EDA

The Voice Of Ontario's Electricity Distributors

September 26, 2007

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, Ontario M4P 1E4

Dear Ms. Walli:

Re: EB-2007-0673 – 3rd Generation Incentive Regulation for Electricity Distributors

Please find attached the EDA response to the request for comments in respect of the OEB Staff Scoping Paper on 3rd Generation Incentive Regulations.

Yours truly,

Kevin Fahey

for Richard Zebrowski
Vice President, Policy & Corporate Affairs

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Attach.

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<u>EDA Submission on OEB Staff Scoping Paper on 3rd Generation Incentive Regulation for Electricity Distributors: Board File No. EB-2007-0673</u>

Overall, the EDA supports the Ontario Energy Board (OEB) staff's proposed scope for development of the 3rd generation incentive regulation mechanism (IRM) for electricity distributors. It appears to cover the main concerns raised by EDA members in the past regarding incentive regulation mechanisms, namely capital investments, lost revenue due to conservation initiatives, and the recognition of differences in capabilities and efficiencies between distributors. The issue of service quality has also been identified by EDA members as a key concern but we understand that it will be addressed in a parallel consultation, which we expect would be coordinated with the IRM consultation. The EDA participated in the stakeholder consultation on September 13 and would like to provide additional comments with respect to some of the issues raised in the consultation.

The Evolving Roles and Responsibilities of Ontario Distributors Need to Be Given Careful Consideration

Ontario distributors are increasingly faced with responsibilities associated with new initiatives. Among these are the delivery of conservation and demand management programs, installation of smart meters and distributed generation. Each of these has important implications for distributor operating costs, capital investments and revenues. For example, demand management and new distributed generation – which are seen to be in the broader public interest – can lead to lower than expected revenues for utilities.

As a result, distributors may face conflicting objectives and incentives: on the one hand, pursuit of the public interest may be deemed an important objective for public sector utilities; on the other hand, the associated programs can have a deleterious financial impact leading to poor performance scores and disapproving assessments by the regulator and shareholders. Moreover, utilities may, for various reasons, participate in varying degrees in these programs which will, in turn, have differential impacts on their costs.

In the view of the EDA, it is therefore important that the present process on 3rd generation IRM give full and proper consideration to ensuring that the potential for incentive conflicts arising out of the broadening mandates for distributors are minimized. Furthermore, the impacts of participation in these various programs on distributor performance need to be taken into account.

In this respect, a clear understanding of the principles and objectives of incentive regulation needs to be attained *before* proceeding with any detailed discussions of specific issues or the design of the regulatory models. Having a clear understanding of the fundamental objectives will assist in the development of issues to address the more detailed aspects of the incentive regulatory framework for Ontario's electricity distributors.

Financial Viability of Electricity Distributors is a Minimum Condition That Must Be Met

The first principle set out in the Staff Scoping Paper at page 3 states "*The financial viability of the electricity distribution sector should continue to be balanced with the interests of consumers.*" The EDA notes that this principle appears to combine the key components of the two distinct principles listed in Section 1. (1) of the *Ontario Energy Board Act, 1998* (the Act):

1. To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.
2. To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.

The EDA believes that the proposed principle of balancing consumer interests against financial viability implies there should be a trade-off between the two principles identified in the Act. The long-term financial viability and sustainability of the electricity distribution industry is essential to achieving the goal of meeting the needs and interests of the consumer. Consequently, the EDA does not believe that a trade off between the two principles is in the best interests of the consumer or the industry.

In the view of the EDA, financial viability is a minimum condition that needs to be met in much the same way that the provision of a certain level and quality of service by distributors is viewed as a minimum standard that distributors must meet.

Incentive Considerations

An effective incentive regulation regime is fundamentally dependent on the presence of appropriate incentives in various dimensions. For example,

> If the term of the regulatory mechanism is too short, utilities will have little incentive to implement new efficiencies or to invest in innovation, lest the benefits be clawed back immediately through rebasing.
>
> If utility efficiency is judged primarily on its OM&A costs relative to other utilities, then there will be incentives to over-invest in capital and to under-spend on operation and maintenance. While short-term OM&A costs may be reduced, the long-term total costs of service might be higher than necessary.

In the view of the EDA, additional consideration needs to be given to the objectives and incentives faced by public sector enterprises. Public utilities are often assigned broader public interest mandates than private sector companies. Any evidence that is adduced from OEB incentive regulation of natural gas utilities must therefore be interpreted with the understanding that gas utilities in Ontario are privately owned, while most of the electricity distributors in Ontario are in the public sector.

Service Quality and Reliability Can Have Significant Impacts on Costs and Need to Be Properly Incorporated Within the Present Process

The EDA understands that the OEB is planning to resume work on Service Quality Regulation (SQR), and that this work will proceed in parallel with the present proceedings. The EDA believes that the timely resolution of issues related to SQR is essential to the effective evolution of incentive regulation and its implementation.

Service quality and reliability drive the costs utilities incur. This point was made on a number of occasions at the Technical Consultation for the Comparison of Distributor Costs, EB-2006-0268, September 12-13, 2007.

Thus, in the view of the EDA, the regulation of service quality and of incentive regulation for purposes of setting rates involve important linkages that make it very difficult to consider each in isolation. Consequently, the EDA believes the continuing work on service quality regulation will provide results that will need to be folded into the evolving IRM at the appropriate time.

Major Work Needs to be Completed if Benchmarking is to Play a Useful Role in 3rd Generation IRM

The OEB is presently engaged in a staged consultation process with respect to the comparison of Ontario distributor costs (EB 2006-0268). The EDA is supportive of this process and recognizes the importance of benchmarking, which involves more than the comparison of costs.

The recent report prepared by the Pacific Economics Group entitled "Benchmarking the Costs Of Ontario Power Distributors", April 25, 2007, was reviewed by various stakeholders at the Technical Consultation for the Comparison of Distributor Costs, EB-2006-0268, September 12-13, 2007. The EDA is of the view that the statistical analysis of OM&A costs has sufficient shortcomings that it is not suitable in its present form for incorporation into incentive regulation. The EDA concerns include the following:

1. The analysis focuses on OM&A costs rather than total costs. In a capital intensive industry such as electricity distribution, capital costs typically constitute the majority of total costs.

2. It is possible to usefully analyze OM&A costs as an individual component of total costs, for example using a "short-run cost function" where OM&A costs constitute the dependent variable. However, even in such cases, one needs to account for the level of capital stock and other capital-related variables as explanatory variables. Put simply, lower observed OM&A costs may be the result of higher capital costs.

3. A number of important additional variables need to be either directly modeled or at a minimum, factored into the benchmarking analysis. These include service quality and reliability, age of distribution plant, customer mix and variations in voltage levels within

a distributor. In addition, the "wage" variable used in the analysis should likely be replaced by a more direct measure.

4. There are important issues relating to the consistency of accounting and data collection across utilities that need to be addressed. The EDA recommends that the summary of "USoA/Accounting Issues for Discussion" developed by the Cost Allocation Working Group be used to provide an illustration of relevant issues that are pertinent for the development of 3rd generation IRM. The EDA and its members are willing to assist the OEB, and devote their time and resources, in addressing this important issue.

If benchmarking analysis is to form a part of the next rate-setting process, then these important shortcomings need to be addressed in timely manner.

The EDA has concerns that the present time-frame may not allow for completion of these required tasks. It is understood that OEB staff intend to issue an initial proposal by late November. At the September 13th consultation it was clear that some stakeholders are seeking to use the cost comparison results for the 3rd generation IRM as the method to address distributor diversity. Many other parties, however, have submitted that this initiative needs to be further developed prior to its use in 3rd generation IRM.

Concluding Comments

In the view of the EDA, the present process will have far-reaching and long-term implications for Ontario electricity distributors. Indeed, it would be difficult to over-estimate the importance of this process for the Ontario electricity distribution industry, its customers, and other various stakeholders. If the objective is to create a durable incentive regulation regime that will provide sufficient regulatory stability for utilities and their customers, there must be confidence that the regime can sustain itself in the coming years. That confidence can only be attained if the issues raised here and by other participants are given fulsome consideration and a proper balance is struck.

It is the belief of the EDA that a clear understanding of the principles and objectives of incentive regulation needs to be attained *before* proceeding with any detailed discussions of specific issues or the design of the regulatory models. Once the general principles have been established and clarified, at that point it would seem appropriate to consider more detailed aspects.

One of the most fundamental decisions that will then need to be made is how the regulator will deal with future capital costs. For example, will distributors be able to submit multi-year capital plans for approval to the regulator or will the regulator rely on a single test-year approach?[1] The OEB benchmarking analysis prepared by the Pacific Economics Group has focused on OM&A costs. As a preliminary observation, it would appear that benchmarking of OM&A costs (rather than total costs) would seem to be more compatible with a multi-year capital review approach. However, full consideration needs to be accorded to alternative approaches.

[1] Given that a number of distributors have suggested that major capital investments and refurbishments will be necessary in the near-term, the regulatory treatment of capital expenditures is of particular significance.

Other key choices that will need to be made include the general regulatory mechanism (e.g., price-caps vs. revenue caps), the time period over which a specific calibration of the mechanism will apply, whether and how earnings should be shared and the treatment of extraordinary events which affect costs.

Variants of incentive regulation have been implemented in a number of jurisdictions and industries to meet varying goals and with varying degrees of success. Its implementation in the Ontario electricity distribution industry requires a thorough and thoughtful approach if it is to achieve success.

Finally, there are many competing issues that need to be addressed in the development of 3rd generation IRM as noted at the recent workshop on this subject matter. In this respect the EDA recommends the development of an orderly process to prioritize the key issues such that only those that need to be considered in the formulation of the 3rd generation IRM model and that will help to address the immediate and near-term circumstances that the distributors will face at the start of 3rd generation IRM. Other issues of lower priority can be dealt with at a later date as part of the evolution of incentive regulation, as has been the experience in other jurisdictions that have advanced their incentive regulatory frameworks over a number of years. In the view of the EDA, it would be neither prudent nor efficient to attempt to address all of the issues at once.