<u>Establishing 2006 Electricity Distribution Rates</u>
<u>Initial Issues for Generic Methodology Review</u>

<u>Note:</u> Significant changes and additions from the preliminary issues list discussed at the consultation on July 6-7, 2004 are shown in *italics*.

<u>Use of 'comparators' to assist prudence review of LDCs' costs:</u>

1. Comparators and Cohorts
   – *An LDC's application for 2006 distribution rates will be judged on its own merits, including assessment of trends in its historical investments and expense categories. However, the significant restructuring that has occurred in recent years may constrain the amount of data that can be used for such historical trend analysis.*
   – The Board is interested in using comparators to assist in the review of LDCs' individual rate applications, particularly in light of the number of applications that it will have to process. Board staff would compare various operational and financial statistics between LDCs as a means of identifying outliers and anomalies. Identified anomalies would then be followed up for further explanation. The Board wants useful comparators to be identified, to the extent possible, in advance.
   – What would be useful comparators to assist in expeditious processing of individual rate applications? For example: costs per customer, billing and collection expenses per customer, growth rates in certain capital and expense categories, etc.
   – To further aid in the use of comparators as part of the rate application review process, can the various Ontario LDCs be grouped into a smaller number of cohorts or peers (for example, based on size, operating characteristics, structure, or operational and management processes)?
   – What would stakeholders suggest be a practical segmentation of Ontario LDCs into cohorts or peer groups for reviewing 2006 rate applications?

The Board views that the following revenue requirement and selected rate design matters to be pertinent for establishing new electricity distribution rates for the 2006 rate year and hence should be covered in the updated Distribution Rate Handbook.

<u>Revenue Requirement - General Issues:</u>

2. Test Year for establishing Rate Base / Revenue Requirement
   – *Traditional Cost-of-Service uses concepts of historical, bridge and test years for setting the revenue requirement and to aid in assessing its "reasonableness" against historical trends and future expectations.*
   – *Electricity distribution rate unbundling was done on a historical test year.*

Gas distribution rate-setting typically uses a forward test year.

- Merits of historical versus future test year.
- Should one approach apply to all LDCs?
- *Specific choice for a historical test year or for the historical basis of a future test year, on the premise that the choice should be relatively recent but also representative of normal weather, load, etc.*

3. Load Forecast
   - If using a forward test year, acceptable methodologies to be used for the load forecast employed for determining the revenue requirement. *This could also take into account relevant factors occurring during the 2006 rate year, such as reduced load and revenue erosion due to DSM and conservation efforts.*

4. Test Year Adjustments
   - What types of adjustments in historical or future test year data might be allowable (for example, for one-time occurrence in the historical data that are not expected to recur, or for known and material changes, *such as those related to Demand-Side Management/conservation and metering, that are expected to persist*)?
   - What criteria (e.g., materiality, exogeneity) should be used for identifying allowable adjustments?
   - What should be provided in support of proposed adjustments?

5. Weather Normalization
   - To what extent does weather factor into distribution network costs and investments? Is there a need for weather normalization, of historical or future test year data, in the electricity distribution sector?
   - If weather normalization is appropriate, what methodology or methodologies would be suitable?
   - *Would other weather impacts, such a significant flood or ice storm, be more appropriately addressed through a one-time adjustment?*

6. (Maximum) Return on Equity for 2006 Electricity Distribution Rates
   - The current formula is based on the same approach as used in the natural gas sector, but with a separate forecast of interest rates and of the risk premium.
   - Application of current formula in light of current interest rates and economic conditions.
   - Bearing in mind the Board's recent decision on the generic ROE for Ontario gas distributors (RP-2002-0158), are there any adjustments to the electricity distribution ROE formula that warrant serious consideration?
   - What economic estimates should be used in the ROE formula (e.g., annual vs. multi-year forecasts of long-term Canadian bond interest rates)?

- *As a related sub-issue, where necessary, treatment for 1999 financial losses.*
- *Another related sub-issue is the treatment of LDCs that operate other than as for-profit OBCA corporations.*

7. Debt/Equity Structure
   - Are the current deemed D/E structure(s) still appropriate? If not, what other common approach may be more suitable?
   - Merits of using a utility's actual D/E, in lieu of a deemed D/E, for rate-setting.
   - *Regulatory treatment of LDCs whose actual D/E structure is materially different from the deemed structure. In other words, how to ensure that ratepayers do not face extra costs or financial risk.*
   - *Issue of short-term versus long-term debt in financial structuring considerations.*

8. Debt Rate / Cost of Capital
   - The current deemed Debt Rates were based on a forecast of long-term Canadian bond rates, and were adjusted based on utility size.
   - Continuation of size-related debt rate, or should the debt rate be uniform or related to other factors (e.g., borrowing capability).
   - *Separate treatment for short- versus long-term debt?*
   - Updating of Debt Rate(s) to reflect current economic conditions and interest rates.

9. Depreciation Rates
   - Depreciation rates set out in Distribution Rate Handbook were carried over from the former regulator. Is there any evidence of necessary industry-wide updates currently needed?
   - Stakeholder views on a limited review of depreciation in 2006, such as: amortization of select assets, salvage valuation, asset verification studies, or updating technical inputs (e.g., composite service life statistics).
   - Merits of true-up provision requiring differences between theoretical depreciation and booked depreciation in excess of a specific percentage to be amortized over the remaining life of the asset.
   - *Is this an appropriate time to undertake a comprehensive review of depreciation rates?*
   - *Merits of reviewing depreciation rates in the longer term through an industry-wide depreciation study.*

10. Transfer Pricing and Shared Corporate Services
    - *LDCs may acquire services from affiliated or unaffiliated firms. Transactions between the regulated utility with affiliated firms must be compliant with the Affiliate Relationships Code for Electricity Distributors and Transmitters.*

- How to review prudence of expenses paid for services outsourced to affiliates (or non-affiliates)? Similarly, review that appropriate compensation paid by affiliated firms for services provided through an LDC.
- What method(s) will be acceptable for rate purposes when allocating the cost of shared corporate services (i.e., of a parent company) to the regulated utility?

11. Low Voltage and Wheeling Costs
    - Host distributors are presently providing low voltage and wheeling services, but without recovery in rates.
    - *Treatment in 2006 revenue requirement of Low Voltage charges embedded distributors incur and will pass through to their customers.*

12. 2006 Taxes / PILs
    - A fair and practical (for both LDCs and the Board) methodology for calculating an allowance for taxes / PILs in 2006 rates.
    - Impact of any expected changes in 2006 tax rates or rules.
    - *While tax planning should be encouraged, the opportunity for significant variation between PILs recovery and payments should be minimized.*
    - Merits of using of actual versus deemed figures in regulatory tax calculations.
    - Review whether LDCs are optimizing tax deductions?
    - "True-up" of historical PILs (2005 or before) will be addressed separately.
    - Whether taxes should be inside or outside a future PBR envelope, as well as appropriate sharing of benefits of tax planning, will be addressed later.

<u>Distribution Rate Base Issues:</u>

13. Definition of Distribution Rate Base
    - The Distribution Rate Handbook lists what assets and accounts should be included in the distribution rate base, but there have been some changes to the Uniform System of Accounts over time.
    - Are there assets for which the classification should be clarified or changed (e.g., treatment of >50 kW transformer assets)?
    - For assets *that are shared between distributors (e.g., joint investments in a shared Transmission Station)*, or assets shared between distribution and non-utility functions, should specific methods be approved for apportioning the appropriate amount to the distribution rate base?
    - *Treatment of contributed capital that a distributor provides to a transmitter for transmission system expansion.*
    - *Treatment of wholesale meters purchased by distributors upon seal expiration and re-certification.*

14. Rate Base Measurement Date(s)
    - Electricity distributors have historically reported data for RRR and rate application filings for the calendar year, while the "rate year" for 2006 is presumed to be May 1, 2006 to April 30, 2007.
    - What approach should be adopted for dealing with the timing difference between the calendar (report) year and the rate year? Should this be done for the 2006 rate year?
    - What approach should be used for valuing the rate base over a 12-month period (average of monthly values, averaging of start and end dates values, end of period value)?

15. Working Capital Component of Rate Base
    - The previous working capital allowance (WCA) was based on a formula originating when Ontario Hydro regulated the industry and consisted of 15% of controllable costs plus the Cost of Power.
    - Should a common WCA formula continue to be used? How should it be updated in light of subsequent industry restructuring and rate unbundling?
    - Should some LDCs be required to conduct lead-lag studies to empirically establish their working capital requirements? Could the results of these studies be extended to other LDCs? Should any LDC requesting a WCA greater than that provided for by the new formula be required to file a lead-lag study?
    - *Merits of establishing an industry group to conduct lead-lag studies for all LDCs as a basis for a longer-term updating of the WCA.*

16. Capitalizing Expenses
    - Reasonableness of a LDC's policy regarding capitalization of expenses.
    - Consistency between utilities.
    - Merits of incremental vs. full cost approaches towards capitalizing overhead or indirect costs.

17. Capital Projects
    - How should the prudence of capital expenditures be reviewed?
    - Merits of project-by-project review versus use of trendlines.
    - *Can materiality thresholds or criteria be established for identifying projects that would be subject to more significant review? Should investments proportionate to customer and load growth be subject to less review? How should historical trendlines be established for assessing growth-related investments?*
    - What level of review is appropriate for major projects? What evidence or filing requirements would assist in expeditious review of major projects?

18. Contributed Capital
    - Distributors are presently allowed to earn a return only on pre-2000 contributed capital, and until such assets are fully depreciated.

– Post-1999, the DSC specifies criteria of when and how much contributed capital may be required.
– *Review of appropriate accounting of pre-2000 and post-1999 contributed capital.*

19. No-Cost Capital
– Beyond contributed capital, there may be limited use of “no-cost” capital in the Ontario electricity distribution sector.
– Where no-cost capital does arise, what is the appropriate regulatory rate treatment? What specific items should be included (e.g. pension assets)?

20. Rate-Setting Treatment of Capital Gains
– Should a uniform approach be followed for distributing gains from sale of utility assets between shareholders and ratepayers? Would the same approach apply to sale of shares?

<u>Operating Expense Issues:</u>

21. Distribution “Wires Only” Expenses
– The Distribution Rate Handbook lists various utility and non-utility expenses (and revenues), but there have been subsequent changes to the Uniform System of Accounts.
– Does the classification of any item need to be clarified or changed?

22. Post-Retirement Benefits and Pensions
– What pension costs are allowed into the distribution revenue requirement (e.g. treatment of a pension surplus, shortfall or contribution holiday; valuation measures to reduce volatility)?
– In light of CICA s. 3461, must an LDC adopt the accrual method of accounting for post-retirement benefits for rate-setting purposes? If an LDC changes from the cash to the accrual method, what should be regulatory treatment (e.g. amortization) of the one-time expense as a result of the change-over.
– *Regulatory review requirements of pension assets, economic assumptions used in plan calculations, and plan management, while recognizing 3rd-party review of pension plan management, where applicable.*

23. Site Restoration and Removal Costs
– For any LDCs to which this applies, what are the rate-setting impacts of compliance with the new CICA s. 3110 (effective 2004)?

24. Insurance Expense
– Determination of appropriate reserves for distributors that self-insure, or appropriate insurance expenses for distributors that use 3rd-party insurers.

25. Bad Debt Expense

- Security deposits policies (and Government legislation re: heating season cut-offs) have created clear-cut requirements and policies that LDCs must comply with. These place some limitations on LDCs' abilities to control bad debt expenses.
- *LDCs have noted that their uncollectibles are related to individual circumstances (e.g. seasonal customers, university and college populations, economic conditions). It may not appropriate to have a common bad debt allowance for all LDCs. However, is it possible to develop a common methodology for establishing the appropriate bad debt expense for an LDC given its circumstances?*
- *What support should an LDC provide in support of its bad debt expense allowance?*

26. Employee Compensation and Staffing

- Review of reasonableness of total executive compensation (base, incentive plans, and supplemental income and benefits). Review of the distribution of the costs of the incentive plans and supplemental income between shareholders and ratepayers (for example, based on who receives the benefits from achievement of corporate targets). Review of allocation of executive salaries within a corporate group.
- Merits of a uniform approach in respect of regulatory review of bonuses (such as dividing costs 50/50 between shareholders and ratepayers) versus a case-by-case review of the terms of each incentive plan.
- Review of reasonableness of non-management labour costs.

27. IT Costs

- Review of prudence of IT costs, including treatment of IT outsourcing costs and of IT project cost overruns.
- *Consideration of RMR-related system costs in historical, and of system changes due to bill format, Regulated Price Plan and metering initiatives that may affect costs in 2006 (and possibly in 2005).*

28. Advertising, Entertainment, Charitable/Political Contributions, Employee Dues, Research & Development

- What is an appropriate regulatory treatment of expenditures that may benefit the ratepayers only partially?
- What thresholds should be used for assessing degree of review of an LDC's expenditures on any of these items?

2006 Rate Design Matters:

Board staff have proposed that certain rate design issues, discussed below, be addressed as part of setting 2006 distribution rates. Hence, these issues would be examined as part of the fall 2004 generic process.

It is proposed that other rate design issues be addressed after the updated cost allocation results become available, as part of the process for establishing 2007 distribution rates.

While it is recognized that the treatment of Demand-Side Management and conservation initiatives will impact on the setting of 2006 distribution rates, it may be that the treatment is better dealt with outside of this generic process. The same approach is also expected with respect to any new treatment of the distribution loss factor as it relates to energy conservation and efficiency.

Rate treatment of smart metering initiatives for large consumers may be addressed in the generic process. The need for and design of Time-of-Use distribution rates and their effectiveness in encouraging load shifting are also of interest to the Board. Policy considerations and longer-term implementation of smart metering beyond 2006, will be addressed through another forum.

To the extent that there are material impacts arising from DSM / conservation and metering initiatives that will affect the setting the 2006 distribution revenue requirement and rates, these will be factored into the Distribution Rate Handbook, and may be considered in the generic process. However, it is not possible to guarantee the timing and sequencing of these initiatives at this time, although the Board is cognizant of the overlaps and will try to ensure appropriate sequencing.

The future commodity pricing mechanism under development may have an impact upon 2006 rates (e.g. through the WCA), and it is expected this will be addressed by the time that applications will be filed in mid-2005.

29. Specific Service Charges
    - Specific Service Charges and associated costs are to be considered as part of establishing the 2006 revenue requirement.
    - Will also address variability in types and charges for Specific Service Charges across all distributors, with an aim of increased consistency in definition and application. For example, should there be a single charge for each such service across Ontario?

30. Unmetered Scattered Load
    - Definition and rate treatment of Unmetered Scattered Load (cable TV, payphones, advertising, etc.). Is a three-tiered (account charge, per connection charge, estimated consumption) structure appropriate?
    - Is it practical to establish new unmetered scattered load structure based on currently available cost data?

31. Time-of-Use Rates

- Even prior to completing new cost allocation studies, the merits of integrating the former TOU distribution rate classes that appear in the tariff schedules of various LDCs into more appropriate rate classes.
- Design of Time-of-Use distribution rates for large consumers to encourage load-shifting.

32. Fixed/Variable
    - In advance of new cost allocation studies, it may be desirable to start addressing some of the variability in the fixed (Monthly Service Charge or "MSC") and variable (demand/energy-related) tariffs across the province.
    - Should there be partial movement towards more uniform monthly service (fixed) charges for each rate class across Ontario in 2006?
    - *Approaches that could be used to help to reduce the variability in distribution rates across the province (e.g. more uniformity through ratio analysis - [Residential MSC]:[GS < 50 kW MSC]).*
    - *How to ensure that rate movements will not be in opposite direction to what the updated cost allocation studies will show for 2007.*

33. 2006 Rate Mitigation
    - Rate mitigation may be used, as it has been historically, to reduce significant rate impacts. Should a common rate mitigation test or methodology be adopted? What test(s) or methodology for mitigating rate impacts are appropriate?

34. *Rate Harmonization*
    - *Section 5.6 of the DRH allows for a ±5% impact per annum related to rate harmonization (for service areas of merged or acquired LDC service areas, where appropriate). What, if any, update is needed to this approach?*

35. *SSS Administration Charge*
    - *Review of the SSS Administration Charge, currently $0.25 per month.*

36. *Cost Allocation*
    - *Even in the absence of the updated load data and cost allocation study, some methodology would need to be used for allocating the 2006 revenue requirement between the defined rate classes.*
    - *This could be based on the approach used for allocating the RUD and RAM revenue requirements amongst classes. Some improvements or variations on this approach could also be entertained.*