

Ontario Energy Board



3rd Generation Incentive Regulation for Electricity Distributors

Staff Scoping Paper

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Introduction

The Ontario Energy Board (the “Board”) is initiating a consultative process on the development of the principles and methodology for the third generation incentive regulation mechanism (3rd Generation IRM) for electricity distributors.

*Development of 3rd
Generation IRM*

This paper has been prepared by Board staff to assist those consultations by proposing a common framework for discussion. It describes the context in which 3rd Generation IRM will be developed and proposes underlying principles to guide the work, issues to be considered, and an approach to the upcoming consultations.

Based on a consideration of comments received from interested parties on this paper, the Board will confirm the scope of issues for the consultations.

*This paper and
comments received
will help the Board
scope issues*

Context

In 2006, the Board announced its intention to implement a multi-year rate-setting plan for distributors, to be effected through a number of initiatives. The Board has since confirmed the cost of capital to be used in adjusting annual revenue requirements for 2007 and beyond, and established a simple, practical and mechanistic price cap rate adjustment mechanism (2nd Generation IRM) for electricity distributors over the period 2007 to 2009. The Board continues to review electricity distributors’ cost allocation informational filings, and is currently consulting with the sector on a comparative utility cost analysis methodology for electricity distributors. Work is also underway to identify barriers to and explore incentives for conservation and demand management (CDM) activities undertaken by electricity distributors, as

*Initiatives that may
affect electricity
distribution rate-
making in the
coming years*

well as to identify barriers to distributed generation. The Board has begun to examine whether a fundamental redesign of electricity distribution rates is warranted in light of developments in metering, CDM, and distributed generation. The review of the service quality indicators and standards for electricity distributors will also resume.

In addition, the evolution of rate-making in the electricity sector can be informed by the work that is currently underway to put in place an incentive regulation framework for natural gas distributors beginning with the 2008 rate year.

Principles underlying the development of 3rd Generation IRM

The Board's responsibility is to set rates that are just and reasonable. The legislative framework provides the Board the discretion to select the most appropriate approach to rate-setting. The Board's guiding objectives are set out in section 1 of the *Ontario Energy Board Act, 1998*.

Regulation that promotes economic efficiency in the energy sector ultimately serves the best interests of ratepayers, investors and the province as a whole. Incentive regulation, benchmarking and service quality standards are all tools that contribute to the advancement of that aim.

Building upon this foundation, Board staff believes that the Board's statutory responsibility is best fulfilled, and its statutory objectives in relation to electricity are best promoted, using a multi-year rate-setting methodology that is designed on the basis of the following principles:

1. ***The financial viability of the electricity distribution sector should continue to be balanced with the interests of consumers.*** This requires a consideration of the impacts of rate adjustments while at the same time ensuring that prudently incurred costs required for the operation of a distribution system are recovered from customers.
2. ***The pursuit of economic efficiency should be encouraged.*** 3rd Generation IRM should encourage greater economic efficiency by providing incentives for the implementation of sustainable operational efficiency improvements. The benefits of these efficiency improvements should be shared by customers and shareholders.
3. ***The incentive regulation framework must be sustainable.*** During the 2006 consultation process on 2nd Generation IRM, many participants expressed their views and expectations for 3rd Generation IRM. In addition to specific comments on the various elements of an incentive regulation regime such as an inflation factor and an X-factor, other fundamental issues of concern and debate included capital investment under incentive regulation, lost revenue due to changes in consumption, distributor diversity and the role of service quality regulation. Some of these matters were touched on, but not thoroughly examined, in the development of the 2nd Generation IRM. In general, the expectation expressed by stakeholders was for a longer-term comprehensive incentive regulation framework that may be applied uniformly (in terms of principles and methodology, but not necessarily the specific adjustments) to all rate-regulated electricity distributors in Ontario.

4. ***Rate volatility should be minimized.*** This should provide an environment where consumers and electricity distributors are better able to plan and make decisions.

In addition, the rate-setting methodology should be predictable, understood by all participants, and capable of implementation through a regulatory process that is efficient while at the same time addresses the concerns of interested parties and ensures openness and transparency. The costs of administering the methodology, including the costs imposed on all participants, should not exceed the benefits to be derived from the methodology.

Issues regarding the development of 3rd Generation IRM

In its December 20, 2006 “Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario’s Electricity Distributors”, the Board addressed the implementation of its cost of capital policy, and specifically noted that it did not anticipate reviewing the issue again in the context of 3rd Generation IRM. Staff has therefore not included cost of capital as an issue in relation to the 3rd Generation IRM consultations.

Cost of capital is not expected to be reviewed in this consultation

Also in that Report, the Board indicated that it would resume the work that it started in 2003 on Service Quality Regulation (SQR). Staff understands that the work that the Board started in 2003 on SQR will resume and proceed in parallel, but separate from, this consultation, and has therefore also not included SQR as an issue in relation to the 3rd Generation IRM consultations. Staff anticipates that details on the SQR consultation will be issued in due course.

Service Quality Regulation is expected to be developed separately and in parallel to this consultation

The Necessary Elements of an IRM Framework

The form of IRM¹ is an issue that will be considered early in consultations with stakeholders. This consultation will also consider all of the necessary elements of an IRM framework including the term of the plan, the inflation and productivity factors, the potential for an earnings sharing mechanism, and the treatment of unforeseen events. The consultations will also include a focus on issues associated with capital investment, lost revenue due to changes in electricity consumption, and distributor diversity.

Capital Investment

In the consultation on 2nd Generation IRM that occurred in 2006, a number of participants commented that the IRM regime needs to ensure that sufficient incentives are available in order to achieve efficiencies, recognizing the time patterns of costs and savings; and to provide for the expeditious review and approval of capital expenditure programs. Some participants argued that certainty in relation to capital expenditures beyond the single future test year is needed. It was suggested that the regime could include some form of approval of a multi-year capital plan and not just capital items that may arise in the following year.

Is there a need for special treatment of capital spending in an IRM framework?

¹ There are a various approaches to incentive regulation. Two popular examples that use indexing are price caps and revenue caps – a price cap sets the maximum price that a distributor may charge, and a revenue cap sets the maximum allowable revenue requirement. Further, there are two general approaches to the design of rate and revenue cap indexes: the “North American” approach and the “British” approach. Under the “North American” approach, a single forecasted base year is adjusted over several years by an index. Under the “British” approach, several years are forecasted to set the appropriate index. Please see the report entitled “Second Generation Incentive Regulation for Ontario Power Distributors”, prepared by Dr. Mark Newton Lowry of Pacific Economics Group, for a detailed discussion. The report is available on the Board’s web site at http://www.oeb.gov.on.ca/documents/cases/EB-2006-0088/report_peg_140606.pdf.

In its July 23, 2007 “Report of the Board on Rate-making Associated with Distributor Consolidation” and associated covering letter, the Board indicated that electricity distributors’ concerns over partial rebasing to account for needed capital expenditures should be examined as part of the development of the 3rd generation IRM.

Staff proposes that this consultation further explore the appropriate treatment of capital investments.

Lost Revenue due to Changes in Electricity Consumption

In its March 2, 2007 “Report of the Board on the Regulatory Framework for Conservation and Demand Management by Ontario Electricity Distributors in 2007 and Beyond”, the Board indicated that consideration of alternative mechanisms to address lost revenue due to changes in electricity consumption, including those resulting from all forms of conservation, should be considered as part of the process to develop 3rd Generation IRM and/or during the Board’s review of options for the fundamental redesign of electricity distribution rates.

Alternative mechanisms to address lost revenue due to changes in electricity consumption will be considered

Distributor Diversity

During the 2nd Generation IRM consultation, many participants commented that, in 3rd Generation IRM, the productivity factor should be more reflective of the status of the distribution sector in Ontario and account for differences amongst electricity distributors. Staff notes that the work done to date in relation to the comparative utility cost analysis could contribute to the development of an X-factor that recognizes distributor diversity. Further consideration should be given to the question of whether and how the results of the cost comparison initiative can be used in IRM.

How and to what extent should distributor diversity (e.g., capabilities and built-in efficiencies) be reflected in an IRM framework?

Staff proposes that this consultation consider how and to what extent distributor diversity should be reflected in an IRM framework.

Approach and Overall Project Timeline

It is expected that this consultative process will culminate with the issuance of a Board report setting out the principles and methodology for the 3rd Generation IRM that will be used to adjust electricity distribution rates starting in 2009 for those distributors whose 2008 rates were based on a cost of service review.

Board staff proposes that this consultation involve consultation documents, adequate response periods, stakeholder consultation conferences, and the use of a stakeholder working group. Staff will also work with an expert consultant to carry out any necessary supporting data analysis. Results of discussions and analysis with stakeholders will inform the Board's report on 3rd Generation IRM.

The proposed approach and draft timetable for the process are set out on the next page.

Target	Event/Milestone	Regulatory Schedule
2007		—2007—
July	Initial consultation on issues by means of written comments (due mid-September) on Board staff's scoping paper on issues associated with development of 3 rd Generation IRM.	
August	A stakeholder working group will be established to assist staff in the development of 3 rd Generation IRM.	● August – 1 st tranche of distributors file rate rebasing applications.
Early-September	Stakeholder consultation conference for all interested parties on staff's scoping paper.	● September – 2 nd Generation IRM filing guidelines issued.
<i>Late -September</i>	<i>Written comments due on issues associated with development of 3rd Generation IRM.</i>	
Mid-October	Board confirmation of issues. The Board will confirm the issues for consultations going forward.	
October-November	Stakeholder working group meetings.	
Late-November	Staff initial proposals A Board staff discussion paper containing initial proposals will be released for comment by interested parties (written comments due mid-January 2008).	● November – Remaining distributors file 2 nd Generation IRM applications.
December	Stakeholder consultation conference for all interested parties on staff's initial proposals.	
2008		—2008—
<i>Mid-January</i>	<i>Written comments due on staff's initial proposals.</i>	
January-April	Staff revised proposals (if necessary). A revised Board staff discussion paper, including data analysis, may be issued for comment in February (comments tentatively due mid-March 2008). A stakeholder consultation conference for all interested parties on staff's revised proposals may be scheduled in February, and further stakeholder working group meetings may be needed in February and March.	
June	Board Report issued. The Board will release its report describing the principles and methodologies of the 3 rd Generation IRM rate adjustment mechanism for setting electricity distributor rates in 2009.	● August – 2 nd tranche of distributors file rate rebasing applications. ● August – 2 nd and 3 rd Generation IRM filing guidelines issued.
		● October – Remaining file 2 nd or 3 rd Generation IRM applications.
2009		—2009—
	Rates are Set	● April - Board approves 2009 rates and issues rate orders. ● May 1, 2009 – Rates in effect.

All interested parties will have the opportunity to participate in a meaningful way in this consultative process. The stakeholder working group which will be established will help staff carry out the necessary analysis to review and evaluate options.

Various ways to participate in this consultation

Working Group Information

As outlined in the Board's letter accompanying this paper, stakeholders with relevant qualifications are invited to nominate themselves or a third party to participate on the working group. A short statement demonstrating relevant experience and qualifications should be provided as part of the nomination. Based on the guideline outlined below, Board staff will select working group participants from those that respond.

Participation on the working group

Guideline for Composition of the Working Group

The members of the working group will represent identifiable constituencies, including ratepayers, environment, and electricity distributors, and have:

- Knowledge of incentive regulation (theory and practice);
- Knowledge of technical analysis underlying incentive regulation (e.g., total factor productivity, approaches to benchmarking); and
- Familiarity with the financial and operational circumstances of electricity distributors in Ontario.

Depending on the number of nominations received, it may not be possible to accommodate all interested participants within the working group. Staff will, however, ensure that each relevant constituency is represented.

It is expected that the working group will meet in up to two phases (i.e. supporting relation to the development of staff's initial proposals and any revised staff proposals) over a six-month period. The meeting time in each

phase is expected to be up to three or four days. Board staff will lead these meetings.