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Establishing 2006 Electricity Distribution Rates
Potential Issues for Generic Methodology Review

Submission of the Power Worker's Union

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1 INTRODUCTION

By way of notice dated June 16, 2004 the Ontario Energy Board ("OEB" or "Board") has stated its intent to initiate a process for establishing 2006 electricity distribution rates. The PWU intends to actively participate in the Board's process for establishing 2006 electricity distribution rates as it did in the Board's process that established the electricity distributor's initial unbundled rates and performance-based regulatory framework. To this end, the Power Worker's Union (PWU) has retained Elenchus Research Associates ("ERA") to provide input to the Ontario Energy Board, on its behalf.

The PWU represents over 15,000 members in 40 different collective agreements with as many employers, mostly in the electricity industry. This includes Hydro One, 23 local distribution companies other than Hydro One, Ontario Power Generation, Bruce Power, TransAlta in Ottawa, Northwind Power, Mississagi Power, the Electrical Safety Authority, as well as the Independent Market Operator. The PWU also represents workers at some local cable and telephone companies, the County of Brant, Kinectrics, New Horizon System Solutions, Inergi, and operators at Atomic Energy of Canada Ltd. The PWU is also a partner in Bruce Power Inc.

In looking after its members' welfare the PWU takes a profound interest in the welfare of the energy industry and the effective provision of services to the public. In-line with purpose (c) of the *Electricity Act, 1998* and the Ontario Energy Board's objective (3) in the *Ontario Energy Board Act, 1998*, PWU members, in seeking to serve the public more effectively, strive to provide consumer value with respect to prices, and the adequacy, reliability and quality of electricity service. The PWU's participation in Board consultations and proceedings therefore provides a balanced view that is reasonable from both the ratepayers' and distributors' perspective and assists the Board in upholding a key regulatory objective.

In this submission, a high level framework for establishing 2006 distribution rates that sets out rate principles and a strategic direction to guide the process is put forth followed by comments on the specific issues included on the Board's preliminary issues list.

2 Working from a Framework

A framework that sets out the rate principles and strategic direction for 2006 distribution rates will facilitate the development of regulatory policy and guidelines to be used in establishing the rates. Articulation of rate principles upfront will result in the development of focused regulatory guidelines and consistency in the Board's regulation of the distribution companies. Also, there needs to be fundamental consistency in the Board's on-going regulation of the electricity distribution companies that takes into account changes in legislation and regulation, industry structure and circumstances, and customer expectations. Therefore, consideration of the Board's framework that established current rates should provide the start point for a strategic path towards the establishment of 2006 rates.

2.1 Regulatory Principles

On October 2, 1998 prior to the development of the regulatory framework for the electricity distributors' rate unbundling and first generation PBR plan, the Board set out principles to guide it in developing and implementing performance-based regulation (PBR[1]). These principles are as follows:

1. The PBR framework should address all specific requirements of the legislation and regulations.
2. The PBR framework should protect customers and result in prices for regulated services that are just and reasonable.
3. The PBR framework should discourage cross-subsidization between regulated and competitive services.
4. The PBR framework should encourage greater economic efficiency by providing the appropriate pricing signals and a system of incentives to maintain an appropriate level of reliability and quality of service.
5. The PBR framework should permit the utility an opportunity to earn a reasonable return on shareholder capital and to maintain its financial viability.
6. The PBR framework should be transparent and as simple as possible. The cost of administering PBR, including costs imposed on all participants, including the regulated entity and the regulator, should not exceed the benefits available from PBR.
7. PBR should allocate the benefits from greater efficiency fairly between the utility/shareholder and the customers.
8. A PBR framework should be flexible and able to handle changing and varied circumstances.

[1] Ontario Energy Board Draft Policy on Performance Based Regulation. October 2, 1998.

9. The PBR framework should facilitate the use of efficient processes.

As the Board indicated in putting forth these principles, they are based on the general objectives as stated in Bill 35 and sound regulatory practices. As such the principles as a whole are not limited to PBR mechanisms, but should apply to the Board's rate setting processes in general. Removing the reference to PBR, then, the principles are restated as follows:

1. The framework should address all specific requirements of the legislation and regulations.
2. The framework should protect customers and result in prices for regulated services that are just and reasonable.
3. The framework should discourage cross-subsidization between regulated and competitive services.
4. The framework should encourage greater economic efficiency by providing the appropriate pricing signals and a system of incentives to maintain an appropriate level of reliability and quality of service.
5. The framework should permit the utility an opportunity to earn a reasonable return on shareholder capital and to maintain its financial viability.
6. The framework should be transparent and as simple as possible. The cost of administering [*the regulation framework*], including costs imposed on all participants, including the regulated entity and the regulator, should not exceed the benefits.
7. [*The framework*] should allocate the benefits from greater efficiency fairly between the utility/shareholder and the customers.
8. A framework should be flexible and able to handle changing and varied circumstances.
9. The framework should facilitate the use of efficient processes.

The first step in establishing a framework for 2006 distribution service rates therefore is a review of the Board's rates principles in the context of legislative amendments introduced since Bill 35, including Bill 100. The Board's objectives in Bill 100 are fundamentally different from those in Bill 35 in the absence of an objective to facilitate competition.

2.2 Strategic Plan

In its October 2, 1998 draft policy on PBR, the Board also states that the utilities' cost of service will provide the foundation upon which the PBR plans will be constructed and the basis upon which its results will be assessed. Consistent with this policy the framework for a second generation PBR would start with the development of initial rates based on cost of service/rate of return regulation ("COS/ROR") that determines reasonable rates for an individual distribution company. While there has been no notice from the Board on the timing of a second generation PBR plan for the electricity distributors, the 2006 rates could serve as the going-in rates for a potential second generation PBR plan.

If the 2006 rates were to serve as going-in rates for a PBR plan, then following the initial rate setting process, a PBR rate adjustment process would follow. The framework would therefore consist of two distinct processes:

- Initial rates based on COS/ROR; and
- PBR rate adjustments for the remaining duration of the PBR plan.

It is therefore assumed that the regulatory process for setting 2006 rates is COS/ROR. In COS/ROR the reasonableness of a regulated company's costs are reviewed and a reasonable rate of return is established for the test year. Review of costs is generally based on the company's historic costs as well as the company's circumstances rather than on external comparators, or other companies' costs. The use of comparators in setting initial rates does not provide for reasonableness of costs and adequacy of revenue that ensures the regulated company's financial viability and the protection of customers' interests with regard to service quality and reliability.

In PBR, the company is provided with incentives for efficiency performance, generally, based on external comparators, or benchmarks. Thus, having established a company's start point through COS/ROR, PBR then provides the company with incentives to move towards a performance benchmark determined through external comparators.

Establishing a framework upfront will clarify a strategic path and help distinguish the issues that need to be addressed in the process of establishing 2006 electricity distribution rates and the issues that need to be addressed in establishing PBR rate adjustments.

3 APPROACH TO ESTABLISHING 2006 ELECTRICITY DISTRIBUTION RATES

The following are some high level comments on establishing 2006 electricity distribution rates provided in the context of a framework approach described in the previous sections.

3.1.1 Use of Comparators

The Board's June 16, 2004 Notice states that a "key element" included in the preliminary issues list is the concept of comparators, which the Board hopes will be useful for reviewing the reasonableness of 2006 cost forecasts. While there are a large number of electricity distribution companies in the province for which 2006 rates need to be set, effectiveness and not convenience should drive the process for establishing 2006 rates. The use of comparators, while convenient, can minimize the consideration of the individual distributor's circumstances in the rate review process, and compromise its financial viability and ability to maintain service quality and reliability. The input sought on the use of comparators and cohorts in the Board's preliminary issues list demonstrates a tendency towards applying a PBR approach to a COS/ROR process.

With the exception of transition costs, the distributors' costs have not been reviewed since the administrative review of 1999 rates by the former Ontario Hydro under the *Power Corporation Act*. With the pressure of having approved unbundled rates in place for market opening, the distributors' year-end 1999 revenue levels with an appropriate adjustment for phasing-in a market based rate of return (MBRR), were used by the Board as the basis for establishing initial unbundled rates. Given that at least six years will have elapsed between the review of costs in setting 1999 rates and in setting 2006 rates, it is time that the reasonableness of the rates of the individual distributors in relation to their costs are reviewed. Whereas the OEB's first generation PBR rate adjustment formula for the electricity distributors and a complete phase-in of the MBRR would have provided for some reasonableness of rates, the rate freeze implicit in section 79.6 of the *Ontario Energy Act, 1998* precluded this opportunity. Using external comparators as a "key element" in setting 2006 distribution rates is akin to prolonging the period in which rates are applied without the determination of reasonableness of rates.

While there have been numerous amalgamations and mergers in the electricity distribution sector, for most of these newly formed distributors, at least 3 years will have elapsed since the amalgamation or merger took place by the time 2006 rate application are filed. Therefore, most of the distributors should have several years of historic cost data available and the importance of these historic costs as a key element in the review of 2006 rates should not be overlooked.

3.1.2 Rate of Return

In terms of determining the rate of return there are a plethora of issues that need to be dealt with. These issues, including that of a level playing field between the electricity and gas distribution sectors, were dealt with in A Discussion Paper on The Determination of Return on Equity and Return on Rate Base for Electricity Distribution Utilities in Ontario, prepared by Dr. William T. Cannon for the Board in 1998. The allowed rate of return for the electricity distribution companies' initial unbundled rates, as set out in the Board's Electricity Distribution Rate Handbook are based on recommendations in this discussion paper. A good start point for discussions on the allowed rate of return (ROR) for 2006 would be a version of this report updated for current circumstances. The updated report would consider allowed returns on equity and total capital that would be sufficient to enable a prudently managed distribution company to attract new debt. The updated document would provide focus for stakeholder input on issues related to ROR and enhance the efficiency of the consultative process.

An addition to the terms of reference for such a study would be the working capital allowance as a component of rate base, which was to have been revisited once the electricity market rules had been introduced and it is therefore timely to do so for 2006 rates.

Another addition to the terms of reference for the discussion paper might be the basis on which the third installment towards a MBRR is to be determined.

3.1.3 Rate Design

Subsection 79.4(1) of the Ontario Energy Board Act provides that low-volume and designated consumers pay electricity prices as set by regulation from April 1, 2004 to April 30, 2005 or earlier as prescribed by regulations. Bill 100 makes the Board responsible for setting and approving subsequent electricity prices. The electricity pricing will send pricing signals to consumers that will impact the distribution sector's revenue. Distribution rate design issues therefore need to be reviewed in conjunction with electricity pricing issues and the Board's rate principles. Given the significant change in the Board's objectives with regard to the facilitation of competition, electricity price set by the Board can be expected to move away from competitive pricing (Standard System Supply) to cost-based pricing.

Further, in identifying rate design issues for 2006 rates, the objectives of the current distribution service rate design needs to be understood as well as the reason for the differences between the existing rates of the distributors. This provides the appropriate start point for 2006 rate design considerations. The design of current rates was an undertaking of the Board's Performance-Based Regulation Distribution Rates Task Force in 1998-1999 and their deliberations are documented in the Task Force's report[2].

4 COMMENTS ON THE BOARD'S PRELIMINARY ISSUES LIST

The following sections provide comment on items included in the Board's preliminary issues list.

4.1 Use of 'comparators' to assist prudency review of LDCs' costs

1. Comparators and Cohorts

    High level comments on the use of comparators as a key element in establishing 2006 rates are provided in section 3.1.1. The following are additional comments.

    In setting 2006 rates, comparators can be used to gain an understanding of an individual distributor's circumstances in terms of its service territory's geography, customer profile, uniqueness of distribution system etc, relative to similar sized distributors. Such an understanding will help identify parameters that distinguish utilities and facilitate the establishment of cohorts for benchmarking purposes should such a exercise be undertaken in the future. The distinction here is the use of comparators in the 2006 rate review process to gain information required in a future benchmarking process, rather than as the basis for setting 2006 rates.

    It is not appropriate to establish regulatory guidelines based on comparators for the purpose of rendering the processing of individual rate applications expeditious. This results in rigidity in the review process that overlooks individual circumstances and compromises regulatory robustness for regulatory convenience.

    For the purpose of reviewing 2006 rates, the distributors might be asked to provide information in their applications on the cost drivers of operating and maintaining their systems in historic years as well as in the test year to help the Board assess the reasonableness of costs.

[2] Report of the Ontario Energy Board Performance-based Regulation Distribution Rates Task Force. May 18, 1999.

With regard to establishing cohorts, the Board might seek expert assistance in using historic data to carry out benchmarking research and in reviewing appropriate benchmarking techniques for any future benchmarking exercise the Board might undertake.

4.2 Revenue Requirement –General Issue

2. Test Year for Establishing Rate Base/Revenue Requirement

   The test year should be the rate year (e.g. future year), which in this case is 2006. A historic year (i.e. 1999) was used in establishing initial unbundled rates because of the time limitation imposed by the impending market opening. Using historic 1999 revenue as the basis for initial unbundled rates precluded the need for the review of the distributors' costs for the rate year. Therefore, if the outcome of discussions on establishing revenue requirement for 2006 is to use a historic year, then the remaining issues put forth on the preliminary issues list under "Revenue Requirement – General Issues" would be mute points.

3. Load forecast

   Given that the distribution companies have not needed to file load forecasts in support of their rates in the past, there is a need to understand where the utilities are at in terms of load forecasting expertise.

   Under the former Ontario Hydro's regulation, there was no requirement for the distributors to weather adjust volumes for the test year. Generally, the historic volumes were only adjusted if significant changes were expected in customer base e.g. new large commercial/industrial customer.

   Therefore, an issue that might be discussed is Weather Normalization Adjustments that would help, at least in part, overcome any paucity in the utilities' load forecasting expertise.

4. Test Year Adjustments

   Generally it is the applicant that identifies the adjustments required and that has the responsibility of providing justification for the adjustment.

   In addition to test year adjustments that might be included in the distributors' rate applications, is a test year adjustment consideration related to the treatment of volume variance resulting from utility DSM programs through mechanisms such as the Lost Revenue Adjustment Mechanism ("LRAM").

   While DSM programs for the electricity distributors have not yet been developed, the determination of whether an LRAM should be used will not impede the development of the programs. Rather, it will facilitate the discussions on DSM programs

5. Weather Normalization

   See item 3 on Load Forecast.

6. (Maximum) Return on Equity for 2006 Electricity Distribution Rates

   See section 3.1.2 on Rate of Return.

7. Debt/Equity Structure

   See section 3.1.2 on Rate of Return.

8. Debt Rate/Cost of Capital

   See section 3.1.2 on Rate of Return.

9. Depreciation Rates

   Depreciation schedules should be reviewed on an on-going basis. Therefore, if the Board intends to continue with the former Ontario Hydro's approach of setting depreciation schedules for the distributors it will need to review the schedules on an on-going basis. Any changes in depreciation rates resulting from depreciation studies conducted in between rate reviews would then be introduced in the distributors' subsequent rate adjustments.

   The Board's setting of depreciation rates, however, should not preclude the distributors from applying for revisions to depreciation rates to reflect their utility-specific circumstances.

10. Transfer Pricing and Shared Corporate Services

    As a first step, input should be sought from the distributors to gain an understanding of the types of transfer pricing and shared corporate services that are currently in place as well as the cost allocation applied to identify the scope of this issue.

11. Low Voltage and Wheeling Costs

    The low voltage transformation and wheeling services identified here are not services that are provided by host distributors in their capacity as distributors. Rather they are services that would normally be provided to distributors by a transmission company. Presumably, economic and operating efficiencies were among the factors considered that resulted in host distributors taking on wholesale services for embedded distributors. As such the recovery of low voltage and wheeling costs may bring in a myriad of issues. However, these issues are only of concern to a subset of the distributors. Therefore, including low voltage and wheeling rates in a process for establishing 2006 distribution service rates may result in compromising the examination of these issues, or alternatively render the process of establishing 2006 distribution rates inefficient. It is therefore suggested that low voltage and wheeling costs not be included as an issue in this process, but that it be reviewed in a separate process.

12. 2006 Taxes/PILS

    See section 3.1.2 on Rate of Return.

4.3 Distribution Rate Base Issues

13. Definition of Distribution Rate Base

Where clarification is required it should be provided in the Board's guidelines for 2006 rates. Guidelines for rate basing shared assets should be consistent with those on the allocation of costs for shared corporate services.

14. Rate Base Measurement Date

The 1999 year-end rate base was used in setting initial unbundled rates while the former Ontario Hydro's regulatory function used the average of the opening (year-start) and closing (year-end) rate base in reviewing the distributors' ROR levels as a revenue limiting criterion. Perhaps, rate base determination could be included in the terms of reference of the discussion paper on rate of return.

15. Working Capital allowance in Rate Base

See section 3.1.2 on Rate of Return.

16. Capitalizing Expenses

The issues listed are appropriate issues for policy consideration.

An additional issue is the rate basing of DSM expenses as suggested in the Board's decision on gas DSM (E.B.O. 169-III)[3]. In this decision, the Board states the following:

> "The Board, therefore, also endorses the proposal in the Consensus Statement that the costs of long-term DSM programs (i.e. those with duration of more than one year) be included in rate base and amortized over the estimated useful life of the programs…". [page 72 para 7.1.2].

Again while DSM programs for the electricity distributors have not yet been developed, the determination of whether DSM expenses might be rate based will facilitate the discussions on DSM programs.

17. Capital Projects

Individual distributor's significant capital projects should be reviewed on their own merit with the distributor providing justification for the need and cost level of the project. Again, as noted earlier in this submission, regulatory review processes should not be implemented solely, or in large part for the sake of convenience.

18. Contributed Capital

A check of contributed capital that is earning ROR might be left as part of the review of the distributors' annual financial filing where it may be done more efficiently then in a rate review process. This approach would make it a check for

[3] E.B.O. 169-III. A Report on the Demand-Side Management Aspects of Gas Integration Resource Planning: for The Consumers' Gas Company Ltd. Centra Gas Ontario Inc. and Union Gas Limited. Report to The Board. July 23, 1993

regulatory compliance providing the distributors with incentive for getting it right. An upfront prudence check would not be conducive to efficient regulation.

19. No-cost Capital

A start point on this issue is a definition for "no-cost" capital.

20. Rate-setting Treatment of Capital Gains

This issue needs to be considered in terms of level playing field between the electricity and natural gas distributors.

4.4 Operating Expenses Issues

21. Distribution "only" Expenses

Clarification should be provided as necessary in the Board's guidelines for 2006 rates.

As indicated earlier in this submission, regulatory treatment of DSM expenses needs to be considered.

22. Post-Retirement Benefits and Pension

Some of the items put forth under this heading are management responsibilities that ought be left to management unless there are mismanagement issues that arise.

23. Site Restoration and Removal Costs

These costs ought to be reviewed for prudence just as any other compliance-related costs are (e.g. health and safety).

24. Insurance Expense

The distributors have historically made their own decision with regard to insurance expenses or appropriate level of reserves. Since each distributor likely has come to understand its individual risks, it would be better to leave decisions on insurance expenses to management and seek explanation from them on their insurance expenses. In addition, historic information can help in assessing the reasonableness of the expense.

25. Bad Debt Expense

Bad debt circumstances may vary considerably between distributors and the use of a single method to calculate a perceived "appropriate amount" of bad debt may not be reasonable. Again, historic data will help in assessing the distributor's bad debt expenses.

26. Employee compensation and staffing

This is an area that is the responsibility of management and shareholder and should be left to them to manage. Examining historic levels of the individual utility will help in assessing reasonableness.

27. IT Costs

Again this is the responsibility of management and should be left to them to manage. Again a review of historic levels of individual utilities will help in assessing reasonableness.

28. Advertising, Entertainment, Charitable, Research and development

This is the responsibility of management and should be left to them to manage. Again a review of historic levels of individual utilities will help in assessing reasonableness.

4.5 Rate Design Matters

29. Specific Service Charges

In providing comment on this issue it is assumed that specific services are flat charges for services that are not included in general distribution rates and that are charged to customers on a user-pay basis. Further, for some field services not included in general distribution rates, a distributor might charge the customer the actual cost of the service rather than a flat specific service charge.

Under the former Ontario Hydro's regulatory regime, Ontario Hydro set charges for specific services based on surveys of a sample of distribution companies to determine a reasonable level for a specific service charge. The guidelines allowed distributors to charge levels up to the level set by Ontario Hydro without requiring them to provide justification for approval. If a distributor, however, applied to charge a level beyond that set by Ontario Hydro, it was required to provide cost justification. The Board could adopt a similar approach.

Variability in the type of specific services that distribution companies charge for is to a large extent a reflection of the differences in the standards of service between distribution companies. As an example some distributors may charge for Lawyer's Letters while others do not. The distributors that charge for Lawyer's Letters do not include this service in their standard of service, while the distributors that do not charge for Lawyer's Letters include this service in their standard of service. At issue therefore, is whether the Board expects all the electricity distribution companies to have the same standard of service, or whether the Board will allow the distribution companies to have some autonomy on their standard of service.

30. Unmetered Scattered Load

It is timely to review the definition and rate determination for unmetered scattered load. However, the rate determination might be best left until the cost allocation studies are available.

31. Time-of-Use (TOU) Rates

The former TOU rates were designed around the former Ontario Hydro's wholesale TOU rates and not around distribution system constraints. Unless there are distribution system constraints that might be alleviated through distribution TOU rates, there would unlikely be any benefit to be gained from distribution TOU rates.

The first issue therefore is to determine whether there are any benefits that might result from distribution TOU rates, including distribution benefits to be had from load shifting of large-use customer load.

32. Fixed/Variable

See section 3.1.3 on rate design.

The differences in the levels of the monthly service charges and volumetric charges charged by the distributors are related to differences in the distributors costs and to differences in their rate structures (i.e. the level of rates for the rate blocks) that existed prior to unbundling. The distributor's existing rate structure determined the degree of customer rate impact that resulted from the move to the new unbundled rate design. Reducing the monthly service charge and increasing the volumetric charge to minimizing rate impact further acerbated the rate variability.

Moving towards similar monthly service charges thus, can be expected to result in substantial rate impact for some distribution customers. The issue therefore is whether the Board would prefer uniform rates over stable rates. Another issue to consider is why the Board would insist on uniform monthly service charges in the electricity distribution sector and not in the natural gas distribution sector.

33. 2006 Rate Mitigation

While rate impact is always an issue, it would be practical to first identify the scope of rate adjustments anticipated and deal with rate design issues to provide context to discussions on rate mitigation methods.