September 21, 2007

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge St., Suite 2700
Toronto, ON, M4P 1E4

Re: 3rd Generation Incentive Regulation for Electricity Distributors
Comments on the Board Staff's Scoping Paper Board File No.: EB-2007-0673

These comments are provided on behalf of Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc., collectively referred to as the Coalition of Large Distributors ("CLD").

The CLD supports the development and implementation of a 3rd Generation incentive regulation mechanism (IRM) for setting rates in the electricity distribution sector. We are encouraged that the Board is committed to developing its 3rd Generation IRM with input from all stakeholders.

While many view IRM as a tool that may expedite the rate setting process and minimize regulatory burden, the development and implementation of an IRM scheme is more complex and challenging than what may first meet the eye. The theoretical and quantitative underpinnings of various IRM schemes are subject of great debate worldwide and are dependent on the **objectives** that the regulator hopes to achieve and the **context** in which the sector operates. Accordingly, the CLD would submit that Board staff, together with the Working Group and other stakeholders, need to develop a consistent understanding of the objectives of the 3rd Generation IRM – and their ranking relative to one another - and <u>then</u> develop a scheme that supports achieving these objectives given the context in which the sector operates. This needs to be done *before* the parameters of the scheme can even be identified. Not doing so may significantly undermine the effectiveness of IRM and result in customers and distributors to be worse off than they were under cost of service regulation.

The CLD is encouraged that the Board is affording the time to research and develop the 3rd generation IRM through its three initiatives relating to incentive ratemaking. Clearly, a well-designed, forward-looking IRM benefits consumers, distributors and the regulator.

Principles underlying the development of 3rd Generation IRM

The Board's ultimate responsibility is to set just and reasonable rates – for both consumers and distributors. That is, distributors should be able to recover their prudently incurred costs regardless of the regulatory regime. Section 70 of the *Ontario Energy Board Act* gives the Board discretion on the methods or techniques to be applied in determining distribution rates within the objectives identified in Section 1 of the *Act*. To this end, 3rd Generation IRM needs to meet these principles.

The CLD supports the principles developed by Board staff and suggests the following additions. An incentive regulation framework must:

a. Establish a framework that is conducive to investment to maintain a safe and reliable distribution system, service quality and financial health;

b. Rely on a fair, transparent process that is timely, practical and sustainable; and,

c. Provide rate predictability.

Objectives of the 3rd Generation IRM

Jurisdictions around the world have had different public policy and regulatory policy objectives when embarking on IRM. As mentioned in the Stakeholder Conference service quality regulation was a key policy objective in the regulation of the electricity distribution sector in New South Wales Australia, whereas in the Netherlands the objective of the regulator was to improve efficiency of the distribution sector.

An IRM designed to encourage distributors to improve efficiency will have different parameters from an IRM that is designed to improve service quality. Similarly, if an IRM fails to take into account significant capital investments required within the plan period, distributors run the risk of not recovering their costs, which in turn may have negative impacts on reliability, leaving customers worse off.

While the following list of goals is non-exhaustive, and many goals are not necessarily mutually exclusive, it is nearly impossible to design an IRM that targets excellence in each area at the same time. Potential IRM objectives include:

- improving efficiency – though after many years of rate freezes it is not clear that significant inefficiencies exist among large distributors in Ontario;
- to foster business innovation – innovation requires a reward structure with returns well above regulated ROEs;
- avoiding yearly cost of service applications – which can be accomplished by deploying fairly simple formulaic approaches;
- improving service quality – doing so may require additional capital, particularly if the levels of quality targeted exceed historical norms;
- meeting IPSP goals – to the extent that this involves greater resourcing, utilities should not be penalized in the X factor for costs of responding to additional mandates;
- encouraging consolidation – however, it is not clear that the IRM is the best approach for achieving this;
- responding to perceived international best practice – one needs to keep in mind that the Ontario policy environment is unique from other jurisdictions.

Events since 2002 have demonstrated that for policy evolutions in the power sector to succeed, they need to be focused, prioritized, and well coordinated. Attempting to achieve too many things at once simply leads to doing them all badly, further detracting from the goal of providing reliable, reasonably priced electricity to Ontario consumers. Priorities need to be chosen carefully, and the distributor's role in meeting those priorities needs to be well specified. Rate redesign should only occur *after* priorities and roles have been clearly delineated.

The CLD suggest that the Board staff develop a prioritized list of the objectives of 3rd Generation IRM. An approved list can then be discussed at the working group level.

Context of 3rd Generation IRM

Incentive regulation needs to take into account the environment in which distributors are operating now and in the foreseeable future.

The 3rd Generation IRM needs to be developed in the context of:

a. Barriers to and incentives for conservation and demand management – Distributors will be entering into contracts with the OPA to deliver CDM programs and/or developing their own CDM programs as well as those established Ministry of Energy. The IPSP proposes significant additional investment in CDM. This will impact operating and capital costs; indeed, it may be appropriate for such costs to be excluded from future productivity calculations entirely. Successful CDM programs, regardless of their source will have an effect on revenue. The IRM plan needs to take into account that such costs and lost revenue will be incurred within the life of plan.

b. Barriers to and incentives for distributed generation – The Standard Offer Programs are encouraging the development of distributed generation. The IPSP proposes significant additional investment in distributed generation. Distributors will incur costs related to connecting and supporting distributed generation and load displacement generation. Successful load displacement DG will result in lost revenue for distributors. The success of distributed generation is in part dependent on a properly designed 3rd Generation IRM. Indeed, a set of incentives specific to DG connections could be developed which protect distributors from DG costs and loss of revenue while providing upside if DG connection applications are handled in a timely and economic fashion.

c. Capital investment – Many distributors are facing the need for significant capital investment in order to replace ageing assets or to meet new growth. The IRM plan will need to be developed within this context to ensure that service quality, reliability and safety are maintained.

d. Smart Meter Initiative – Distributors are investing significant capital and operating costs in order to meet the Government's Smart Meter Initiative and the IRM needs to be developed within such a context. Furthermore, as time of use rates are developed, their impact on IRM outcomes needs to be fully explored.

e. Comparative utility cost analysis methodology – Distribution companies have different corporate objectives, structures and operating environments. Differing capital stock, valuation and capitalization policies all have an impact on data comparability. Consistency in data is central to improving the meaningfulness of comparability of data. Treatment of data for consolidated utilities also needs to be examined, as do responses to

CDM and IPSP initiatives.[1] This has a major impact on performance monitoring and the setting of any X –factor.

f. Review of service quality regulation (SQR) – The interrelationship between SQR mechanism and 3rd Generation IRM needs to be explicitly taken into account, particularly in the context of rewards, penalties, potential earnings sharing, and associated allowed capital expenditures.

g. Specific Service Charges – The OEB is conducting a review of certain customer services and classification. The IRM needs to be flexible in order to accommodate the implications of any potential changes.

The IRM scheme will also have to evolve in the context of:

a. Review of distributors' cost allocation information filings – The degree to which distributors' cost allocation calculations will result in changes to rates has yet to be determined. The IRM scheme needs to be able to accommodate any potential changes.

b. Rate design changes in light of SMI, CDM and DG – This review is intended to consider the need for, and approaches to, changes to distribution rate design in light of industry changes and emerging issues. The IRM will have to evolve in order to take into consideration any rate design changes.

c. Rate treatment of distributor consolidation – The Board issued its report on the rate treatment of distributor consolidation that contained implications for rate harmonization and cost recovery.

We are grateful for the opportunity to work with the Board, Board staff, and other stakeholders to help ensure that the IRM focuses on the appropriate targets and is workable and sustainable. We would urge the Board to devote as much time as is needed to developing a workable IRM. We believe that investment of the time in developing 3rd generation IRM will pay off in a more durable set of arrangements, which could then remain in place for a longer period of time. We look forward to further consultations on these matters.

Yours truly,

(Original signed on behalf of the CLD by)

Paula Conboy
Director of Regulatory and Government Affairs
PowerStream Inc.

[1] It would be unfortunate, for example, to see utilities which have responded aggressively to CDM mandates be penalized in the IRM for taking on the staff and costs to do so.