VECC INTERROGATORY #18

INTERROGATORY

Reference: The Report, page 5, lines 9-15

Preamble: "rewards of success are likely to be borne by ratepayers"
"the costs of failures are borne by shareholders"

a) Please comment on the extent to which PBR schemes can shift the rewards for success from the ratepayer to the shareholder.

b) Who should bear the risks associated with allowing competition, as proposed in the report, in the distribution sector (e.g., the shareholders)?

c) If it is the utilities' shareholders, please explain how the regulator can ensure this occurs.

d) If it is the utilities' ratepayers, please explain how the regulator can ensure that the ratepayers also receive the benefits (particularly under a PBR scheme) and that the level of risk borne by the ratepayers is appropriate.

RESPONSE

(a) Except where rates are fully delinked from costs during the transition to a competitive market (e.g., the CRTC Price Cap Regime), PBR regimes tend to involve periodic rebasing. In addition, PBR regimes often involve an explicit mechanism for sharing benefits (or losses). Furthermore, even in traditional regulatory regimes based on a future test year, shareholders gain the short run benefit of efficiency improvements.

As a result, PBR regimes tend to alter the sharing of benefits, giving the shareholder an increased share of the mid-term "rewards of success" and "costs of failures". Generally, the longer term benefits and costs still accrue to ratepayers.

Consequently, PBR is an improvement over traditional rate-base rate-of-return ("RB-ROR) regulation in terms of the incentive to be more efficient, but it provides less effective incentives than competition.

In addition, that the introduction of PBR does not address the primary impediments to the types of innovation that are specifically associated with dynamic efficiency, such as institutional and mindset inflexibility and a bias to using assets to the limit of their physical life, regardless of the benefits of modernization.

(b) Given the limited form of competition outlined in the Report, it would be appropriate for shareholders to bear the risk of competition. The proposals protect against true stranding due to customers moving from one distributor to another. The only risk faced by an incumbent is that growth may be reduced if it is unable to attract customers in unserved and underserved locations within its traditional service area. Incumbents have the ability to offset such losses by adding customers outside their traditional service areas.

If shareholders do not enjoy the benefits of success and costs of failure in the competitive environment, the potential discipline of the competitive market would be severely blunted. Distributors would have less incentive to rationalize in whatever way necessary to be more competitive if the shareholder is protected against the consequences of not responding to competitive forces.

(c) The practical reality is that under traditional RB-ROR regulation, significant regulatory effort would be required to ensure that the benefits and risks of competition, like any other activity that affects profitability, is borne by shareholders. Under PBR, however, the benefits and costs would be shared between shareholders and ratepayers.

Furthermore, to the extent that the structure of the market responds to competitive forces, in that less efficient distributors would be absorbed by more efficient distributors or other new owners, even where ratepayers share in losses due to competition in the first instance, it can be hoped that they will benefit in the longer run from rationalization of the Ontario distribution sector, changes in management, and other efficiency improvements that result from the dynamics of competition.

(d) See the response to (c).