

A blurred background image of a business meeting with several people in professional attire sitting around a table.

# Final Executive Report

## Cost Assessment Model Review

Prepared For:  
The Ontario Energy Board

December 11, 2015

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## TABLE OF CONTENTS

<b>BACKGROUND</b> .....	<b>3</b>
<b>OBJECTIVE AND SCOPE OF WORK</b> .....	<b>4</b>
OBJECTIVE .....	4
SCOPE OF WORK.....	4
<b>METHODOLOGY</b> .....	<b>5</b>
<b>OEB’s CURRENT COST ASSESSMENT MODEL</b> .....	<b>6</b>
<b>JURISDICTIONAL REVIEW</b> .....	<b>7</b>
<b>BEST PRACTICE APPROACH</b> .....	<b>8</b>
BEST PRACTICE CRITERIA .....	9
<b>RECOMMENDATIONS AND CONSIDERATIONS</b> .....	<b>10</b>
RECOMMENDATION 1: MARKET SURVEILLANCE PANEL COSTS .....	10
RECOMMENDATION 2: COST DRIVER FOR APPOINTEE/STAFF AND PROJECT COSTS .....	10
RECOMMENDATION 3: ELECTRICITY AND GAS DISTRIBUTION INTRA-CLASS ALLOCATION .....	11
RECOMMENDATION 4: ELECTRICITY TRANSMITTERS .....	12
RECOMMENDATION 5: LOW VOLUME ELECTRICITY RETAILERS & GAS MARKETERS INTRA-CLASS ALLOCATION.....	12
RECOMMENDATION 6: FREQUENCY OF CHARGE .....	12
<b>IMPACT OF RECOMMENDATIONS</b> .....	<b>13</b>
IMPACT ON COST ASSESSMENT MODEL AND REGULATED ENTITIES .....	13

## BACKGROUND

The *Ontario Energy Board Act, 1998 (the Act)*, the *Electricity Act, 1998* and other provincial legislation establish the framework for the mandate and authority of the Ontario Energy Board (also referred to as the OEB). Under S.26 of the Act, OEB's Management Committee is permitted to allocate all expenses incurred and expenditures made by OEB in exercising its powers to the classes of payors as prescribed by O.Reg. 16/08. The OEB's fiscal year commences on April 1 and ends on March 31. Costs incurred by the OEB are assessed to classes of payors in alignment with the fiscal year of the OEB.

Under O.Reg. 16/08, the following classes of payors may be assessed costs by the OEB:

1. Distributors (licensed under Part V of the Act).
2. Transmitters (licensed under Part V of the Act).
3. Gas transmitters, gas distributors and storage companies (subject to S.36 of the Act).
4. The Independent Electricity System Operator (including the former Ontario Power Authority).
5. Ontario Power Generation.
6. Licensed gas marketers (licensed under Part IV of the Act).
7. Licensed low volume electricity retailers (licensed under Part V of the Act).

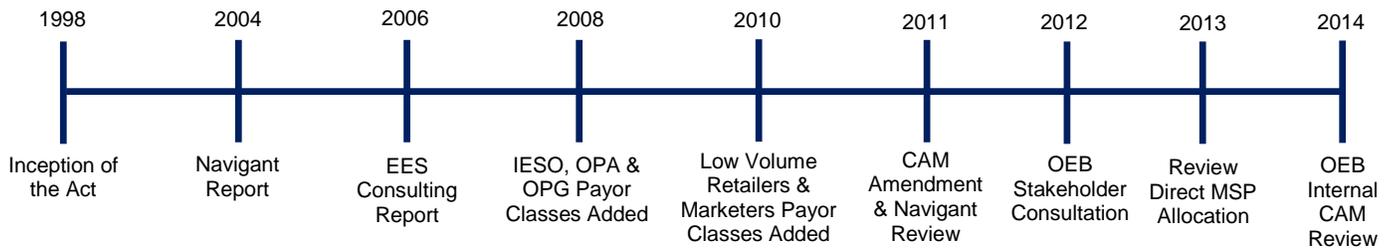
The OEB's annual cost assessment is comprised of the total of operating expenses (excluding all non-cash expenses) and capital expenditures less other funding sources for the fiscal year. The OEB's revenues arise from the following:

- Fees charged under S.12.1 of the Act.
- Cost assessments issued under S.26 of the Act (represents the majority of revenues).
- Costs payable to the OEB which are recovered under S.30 of the Act in relation to a specific proceeding or consultation process.
- Administrative penalties assessed against a person under S.112.5 of the Act arising from an OEB hearing and subsequent OEB decision.
- Income earned on investments.

The OEB has employed the following guiding principles in developing the Cost Assessment Model (CAM) to allocate S.26 budgeted costs to payor classes:

- All payor classes included in O.Reg. 16/08 will be assessed.
- The CAM should be clear and direct, fair, transparent, cost effective and provide incentives to use regulatory services efficiently.
- The CAM should ensure that ultimately costs incurred in regulating the customer groups are recovered from those customer groups.
- The CAM should allow the OEB to be financially self-sufficient and avoid the need incur debt.
- The CAM should strive for stable, predictable assessments and/or fees for market participants.
- The OEB should seek to mitigate year-over-year volatility in the apportionment of its funding requirements to each class of market participant.
- Allocation within a given class of payor should balance fairness, accuracy and predictability, wherever possible.

The timeline below depicts the evolution of the OEB’s CAM, including modifications to payor classes, previous consultant studies, internal reviews and stakeholder consultation:



The timeline highlights the significance of the CAM to the ongoing achievement of OEB’s mandate, vision and strategic objectives through continued cost recovery from market participants. The CAM is a complex consideration for OEB and warrants significant attention from the OEB’s management. The completion of various internal and external studies (as outlined in the timeline above) demonstrates the critical evolution of the CAM to align with OEB’s changing operational structure over time. As additional participants enter the Ontario marketplace, the OEB must continually adapt its CAM to ensure alignment with the province’s evolving regulatory environment and context.

As part of the Renewed Regulatory Framework last year, OEB highlighted a renewed focus on four performance outcomes including customer focus. OEB recognizes the elements of policy and market structure in Ontario have changed and that the CAM must adapt to continue assessing OEB related costs in an effective, transparent and fair manner for customers, particularly electric and gas distribution customers. Additionally the CAM should align with the changing overall approach and policy of OEB and the increase in customer focus along with the evolving Ontario market place as mentioned before.

## OBJECTIVE AND SCOPE OF WORK

### OBJECTIVE

The objective of OEB’s Cost Assessment Model review is to identify areas for potential improvement based on jurisdictional best practices and opportunities relative to changing OEB policy, strategic objective and mandate.

### SCOPE OF WORK

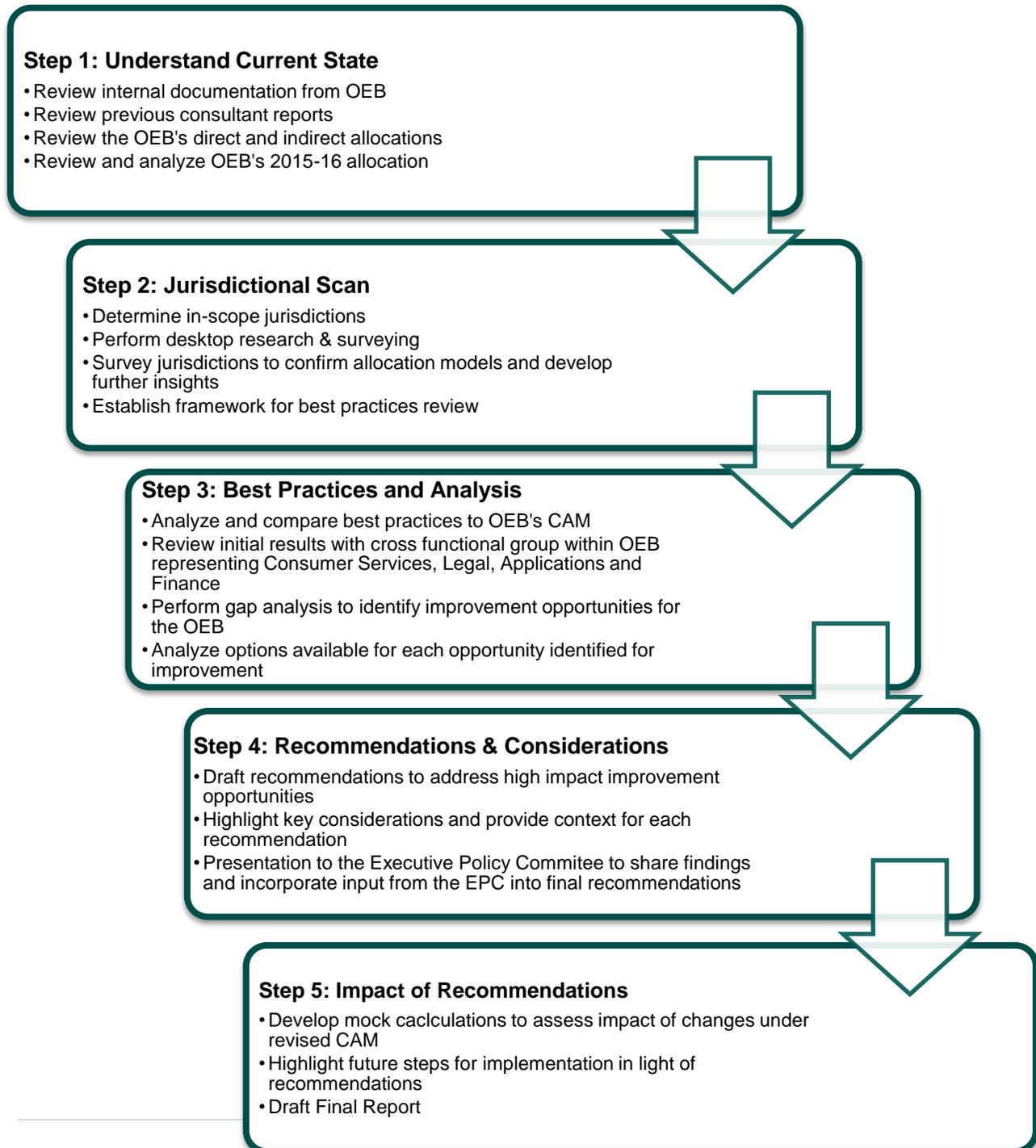
MNP was engaged by OEB to review the current CAM approach and model and assess its alignment with best practices, as well as the evolving operations of OEB. The scope of this review includes assessment of the current state, including the current CAM model and methodology. OEB requires an evaluation of the CAM allocation of S.26 costs to ensure full and fair cost recovery according to the principles of transparent cost allocation. The current state review also assesses the current payor classes and provides some assurance that these classes accurately reflect the market participants regulated and licensed by OEB.

MNP performed a jurisdictional scan, consulted with OEB departments to identify risks and concerns of identified best practices and provided draft recommendations to the Executive Policy Committee for review and discussion. MNP also reviewed and assessed aspects of timing and frequency of CAM execution, and evaluated the intra-class allocation factors that lead to the most accurate allocation in line

with cost causation at the customer level. This report establishes recommendations for implementation and sustainment by the OEB staff.

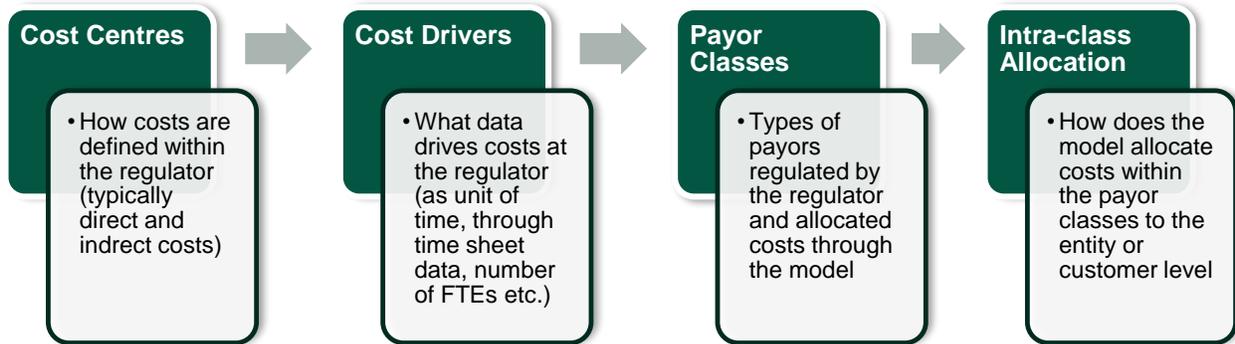
## METHODOLOGY

For this assignment, we relied on our cost allocation review methodology to ensure the OEB's CAM is aligned with OEB's recently restructured operations and reflects best practices. The diagram below provides an overview of our approach:

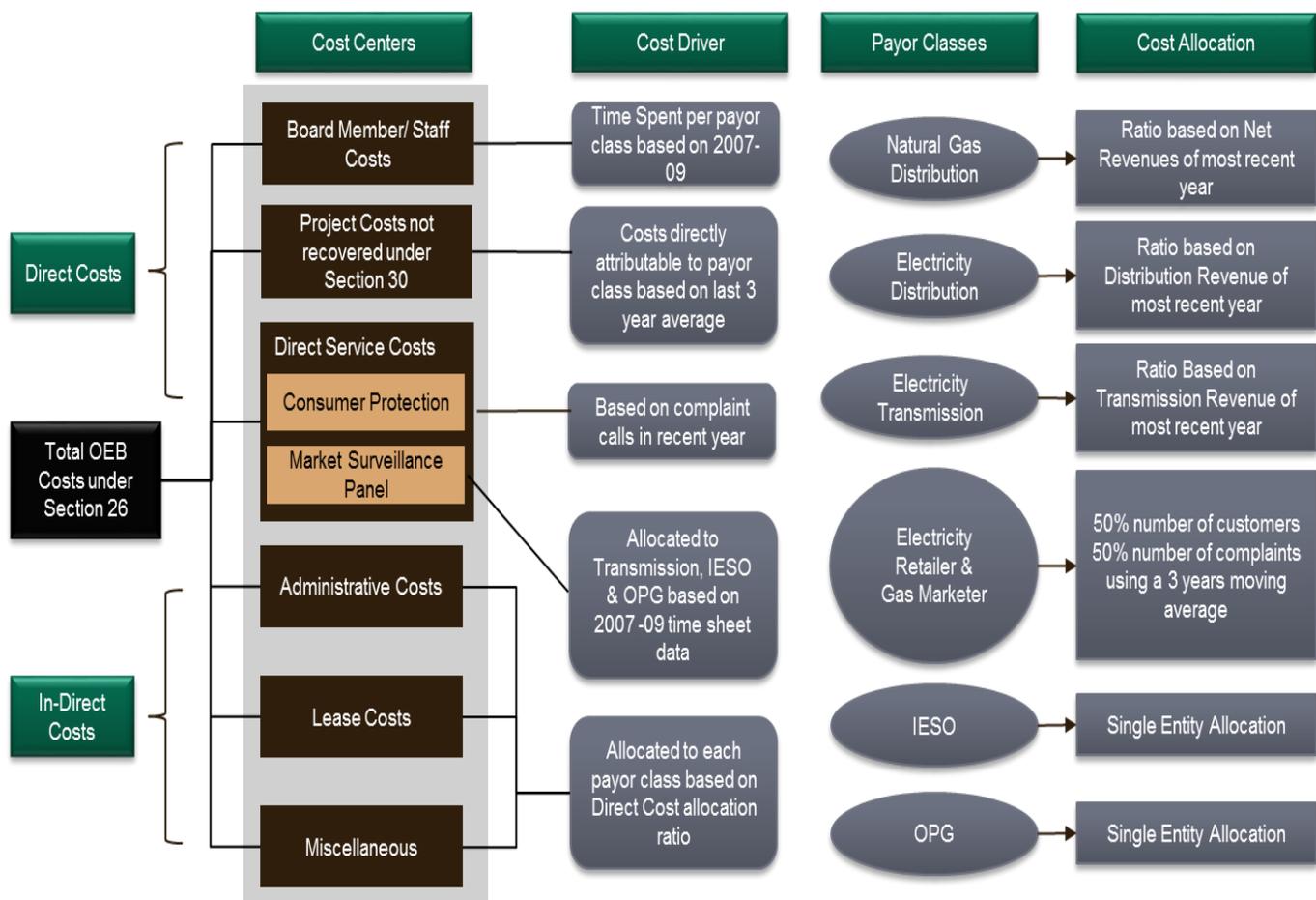


## OEB’S CURRENT COST ASSESSMENT MODEL

The current OEB Cost Assessment Model is a product of periodic review and amendment from the first time it was developed and implemented. As part of the review process it was essential to disseminate the CAM into component sections to better compare with cost allocation models of other jurisdictions and identify best practices. The key features of cost allocation are described below:



The following diagram provides a snapshot of the OEB’s cost assessment model in light of these key attributes:

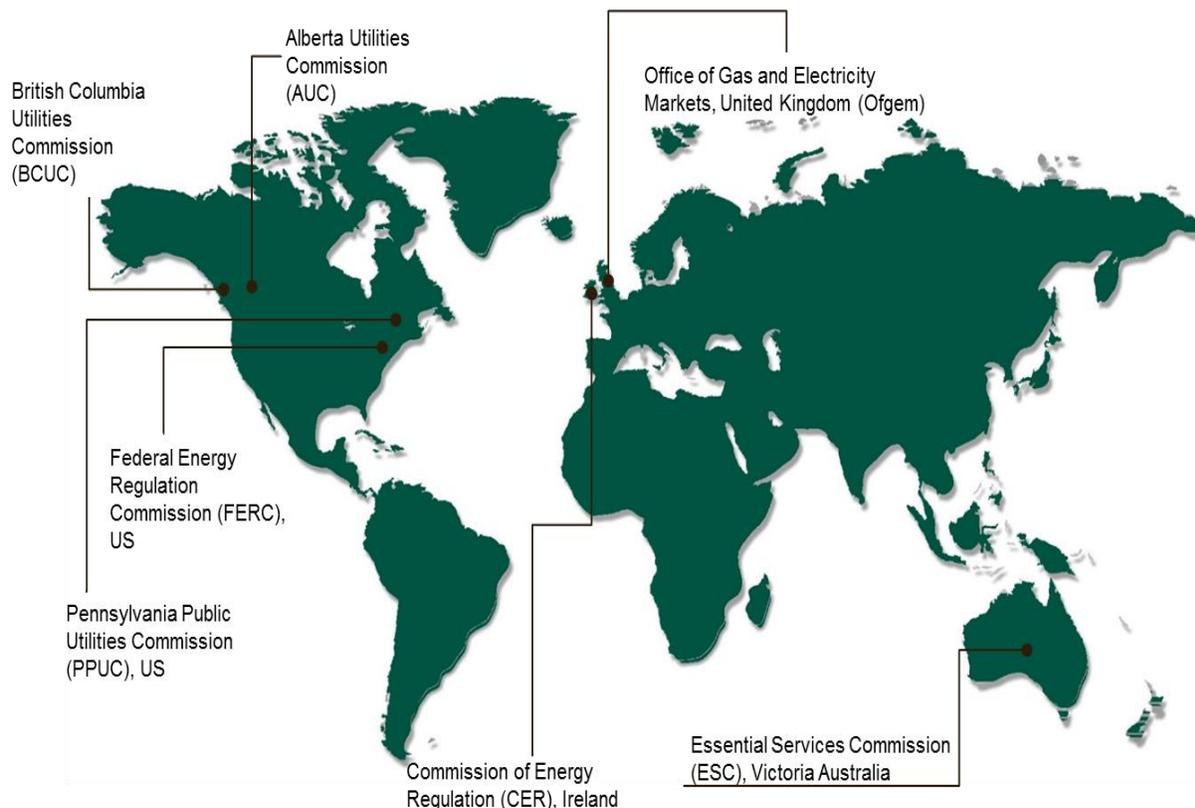


## JURISDICTIONAL REVIEW

Our jurisdictional scan included seven other regulators from around the world as part of the review of Best Practices for the cost allocation model. All regulators selected an agreed upon for comparison reflect a level of relevance to OEB regarding the following criteria:

- a) Similar entities that are regulated.
- b) Recovery of costs not based on government funding or appropriations.
- c) Maturity of the energy market and deregulation in those jurisdictions.

The map below provides the jurisdictions included as part of this review:

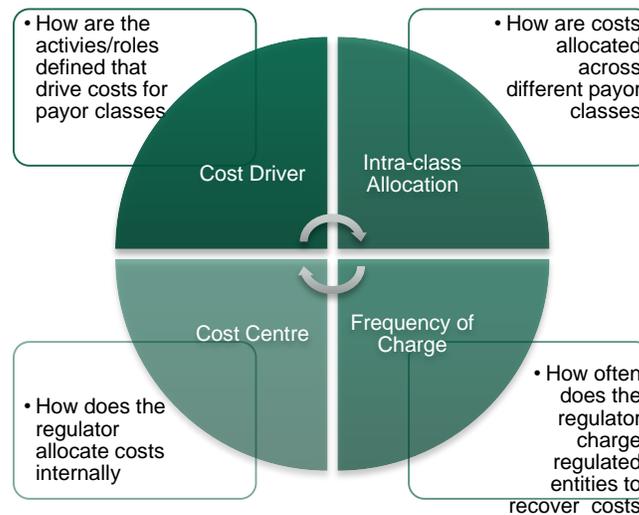


Our research and detailed review of the cost allocation models of each of the regulators was accentuated by a survey of the above jurisdictions. The online survey not only verified our established understanding of the jurisdictions but gave us additional insights into the rationale and details of how the allocation models currently work and how it may have evolved over time to better suit the needs of the energy markets in those jurisdictions.

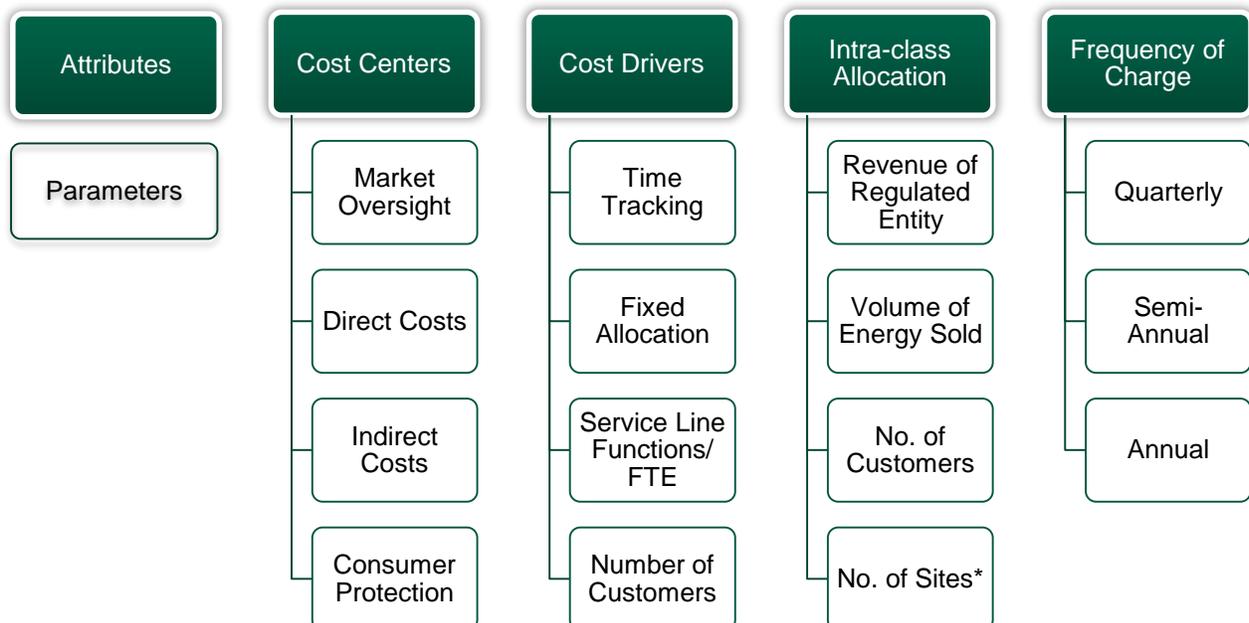
## BEST PRACTICE APPROACH

### Model Attributes

MNP’s review of cost allocation models from different jurisdictions assisted in identifying the key parameters that define effective allocation models. The review provided key insight into how different model attributes interact with each other to form the basis of both the fundamental and unique requirements of each regulator. The jurisdictional scan was essential to establish an understanding of best practices identified from the regulators reviewed in relation to the OEB’s current CAM Model. The model attributes align very closely with the core attributes of the current OEB model.



The following diagram demonstrates the key model attributes and related variable parameters that were observed during our jurisdictional review. For example, typical regulators assess and invoice their regulated entities on either a quarterly, semi-annual or annual basis.



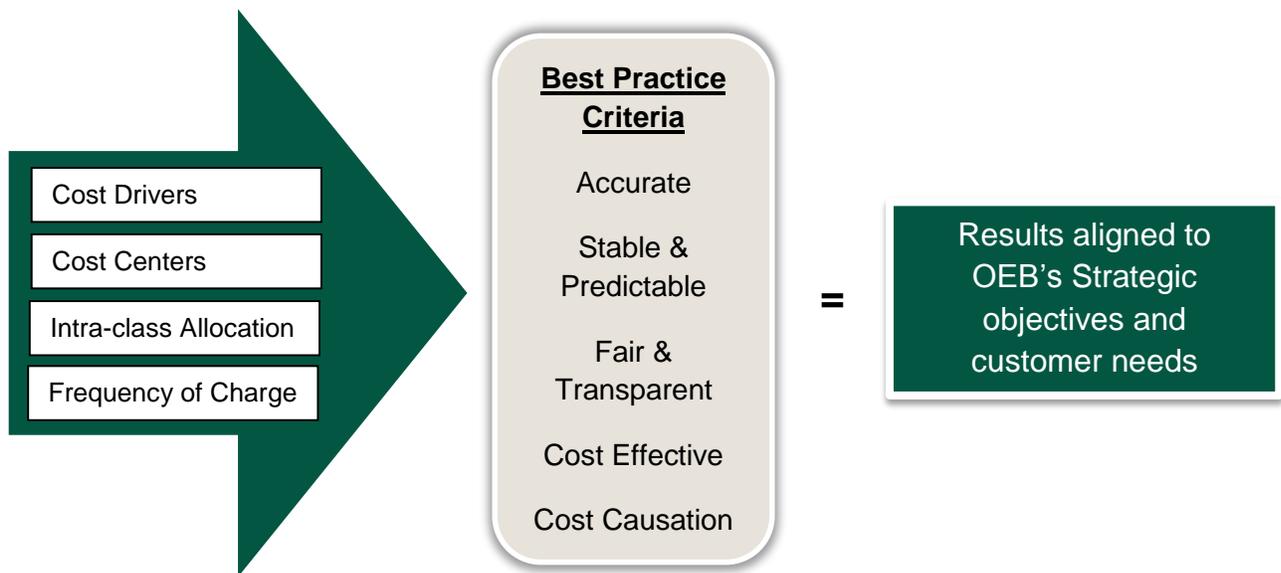
## BEST PRACTICE CRITERIA

To establish criteria for defining what best practice should represent, MNP mirrored the guiding principles that OEB has set in establishing the cost assessment model itself. Based on these guiding principles, we identified the following Best Practice Criteria for each cost allocation model attribute:

<u>Best Practice Criteria</u>	<u>Description</u>
Accurate	• The cost allocation model accurately calculates the costs to be recovered through each payor class and regulated entity
Stable & Predictable	• The cost allocation model is stable across time and is predictable
Fair & Transparent	• The cost allocation model is balanced, providing a fair allocation while being transparent
Cost Effective	• The cost allocation model is cost effective and does not put additional cost burden on the regulatory environment
Cost Causation	• The cost allocation model recovers costs from the regulated entity responsible in part or in whole for incurring the cost

\* Note: A site is a unique end-use service delivery point. For our analysis we will consider number of customers as a close approximation for number of sites.

In summary, best practices across jurisdictions were identified and established using the following approach. The core attributes identified include the most likely opportunities for improvement and they include:



## RECOMMENDATIONS AND CONSIDERATIONS

Insights from the jurisdictional, scan combined with MNP's detailed analysis and evaluation of best practices, establishes a number of recommendations to enhance the OEB CAM. Each recommendation discussed below includes considerations to optimize and streamline implementation.

### RECOMMENDATION 1: MARKET SURVEILLANCE PANEL COSTS

The MSP is a necessary cost centre for the OEB and typical for some regulators with a wholesale market oversight mandate. Currently, MSP costs are allocated across three different payor classes based on a prorated mechanism that mirrors how other direct costs are allocated using the 2007/09 time data. The basis for our recommendation is as follows:

- Direct costs attributed to MSP include project costs and per-diem costs of Members of the panel plus any applicable FTE staff. Indirect costs are also allocated by the direct cost proportion proxy.
- Direct cost proxy data (2007/09 or otherwise) does not reflect true costs of MSP which is a unique and more isolated cost centre. The allocation approach should be amended.
- By allocating total cost recovery to the IESO for the Market surveillance Panel, costs would be shouldered by all IESO administered market participants in the electricity market equitably and prudently.

#### Recommendation 1:

- 1) Continue with MSP as a separate cost centre attributing both direct and indirect costs.
- 2) Allocate total costs of MSP (both direct and indirect) to IESO.

#### Considerations

- Under the OEB's CAM, IESO's total allocation (including OPA) stands at \$1.57 million. The impact of assessing the entire MSP cost to IESO, in isolation, is expected to increase the system operator's overall allocation. This total allocation will include Staff, Appointee and Project cost as well as associated indirect costs. However, this change in allocation in tandem with the recommended changes to the cost driver (which will alter the allocation to all payor classes), will in fact reduce the IESO's total allocation, albeit marginally. However, any future budget increases will increase the IESO assessment.
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- OEB will be in a position to determine if IESO can recover costs through the market usage fees as part of the budgeting and approvals process.

### RECOMMENDATION 2: COST DRIVER FOR APPOINTEE/STAFF AND PROJECT COSTS

Direct cost allocation can be improved by updating the data that supports the allocation factor more frequently to enhance its accuracy. The most straightforward solution is to implement a time tracking system that provides real data on a quarterly or annual basis and provides OEB management with the

direct and real information required to develop payor class allocation factors based on the amount of FTE time spent regulating and servicing each payor class.

However, it is recognized that the OEB's unique operating environment combined with the costs associated with implementing a staff and appointee time tracking system make the process more administratively burdensome, where the OEB does not see a net benefit to implement time tracking. MNP's recommendation is based on the OEB's assessment of net benefit.

In absence of a time tracking system, it is recommended that OEB department managers review their staffs' efforts (as associated with each payor class) and update budget estimates every three years to provide a three-year ex-post update of the payor class allocation factors based on more relevant and accurate data. While this approach could be more frequent, the OEB felt that a 3-year frequency for review was sufficient.

### Recommendation 2:

- 1) Budgeted estimate every three years provided by department managers reflect staff efforts for each payor class.
- 2) Managers will use their own proxy information to develop annual level of effort estimations to ensure that the three year updates are as accurate as possible.

### Considerations

- It is assumed that over a three year period the level of effort remains fairly stable. However, unique circumstances within the period, or periodic changes to policy or market structure may lead to more significant changes and therefore adaptations as required.

### RECOMMENDATION 3: ELECTRICITY AND GAS DISTRIBUTION INTRA-CLASS ALLOCATION

The result of our analysis and best practice review across jurisdictions for Electricity and Gas Distribution payor classes' intra-class allocation is summarized below:

- Revenue based allocation is prone to higher volatility as rate setting fluctuations and investment trends impact revenues, especially when based on a single year's data.
- Disparity in rates and rate classes across LDCs may lead to misaligned CAM burden for customers.
- Where consolidation results in shifts in rate structures, revenue based allocation could inappropriately direct higher CAM costs to the customers of the lower cost utility.
- According to best practice, both volumetric intra-class allocation as well as customer based allocation are the most consistently applicable, transparent and stable methods to levelize regulatory costs to customers.
- From OEB's perspective, a customer-based allocation will provide a more stable and predictable mechanism with the additional simplicity that it provides to the end consumer to understand the cost of regulation.

### Recommendation 3:

- 1) Customer based allocation for gas distribution companies.
- 2) Customer based allocation for electricity distribution companies.
- 3) Smooth out year over year fluctuation with a 3 year rolling average of customer data for both payor classes.

## Considerations

- Implementation of a customer based allocation would impact certain regulated entities more than the others, however as a pass through item to end consumers, customer based allocation would ensure a more stable and predictable allocation mechanism to all customers.

## RECOMMENDATION 4: ELECTRICITY TRANSMITTERS

Electricity transmitters will continue to use revenue metrics with the uniform rate structure leading to simple and stable implementation with little relative benefit of a change to customer-based metrics. Moving to a 3-year rolling average instead of a single year's data for revenues, however, will provide much more consistency for intra class allocation across all applicable payor classes.

### Recommendation 4:

1. Continue with a revenue based allocation.
2. Use a 3 year rolling average for revenue ratios instead of using most recent year's revenue data.

## RECOMMENDATION 5: LOW VOLUME ELECTRICITY RETAILERS & GAS MARKETERS INTRA-CLASS ALLOCATION

Total number of customer complaints of these two payor classes is declining, resulting in higher fixed costs. As the number of complaints go down, the level of effort required to address complaints would also go down. Hence, there may be an opportunity to revisit the allocation driver weighting between customers and complaints to better align with the principles of accuracy and causation. However, as the OEB is currently in the process of consultations on OEB's codes, rules and other regulatory instruments applicable to these payor classes, and the impact of the recently passed Bill 112 is still to be seen, it may be pre-mature to change the allocation model at this time for the two payor classes.

### Recommendation 5:

Continue status quo of allocating costs based on a 50/50 split between number of customers and customer complaints, but consider changing the split in the future based on evolving trends in complaints and market rules.

## Considerations

- A change in the current split may require consultation from market participants before implementation.

## RECOMMENDATION 6: FREQUENCY OF CHARGE

The CAM currently assesses the regulators on an annual basis and then bills each regulated entity their share of allocation on a quarterly basis. This quarterly invoicing of charges to utilities is a best practice across the jurisdictions we have reviewed. In light of this best practice we recommend to the OEB to continue with this approach and maintain status quo when it comes to invoicing the regulated entities.

### Recommendation 6:

Continue with status quo quarterly billing.

## IMPACT OF RECOMMENDATIONS

### IMPACT ON COST ASSESSMENT MODEL AND REGULATED ENTITIES

The following mock calculations demonstrate how the allocation would change for payor classes. These estimates have been provided by OEB under the recommended time allocation on a three year basis.

#### Payor Class

The following table summarizes the change in allocation to payor classes based on Recommendation 2 of updating the cost driver for Appointee and Staff costs as well as Recommendation 1 to allocate total MSP cost centre to IESO.

Payor Class	Current Assessment (\$)	Mock Assessment (\$)	Change (\$)	Change (%)
Gas Utilities	5,000,025	7,561,595	2,561,569	51%
Electricity Distribution	19,495,359	18,978,466	(516,894)	-3%
Electricity Transmission	4,043,927	1,990,445	(2,053,483)	-51%
IESO*	1,569,747	1,560,622	(9,125)	-1%
OPG	1,085,079	1,287,290	202,211	19%
Low Volume Electricity Retailers	1,354,278	1,149,118	(205,160)	-15%
Marketers	918,025	938,905	20,880	2%
Total 2015-16 Budget	33,466,441	33,466,441		

\* OPA allocation has been added to IESO since the merger of OPA with IESO on January 1, 2015.

The major change in allocation is experienced by the gas utilities and electricity transmission payor classes. This would have a trickledown effect on the intra-class allocation for gas distribution payor class.



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