economic Group ("PEG") that was included in the above communication, and in the subsequent revised version of the PEG report issued by the Board on December 4, 2008. Generally Hydro One is supportive of the work done by Board Staff and PEG as reported above. This effort further completes the data inventory and improves the quality of the analysis that underlines the distributor cost comparison by including in the OM&A costs an estimate of the equivalent O&M costs incurred by embedded utilities in respect of Low Voltage ("LV") charges applied by Hydro One.

Hydro One agrees with PEG that generally the inclusion of LV costs has little impact on the outcome of the results.[1] The dominant factors that drive the statistical significance of the variables studied in PEG's econometric models are customer numbers, volume of energy delivered through the distribution system and the length of distribution feeders employed.

[1] "Sensitivity Analysis on Efficiency Ranking and Cohorts for the 2009 Rate Year", Pacific Economics Group report attached to November 21, 2008 letter, page 5.

At this juncture, Hydro One believes it would be appropriate to bring closure to incremental improvements to the quality and analysis of OM&A data. Addressing the relative efficiency rankings of utilities solely from the OM&A cost comparison perspective would yield diminishing returns.

To address effectively the issue which the Board is seeking commentary on, namely,

> "….*What changes, if any, to the model arising from the attached sensitivity analysis should the Board consider to further reduce the potential for misclassification*."[2]

the answer must be sought in the bigger project on cost comparison. Cost comparisons based on OM&A reviews only are incomplete, since these costs generally represent at best 50% of the costs incurred by utilities in operating their distribution businesses. In its previous commentary on this subject,[3,4] Hydro One has repeatedly made reference to the need for inclusion of capital costs. Given the diversity of operations of the electricity distribution utilities in Ontario, it is only reasonable to expect that an assessment of distributors' total costs is more likely to lead to a meaningful outcome that helps to categorize utilities into efficiency rankings. Adding capital cost considerations is the appropriate next step in the evolution of cost comparison methodology which the Board aims to use as one of the tools for rate setting purposes.

Hydro One believes that the cost comparison and benchmarking of utility performance will continue to benefit from refinements to data quality and methodologies for analysis. However, the scope of the analytical process must capture not only all relevant factors but it must also include an assessment of the balance between the benefits of the refinements versus the costs of implementing the refinements, and the scale of materiality involved. The Board and utilities can factor plans for such improvements into future iterations, once the total framework is further advanced. For now, however, we feel that the Board needs to move forward with approving rate changes under 3GIRM. At the same time we encourage the Board to resume at the earliest opportunity, the next phase of cost comparison and benchmarking which can evolve in step with the Board's evolution in incentive regulation rate making. Benchmarking is an essential and integral component of incentive regulation. We must move forward with appropriate changes to strengthen the incentive regulatory model and to ensure its success in future rate setting.

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[2] *Ibid*, page 1.

[3] EB 2006-0268 - "Comparison of Electricity Distributor Costs", Hydro One Networks comments on release of final consultant's report, April 28, 2008.

[4] *Ibid*, Hydro One Networks comments on consultant's report, June 26, 2007.

In conclusion, Hydro One recommends the Board implements the Stretch Factor assignments as proposed by Board Staff in the November 21, 2008 letter for setting 2009 distribution rates under 3GIRM. Furthermore, Hydro One recommends that the Board embark at the earliest opportunity on the next phase of refinements with respect to the evolution of its cost comparison process.

Sincerely,

Susan E. Frank