

**Ontario Energy Board
EB-2006-0266**

Report of the Board

on the Regulatory Framework for Conservation and
Demand Management by Ontario Electricity Distributors in
2007 and Beyond

March 2, 2007

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1.0 INTRODUCTION

1.1 Context

With the passage of the *Energy Competition Act, 1998*, distributors became “wires only” companies, and were restricted from engaging in business activities other than distribution. With the passage of the *Electricity Restructuring Act, 2004*, distributors were expressly permitted to engage in certain specified business activities, including conservation and demand management (“CDM”). Under that same *Act*, the Ontario Power Authority (“OPA”) was created and empowered to enter into contracts to provide, among others, CDM services.

After a three-year moratorium on electricity distribution rate changes under Bill 210, on May 31, 2004, the Minister of Energy granted approval to all distributors in Ontario to apply to the Board for an increase in their 2005 rates by way of the third instalment of their incremental market adjusted revenue requirement (“MARR”). This approval was conditional upon a commitment to reinvest in CDM an equivalent of that amount. Consequently, in 2005 distributors brought forward, and the Board approved, \$163 million in CDM funding for distributors, an amount related to the third tranche of their MARR.

The Board subsequently provided processes for distributors to apply for additional funding as part of the 2006 and 2007 distribution rate adjustment processes.

On July 13, 2006, the Minister of Energy issued a directive to the OPA instructing it to organize the delivery and funding of CDM programs through Ontario distributors (the “Directive”). The Directive established a three year fund of up to \$400 million (the “Distributor CDM Fund”), to be administered by the OPA. While the Directive was one of eight directives on CDM issued to the OPA, it is the only directive with a focus on funding for distributors.

On January 25, 2007 a Board staff discussion paper was issued for comment. The Board received submissions from thirteen parties, and the Board’s regulatory framework for CDM activities by distributors set out in this Board Report has been informed by those submissions.

1.2 Guiding Principles

The Board has a responsibility to set electricity distribution rates that are just and reasonable.¹ It has been left to the discretion of the Board to select, amongst available approaches, the regulatory framework that is optimally suited to achieving that end, while ensuring consistency with Board’s guiding objectives as set out in section 1(1) of the *Ontario Energy Board Act, 1998*.

¹ *Ontario Energy Board Act, 1998*, section 78(2) and 78(3).
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Building upon the legislative foundation, the Board is of the view that its statutory responsibility with respect to CDM is best fulfilled, and its statutory objectives in relation to electricity CDM are best promoted, using a regulatory framework that is designed on the basis of a number of guiding principles set out below.

Parties agreed with the guiding principles set out in the staff discussion paper, and provided some suggested enhancements to these principles. The Board has considered parties' comments, and, where it was appropriate, revised the guiding principles accordingly.

In designing a regulatory framework for CDM activities by distributors, the Board is guided by the following principles:

- 1. Implementation of government policy should be facilitated.** Government policy includes: giving the OPA responsibility for organizing delivery and funding of CDM activities; optimizing CDM as a tool for resource planning; and, identifying and developing innovative strategies to accelerate the implementation of conservation, energy efficiency and demand management measures, including strategies to encourage and facilitate competitive market-based responses.
- 2. Regulatory certainty and predictability should be provided.** The framework should allow distributors to plan and to make investment decisions.
- 3. Confusion in the CDM marketplace should be minimized.** The framework should ensure that the respective roles of all CDM market participants including distributors, the Independent Electricity System Operator ("IESO"), the OPA, the Board and consumers are clearly defined and understood.
- 4. Administrative efficiency should be attained to minimize the regulatory burden to distributors, and costs to ratepayers, while maintaining transparency and thoroughness in regulatory processes.** The framework should provide for processes that are as streamlined as possible to ensure that the delivery of CDM is achieved on a cost effective basis and that any unnecessary duplication of requirements on distributors by the Board and the OPA is avoided. The costs imposed on all participants should not exceed the benefits achieved.

1.3 Organization of this Report

The remainder of this Report is organized as follows: Section 2 sets out the Government's policy framework for CDM, specifically, its CDM targets and vision for the Integrated Power System Plan (IPSP). Section 3 provides an overview of the role that distributors have played in the delivery of CDM over the past few years and discusses the potential role of distributors beyond 2007. Section 4 discusses the regulatory treatment of distributor CDM activities. Section 5 addresses the integration of the

framework with future rate adjustment processes, and concludes by highlighting certain issues related to the delivery of CDM programs by distributors.

2.0 THE POLICY FRAMEWORK

2.1 Culture of Conservation & CDM Targets

The Government of Ontario has committed to building a “culture of conservation” and has undertaken a coordinated effort involving different levels of government, distributors, the Board, the IESO, the private and not-for-profit sectors, and electricity consumers. The Government has also set targets for total peak demand reduction from CDM activities, and has issued eight directives to the OPA regarding specific initiatives to assist with achieving those targets. On June 13, 2006, the Minister issued to the OPA the “Supply Mix Directive”, which establishes a load reduction target of 6,300 MW by 2025 with the following interim peak demand reduction targets from CDM initiatives:

- 1,350 MW by 2007, and
- 1,350 MW by 2010, and
- 3,600 MW by 2025.

It is expected that CDM initiatives undertaken by all market participants (including distributors), as well as changes to codes, standards and regulations, will contribute towards achievement of these objectives.

2.2 Integrated Power System Plan

CDM initiatives will form part of the OPA’s IPSP. Under the *Electricity Act, 1998*, the OPA is responsible for developing both an IPSP and adequate procurement processes for managing electricity supply, capacity and demand, in accordance with the IPSP. In developing the IPSP, the OPA is also required to identify and develop innovative strategies to accelerate the implementation of conservation, energy efficiency and demand management measures. The IPSP must meet the conservation, generation and transmission goals set out in the Supply Mix Directive in an economically prudent and cost effective manner.²

Until such time as the first IPSP is approved, the OPA will continue to operate under government directives issued to the OPA to enable any funding required for CDM.

Once approved, the IPSP will act as the OPA’s roadmap for, among other things, CDM initiatives, and it is expected that CDM programs that may be delivered by distributors would be consistent with the OPA’s direction, as articulated in the IPSP.

² See the December 27, 2006 “Report of the Board on the Review of, and Filing Guidelines Applicable to, the Ontario Power Authority’s Integrated Power System Plan and Procurement Processes”, available on the Board’s website at www.oeb.gov.on.ca
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3.0 THE ROLE OF THE DISTRIBUTOR

3.1 2005 to 2007

In 2004 the Government permitted distributors to apply to the Board for an increase in their 2005 rates as part of the third instalment of their MARR. As a result, distributors prepared, and submitted CDM plans to the Board.

Distributors delivering CDM programs currently funded through distribution rates are responsible for the full life-cycle management (i.e. planning, design, delivery, evaluation and reporting) of CDM programs implemented in their service areas. Distributors must obtain Board approval of CDM plans and budgets and provide regular reports to the Board on the progress of the CDM programs.

Under the current model, the Board is responsible for approving the funding of CDM programs through distribution rates, with a focus on reviewing the prudence of CDM expenditures. To that end, the Board developed processes for distributors to apply for third tranche funding through 2005 distribution rates and for additional funding through 2006 and 2007 distribution rates. Funding through 2007 distribution rates is discussed in more detail in section 4.1.1 of this Report.

The current model includes review and approval of spending levels and proposed programs within distributors' CDM plans, reporting requirements, and evaluation. In order to assist distributors with performing a cost-benefit analysis of programs, the Board developed a Total Resource Cost ("TRC") Guide, which was released in September 2005.

With regard to reporting, approval of third tranche funding was conditional upon distributors submitting quarterly and annual reports. For 2006 incremental funding, only annual reports are required.

3.2 2007 to 2010

Once the Distributor CDM Fund is up and running, it is expected that funding for, and delivery of, the majority of distributor CDM activities will be coordinated by the OPA. The Directive sets out the respective roles and responsibilities of the OPA and distributors. According to the Directive, responsibility for the design of standard programs will lie with the OPA. These standard programs may include consumer awareness and education programs, market capacity building, and market transformation programs. Distributors may also design custom programs and apply to the OPA for funding of these programs.

Pursuant to the Directive, the OPA will be responsible for ensuring that all areas of the province have access to an appropriate set of CDM programs. This means that where a distributor has not entered into a contract with the OPA or where the OPA sees a need to deliver one or more specific CDM programs not being implemented by the

distributor, the OPA may either directly, or through a third party, deliver the CDM programs to consumers in the distributor's service area.

The Directive also states that the OPA will be responsible for implementing an accountability framework and for reviewing the activity and results achieved by distributors against that framework.

Under the model laid out in the Directive, distributors will contract with the OPA for delivery of CDM programs. Distributors will be important delivery agents of OPA-funded CDM programs.

As set out in section 4.1.1 of this Report, distributors would also be able to apply to the Board for funding through distribution rates for certain CDM programs.

3.3 2010 and Beyond

The July 13, 2006 Directive is silent on the role of distributors in, and the source of funding for, CDM beyond 2010. As evidenced by the Government's long term conservation targets set out in the Supply Mix Directive, the Board assumes that the Government intends that CDM resources will be necessary beyond 2010.

The development of specific distributor CDM funding indicates that the Government considers distributors to be important delivery agents in the near-term (2007-2010), and that funding through the commodity cost, as part of the Global Adjustment Mechanism is the appropriate funding vehicle. The Distributor CDM Fund is, however, an interim measure to provide funding to distributors for CDM activities, until the implementation of the IPSP and associated procurement processes. It is expected that the OPA will, in the IPSP, identify the costs and funding needs associated with its planned conservation and supply resources.

In addition, as the conservation culture develops and market signals become clearer, a competitive energy services market may drive conservation without additional funding through distribution rates or from the OPA.

The framework outlined in this Report is not limited to addressing distributor use of OPA funding associated with the Distributor CDM Fund; it also addresses the regulatory treatment of funding for distributors from other OPA CDM procurement processes, and from distribution rates.

4.0 THE REGULATORY FRAMEWORK

The Board assumes that once the Distributor CDM Fund is up and running, there will be two streams of funding available to distributors for the delivery of CDM programs: funding from the OPA, and funding through distribution rates. The ratemaking implications of each funding stream are different. In developing this regulatory framework, the Board has been guided by its December 10, 2004 decision in the

conservation and demand management proceeding (RP-2003-0203) and the Report of the Board on the 2006 Electricity Distribution Rate (“EDR”) Handbook, which together set out the current treatment of CDM activities funded through distribution rates.

This section begins with an overview of the sources of funding available to distributors for CDM, and then moves to a discussion of the regulatory framework as it applies to each funding stream.

4.1 Program Planning

4.1.1 CDM Funding

OPA Funding

The OPA has a number of mechanisms available to it for funding CDM activities, including: the recently announced Distributor CDM Fund; the Conservation Fund; the Technology Development Fund; and OPA procurement processes needed to implement the IPSP and any other Ministerial Directives.

OEB Funding

Upon implementation by the OPA of the Distributor CDM Fund, most CDM funding for distributors will be provided by the OPA, either through the Fund or other OPA procurement processes. The Board is mindful, however, that to successfully meet the Government’s CDM targets, continued funding of CDM activities through distribution rates may be necessary, and the continued availability of this funding stream is not precluded by the Directive or otherwise.

Board staff proposed that funding through distribution rates be restricted to initiatives targeted to consumers within the distributor’s licensed service area, and to initiatives that neither the OPA nor any other entity is already delivering within the distributor’s service area. Such targeted initiatives might include, for example, a load control program that is triggered by conditions on the distributor’s local system, rather than solely on province-wide market conditions, or a distribution system improvement initiative to reduce line losses.

Submissions of Parties

Parties were generally supportive of a dual funding model, but requested further details as to division of responsibilities between the Board and the OPA, and the application process for distributors. Some parties suggested that the Board make it a requirement that distributors first apply for funding from the OPA before making any application to the Board. Other parties suggested that the Board should encourage distributors to apply to the OPA first, but not necessarily make it a requirement.

In its submission, the OPA reported that it would not be in a position to fund distributor designed programs by October 1, 2007, as previously reported to the Board. The OPA further advised that funding would only be available for five standard programs³. The OPA requested that the Board encourage distributors to apply to the Board for funding through distribution rates for all other programs through to the end of the 2007 rate year, which ends April 30, 2008.

Conclusions

The Board considers it important that distributors be able to continue to deliver cost effective CDM programs. The Board originally expected that funding from the OPA would become available in October 2007, and that incremental funding through distribution rates would only be required for the period from May 1, 2007 to September 30, 2007. However, as indicated by the OPA's submission in this process, this potential funding gap will be longer than expected. The Board has experience in reviewing and approving CDM program proposals, and is thus in a position to ensure funding is available for CDM programs during this interim period. **As a result, the Board has determined that it is necessary to provide an extension of incremental funding for programs originally funded through third tranche funding, until such time as OPA funding for these programs becomes available.**

New programs or existing third tranche programs that are the same as the five soon to be offered by the OPA are not eligible for distribution rate funding.

Filing requirements for the extension of incremental funding for third tranche programs are outlined in the letter issued by the Board on March 1, 2007.

The Board will continue to receive applications for funding through distribution rates for programs designed to address local reliability or system improvement situations.

As funding from the OPA becomes available for all other types of programs, the Board expects that distributors will apply to the OPA for funding. However, where funding is not available from the OPA at the time of application, distributors may apply to the Board for funding through distribution rates. The Board will coordinate with the OPA to ensure that there is no duplication of funding.

In all cases, programs funded through distribution rates must be targeted to consumers within the distributor's licensed service area.

Filing requirements for new CDM programs will be the same as those outlined in the Board's Filing Requirements for Transmission and Distribution Applications, issued November 14, 2006.

³ The OPA has advised that these five programs are: Business Incentive Program, 10/10, Residential Demand Response, Appliance Retirement, and Small Commercial Direct Install.
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The Board believes that this funding framework recognizes the OPA's primary responsibility for funding CDM programs in the province, and encourages participation in the OPA's CDM processes, while providing CDM funding continuity and preventing the cross-subsidization of one distributor's ratepayers by the ratepayers of another.

4.1.2 Revenue Protection

Background

Unforecasted CDM results can have the effect of eroding distributor revenues due to lower than forecast throughput. Distributors recover fixed distribution costs through both a fixed and a variable rate, which is set based on a forecast of consumption. If actual consumption is less than the forecasted amount used for rate-setting purposes, the distributor earns less revenue than it otherwise would have, all things being equal. Since the intention and effect of CDM activities is to reduce capacity and energy use, it also has the effect of reducing throughput and associated distributor revenues, which can result in a disincentive for distributors to deliver CDM programs.

A mechanism to compensate for distributor-induced lost revenues is intended to remove the disincentive for a distributor to implement CDM programs.

In its December 10, 2004 decision in proceeding RP-2004-0203, the Board concluded that a lost revenue adjustment mechanism ("LRAM") was appropriate for electricity distributors, and that it should apply to CDM expenditures relating to the third instalment of distributors' MARR. The Board provided such a mechanism as part the 2006 EDR process. This LRAM is also available for approved CDM activities funded in 2006 and 2007 through distribution rates.

LRAM is a retrospective adjustment, which is designed to recover revenues lost from CDM activities in a prior year. It is designed to compensate a distributor only for unforecasted lost revenues associated with CDM activities undertaken by the distributor within its licensed service area.

On November 2, 2006 the Board issued a letter inviting stakeholder comment on a proposal from the Electricity Distributors Association ("EDA") regarding a revenue stabilization mechanism for distributors. The proposal is outlined in a report entitled, *Designing an Appropriate Lost Revenue Adjustment Mechanism (LRAM) for Electricity CDM Programs in Ontario*, developed for the EDA by Elenchus Research Associates ("EDA Proposal"). The EDA Proposal sets out a comprehensive revenue stabilization adjustment mechanism ("RSAM") that uses the variance between forecast and actual consumption as the basis for a lost revenue adjustment. Since the RSAM would eliminate the impact of all variances from forecast in electricity demand, it would not only address the impact from all CDM programs, regardless of whether implemented by the distributor, but also any other factors that might affect electricity demand (e.g. the economy, weather and customer growth).

By letter dated December 11, 2006, the Board informed parties that the EDA proposal, and the comments received, would inform the work being undertaken by Board staff in the process that has culminated with the release of this Report of the Board.

Submissions of Parties

There was general agreement by parties that alternatives to the current form of LRAM, such as the one proposed by the EDA, should be considered by the Board as part of the process to develop 3rd Generation IRM and/or during the Board's review of options for the redesign of electricity distribution rates.

One party submitted that it is not clear whether there has been any measurable revenue erosion to date, and that a review of the extent of revenue erosion should be undertaken before the current form of LRAM is adopted for future CDM activities.

Another party submitted that not all CDM activities actually reduce distributor revenues, and as such, the current form of LRAM may not, in the long term, be sufficiently sophisticated to deal with all aspects of the impact of CDM on distributor revenues.

However, many parties expressed concern that the current form of LRAM does not address the impacts on distributors of CDM activities undertaken within a distributors' licensed service area by third parties. Some parties submitted that relying on prospective forecasting was insufficient protection for distributors, since distributors may not be able to accurately forecast the impacts of third party CDM efforts and since for some distributors, rebasing may not occur until 2010.

One party suggested that a straight forward and efficient method to address the issue of revenue erosion due to unforecasted CDM activities was to move to a fixed distribution charge.

Another party suggested that if ratepayers are responsible for paying for revenue protection through adjustments to distribution rates, then ratepayers should also share in the net income realized by distributors from the delivery of CDM programs.

Conclusions

LRAM was created to remove a disincentive for distributors to deliver conservation programs. This revenue protection mechanism was not originally developed to reduce the risk of energy consumption fluctuations generally on distributors.

The Board has determined that the current form of LRAM will be available to distributors to address revenue erosion resulting from distributor CDM activities, regardless of whether the programs are funded by the OPA or through distribution rates. The LRAM will apply to programs implemented by the distributor, within its licensed service area, including programs delivered by the distributor itself

and/or programs delivered for the distributor by a third party (via contract with the distributor, where the distributor has contracted with the OPA but has outsourced CDM program delivery to a third party).

While the Board notes parties' concerns about the potential for revenue erosion due to CDM activities undertaken by third parties, the Board is of the view that it is premature to implement an alternative to the current form of LRAM at this time. The Board has seen no evidence to date that distributors are experiencing any undue hardship due to revenue erosion. To date, the Board has received only one application for LRAM recovery. In addition, if distributors believe that the effects of third party CDM efforts have been inaccurately forecast and factored into their current distribution rates, distributors have the option of applying for early rebasing.

The Board has also determined that consideration of alternative mechanisms to address lost revenue due to changes in electricity consumption, including those resulting from all forms of conservation, should be considered as part of the process to develop 3rd Generation IRM and/or during the Board's review of options for the fundamental redesign of electricity distribution rates. These processes will provide the opportunity to explore parties' concerns about the potential revenue impacts on distributors of CDM activities undertaken by third parties.

4.1.3 Incentive Mechanisms

Background

LRAMs remove a disincentive for distributors to implement CDM, but do not provide an incentive for distributors to aggressively implement CDM programs. Given a certain level of resources, the distributor must make a trade-off between pursuing a CDM activity versus a distribution activity.

In the 2006 EDR process, a Board staff consultant, London Economics Inc. ("LEI"), advised in its report to the Board that it was unreasonable to expect distributors to pursue programs which provided no financial return for their shareholders. Furthermore, LEI noted that it is important to emphasize that any incentive needs to be in addition to the normal allowed return, otherwise it does not serve as an incentive at all.

CDM Activities Funded by the OPA

Analysis

Achievement of the Government's CDM targets will require significant effort from all market participants that deliver CDM programs to electricity consumers. By creating an OPA-administered CDM Fund solely for distributor delivered programs, the Government has signalled its desire for distributors to be part of the effort to achieve these targets. Regardless, distributors, like any other CDM delivery agent, may require financial

inducements to aggressively pursue OPA-funded CDM initiatives, given the tradeoffs involved.

The Board is therefore of the view that incentives should be used to encourage participation in the OPA's CDM procurement process in order to ensure that distributors deliver sufficient CDM programs to maximize achievement of the Government's CDM targets. Incentives should also be linked to measured and verified results, and act as a reward for achieving those results. The incentives should also be consistent with incentives earned by other parties in the market delivering CDM on behalf of the OPA and the Government.

Submission of Parties

Parties were generally supportive of staff's proposal that the Board should not provide an incentive mechanism for programs that are funded by the OPA. However, one party was not in agreement on the basis that distributors should be encouraged to aggressively pursue CDM, and that the OPA's incentive framework was not known.

Conclusions

The Board has determined that it will not provide a shareholder incentive mechanism for CDM activities funded by the OPA.

As the entity responsible for designing procurement processes, and program contracts, and for the measurement and verification of results, the Board believes that the OPA has the opportunity to design results-oriented incentive mechanisms that are most suited for the programs and individual distributors. The OPA's CDM initiatives may benefit from different incentive structures depending on the resource being obtained or the proponent offering to provide the resource. While the complete details of the OPA's incentive structure are not available, the Board understands that the OPA has proposed an incentive mechanism as part of its CDM contracts with distributors.

CDM Activities Funded Through Distribution Rates

Analysis

Two salient issues with respect to incentive mechanisms for activities funded through distribution rates are: (1) whether an incentive should be provided; and (2) whether an incentive is necessary for all types of CDM activities funded through distribution rates.

With regard to the first issue, there is an argument against the Board establishing a shareholder incentive mechanism for CDM activities funded through distribution rates before the OPA announces its own plans in regards to incentives. The OPA has not yet determined a distributor CDM incentive structure. Until that is known, there is a risk that the Board will create an incentive that has the unanticipated and inappropriate effect of making one funding source more attractive than the other. This would happen if one

shareholder incentive structure is more generous than the other. This would be avoided if distributors are prohibited from applying to the Board for funding through distribution rates for programs that are offered by OPA. The Board is of the view, however, that its framework for funding through distribution rates (as set out in section 4.1.1) is adequate to mitigate any bias against OPA-funded programs, regardless of the incentive structure, if any, designed by the OPA.

In its December 10, 2004 decision in proceeding RP-2003-0203, the Board found that a shareholder incentive was an appropriate way to encourage distributors to pursue CDM programs. The Board approved a shareholder incentive of 5% of the net savings, as established by the TRC test. This Shared Savings Mechanism (“SSM”) applies only to expenditures on the customer-side such as efficiency improvements in the use of electricity, and not to utility-side expenditures such as distribution system improvement projects. The Board concluded that the inclusion of capitalized assets into rate base provides sufficient incentives, and that an additional incentive in the form of the SSM is not necessary.

Submissions of Parties

With one exception, there was a consensus that an incentive mechanism should be provided in the short term for CDM programs funded through distribution rates, and that the current form of SSM is appropriate. The party opposing an incentive mechanism submitted that it is not clear that publicly owned distributors require an incentive to pursue CDM, and that since most funding will be provided by the OPA, an incentive mechanism for programs funded through distribution rates is not needed.

Two parties submitted that while an incentive may be appropriate in the short term, in the long term, it is not clear that distributors require incentives to undertake CDM activities, given that most distributors are publicly owned, and that CDM is a government policy. One party also suggested that distributors should not require incentives to provide quality service to ratepayers, and that CDM is simply part of that service.

Several parties also suggested that the issue of incentives be reviewed as part of the process to develop 3rd Generation IRM.

Another issue raised by parties in the context of incentives was that of the proper treatment of capital assets. Board staff proposed that the incentive mechanism available to distributors be consistent with the model currently in place, which does not apply to utility-side expenditures. Rather, these expenditures can be included in rate base. One party submitted that the return on utility side investments would not likely provide sufficient incentives to invest in CDM programs. Another party made a stronger statement, suggesting that the SSM actually provides a greater incentive than the inclusion of assets in rate base.

One party noted that it may be premature to redesign the SSM, without further experience with applying the current mechanism, and without reviewing the effectiveness of incentive mechanisms used by the OPA.

Conclusions

The Board sees no change in circumstances that would suggest that distributors no longer need a shareholder incentive to encourage them to participate in CDM in the short term. **The Board has determined that an incentive mechanism for CDM activities funded through distribution rates will continue to be available to distributors, and that this mechanism will be consistent with the model currently in place.**

The Board agrees with parties that it would be beneficial to undertake a review of the need for, and structure of, incentive mechanisms, and the appropriate treatment of capital assets. As noted by one party, it is premature to implement a new mechanism without further experience with the current mechanism. **To that end, the Board is of the view that a review of incentive mechanisms should be considered as part of the Board's process to develop 3rd Generation IRM and/or during the Board's review of options for the fundamental redesign of electricity distribution rates.**

4.2 Program Delivery

4.2.1 Cost Allocation

Background

The Board anticipates that going forward, distributors may concurrently undertake CDM activities funded through distribution rates, and CDM activities funded by the OPA. Consequently, distributors may incur some costs that are common to the delivery of CDM programs, either recovered from distribution rates or funded by the OPA. Since the treatment of these costs may have ratemaking implications, the Board needs to determine whether they should be allocated on a marginal or a fully allocated basis.

A fully allocated costing methodology results in the allocation of direct costs and a proportional share of indirect costs. This methodology would, for example, include a proportional allocation of an employee's benefits for time and efforts spent in relation to CDM activities funded by the OPA. In order to avoid double-counting (since all existing direct and indirect costs are included in distribution rates), the direct costs and the proportional share of the indirect costs attributable to OPA-funded CDM activities should then be removed from the distributor's distribution rates, and more appropriately recovered through the distributor's OPA-funded CDM activities.

A marginal costing methodology results in an allocation of variable costs only, and excludes any indirect costs such as fixed or overhead costs. Marginal costs in this case are defined as the costs that would no longer be incurred in the absence of OPA-funded

CDM activities. Under this approach, no existing costs would need to be removed from the distributor's distribution revenue requirement.

Analysis

Adopting a marginal costing approach may be desirable if it effectively facilitates broader reach of the OPA's CDM funding, which would help to further the Government's energy conservation goals. This incentive arises because only incremental costs incurred by the distributor are contracted for, and allocated to, the OPA-funded CDM activity; no existing costs are removed from the distributor's distribution revenue requirement, and there is, therefore, no reduction in distribution rates. Instead, distributor CDM budgets would be lower than with fully allocated costing, so the OPA CDM fund may go farther since distribution rates would contribute to funding fixed and overhead costs. Some parties might view this as cross-subsidization. Others might view it as a more efficient use of resources to get benefits or services that would otherwise be more expensive.

Marginal costing can also provide distributors with a competitive advantage over non-distributors when bidding in OPA CDM procurement processes. Since a portion of the distributor's costs would be paid for by the distributor's distribution ratepayers, the distributor may be able to underbid a non-distributor, which must recover its full costs under the contract. If non-distributors were unable to compete on a level playing field, they may opt not to participate in the OPA's CDM processes, thus eliminating potential CDM market players. Such a result appears contrary to the OPA's long-term strategic approach to conservation, as articulated in the Chief Energy Conservation Officer's 2006 Annual Report, which has a near-term objective of building capability among all market players.

While allowing the use of some of the existing infrastructure of a distributor to implement CDM programs may contribute to the overall benefit of CDM program delivery, there should be some recognition of the added burden that this places on the distributor. Management attention may be divided and operational risks (e.g. insufficient resources to provide effective distribution and related customer care services) may be increased as a result of these activities.

Adopting a fully allocated costing approach would result in the removal from distribution rates of the full costs incurred by a distributor in delivering an OPA-funded CDM program. This removal of costs means that the distributor's ratepayers receive a benefit, through lower distribution rates, as a result of the economies of scale resulting from shared resources. There is no cross subsidization between the OPA-funded CDM activities, and those activities funded through distribution rates. The benefit also recognizes the potential additional costs of a distributor pursuing these activities, such as the divided management attention and increased operating risks.

Fully allocated costing may also be appropriate from a resource planning perspective since CDM can be viewed as an alternative and compared to electricity supply and

system expansion or enhancement. The OPA is required to consider all of these resources in developing the IPSP. A fully allocated costing method would allow for a more meaningful comparison of resource options, given that there would be greater transparency and the full cost would be allocated to the CDM activity.

Fully allocated costing also overcomes the potential negative impacts on competition resulting from marginal costing. The inclusion in a bid of the full costs of delivering CDM programs means that non-distributors can compete on a level playing field with distributors. The OPA expressed a preference for a level playing field in its December 20, 2005 submission to the Board's generic CDM issues proceeding (RP-2002-0020 / EB-2005-0523), in which the OPA commented on evidence from Newmarket Hydro which suggested that a distributor's administrative costs related to the implementation of OPA programs and services should be recognized and recoverable through the Board's ratemaking process. In its submission, the OPA stated:

When bidding in OPA procurement processes, non-LDCs [local electricity distributors] will have to incorporate the recovery of any administrative costs in their bid and it is unclear why the LDCs should not be on the same level playing field.

The Board also notes that a fully allocated costing approach is consistent with the Board's current position for ancillary and non-utility activities undertaken by natural gas utilities.

Submissions of Parties

There was general agreement among most parties with staff's proposal for fully allocated costing. However, two consumer groups submitted that marginal costing is the appropriate method, since businesses in the marketplace evaluate opportunities on a marginal cost basis. One party suggested that distributors should only use fully allocated costing for programs delivered outside of the distributor's licensed service area, but that most distributors would likely concentrate on the delivery of programs within their licensed service area. The other party suggested that marginal costing was also more appropriate for CDM programs because the OPA should use marginal costing for the purposes of comparing CDM and supply side options for the IPSP, and because a distributor's distribution rates will not rise as long as the distributor recovers the marginal costs of its CDM programs.

Among the parties that supported fully allocated costing, the comments provided focused on the need for more clarity as to how distributors should implement fully allocated costing, and on the treatment of assets.

Conclusions

The Board has determined that distributors must use a fully allocated costing methodology for all distributor-delivered CDM activities. Capitalized assets

associated with distribution rate funded CDM activities will be included in rate base, and will be treated in the same manner as distribution assets. Assets purchased with funds from the OPA will not be eligible for inclusion in rate base, nor any ongoing operating costs associated with the asset. Distributors should include the full cost of assets, including ongoing operating costs, in the OPA program budget.

The Board notes the comments made in support of marginal costing, but is of the opinion that the basic ratemaking principle of preventing cross subsidization must be upheld, and that fully allocated costing is the most appropriate method to achieve this.

Where the funding is coming from the OPA, the separation in costs will appropriately establish distribution rates. Where the funding would be from the distributor's rates, fully allocated costing will ensure that the CDM programs are cost effective. Consistent with the separation of costs, the Board has also determined that any penalties imposed on distributors by the OPA would not be eligible for recovery through distribution rates.

In order to assist distributors with the implementation of fully allocated costing, the Board has provided guidelines which are attached as Appendix A to this Report.

4.2.2 Revenue Allocation

Background

Under contracts with the OPA, distributors may receive funds related to program budgets, incentives, and other revenues. The regulatory treatment of these revenues, specifically whether they are retained by shareholders or applied to the distribution revenue requirement, may influence shareholder decisions about participation in the OPA's CDM processes. In addition, revenues are also generated by incentives from distribution rate-funded CDM activities and these revenues need to have defined regulatory treatment.

Analysis

While factoring revenues earned from OPA CDM contracts into distribution rates may benefit a distributor's ratepayers by potentially lowering distribution rates, it would act as a disincentive to distributor participation in the OPA's CDM processes. In addition to being contrary to the principle of facilitating Government conservation policy, it would be unfair to distributors. Their distribution rates have been set based on what is reasonably necessary to deliver electricity and manage the requisite infrastructure.

Given the Board's position that fully allocated costing of CDM activities should apply, treating revenues differently would be inconsistent with the principle of a symmetrical treatment of costs and revenues. If costs associated with OPA-funded CDM activities are separated from the distribution revenue requirement, then revenues should be as well.

Allowing the shareholder to retain all revenues earned through OPA-funded CDM will provide an incentive to distributor delivery of CDM programs. Maintaining separation between distribution revenues and revenues from OPA-funded CDM would mean that distributors would not be subject to a reduction in distribution rates due to revenues earned from the OPA.

In addition, the concept of a shareholder incentive for delivery of distribution rate-funded CDM activities would be negated if those funds were used to reduce the revenue requirements of a distributor.

Submissions of Parties

There was general support for staff's proposal of requiring the separation of revenues earned from OPA CDM contracts from the distributor's distribution revenue. Parties noted that this treatment was appropriate in the context of fully allocated costing.

However, one party disagreed with staff's proposal, on the basis that where CDM activities are undertaken within a regulated utility, there is a change in the risk profile and profit signals within the utility. As a result, this party suggests that distributors may pursue CDM profits at the expense of fulfilling their obligations as licensed electricity distributors.

In addition, one party submitted that while revenues should be kept separate, distributor shareholders should not retain one hundred percent of the net income earned from OPA CDM contracts since ratepayers are responsible for compensating distributors for lost revenue through LRAM, and since the sharing of profits reduces the need for stringent oversight of fully allocated costing.

Conclusions

Consistent with the Board's position on the treatment of costs associated with OPA-funded CDM activities, the Board has determined that revenues earned from OPA CDM contracts be kept separate from the distributor's distribution revenue requirement. The Board believes that this will best facilitate implementation of Government policy and provide distributors with regulatory certainty and predictability.

Any net revenues generated by a shareholder incentive for distribution rate-funded CDM will be separate from (i.e. over and above) the distributor's distribution revenue requirement.

The Board is not convinced that the sharing of revenues is required to protect ratepayers. The Board notes the concerns about the proper implementation by distributors of fully allocated costing, and has, as noted above, provided guidelines to address this matter.

Further, the Board is of the view that its Service Quality Regulation (“SQR”) regime and compliance function can provide adequate monitoring and where necessary, enforcement, to ensure that distributors continue to comply with their legal and regulatory obligations as licensed electricity distributors.

4.3 Program Evaluation

Background

Effective monitoring and evaluation of CDM programs is critical to ensure that activities are cost effective and provide real savings to consumers. Evaluation also provides distributors with the opportunity to identify ways in which a program can be changed or refined for greater efficiency in delivery and cost effectiveness.

The evaluation of CDM activities is important to support the Board’s review and approval of LRAM claims made by distributors. Evaluation of the energy savings of a program is needed to determine impact on a distributor’s revenues as a result of reduced throughput.

CDM Activities Funded by the OPA

Analysis

The OPA has responsibility for managing the evaluation, measurement and verification (“EM&V”) of results associated with the programs it funds. In its 2007 expenditure and revenue review application to the Board, the OPA reports that in 2007, it intends to produce a standardized process for evaluating and reporting on all CDM programs. The OPA reports that its responsibilities in EM&V will be to set protocols, undertake compliance reviews, and enforce requirements. The OPA will use a TRC test to screen CDM programs implemented in 2007, with the exception of educational programs. This TRC test will build on the Board’s current TRC model. Although the OPA also reports in its application that it has developed a set of EM&V principles to guide its development of EM&V requirements, it has not released any information about its evaluation protocols to date.

Given the ratemaking implications of program evaluations, intervenors and ratepayers need to be confident that evaluations are an accurate reflection of actual program results. The Board also needs to be satisfied that the EM&V results are appropriate for use in LRAM assessments. The practice in the gas sector is that independent audits are carried out on the results claimed by a utility. This promotes greater confidence in the results. As agreed to by parties in the Board’s natural gas demand side management generic issues proceeding (EB-2006-0021), and accepted by the Board, the role of the auditor is to provide an opinion on proposed recovery amounts; verify financial results in the evaluation; review the reasonableness of input assumptions; and recommend future evaluation work.

Submissions of Parties

Parties were generally supportive of the principle of an independent review of results for the purposes of LRAM claims. The OPA submitted that it will require an independent third party evaluation of all programs carried out under the July 13, 2006 Directive. As such, the OPA submitted that it was unclear what value an audit would provide that is not provided by an independent third party evaluation.

Conclusions

The Board has determined that distributors will be expected to provide an independent third party evaluation of program results when filing LRAM claims with the Board, and that the scope of the evaluation should be limited to confirming that the participation level in the distributor service area is accurate and that the energy savings assumptions used in the calculation of the lost revenue amount are consistent with those used by the OPA.

CDM Activities Funded Through Distribution Rates

Analysis

For CDM activities currently funded through distribution rates, distributors are responsible for evaluating program results, and for providing regular reporting to the Board of the results of these evaluations. Evaluations are also required for the purposes of LRAM and SSM claims.

Submissions of Parties

Parties were generally supportive of staff's proposal that distributors undertake program evaluations, and provide results to the Board that have been reviewed by a third party, but requested further detail as to the evaluation process. One party submitted that there should be a process for establishing energy savings assumptions for custom distributor-designed CDM programs. Another party submitted that further details are required with respect to the nature and scope of the review.

Two parties submitted that the Board and the OPA should coordinate to develop a common evaluation protocol, and a common TRC Guide.

Conclusions

The Board has determined that distributors will be expected to undertake program evaluations, and to provide results to the Board that have been reviewed by a third party. In this case, the review would include the scope identified above as well as the cost effectiveness results as determined by a TRC test analysis. Since this review is specific to the distributor's unique program, it can also include suggestions for improvements in the program.

The Board is of the view that administrative efficiency should be facilitated where possible, and that the use of common evaluation protocols would be consistent with this principle. However, the OPA's evaluation protocols are not known at this time. As a result, the Board cannot make any commitment at this time to adopting the same measures. The Board will, however, continue to explore options for coordination with the OPA to develop consistent evaluation requirements for the purposes of CDM activities funded by the OPA and through distribution rates.

With respect to establishing cost effectiveness data for distributor programs for which no data was provided by the Board (in the TRC Guide), the onus is on the distributor to substantiate their claims.

4.4 Program Reporting Requirements

Background

Reporting on the progress and success of CDM programs is critical to maintaining accountability and transparency.

CDM Activities Funded by the OPA

Analysis

The OPA has not yet issued its reporting requirements for distributors that contract with the OPA to obtain funding from the Distributor CDM Fund.

Reporting requirements should require appropriate information to be collected, without creating an administrative burden for distributors. That is, the need for and use of the information provided should justify the cost of collecting the data and preparing reports. Given the involvement of distributors, the OPA and the Board in CDM, there is a need to establish clear guidelines and requirements for reporting to reduce duplication of efforts and minimize the administrative burden for all parties.

Ideally, one set of data and reporting requirements should serve the needs of all; however, this may not be reasonable or realistic. For example: distributors will need information to assess opportunities for improvement in program administration and execution; the OPA will need information to assess overall effectiveness of programs to deliver results, including information that will demonstrate achievement of supply mix targets and help determine contract incentive awards for the distributors; and the Board will need information to support its review and approval of LRAM claims made by distributors.

Submissions of Parties

No common issues were raised by parties regarding reporting requirements for OPA funded CDM activities. There was support among distributors for staff's proposal to limit reporting requirements on OPA funded CDM programs to the information needed to assess an LRAM claim. However, one party submitted that the Board should work with the OPA to establish a set of common informational filings.

Conclusions

The Board has determined that reporting requirements for CDM programs funded by the OPA will be limited to only the information that the Board needs to assess an LRAM claim, and that the information must only be filed with the Board when such a claim is filed. The Board is not convinced that common informational filings are appropriate. Collection by the Board of information relating to OPA funded CDM programs, spending and results may cause confusion as to accountability relationships, and an expectation that the Board will review and comment on these programs. Distributors are however accountable to the OPA for the programs it funds, and the Board has no mandate to review the performance of distributors in the delivery of programs funded by the OPA.

CDM Activities Funded Through Distribution Rates

Analysis

Distributors are currently required to provide quarterly and annual reports to the Board on their CDM initiatives funded through third tranche funding. Annual reports are also required in relation to 2006 incremental funding, but not quarterly reports.

In the quarterly reports, distributors must report on the progress of any initiatives within their CDM plan. In the annual report, distributors must provide an evaluation of the effectiveness of the distributor's CDM plan, including a cost-benefit analysis. Distributors must also report on any lessons learned over the course of the year with the aim of improving the efficiency and cost effectiveness of future program delivery, and to provide information for other distributors with respect to CDM programs.

As part of their Reporting and Record-Keeping Requirements filings on deferral/variance account balances, distributors are also required to report the costs, investment expenditures, and related revenues associated with CDM.

These reporting requirements continue to provide useful information to the Board and to parties interested in the performance of distributor CDM programs.

Submissions of Parties

No common issues were raised by parties regarding reporting requirements for CDM activities funded through distribution rates. There was support among distributors for staff's proposal that reporting requirements for CDM activities funded through distribution rates be based on the current annual reporting requirements. One party submitted that in addition to the Board's review of distributors' 2005 annual reports, the Board should also undertake a review of distributors' 2006 annual reports, to determine potential opportunities for improvement.

Conclusions

For CDM programs funded through distribution rates, the Board has determined that the reporting requirements will be based on the recently modified annual reporting requirements for third tranche and other distribution rate funded programs. These reporting requirements are outlined in the Board's March 1, 2007 Requirements for Annual Reporting of Conservation and Demand Management Initiatives. These guidelines are based on the 2005 reporting requirements, but have been revised to improve the consistency and quality of reporting, following a review of some distributors' 2005 annual reports. These requirements will be used for future annual reporting as well.

5.0 OTHER MATTERS

5.1 Integration with the Multi-Year Rate Plan

In its December 20, 2006 "Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors" (EB-2006-0088/EB-2006-0089), the Board stated that CDM related costs to be recovered through distribution rates (i.e. new spending on CDM, revenues from LRAM and SSM) will be dealt with separately from the 2nd Generation IR mechanism rate adjustment.

As stated previously in this Report, the Board has determined that alternatives to the current LRAM and SSM should be considered in the Board's work to develop the 3rd Generation IRM or the Board's review of options for the fundamental redesign of electricity distribution rates.

5.2 Service Quality Regulation

Background

Service quality regulation (SQR) is intended to establish some accountability for the quality of service being provided by distributors that is being funded by ratepayers. Distributors are required to report on their performance on certain service quality indicators (SQIs), as set out in the 2006 Electricity Distribution Rate Handbook, in relation to their activities, including CDM activities, funded through distribution rates.

Distributors are expected to establish their operating performance at levels no less than the minimum standards, taking into consideration the needs and expectations of their customers.

Analysis

While the effect of the Board's approach to cost and revenue allocation is to maintain a financial separation between CDM activities funded by the OPA, and activities funded through distribution rates, it is not clear how distributors might separately track service performance for each type of activity, especially where distributors are sharing resources such as call centres between CDM activities and other activities undertaken by the distributor, and between CDM activities funded by the OPA and CDM activities funded through distribution rates.

Submissions of Parties

There was support for consideration of CDM activities within the SQR regime, but parties submitted that SQR requirements should not apply to OPA funded CDM activities, since these are outside the scope of the Board's oversight.

Conclusions

In its December 20, 2006 Report in proceeding EB-2006-0088/EB-2006-0089, the Board indicated its intention to resume an SQR review that began in September 2003, with an aim to refine its SQR regime for electricity distributors. **The Board has determined that consideration of distributors' CDM activities, both OPA funded and distribution rate funded, should form part of the Board's SQR review.**

5.3 Minimizing Customer Confusion

Background

There may be a number of parties delivering CDM programs to electricity consumers in Ontario, which may cause confusion for customers who have generally been accustomed to receiving CDM services from the distributor licensed to deliver electricity in the service area where the customer lives, and/or has an account for electricity service. Customers have a high level of trust with their local distributor and may be concerned to discover that the service they are receiving is not from their distributor but is instead being provided by an unaffiliated third party.

Submissions of Parties

Parties agreed that there is potential for confusion, given the number of market participants involved in delivering CDM programs. Parties noted that further clarity from the OPA might be helpful.

Conclusions

The Board understands that the OPA plans to use the powerWISE brand, currently used cooperatively by the Ministry of Energy and several distributors, as the “voice” of CDM in Ontario. The Board also understands that the OPA intends to develop brand standards and guidelines to ensure consistency in branding and messaging for users of the powerWISE brand, including distributors.

6.0 SUMMARY

In summary, this Report sets out the following views of the Board:

- It is necessary to provide an extension of incremental funding for programs originally funded through third tranche funding, until such time as OPA funding for these programs becomes available. As funding from the OPA becomes available, the Board expects that distributors will apply to the OPA for funding. However, the Board will continue to receive applications for funding through distribution rates for distribution system improvement programs, and any other programs not offered by the OPA at the time of application.
- The current form of LRAM will continue to be available to distributors to address revenue erosion resulting from distributor CDM activities, regardless of whether the programs are funded by the OPA or through distribution rates. Consideration of alternate mechanisms to address lost revenue due to these changes in demand, including conservation, will form part of the process to develop 3rd Generation IRM and/or the Board’s review of options for the fundamental redesign of electricity distribution rates.
- The Board will not provide a shareholder incentive mechanism for CDM activities funded by the OPA.
- The Board will continue to provide an incentive mechanism for CDM activities funded through distribution rates, and this mechanism will be consistent with the model currently in place. Consideration of alternate mechanisms will form part of the process to develop 3rd Generation IRM and/or the Board’s review of options for the fundamental redesign of electricity distribution rates.
- Distributors must use a fully allocated costing methodology for all distributor-delivered CDM activities.
- Revenues earned from OPA CDM contracts must be kept separate from the distributor’s distribution revenue requirement.
- For CDM activities funded by the OPA, distributors will be expected to provide an independent third party evaluation of program results when filing LRAM claims with the Board.
- For CDM activities funded through distribution rates, distributors will be expected to provide to an independent third party evaluation of program results.
- Reporting requirements for CDM programs funded by the OPA will be limited to the information the Board needs to assess an LRAM claim, and the information should be filed only when a claim is filed.

- The reporting requirements for CDM activities funded through distribution rates will be based on the current annual reporting requirements for third tranche and 2006 funding.
- Consideration of distributor CDM activities will form part of the Board's SQR review.

APPENDIX A:

**GUIDELINES FOR THE APPLICATION OF
FULLY ALLOCATED COSTING FOR CDM ACTIVITIES**

Guidelines for the Application of Fully-Allocated Costing for CDM Activities

1. INTRODUCTION

The Board has determined that a fully allocated costing methodology must be applied to all CDM activities. The purpose of these Guidelines is to provide information on how distributors should apply a fully allocated costing approach.

A fully allocated costing methodology results in the allocation of direct costs and a proportional share of indirect costs. This methodology would, for example, include a proportional allocation of an employee's fringe benefits for time and efforts spent in relation to CDM activities.

For CDM activities funded by the OPA, the direct costs and the proportional share of the indirect costs attributable to OPA-funded CDM activities should be removed from the distributor's distribution rates, and more appropriately recovered through the distributor's OPA-funded CDM activities. This is necessary to avoid double-counting, since all existing direct and indirect costs are included in distribution rates.

For CDM activities funded through distribution rates, a fully allocated costing approach is also required but costs will continue to be included in distribution rates. The use of fully allocated costing will ensure that programs are cost effective since the full costs incurred to undertake CDM activities are included in the cost-benefit analysis.

2. COST ALLOCATION PROCESS

Fully allocated costs are the sum of **marginal costs (direct costs)** and **allocable costs (or indirect costs)**. These costs are defined as follows:

Marginal costs - Those costs which would be eliminated or reduced if the CDM activities as a whole were no longer undertaken.

Allocable costs - Those costs which would be incurred regardless of whether or not the CDM activities were undertaken.

Marginal costs can be directly assigned to CDM activities. Allocable or indirect costs must be allocated, using a cost driver, to determine the proportional share of the indirect costs attributable to CDM activities.

2.1 Activity Analysis

In order to determine the costs associated with CDM activities, distributors should use an activity analysis process to assess the nature and extent of the functions being performed throughout the distribution company to undertake the CDM activities, and the links between these functions and the underlying costs. The link is referred to as a **cost**

driver. A **cost driver** is a measure used to allocate, to a CDM activity, the costs of any functions performed within the distribution company to undertake the CDM activity. The analysis should include the identification of all activities performed within the distribution company, whether or not these activities directly or indirectly support CDM activities. This provides a complete activity profile of the distribution company, thereby providing the basis for a complete and reasonable allocation of costs.

Distributors will need to make a determination on the appropriate level of detail used in the activity analysis. Consideration of the costs associated with a finer activity breakdown in comparison to the benefits to be gained must be made.

2.2 Costs to Include

The activity analysis should include, for the purposes of cost allocation, direct and indirect costs such as:

- All Salaries (including supervisory, weekly, hourly and part time labour costs)
- Fringe benefits
- Paid Overtime
- Employee expenses
- Billing and Collection
- Community Relations
- Administration and General expenses
- IT costs
- Office and Computer equipment

This list is not an exhaustive. There may be other costs that need to be considered.

The remainder of this document deals with the allocation of allocable or indirect costs.

2.3 Cost Drivers for Allocable Costs

To complete the activity analysis, a distributor must determine an appropriate cost driver for each activity not directly related to CDM.

Cost drivers should be:

- Representative of how costs are being incurred;
- Implemented in a cost effective manner; and
- Understandable.

Generally, the nature of the activities will need to be assessed in order to select an appropriate cost driver. As discussed below, cost drivers include headcount, time, and volume of activity.

2.3.1 Headcount as a Driver

A common cost driver used to allocate salaries and other labour related costs is headcount. This driver is based on the number of full time equivalents (FTE) needed to support CDM activities. **FTEs** are a measure of labour effort devoted to an activity. For example, if six people each devoted 25% of their time to an activity, the full time equivalent for that activity would be 1.5 FTEs. Part time positions need to be converted into full time equivalents. For example, if an employee works 3 days per week, the full time equivalent would be 0.6 FTE. The allocated FTEs provide the basis to allocate employee related costs such as fringe benefits, paid overtime, employee expenses, or employee related support activities such as Human Resources.

Activities for which a headcount driver is appropriate also include activities that generally support employees in the performance of their duties and are used equally by each employee. Examples of activities where use of a headcount driver may be appropriate for the determination of fully allocated costs are payroll, IT services, and computer and office equipment.

2.3.2 Time as a Driver

Time can also be used as a cost driver for activities such as executive and administrative functions, legal services, and financial analysis. While these functions may not be directly involved in the day-to-day activities related to CDM, the executive and administrative functions, for example, may oversee, and support, respectively, other functions within the distribution company that are directly involved in CDM activities. These functions generally lend themselves to time reporting as they are typically project specific. The use of time is considered practical and appropriate in these cases since it provides a strong link to the incurrence of costs.

In order to calculate the percentage of time to be allocated to CDM activities, the base hours per employee must be determined. The base hours subject to allocation must include only those hours which can be considered to be available for work, including overtime. This ensures that all the costs of an employee, such as vacation or training days, are equally shared across all hours worked.

2.3.3 Number or Frequency of Activity as a Driver

Some activities can be repetitive in nature and consistent over time in terms of the level of effort required to provide service. Examples of such activities might include payroll processing, customer care, and accounts payable. As such, they can be allocated based on the number of events reflecting or causing the activity to be performed and therefore, the cost to be incurred.

For example, call centre costs could be allocated based on number of calls received in relation to CDM activities, and accounts payable processing costs could be allocated based on the number of CDM invoices processed.

2.3.4 Composite Ratio as a Driver

A **composite ratio** is a cost driver which allocates the cost of an activity on the same basis as the allocation of one or more other activities. A composite ratio is normally used to allocate the cost of an activity which supports other activities.

A composite ratio could be used, for example, to allocate the costs of an administrative or general function which support the entire organization. For instance, if the cost drivers described above result in an allocation of 5% of the total OM&A expenses being allocated to CDM activities, then this ratio could be used to allocate the costs of the administrative or general function.