

## **Establishing 2006 Electricity Distribution Rates** **Potential Issues for Generic Methodology Review**

### **Use of 'comparators' to assist prudence review of LDCs' costs:**

1. Comparators and Cohorts
  - The Board is interested in using comparators to assist in the review of LDCs' individual rate applications. 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?

Stakeholders are invited to suggest additions, deletions or changes to the following list at the pre-consultations. Additional issues will be added to the appropriate category (General Revenue Requirement, Rate Base, Operating Expense, or Rate Design).

### **Revenue Requirement - General Issues:**

2. Test Year for establishing Rate Base / Revenue Requirement
  - Merits of historical versus forward/future test year (or combination thereof).
  - Should one approach apply to all LDCs?
  - Preferred choice for a specific past test year.
3. Load Forecast
  - If using a forward test year, acceptable methodologies to be used for the load forecast employed for determining the revenue requirement.
4. Test Year Adjustments
  - What types of adjustments in historical or future test year data might be allowable (for example, for anomalies or for known and measurable changes that are expected to persist)? What should be provided in support of proposed adjustments?

5. Weather Normalization
  - Is there a need for weather normalization, of future test year data, in the electricity sector?
  - If yes, then what methodology or methodologies would be appropriate for weather normalization in Ontario?
  - Should the allowed ROE be reduced if utilities no longer face weather-related risks?
  
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 multi-year forecast of interest rates.
  - Results of application of current formula in light of current interest rates.
  - 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)?
  
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 actual utility-specific D/E, in lieu of a deemed D/E, when setting rates.
  
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.
  - Update of Debt Rate(s) to reflect current economic conditions and interest rates.
  - Debt Rate(s) to be uniform, size-related, based on ability to borrow, or other?
  
9. Depreciation Rates
  - Depreciation rates set out in Distribution Rates Handbook were carried over from the former regulator.
  - Appropriate time to undertake a full-scale review of depreciation rates?
  - 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.

10. Transfer Pricing and Shared Corporate Services
  - What method(s) will be acceptable for rate purposes when allocating the cost of shared corporate services to the regulated utility?
  - How to review prudence of expenses paid for services outsourced to affiliates (or non-affiliates)?
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 methodology for calculating an allowance for taxes / PILs in 2006 rates.
  - Merits of the use of actual versus deemed figures in regulatory tax calculation.
  - How to confirm whether LDCs are maximizing tax deductions?
  - Impact of any expected changes in 2006 tax rates or rules.
  - Relevance of discussions in other Canadian jurisdictions on approaches to tax calculation (e.g. use of "flow through" method).
  - "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.

**Distribution Rate Base Issues:**

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, or assets shared between distribution and non-utility functions, should specific methods be approved for apportioning the appropriate amount to the distribution rate base?

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?
  - What approach should be take towards 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 by the new formula be required to file a lead-lag study?
16. Capitalizing Expenses
  - Reasonableness of a LDC’s policy regarding capitalization of expenses.
  - Consistency between utilities.
  - Significance of accounting debates over the 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.
  - What level of review is appropriate for major projects? Are there filing requirements that can assist review?
  - Establishing a fair trendline in light of historical trends and planned new investments.
18. Contributed Capital
  - Distributors are presently allowed to earn a return only on pre-2000 contributed capital, and until such assets are fully depreciated.
  - Prudence review to check that the appropriate amount of contributed capital is allowed to earn a return.

19. No-Cost Capital
  - Extent of application of “no-cost” capital concept to Ontario electricity distributors. 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?

**Operating Expense Issues:**

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(s) need to be clarified or changed?
22. Post-Retirement Benefits and Pensions
  - Review of economic assumptions used in plan calculations.
  - 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)?
  - Must an LDC move to the accrual method of accounting for post-retirement benefits for rate setting purposes, in light of CICA s. 3461?
  - If an LDC changes from the cash to the accrual method, regulatory amortization of one-time expense as a result of the change-over.
  - Prudence of management of pension assets.
23. Site Restoration and Removal Costs
  - For any LDCs to which this applies, what are the rate-setting impacts of compliance with 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 insurers.
25. Bad Debt Expense
  - What is an appropriate amount for uncollectibles, especially considering interaction with other policies (such as the LDC’s Security Deposit policy)?
  - Should a single method be used to calculate the amount? If so, how should it be determined?

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.
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?

**2006 Rate Design Matters:**

Board staff propose 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. Stakeholder views on inclusions or deletions from this list are sought.

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

While the treatment of Demand-Side Management / demand response initiatives is recognized as potentially impacting on the setting of 2006 distribution rates, it may be expected 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.

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. Stakeholders' perspectives on these possible inclusions or exclusions are sought at the July consultation.

The future commodity pricing mechanism under development may have an impact upon 2006 rates, and it is expected this will be dealt with when the applications are filed in mid-2005.

29. Specific Service Charges
  - Specific Service Charges 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 exploring consistency in definition and application. For example, should there be a single charge for each service across Ontario?
30. Unmetered Scattered Load
  - Definition and rate treatment of Unmetered Scattered Load (cable TV, payphones, advertising, etc.).
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 tariffs for various LDCs into more appropriate rate classes.
  - Design of Time-of-Use 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) and variable (demand/energy-related) tariffs across the province.
  - Should there be partial movement towards a uniform fixed charge for each rate class across Ontario in 2006?
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?