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VIA EMAIL AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto, ON
M4P 1E4

Dear Ms. Walli:

**Re: Board File No. EB-2006-0267:
EDA Proposal for a Revenue Stabilization Mechanism
VECC's Written Comments**

As Counsel to VECC, I am writing to provide our written comments on the Electricity Distributors Association's proposals regarding a Revenue Stabilization Mechanism for volume-related adjustments to the Electricity Distributors revenue requirement and rates.

VECC supported a Lost Revenue Adjustment Mechanism (LRAM) for third tranche CDM and in principle, supports a LRAM to hold Electricity Distributors harmless from revenue loss due to CDM activities.

However with regard to post third tranche CDM activities, particularly those that are not funded through rates, but by the OPA pursuant to the Minister's \$400 million CDM Directive, the LRAM should be addressed as an exogenous factor under second generation Incentive Regulation.

VECC notes that the practice for gas utilities in Ontario and elsewhere has been to record either the lost revenue at current rates in a deferral account, or if a volume forecast has been approved, the difference between the forecast and actual revenues (variance account). Disposition of the LRAM Account Balances is based on an independent audit and includes review of TRC net benefit for

SSM payments. This audit process usually results in approximately a 1 year lag between the end of the rate year and payment to the utility. The implementation of any such a mechanism must be based on fairness to ratepayers and EDs and also requires independent audit/verification of ED claims regarding kwh savings and net TRC benefits.

VECC is opposed to the EDA proposal for a comprehensive revenue adjustment that seeks to hold the Electricity Distributor harmless from other energy consumption risks.

VECC suggests that the EDA proposal is totally inconsistent with the Board's direction for Second Generation IRM for Electricity Distributors:

- The EDA revenue stabilization mechanism is unsuitable for a Rate Cap IRM and a review of regulatory practice indicates that it is only applied (if at all) under a Revenue Cap IRM (such as the paper notes for Terasen BC).
- Under a Rate Cap IRM, such as proposed by the Board, the rates are indexed under a CPI-X formula, but there is no separate process to approve a volume forecast for any utility and the base year volume is applied each year in order to set rates.
- Any adjustment must be based on a rate year Volume Forecast that includes a degree day forecast. The Second Generation IRM does not rely on a volume forecast and most utilities are not capable of providing a test year volume forecast.
- Even if the use of historic year volume forecasts was the basis for an adjustment for year 1 of the IRM then the second and third years have no provision for a forecast.

Detailed comments on the 5 questions posed by Board Staff are attached.

VECC appreciates the opportunity to provide comments. If there are any questions or if clarification is required regarding the comments please contact either Roger Higgin (416-348-9391), Bill Harper (416-348-0193) or myself (416-767-1666).

Yours truly,



Michael Buonaguro
Counsel for VECC

Detailed Responses of VECC to Questions posed by Board Staff on EDA Proposal for a Rate Stabilization Mechanism

Question #1: What are the implications, advantages, and disadvantages of adopting the EDA's proposed approach?

The approach recommended¹ by the EDA's consultant is that:

“the Board adopt a revenue stabilization mechanism that captures the effect of variances from volumetric forecast. This could be done on a weather normalized or non-weather normalized basis and could be done on the basis of either total sales volume or use per customer”

As a result, the EDA has not set out one particular detailed proposal for dealing with lost revenue due to CDM but rather a general approach - revenue stabilization – which could be implemented in a number of ways. However, all of the approaches are based on the premise that utilities (and customers) are to be held harmless “with respect to variances from forecast energy consumption”².

Implications:

- a) Since the concept of a revenue stabilization mechanism is to calculate variances in revenues due to differences between the forecast and actual energy consumption, the approach assumes/presumes that a load forecast was developed and used in the determination of the utility's rates.
- b) A revenue stabilization mechanism goes far beyond just addressing the revenue impacts of CDM. Indeed, given the wide range of factors (e.g., weather, changes in general economic conditions, local plant shut downs, fuel substitution, rate of customer growth) that can affect sales in future year, the impact of CDM may only contribute to a small portion of any overall variance that is calculated.
- c) Eliminating revenue variances removes a significant part of a distribution utility's business risk. Note: Dr. Cannon, in his 1998 Discussion Paper on the Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario, identified various business risks including the risks associated with revenue forecasts³. Introduction of a revenue stabilization mechanism would change the risk profile of electricity distributors in Ontario.

¹ ERA Report, page 21

² Page 20

³ Dr Cannon's 1998 Discussion Paper, pages 10-12

Advantages

- a) In rate setting processes that require a load forecast for the test year as input, adoption of a revenue stabilization mechanism tends to make the “load forecast” as less contentious issue.
- b) Provided a load forecast as been prepared and approved used in the rate setting process, a “revenue stabilization” mechanism is less onerous administratively. It does not require the utility, other stakeholders and the regulator to agree on how overall variance between forecast and actual revenue should be parsed as to between that caused by CDM versus other factors.

Disadvantages

- a) A revenue stabilization mechanism is incompatible with rate setting processes that do not require a load forecast for the test year as input.
- b) Introduction of a revenue stabilization mechanism represents a much more fundamental change in regulatory principles and practice than simply holding utilities harmless for encouraging CDM.
- c) Attempts to refine the revenue stabilization process (i.e., adjust for weather, customer count, etc.) so as to focus more closely just on the impacts of CDM will also make the stabilization process more complex. For example, while the Paper suggests that Hydro One “has a sophisticated model for weather normalizing electricity demand for both heating and cooling degree days⁴”, it is not immediately obvious that other utilities would have the necessary historic data to calibrate the model and be able to apply it to their circumstances.

Question #2: If the Board provided for a revenue stabilization mechanism for distributors, would it affect the distributors’ risk? If so, how might it impact on the distributors’ allowed ROE, and/or the design of an incentive regulation framework?

Implications for Distributors’ Risk and ROE

- As Dr. Cannon noted in his 1998 Discussion Paper: “business owners who supply capital to an enterprise generally expect to receive compensation for two kinds of risks – namely, (1) longer-run enterprise viability risks and (2) short-run, volatility-of-return-related risks⁵”. Furthermore, Dr. Cannon also observed that, in terms of short-run risks, “revenue forecasting risks have

⁴ EDA Paper, page 1

⁵ Page 7

historically dominated the cost forecasting uncertainties”⁶. Dr. Booth, in his more recent expert submission⁷ to the OEB’s proceeding on Cost of Capital for Electricity Distribution Companies made similar comments about the contribution of demand uncertainty to business risk. As a result, introduction of a revenue stabilization mechanism – particularly one that removes virtually all revenue forecasting risk – would clearly have implications for a distributor’s risk and required ROE.

- Adoption of a revenue stabilization mechanism should give rise to a reduction in the equity risk premium allowed for electricity distributors. Determination of the appropriate level of the reduction would require evidence, formal review and a finding by the OEB.

Design of an Incentive Regulatory Framework

- A revenue stabilization mechanism can be readily implemented under cost-of-service based regulation since a load forecast must be developed and approved as part of the rate setting process.
- In the case of incentive regulatory frameworks, some are more conducive to the incorporation of a revenue stabilization mechanism than others. Both of the utilities referenced in the EDA Paper⁸ (Terasen Gas BC and Gaz Métro) utilize a “revenue cap” form of incentive regulation. Under this construct, the revenue requirement is “indexed”⁹ but then a load forecast for the test year is also established in order to translate the revenue requirement increase into a rate increase. It is this load forecast that is then used to determine revenue variances.
- However, the incentive regulatory framework currently proposed by Board Staff is a “price cap” mechanism. Under this formulation, there is no requirement for utilities to develop and seek approval of a load forecast as part of their rate setting process. Indeed, this is one the attractive features of a price cap mechanism that makes it administratively easier to implement than a “revenue cap” mechanism.
- Furthermore, it is important to note that the issue can not be rectified simply by the utility preparing (and obtaining approval) for a “load forecast”. As the EDA Paper notes, the purpose of the “revenue stabilization mechanism” is “to stabilize revenues by passing through to customers the revenue deficiencies and sufficiencies that result from variances from the sales forecast used for

⁶ Page 13

⁷ Cost of Capital for Ontario’s Electricity Distributors, August 2006, page 6

⁸ Page 2

⁹ In both cases the capital-related costs (depreciation, taxes, return on rate base) are determined on a “cost of service” basis, while O&M is “indexed”

rate-setting purposes¹⁰ (emphasis added). Therefore, adoption of a revenue stabilization mechanism to address revenue losses arising due to CDM¹¹, would require that the incentive regulation framework for setting rates involve the development (and approval) of a load forecast for the test year.

Question #3: What are the implications of adopting the EDA’s proposed approach if CDM programs, associated expenditures and program results are not reviewed and tested by the Board in the context of rate recovery?

- The implications of the Board not reviewing and testing CDM programs, associated expenditures and program result are much broader and more profound than simply the issue of lost distribution revenue.
- For CDM programs to successfully contribute to meeting Ontario’s electricity demand/supply balance, it is imperative that the programs implemented offer cost-effective opportunities for electricity savings to all consumers. It is also important that the results of the programs be monitored so that the savings can be reflected as lower future electricity requirements and so that the programs themselves can be refined and revised as necessary. The first point is important, otherwise CDM will have no impact on the electricity planning process and more dollars will be committed for new transmission and generation than necessary. The second point simply recognizes the need to pursue continuous improvement of CDM programs.

It is understood that, for those CDM initiatives sponsored/funded by the OPA, monitoring and evaluation programs will be put in place to identify actual program costs and results. However, it is also understood that distribution utilities will have the opportunity to separately pursue additional C&DM programs within their service areas. There needs to be a similar assurance that these programs are cost-effective (i.e. a wise use of ratepayers’ money); that the results can be reflected in future planning and that the programs are refined based on actual observed results. The OEB is best positioned to ensure utilities CDM programs and related activities meet these requirements.

Furthermore, ensuring that the CDM programs financially supported by rate payers are appropriate and yield results, is consistent with the OEB’s objective of “protecting the interests of consumers “with respect to prices and adequacy, reliability and quality of service”. Also, if the Board does not hold the electricity distributors accountable for determining the cost effectiveness and the reporting of individual program results, it is not clear who will.

¹⁰ Page 2

¹¹ Revenue smoothing mechanisms related to weather would not necessarily require a “load forecast”. However, such mechanisms are meant to address a totally different issue.

- With respect to the specific question posed, if the Board does not itself review CDM programs, it should require an independent audit of the programs, associated costs and program results. Otherwise, in the absence of an LRAM, the utilities have no need to determine the results and it is unlikely that the results of utility specific CDM programs will be calculated at all. Lack of such information will lead to the continuation of programs with initial faulty designs and could lead to underestimating the impact of CDM in future IPSPs and overstate the need for new generation and transmission resources.

Question #4: There are two options set out on page 14 of the report. Do you think one, both, or neither are appropriate? Please provide a detailed explanation for your choice.

- The two options presented on page 14 are:
 - An LRAM with limited scope, and
 - A simplified revenue stabilization mechanism.
- Of the two options, the first is more appropriate. As discussed earlier, the problems with the second option include:
 - It is totally incompatible with the Board's current second generation incentive regulation plans,
 - It represents a fundamental change in regulatory policy and practice that goes well beyond the objective of holding distributor's harmless for CDM initiatives,
 - It would trigger the need for another review of ROE determination and required equity risk premium prior to the implementation of the second generation incentive regulation mechanism, and
 - It eliminates a key driver that utilities otherwise would have to undertake effective evaluations of their C&DM plans and program results.
- In contrast, an LRAM based on evaluations of the actual results obtained from both OPA sponsored and other CDM programs has the following advantages:
 - Can be readily implemented within the framework of the price-cap based incentive regulation mechanism currently envisioned by the OEB, and
 - Supports (and provides an "incentive" to electricity distributors) to perform follow-up audits and evaluations of CDM programs. Such audit/evaluation activities will not only support the design of better CDM programs in the future but also ensure the CDM results are "counted" for purposes of future system planning.
- The main arguments put forward in the EDA Paper¹² for a "revenue stabilization mechanism" are that:

¹² Pages 15 and 19

- It would “cast the net of the LRAM very wide” and thereby ensure that distributors get compensated for any CDM activity over which they had an influence.
- It would eliminate the need to quantify the impact that specific CDM programs would have on electricity demand and, in doing so, remove any risk that some stakeholders may seek to “game the system”.
- It is consistent with incentive regulation and leaves distributors free to exploit all CDM opportunities.
- It is less onerous than an LRAM which requires the determining the impacts of each CDM program.

C&DM is likely to be the cause of only a very small portion of the variance captured by the proposed mechanism. As result, to continue with the “net analogy” the revenue stabilization mechanism will capture more dolphins than tuna. With respect to the second point, an LRAM that is based on evaluation of actual program results does not provide opportunities for “gaming the system”.

Finally, distributors should be expected to undertake adequate due diligence regarding CDM opportunities both before and after spending money on them. As a result, utilities should not be permitted to indiscriminately pursue all CDM opportunities and have not accountability for demonstrating the results obtained from spending rate payer money.

Question #5: Are there alternative approaches to the EDA’s proposal that the Board might consider for setting a lost revenue adjustment mechanism for CDM, including CDM funded by the OPA? If so, what do you think is the most appropriate approach? Please provide a detailed explanation for your proposed approach.

- Within the price-cap incentive regulation framework currently being considered by the Board, an LRAM based on actual program results (attributable to distributors) is the only practical approach. The reasons for this conclusion can be found in the responses to the earlier questions.
- Implementation of the LRAM can be based on a deferral account treatment of volume and revenue differences directly attributable to utility CDM programs. Disposition of the LRAM account would be determined by the Board following an audit/verification.