Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto ON M4P 1E4
Telephone: 416- 481-1967
Facsimile: 416- 440-7656
Toll free: 1-888-632-6273

Commission de l'énergie de l'Ontario
C.P. 2319
27e étage
2300, rue Yonge
Toronto ON M4P 1E4
Téléphone; 416- 481-1967
Télécopieur: 416- 440-7656
Numéro sans frais: 1-888-632-6273

BY E-MAIL AND WEB POSTING

May 15, 2008

To: All Participants in Consultation EB-2007-0673
All Licensed Electricity Distributors

**Re: 3rd Generation Incentive Regulation for Electricity Distributors
Revised Proposal for an Incremental Capital Module**

In light of comments made by participants at the May 6, 2008 stakeholder meeting, Board staff has revised its proposal with regard to an incremental capital module, and invites stakeholder comment on this new proposal.

In response to participants' comments, staff proposes changes to:
- the proposed materiality threshold for invoking the module; and
- the proposed scope for capital expenditures eligible for recovery through the module.

Staff also proposes application requirements in relation to these changes. The rationale and implementation details of staff's revised proposal are explained below.

Revised Proposed Threshold

Participants representing electricity distributors commented that under the proposed threshold of 20-25% of CAPEX in the base year, the capital module could be triggered even if the CAPEX during the IR plan matches depreciation (transcript pp. 27 – 32).

In order to address this concern, staff proposes a threshold of the distributor's average annual CAPEX since the Board-approved base year relative to 150% of the distributor's depreciation expense embedded in base rates. Staff agrees that linking an incremental capital module to a capital budget may be problematic because the base year capital budget is likely to vary significantly among distributors for a variety of reasons. Capital budgets could also be distorted and/or not representative of future investment trends depending on investment cycles, the lumpiness of certain types of investments, and similar factors.

In a conventional cost of service year a distributor recovers depreciation expense and return on rate base as components of its revenue requirement.

Rate base has two components: a component that is related to capital assets, typically equal to the net book value of in-service property plant and equipment (PP&E); and a component for working capital. This discussion considers the component related to capital assets.

In an incentive regulation (IR) year, the “inflation minus X-factor” rate adjustment mechanism *implicitly* adjusts depreciation expense. However, without a specialized capital module a distributor may not have *explicit* adjustments made to its revenue requirement to reflect unusually high capital spending requirements.

As discussed at the May 6th stakeholder meeting (transcripts pp. 29-32), in cases where capital spending in a year part way into an IR plan exceeds the amount recovered through rates for depreciation expense, a distributor may experience a shortfall in funding for depreciation expense compared to what it might otherwise be the case in a cost of service year. When this occurs the distributor may need to finance CAPEX which exceeds depreciation expense recovered in rates, as opposed to funding solely through distribution rate revenues.

To understand this issue better, staff turned to information published in the electricity distribution statistical yearbooks (available on the Board’s web site). In Ontario, the total value associated with electricity distribution property, plant and equipment (PP&E) and depreciation for the past two years are as follows:

	2005	**2006**
Ontario Gross PP&E ($million)	16,219	17,135
Depreciation expense ($million)	633	676
Depreciation expense as a percent of gross PP&E	3.9%	3.9%
Implied average life of PP&E (100/3.9)	25 yrs	25 yrs

Table 1: Ontario Electricity Distribution Plant, Property and Equipment Value

Depreciation expense is an amount of historical cost allocated to time periods. As such it is not reflective of the current cost to replace assets and some sort of adjustment should be made for inflation if depreciation is to be considered in relation to current period spending. In a stable distribution company where the average life of assets is estimated to be 25 years, it may be assumed that that the assets on average are 12.5 years old. Using the 12.5 year assumption an inflation adjustment can then be applied to bring it more in line with current period dollars. Inflation over a 12.5 year period amounts to something of the order of 30-40%.

Implementation Details

If a distributor’s average CAPEX exceeds the proposed threshold of 150% of the Board-approved base year’s depreciation expense, the distributor may apply to recover the revenue requirement associated with unusually high rates of capital spending.

The distributor’s average CAPEX is calculated as the sum of total CAPEX in each IR year (since the base year), divided by the number of years since rates were rebased. The resulting number is then compared to the threshold of 150% of depreciation expense. This approach will create some incentives for companies to invest efficiently in all years of the IR plan and not concentrate investment spending in any given year in order to invoke the module.

As noted earlier, staff's revised proposed threshold is calculated as 150% of the test year's depreciation expense. Staff believes that 150% is appropriate in order to allow for the impact of inflation and to provide a cushion to ensure that only the most serious cases are considered.

The use of depreciation expense in this manner is only as a practical means for establishing a threshold for considering unusually high rates of capital spending. It does not reflect any consideration of prudence. Nor does it indicate that any particular level of capital spending is appropriate in individual distributor circumstances.

Broadened Scope for Capital Expenditures Eligible

To date, consideration of capital expenditures eligible for special treatment in an incremental capital module has focused on drivers that are in the control of the distributor's management such as:

- life-cycle replacement of aging distribution plant;
- additions of non-revenue earning plant to meet new growth demands and/or address system impacts from customer choice of location for connection; and
- perhaps incremental productivity gains achievable.

Revenue-earning plant has not been included in discussions. However, for reasons of simplicity, staff's revised proposal for the threshold test is indifferent to the driver. The driver behind any amount applied for by a distributor will be dealt with in the actual application, as discussed below.

Application Requirements

Staff proposes that a distributor's application to the Board requesting rate relief for incremental CAPEX during IR, should include the following:

- An analysis demonstrating that the threshold test has been met and that the amounts will have a significant influence on the operation of the distributor;
- A description of the underlying causes and timing of the capital expenditures including an indication of whether expenditure levels could trigger a further application before the end of the IR term;
- An analysis of the revenue requirement associated with the capital spending, i.e., the incremental depreciation, return on rate base and PILs associated with the incremental capital, and a specific proposal as to the amount of rate relief sought;
- Justification that the impact on revenue required is incremental to what was included in the application for the base year. Amounts being sought should be directly related to the claimed cause, which must be clearly non-discretionary and clearly outside of the base upon which current rates have been derived;
- Justification that the amounts to be incurred will be prudent. This means that the distributor's decision to incur the amounts represent the most cost-effective option (not necessarily least initial cost) for ratepayers;

- Evidence that the incremental revenue requested will not be recovered through other means, e.g., it is not being funded by the expansion of service to include new customers; and
- A description of the actions the distributor will take in the event that the Board does not approve the application.

Invitation to Comment

In a letter issued by the Board on May 2, 2008, the Board invited interested parties to comment on staff proposal for 3rd Generation IRM presented at the May 6, 2008 stakeholder meeting.

Board staff invites participants to provide an addendum to their comments to respond to the proposals outlined in this letter. This addendum must be filed with the Board by **May 20, 2008** in accordance with the filing instructions set out below.

Filing Material with the Board

All filings in relation to this consultation must quote file number **EB-2007-0673** and include your name, address, telephone number and, where available, an e-mail address and fax number. Three paper copies and one electronic copy of each filing must be provided. Paper copies are to be addressed to the Board Secretary at the Board's mailing address set out above. The electronic copy must be in searchable/unrestricted PDF format, be submitted through the Board's web portal at www.errr.oeb.gov.on.ca and conform to the document naming conventions and document submission standards outlined in the RESS e-Filing Guides (available on the Board's website at www.oeb.gov.on.ca on the e-Filing Services web page). A user ID is required for filings through the web portal. If you do not have a user ID, please visit the Board's web site on the e-Filings Services web page and fill out a user ID password request. If the web portal is not available, the electronic copy may be submitted by e-mail to BoardSec@oeb.gov.on.ca. Participants that do not have internet access may file their electronic copy on diskette or CD.

Filings must be received by **4:45 pm** on the required date.

All materials related to this consultation will be posted on the "Key Initiatives & Consultations" portion of the Board's web site at www.oeb.gov.on.ca. The material will also be available for public inspection at the office of the Board during normal business hours.

If you have any questions regarding this consultation, please contact Lisa Brickenden at 416-440-8113, or by e-mail at EDR@oeb.gov.on.ca. The Board's toll-free number is 1-888-632-6273, and the Market Operations Hotline is 416-440-7604.

Yours truly,

Original signed by

Kirsten Walli
Board Secretary