**ONTARIO ENERGY BOARD**

**IN THE MATTER OF** a proceeding initiated by the Ontario Energy Board to make certain determinations respecting conservation and demand management ("CDM") activities as described in the Electric Distribution Rates ("EDR") Handbook and Total Resource Cost ("TRC") Guide pursuant to sections 19(4) and 78 of the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule B ("OEB Act").

# REPLY SUBMISSION
# on behalf of the
# COALITION OF LARGE DISTRIBUTORS

## Introduction

1. Fifteen parties, including Board Staff and the Coalition of Large Distributors ("CLD"), filed written submissions on the matters at issue in this proceeding; thirteen of these parties made oral submissions.

2. In its written and oral submissions, the CLD made submissions regarding mandated CDM spending, free ridership levels and attribution of benefits.

3. On the question of mandated spending, the CLD asked the Board to refrain from requiring incremental CDM expenditures in 2006. On the question of free ridership levels, the CLD opposed the proposal of GEC and Pollution Probe that the Board require local distribution companies ("LDCs") to demonstrate free ridership levels on a program-by-program basis. Finally, on the question of attribution of benefits, the CLD opposed GEC and Pollution Probe's proposal to have the Board limit an LDC's benefit claim to the incremental benefits associated with its participation in a CDM program with a non-rate regulated party.

4. The CLD's Reply Submission is confined to responding to the submissions of Board Staff on "Issue 1" in the Board's November 11, 2005 Notice of Proceeding and Hearing, namely: "Should the Board order an LDC to spend money on CDM programs in an amount that is different from the amount proposed by an LDC in a test year and if so, under what circumstances?" The CLD's positions on Issue 2 (free ridership) and Issue 3 (attribution of benefits) are as outlined in its Written Submissions and elaborated upon in its oral presentation.

5. The Submission of Board Staff (the "Staff Submission") characterizes Issue 1 in terms of a distributor's "failure to invest in CDM."[1] It then proposes that the prudence or imprudence of this "failure" should be tested by comparing the "cost effectiveness" of such an investment, assuming it were made, to an LDC investment in distribution assets "such that the consequence of failing to invest in the CDM initiative is that distribution rates are higher than they would have been had the CDM investment been made.[2] Board Staff's proposal is referred to below as the "Staff Proposal".

6. Under the Staff Proposal, "[T]he focus is on what the LDC invested in (i.e., the alleged imprudent investment) as an alternative to investing in CDM. Where, for example, the LDC proposes to spend (or has spent) ratepayer money on distribution assets or services when that money could have been more cost effectively spent on CDM initiatives, it is arguable that the expenditure is imprudent."[3]

7. The balance of this Reply Submission is in four parts. The first part discusses the legal standard of prudence that underpins the Staff Proposal, including the circumstances in which prudence issues arise and how the prudence standard is required to be applied. The second part is a brief discussion on "least-cost-planning" concepts (also referred to as "integrated resource planning,"), the real concepts underpinning the Staff Proposal. The third part of this Reply Submissions highlights some of the CLD's concerns and questions regarding the Staff Proposal. The fourth and final part sets out our conclusions.

[1] See for example, Staff Submission, paras. 11 (2nd bullet) and 21 (1st bullet).
[2] *Ibid*., para. 21 (3rd bullet).
[3] *Ibid*., para. 22.

## The Prudence Standard

8. The prudence standard emanated from Mr. Justice Brandeis's opinion in a case decided by the Supreme Court of the United States in 1923. It was subsequently developed in American jurisprudence. It is now applied by utility regulators across Canada, such as the Board, as well as in the United States.

9. Mr. Justice Brandeis held that a public utility should not be prevented "from earning a fair return on the amount prudently invested in it"; that is, invested in the capital assets comprising its rate base. He explained the concept of "prudent investment" in the following terms:[4]

> The term prudent investment is not used in a critical sense. There should not be excluded from the finding of the [rate] base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown. [emphasis added]

10. The prudence standard extends to operating expenses as well.[5]

11. Prudence serves as a standard of care for a utility's management in making decisions giving rise to costs that the utility seeks to recover in rates. The prudence standard does not require that a utility's management make the best decision, however, but only that it make a reasonable one. These decisions must be judged as to their reasonableness at the time they were made, and not after the fact based on hindsight, considering that management must solve problems prospectively. If this were not the case, management would be held to a standard of perfection rather than prudence.

12. The United States Federal Energy Regulatory Commission has summarized the prudence standard as follows:[6]

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[4] *State of Missouri ex. rel. Southwestern Bell Telephone Co.* v. *Public Service Commission of Missouri*, 262 U.S. 276 (1923) at 289.
[5] *West Ohio Gas Co.* v. *Public Utilities Commission of Ohio (No.1)*, 294 U.S. 63 (1935) at 68; see also *Acker* v. *United States*, 298 U.S. 426 (1936) at 431.
[6] *New England Power Company*, Opinion No. 231, 32 FERC ¶ 61,047 at p. 61,084 (1985), reh'g denied, 32 FERC ¶ 61,112 (1985), aff'd, *Violet v. FERC*, 800 F. 2d 280 (1st Cir. 1986).

> [M]anagers of the utility have broad discretion in conducting their business affairs and in incurring costs necessary to provide services to their customers. In performing our duty to determine the prudence of specific costs, the appropriate test to be used is whether they are costs which a reasonable utility management (or that of another jurisdictional entity) would have made, in good faith, under the same circumstances, and at the relevant point in time. We note that while in hindsight it may be clear that a management decision was wrong, our task is to review the prudence of the utility's actions and the costs resulting therefrom based on the particular circumstances existing either at the time the challenged costs were actually incurred, or the time the utility became committed to incur those expenses. (emphasis added)

13. The prudence standard serves as a constraint on a utility regulator's discretion to disallow costs in the rate-making process: a utility is entitled to recover, in its rates, costs that it prudently incurs. If this were not the case, the regulator would be allowed to refuse to allow a utility to recover its costs and thereby to improperly confiscate the utility's property for the account of its customers.

14. In sum, it is clear that:

- Under cost-of-service rate-making, a utility's costs of providing regulated services are examined and, if any such costs are found to be excessive or improper, they are typically disallowed for rate-making purposes. The objective, in other words, is that the costs reflected in rates are prudently incurred. Conversely, imprudent costs are excessive costs which should be disallowed; if they are not, the rates would not be just and reasonable. Put another way, **the prudence standard is used to decide whether a utility regulator should disallow costs. It is not a mechanism that permits a regulator to mandate increased investment.**

- The issue of prudence focuses on the conduct or judgement of a utility's management in incurring costs, in light of prevailing conditions at the time a decision was made. An evaluation of prudence, based on hindsight, is impermissible in law.

- The right to conduct an evaluation of prudence in the context of rate-making does not give a regulator the right to perform management's role and substitute its

decision for that of management. It is simply a mechanism to ensure that only reasonably incurred costs are recovered in rates.

- As a matter of law, LDCs seeking a rate increase are not required to demonstrate, in their cases-in-chief, that all expenditures are prudent. It is presumed that actual expenses contained in a cost of service study reflect good faith and prudent management decisions. This presumption of prudence is rebuttable, however. Where another participant in the proceeding creates a serious doubt as to the prudence of an expenditure and rebuts the presumption of prudence, the LDC has the burden of dispelling these doubts and proving that the expenditure in question was prudent.

- The party seeking to call the prudence of an expenditure into question must do so by adducing evidence or citing material of which the regulator may take official notice. The party must raise "serious doubts" about the prudence of a proposed expenditure. A bare allegation of imprudence is not enough.[7]

**Least Cost Planning**

15. Although Board Staff's test for the appropriate level of CDM spending is described using the language of prudence, the real essence of the proposal has to do with the concepts of "least-cost-planning." These concepts were discussed in the Board's Report to the Minister of Energy on Demand-Side Management and Demand Response in the Ontario Electricity Sector (March 1, 2004) (the "DSM Report").

16. The point the CLD wishes to make, in this regard, is that least-cost-planning should not be confused with the Board's responsibility to ensure that only prudently-incurred costs are included in rates. Prudently-incurred costs are not, necessarily, the same as "least cost", "lowest cost", "most cost effective", or "lowest cost alternatives." The Board should be very cautious about invoking prudence principles as a means of implementing a new, least-cost planning framework whereby decisions to invest in distribution assets

[7] *Indiana Michigan Power Company*, Opinion No. 382, 62 FERC¶ 61,189 at p. 62,238 (1993), reh'g denied, Opinion No. 382-A, 65 FERC¶ 61,087 (1993), aff'd, *Indiana Municipal Power Agency* v. *FERC*, 56 F.3d 247 (D.C. Cir. 1995).

and services are judged against CDM alternatives. An evaluation of prudence is a formal, two-step legal procedure to ensure that rates are just and reasonable. Least-cost planning is an altogether different exercise.

17. The Staff Proposal was made known to the LDCs, for the first time, when the Board Staff filed the Staff Submission on December 20th, 2006. The LDCs had little time to consider and respond to it.

18. If adopted, the Staff Proposal would have profound implications for the way in which LDCs do business. A least-cost framework for decision-making, that links approval of distribution investments to CDM alternatives, in a rate-making context, is a marked departure from the way things are done now. While LDCs seek least-cost solutions to serve their load requirements, they do so by evaluating the relative cost-effectiveness of distribution asset and service alternatives. CDM is relevant from the perspective of determining the load requirement that must be served by such alternatives (i.e., CDM reduces or shifts the load that would otherwise have to be served).

19. At this point, CDM is not sufficiently advanced to permit LDCs to evaluate least-cost distribution solutions against CDM solutions. This is because, in Ontario's electricity sector, CDM is still in its infancy. The individual CDM Plans of the members of the CLD are "first-generation" plans comprising numerous pilot programs. The members of the CLD are seeking to gain experience and build a database that will enable them to forecast how these programs will perform in their particular service territory. The ability to accurately forecast "measure uptake" is an important prerequisite for incorporating CDM into an LDC's least-cost planning framework.

**Some Specific Questions and Concerns about the Staff Proposal**

20. At this juncture, the members of the CLD do not have sufficient information about the legal and practical implications of the new paradigm proposed by Board Staff. They do not know whether and how it will affect their obligation and ability to serve. They do not know how the Board would propose to deal with such issues as the allocation of the risk that is inherent in a decision to substitute a CDM measure for an asset solution. They do not know whether the Board would propose a period of transition and what that period

would be. They do not know what standard of proof the Board would require in order to rebut the presumption of prudence. They do not know what type of evidence would be required to support a decision to invest in assets rather than CDM. They do not know whether planning horizons for system expansions are compatible with planning horizons for the development of CDM measures.

21. The point is that little is known and much is unknown about what the Staff Proposal entails, how it would work, and what steps LDCs would have to take to accommodate it. A brief litany of some of the CLD's concerns and questions is set out below.

**(a) what is the investment that is to be judged?**

22. It is unclear what, precisely, Board Staff is proposing. Is it proposing that the Board judge the prudence of an LDC's decision to invest in a certain level of CDM? Alternatively, is it proposing that it judge the prudence of an LDC's decision to invest in distribution assets and services? The CLD's confusion on this point arises because the Staff Submission describes its proposal in both ways. In some places, the reference to an "imprudent investment" is clearly a reference to an investment in assets and services.[8] Elsewhere, the reference to "imprudent investment" is to a "failure to invest in CDM."[9]

**(b) the test is overly simplistic**

23. The Staff Submission states that "a failure to invest in a CDM initiative is only imprudent when it can be demonstrated that … [the failure] … resulted in higher distribution rates than the rates would have been if the CDM investment had been made."[10]

24. Judging a utility management's decision on the appropriate level of investment in distribution assets and services, against a single criterion – impact on rates – is inappropriate. Many factors influence decisions about system reinforcement, not the least of which are reliability, load growth and power quality. Similarly, management's decision on the appropriate level of CDM investment reflect many different factors. CDM is not a substitute, in all cases, for distribution facilities or services.

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[8] Board Staff Submission, para. 22.
[9] Staff Submission, para. 14 (2nd bullet).
[10] Staff Submission, para. 11 (2nd bullet).

**(c) planning horizons**

25. The Board's DSM Report notes that "distributor least-cost planning would require a sufficiently long horizon, for example at least 10 years, to allow DSM/DR to be a viable alternative when considering investments."[11]

26. LDCs need to be confident that CDM measures are adequate and reliable alternatives to investment in assets and services. This requires them to have a solid understanding of uptake rates for such measures, in their specific service territories. This, in turn, requires LDCs to establish a statistically significant data base by implementing pilot projects and collecting and evaluating data for such projects. As the CLD explained in its submissions-in-chief, this process is underway but is far from complete.

**(d) what evidence will be required?**

27. The Staff Proposal is short on details about how it would or could be implemented. One significant concern has to do with what would be required at the first and second stages of a prudence review. What evidence would a party need to adduce to rebut the presumption of prudence at the first stage? What evidence would an LDC need to adduce to demonstrate "cost-effectiveness"? The former question is particularly critical because without some objective benchmark in this regard, every rate proceeding has the potential to unravel into a never-ending debate about CDM.

## Conclusions

28. The members of the CLD support the Province's commitment to CDM and are, themselves, committed to pursuing CDM opportunities in their service territories. Nevertheless, the CLD urges the Board, in the strongest possible terms, not to accept the Staff Proposal. As an economic regulator, the Board's role is to ensure that costs included in rates are reasonable and not imprudently incurred. Its role is neither to second-guess utility management nor to dictate how it runs its business. The Staff Proposal is highly intrusive in this regard.

[11] DSM Report, p. 13.

29. If the Board is of the view that the Staff Proposal has merit, it should convene a separate generic proceeding to consider it. A prerequisite to a meaningful proceeding would be the issuance of a draft proposal that addressed the legal and practical implications that we have touched on in this Reply Submission. Parties should be given full procedural rights and sufficient time to exercise such rights by, for example, retaining experts, preparing and filing evidence, and cross-examining witnesses.

30. If, despite the objections of the CLD, the Board were inclined to accept the Staff Proposal without further ado, it should not do so in connection with the 2006 EDR applications. It would be inappropriate and profoundly unfair to change the rules of the game that pertain to 2006 rate proceedings by imposing now, at this late stage, a requirement that an LDC's investment decisions be tested against CDM alternatives. Our 2006 plans and budgets were not designed on this basis. Our 2006 EDR applications do not contain evidence that address this matter.

31. The Staff Proposal cannot be implemented in 2006 without impairing the current procedural schedules. This, in turn, would imperil the objective of having new rates in place by May 1st 2006.

ALL OF WHICH IS RESPECTFULLY SUBMITTED on behalf of the Coalition of Large Distributors, by its counsel, this 16th day of January, 2006.

(signed) H.T. Newland
Helen T. Newland