3rd Generation IRM for Electricity Distribution Sector

Setting the Context

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Andy Poray – Hydro One Networks Inc
Paula Conboy – PowerStream Inc.

LDCs support an Incentive Rate Mechanism

- LDCs support the development and implementation of a 3rd Generation incentive regulation mechanism (IRM) for setting rates in the electricity distribution sector. A multi-year incentive regulation has the potential to:
  - 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.
- Incentive regulation has the potential to benefit all parties involved. That being so, achievement of this all-round success will require everyone's commitment.
- The establishment of an IR model needs to be premised on the fact that utilities need to recover prudently incurred costs/forecasted costs.
- Notwithstanding the above the development of IRM needs to be guided by a clear set of objectives that define the end-state goal(s) to be achieved

Need for Objectives

- Clarity of objectives will help to guide the scope of development of IRM
- Having objectives in place will help prioritize and set the timing of the issues that need to be addressed at the outset
- Having clear objectives will allow for orderly development of the IRM

Experience with IRM in Ontario

- 1st generation IRM for electricity distributors never got going
- Early (1999-2003) experiment in the natural gas sector was abandoned
- 2nd Generation IRM is simply a rate adjustment mechanism and not incentive rate making or performance based regulation
- So there is very limited experience with IRM in Ontario that can be of help in designing 3rd generation IRM for electricity distributors

Contextual landscape over the next 3 – 5 years

- Circumstances which the electricity distribution sector will face in the foreseeable future are driven by:
  - IPSP Demand-supply mix.
  - Removing barriers to and creating incentives for conservation and demand management
  - Removing barriers to and creating incentives for distributed generation
  - Smart Metering Initiative
  - Comparative utility cost analysis methodology and use thereof for regulatory purposes
  - Review and implementation of service quality regulation (SQR)
  - Specific Service Charges
  - Review of distributors' cost allocation information filings
  - Rate design changes in light of SMI, CDM and DG
  - Removing barriers to mergers & acquisitions to enhance rationalization

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

Need for Flexibility

- The cost drivers will not all impact utilities in the same way and at the same time
- Some utilities are growing, some are static and some are losing demand
- Some utilities are facing increasing needs to upgrade aging infrastructure
- We are still in a transitional stage with respect to understanding how costs link to service quality provision
- Regulatory framework should allow utilities to choose the model that best suits their circumstances

Importing models from other jurisdictions is not the answer

- Ontario Electricity Distribution Sector is characterized by a large number of heterogeneous companies with unique (to Ontario) cost pressures and operating at different levels of efficiency to meet local and provincial objectives.
- Experience from other jurisdictions suggests that regulatory models tend to reflect local requirements and so there are many variations all reflecting IRM principles
- We should not expect a single model solution as the desired outcome.

“Perfection the enemy of the good”

- IRM is a work in progress
  - We don’t expect to solve all issues in the first round
  - We need to put in place a mechanism that can evolve
  - We need to identify priority issues that we start with because these impact LDCs in the near-term
  - Allow adjustments to me made as we gain experience with IRM and avoid drastic changes to regulatory framework which introduce uncertainty
  - Cost of Service regulation is a viable alternative that utilities should have recourse to if circumstances so warrant

Summary

- Need clear set of objectives for IRM
- Need to prioritize issues that have to be addressed first to kick-start the process
- Need to recognize that flexibility in model design will help utilities to move forward more quickly than if a single model is imposed