

3rd Generation IRM for Electricity Distribution Sector Setting the Longer-Term Context

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Long-Term IR Vision

- The CLD and HONI generally support the concept of incentive regulation for setting rates
- A multi-year incentive regulation process has the potential to benefit all parties:
 - Make the regulatory process more efficient,
 - Provide incentives for the utility to improve performance, and
 - Allow the benefits to be shared more equitably between the utility and its customers.
- Ultimate goal is to use performance based regulation to set distribution rates with rewards and penalties for performance in delivering effective services to customers at reasonable rates
- Need to approach the development of IRM in a *practical* and *reasonable* way.

“Perfection the enemy of the good”

- IRM is a work in progress
 - We are not starting from scratch
 - We don't expect to solve all issues in the first round
 - We need to put in place a mechanism that can evolve with time
 - We need to identify priority issues that we start with because these impact LDCs in the near-term
 - Allow adjustments to be made as we gain experience with IR and avoid drastic changes to regulatory framework which introduce uncertainty
 - There are limitations which need to be addressed but which need not prevent starting down the IR path

Key Initiatives

- Consistent data collecting and reporting
- Recognize diversity in industry structure and operation
- Recognize differentiation in need for capital investment
- Recognize that Ontario is not in a steady-state environment and utilities are continuously subject to changing requirements imposed from outside
- Design of IR must be sufficiently flexible to capture the goals of driving performance with LDCs responsibility to respond to circumstances

Data Requirements

- Need to focus on using Ontario specific data at the outset
- Relying on non-Ontario data to kick-start the process may provide a disincentive for improving data collection in the future
- Need to establish trends that reflect performance of utilities in Ontario
- Need to address the type of data required and deal with confidentiality issues currently in place with RRR

Cost drivers over the next 3 –5 years

- LDCs have different (from each other and from the gas industry) cost pressures over the next 3 to 5 years
 - Capital infrastructure plans (CDM, SM, new and to replace ageing plant)
 - Connection, administration and billing costs for DG, SOP etc
 - Meeting changes in service quality, and other standards
 - Meeting requirements under IFRS/Bill 198
 - Replace/upgrades to IT systems (billing customer care, operations management, finance, control room, telecom) given the landscape changes
 - Costs to meet significant employee retirement/workforce demographic
 - Union negotiations
 - New communication techniques (e-billing, e-post)
 - Customer location/growth
 - Unpredictable weather and increasing storm damage
 - Government initiatives

Utility Diversity

- We are starting with a very wide range of utility perspectives.
- The cost drivers will not all impact utilities in the same way and at the same time
- Designing a “one size” model that applies to all utilities is challenging and may be inappropriate to meet the circumstances
- This diversity is expected continue into the foreseeable future so we need some flexibility in the IR approach to deal with diversity.
- Data verification in 2006 may have been appropriate for *individual* LDCs but not to draw comparisons *across* LDCs.
- Ontario data may provide us with enough to calculate industry average trends but not to compare among individual LDCs. We need to design an IRM that will provide the sector with the incentives to move to a consistent data reporting methodology and perhaps clean up the historical data.

Capital Investment

- Utilities face circumstances that require significant capital investment during the 3GIRM period and potentially thereafter which is not specifically related to steady- state operations, for example
 - High growth
 - Asset aging
 - Government directives – smart meters, distributed generation, Tx connection
 - Regulatory initiatives, e.g. SQR regulation
- Even under a “business as usual” or steady state environment the way rates are set in an IRM require a capital expenditure module
 - Replacement of assets are not always made on a smooth yearly basis (“wall of wires”)
 - Depreciation under historical cost accounting does not reflect replacements costs with such long lived assets
 - The return and depreciation on subsequent capital additions are not recognized for rate setting purposes until re-basing
 - But all the capital costs, depreciation, taxes and interest expense items are still growing
- Without an explicit incorporation of capital expenditures in the IRM many LDCs will be pushed to COS.

Implementation Issues

“Devil is in the detail”

- What's in what's out of plan (e.g. changes in tax policy)?
- How will CDM and we would suggest SM be treated “outside the IR adjustment”?
- How does the deferral of rebasing in M&A work with this?
- What are the threshold/evidentiary burdens to meet when demonstrating why a deviation from core plan is required?

In Summary

- Moving forward with IR requires cooperative approaches to manage the diversity of the LDC industry in Ontario.
- We need to start with the best data we have in hand and move forward “warts and all”.
- Expect imperfections but allow to learn as we go along accepting that the chosen approach is directionally appropriate but that it will not harm the customers, utilities in the short term.