

# Consultation on Issues for Establishing 2006 Electricity Distribution Rates

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presentation on behalf of  
**Electricity Distributors Association**  
July 6, 2004

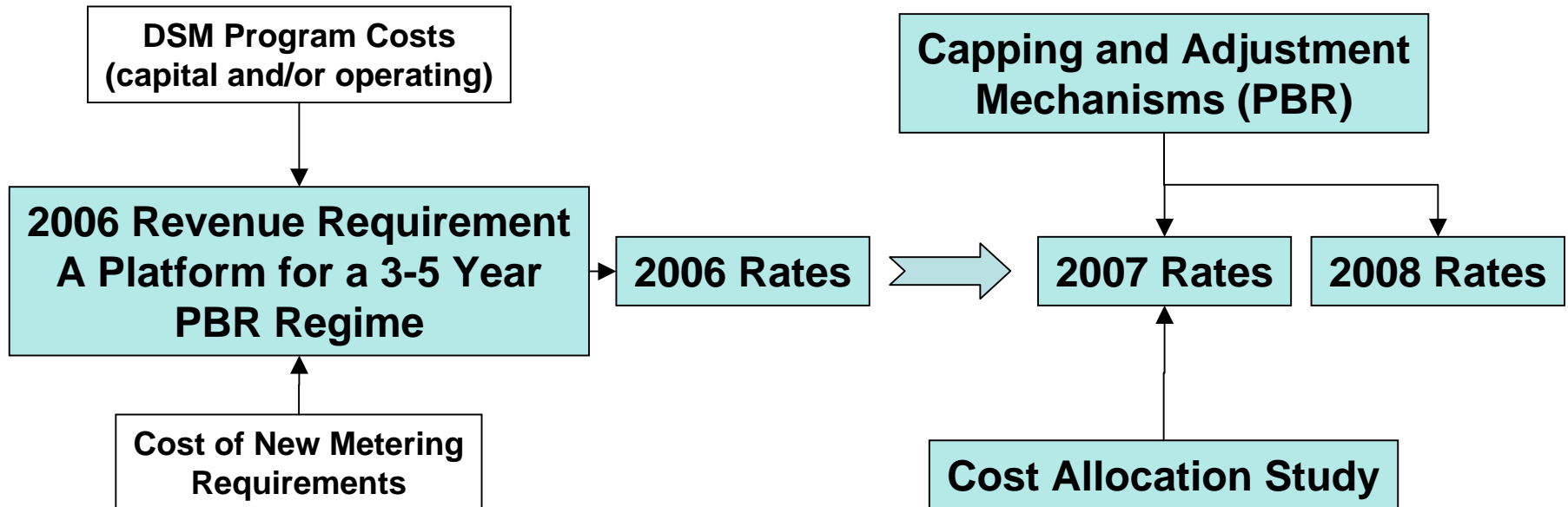
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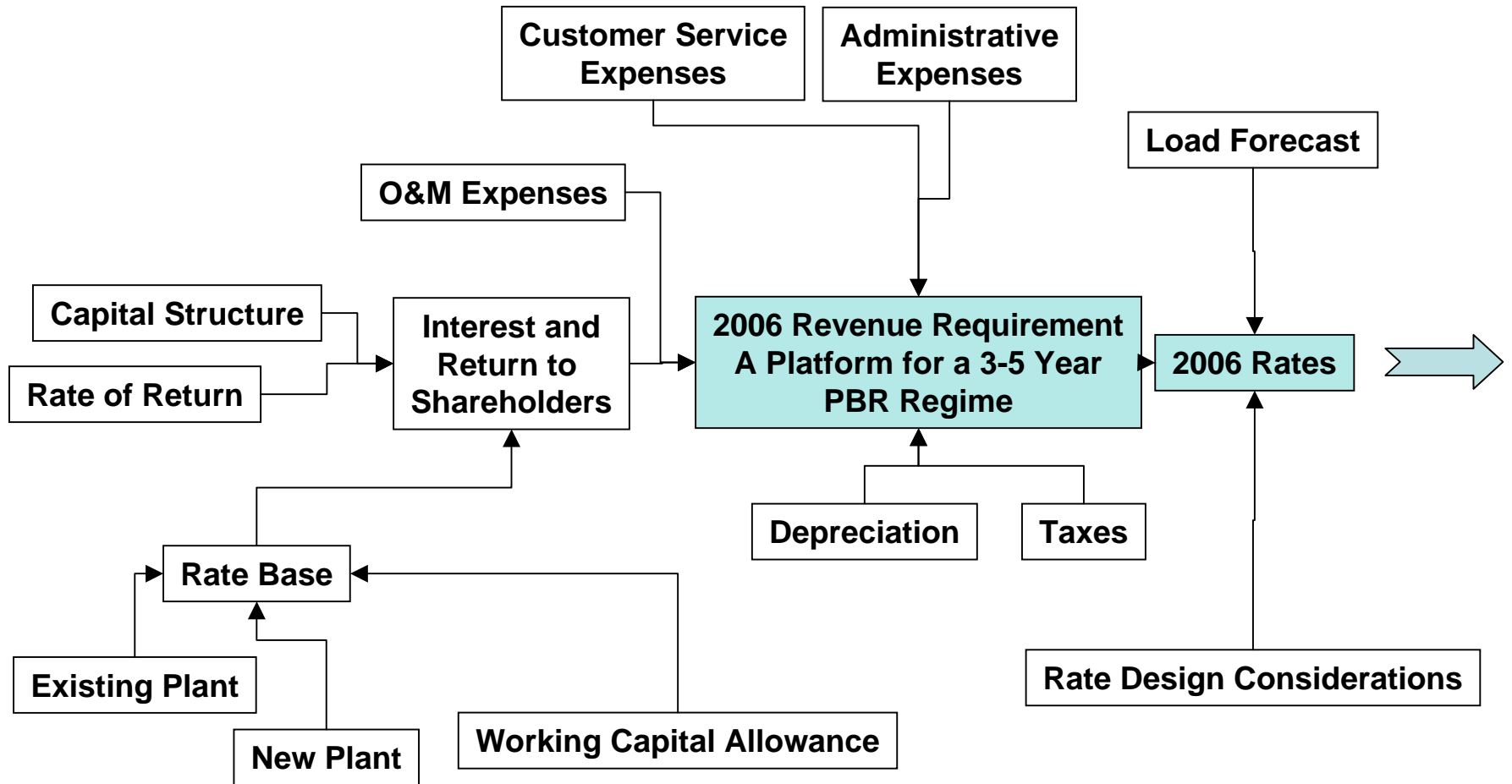
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# Understanding the Process



# Understanding the Process



# Long Term Regulatory Objectives

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- **Regulatory:**
  - Provide effective oversight at a reasonable cost
  - Reduce effects of knowledge gap
- **Efficiencies:** provide incentives to proactively find and implement
- **Service Levels:** protect customers against possibility of reductions in service levels, as utilities pursue cost reductions
- **Rates:**
  - Provide flexibility for utility to implement “efficient” rates **or**
  - Implement stakeholder-supported processes to determine rate structures and rate increases
- **Capital Spending:**
  - Encourage efficiency
  - Avoid disincentives to appropriate spending (also a risk in COS regulation)

# Objectives of the Current Process

- Establish an appropriate “going-in” revenue level for each utility
- Establish appropriate approaches to revenue requirement approvals that can be used in future re-basing
- Handle each LDC’s application promptly, fairly, and **at minimum cost** (to the OEB and to the LDC)
- Set an appropriate basis for PBR II through
  - Establishment of comparator groups and measures
  - Gathering data
  - Clarifying the PBR framework

## 2006 Revenue Requirement -- Where do we need to focus?

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- Controllable by the LDC in the short to medium term
- High dollar or percentage impact on the revenue requirement
- Not reasonable to treat as a pass-through or Z factor under PBR (i.e. to scrutinize later)
- High variability of conditions or practice among LDCs
- Easy or low cost to study (or suitable for a generic study)
- Data are useful to support yardsticking, or to address a rate design goal
- Is not “discrete” enough to be modified during PBR term if necessary

# Going-In Rates – Total Revenue

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- Why this is an issue:
  - It is not certain whether current revenue levels (or currently levels with MBRR) in fact recover costs at current levels – based on 1999 revenues; following a multi-year freeze; some utilities had implemented unsustainable rate reductions which were then “locked in”
  - No experience with rates reflecting full MBRR
  - Still many revenue requirement issues to resolve, including treatment of regulatory assets, “pent-up” capital spending requirements
  - If revenue requirement is too low, utility may be unfairly penalized; if too high, customers will not receive appropriate level of benefits from efficiencies already implemented
  - Any required change in distribution rate levels needs to be considered in light of expected changes in commodity pricing and other bill components

*EDA fully supports a re-assessment of revenue requirement of LDCs for 2006, and as a basis for second-generation PBR.*

# Going-In Rates – Total Revenue

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### Possible strategies

- Set by status quo
  - Low cost to implement, BUT
  - Imbeds any existing inequities – *EDA recommends reject this possibility*
- Set by full cost of service review
  - Provides a fully scrutinized base to which the selected adjustment mechanism can be applied
  - Provides a vehicle for addition of new plant to rate base
  - Since individually determined, is by definition “fair” to each LDC
  - Would assess impacts of move to full MBRR
  - Provides a vehicle for review of capital structures and rates of return if appropriate, BUT
  - Costly in terms of work effort by LDCs, OEB and other parties
  - EDA recommends maximize benefits of this, while minimizing time and costs*
- Simplify and expedite cost of service review by use of rules of thumb and comparators
  - Lower cost than individual review
  - Would require mechanisms to redefine peer groups if LDCs merge or are sold
  - Establishment of comparators and measures may be contentious – *but EDA suggests the effort would be worthwhile immediately and in the future*



# Capital Expenditures

- **Why this is an issue?**
  - Rates are still computed on a 1999 rate base
  - Some LDCs are experiencing rapid growth and require, or have made, major capital additions
  - While capital requirements in excess of embedded average are recovered through contributions if for expansion, mechanisms for incorporation of non-expansion capital are not well defined
  - Certain assets such as substations may have to be constructed in advance of the load, and would raise average unit cost
  - Structure of adjustment mechanisms may not provide for necessary and prudent increases in average unit costs
  - Risk of creating disincentives to appropriate investment exists in cost of service regulation as well as under PBR

# Capital Expenditures

## Possible strategies:

- Regulatory scrutiny of capital plan for entire PBR term
  - Approval provides certainty of cost recovery for the utility
  - Approval on forecast basis creates incentive to stay within projected cost level
  - Possible to incorporate standard cost, benchmark or efficiency factor into approved expenditure
- Designate a major capital project as Z-factor
  - Allows capital requirements to be dealt with as encountered – long term plan (for entire PBR term) not required
  - Keeps treatment explicitly within PBR regime
- Exclude capital from PBR formula
  - Simple
  - Effectively retains a cost of service approach for rate base
- Capital cost incentives (CCIs) – *at some point in future*
  - Provide specific incentives for construction within an efficient budget

*EDA stresses the importance of mechanisms to review and provide approvals for necessary major capital programs, and will work toward a recommendation on the specific mechanism.*

# Going-In Rates – Customer Rates

- **Why this is an issue?**
  - Issue of cross-subsidies between rate classes has not been well studied
  - Badali report has raised issues about rates structures and consistency of fixed charges
  - Recovery of costs for Government’s metering policies will be an issue (i.e. should this go into fixed charges)
  - Appropriate mix of fixed and variable charges should be addressed in order to minimize volume risks for the LDC
  - Government and OEB will be sensitive to potential consumer complaints and rate shock
  - Need to integrate policy on distribution rates with policies on other bill components (transmission, generated energy, etc.)

# Going-In Rates – Customer Rates

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## Possible strategies

- Status quo start
  - Lowest cost to implement - BUT
  - May embed existing inequities between classes of one LDC (cross-subsidization)
  - Fails to resolve inconsistencies in rates between LDCs (such as differences in level of fixed charges) – *EDA does not support this option*
- Discretion of the LDC
  - Allows individual LDC to reflect its own situation, cost profile
  - Consistent with the “revenue cap” approach taken in some jurisdictions
  - Incurrence of implementation costs (e.g. for studies) is at discretion of utility
  - *EDA sees this approach as a desirable long term goal, but recognizes that too many issues need to be resolved at this point*
- Study of specific “customer-related” costs
  - Support adjustment to resolve structural inconsistencies and towards sustainable rate design
  - Gives LDCs a start on their cost allocation studies
  - Sets stage for “secondary” constraints on class rates
  - Note that data from study may also be used to develop adjustment formula for PBR or for yardsticking
  - *EDA supports this mechanism to ensure that the monthly charges of all LDCs recover at least certain identified fixed costs*

# Specific Considerations for 2006 Revenue Requirement

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## Existing Plant in Rate Base:

- No longer controllable – minimum scrutiny unless reason to believe not “used, useful and prudently incurred”

## Proposed Plant:

- Review, establish criteria for prudence and cost
  - Include capital additions for reasons of public policy (smart meters, DSM-related capital)
- Consider approval of rate base for entire PBR term

## Working Capital

- Consider generic “lead-lag” study

## Depreciation

- Defer consideration of rates – depreciation studies complex and costly; treatment is consistent among LDCs
- Focus on significant write-ups or write downs

# Specific Considerations for 2006 Revenue Requirement

## Taxes

- Can be treated as a pass-through under PBR
- Issue of sharing of efficiencies is important

## O&M

- Considerable variability among LDCs
- If taking comparator approach, consider not only density, but
  - Configuration (overhead vs. underground)
  - Age of assets
  - Climate, geography, size and age of centre, other conditions affecting construction

## Customer Service Costs

- May be able to establish rules of thumb for billing, mailing, collection, payment processing
- Cost of services on customers' premises may be more variable
- Cost allocation studies may provide data when available
- Provides basis to move to increased fixed charge in some LDCs and improve consistency of the charge

## Administration

- Administrative arrangements vary among LDCs; cost studies may provide data when available