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Kirsten Walli
Board Secretary
Ontario Energy Board
Suite 2701
2300 Yonge Street
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Dear Ms Walli:

Re: EB-2007-0673

We are counsel to the Consumers Council of Canada in this matter. On behalf of our client we enclose herewith three paper copies of its Comments on the Ontario Energy Board Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors. An electronic copy has also been sent to you.

Yours very truly,

WeirFoulds LLP

Robert B. Warren

RBW/dh

Enc:

CONSUMERS COUNCIL OF CANADA

COMMENTS ON THE ONTARIO ENERGY BOARD STAFF DISCUSSION PAPER ON 3RD GENERATION INCENTIVE REGULATION FOR ONTARIO'S ELECTRICITY DISTRIBUTORS

EB-2007-0673

1. INTRODUCTION:

On February 28, 2008, the Ontario Energy Board ("Board") Staff issued a paper entitled, "Staff Discussion Paper on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors" ("Staff Paper"). In addition, the Board released a report prepared by Board Staff's expert consultant, Dr. Lawrence Kauffman of the Pacific Economics Group, entitled "Calibrating Rate Indexing Mechanisms for 3rd Generation Incentive Regulation in Ontario" ("PEG Report"). The Staff Paper and the PEG Report were drafted following the Board's consultation and working group processes. The Board has asked stakeholders to provide comments on the two reports. These are the comments of the Consumers Council of Canada ("Council").

The Council has very limited comments on the PEG Report and will focus largely on the issues set out in the Staff Paper. Before commenting on the specific issues identified by Board Staff in the paper, the Council will provide some overview comments regarding the regulation of Ontario's electricity local distribution companies ("LDCs").

A number of factors make the Ontario electricity distribution sector unique and will ultimately impact the form of regulation going forward. These include:

- The regulation of the electric distribution sector is a relatively new responsibility for the Board. The Board is not transitioning from years of cost of service regulation;
- Formal regulation is something new for the LDCs, their employees and their shareholders;

- There are currently over 80 LDCs in the Province and, it does not look like that number will change materially in the near future;

- There is a lack of long-term standardized LDC data available, making benchmarking and cost comparisons among the Ontario LDCs difficult;

- Although accounting standards and regulatory requirements mandate common approaches across the sector, the reality is that utilities can and do account for costs and revenues in very different ways;

- The industry has not been proceeding in a steady state environment. The LDCs have taken on new responsibilities, most of which have been mandated by government policies. Government policy may further expand the roles of the LDCs in the future;

- The form of regulation over the last ten years has not been consistent. It has included rate freezes, simplified incentive plans and some cost of service rebasing; and

- LDCs across the Province are not homogeneous. Some LDCs are operating in areas where load growth is significant. Some LDCs are facing the need to replace aging assets and infrastructure. Some LDCs are operating under a "business as usual" type of environment. Some franchise areas are densely populated whereas others are not.

All of the above points demonstrate that defining a simple and cost-effective approach to setting rates for all Ontario's electric LDCs is a significant challenge for the Board. On the one hand, a "one size fits all" solution is likely not possible. On the other hand, defining a custom regulatory model for each and every LDCs is simply not practical.

The Council recognizes that the Board must, in developing its 3rd Generation Incentive Regulation Mechanism ("3rd GIRM") framework balance the interests of utility ratepayers and shareholders to the extent possible. There should also be a recognition that the model cannot be perfectly defined and it will be necessary to allow for that framework to evolve. Accordingly, the Council supports the development of a 3rd GIRM framework that is sufficiently flexible to adapt to changing circumstances, recognizes the diverse nature of the LDCs in the Province, and includes mechanisms to appropriately balance the interests of ratepayers and shareholders. In the submissions below the Council has set out its positions on the issues consistent with this approach.

2. LONG-TERM VIEW OF INCENTIVE REGULATION:

The Staff Paper discusses the need for a viable and flexible long-term approach to setting rates that are just and reasonable (p. 7) The Council supports the need to work towards a long-term flexible approach but acknowledges that it would not be practical, nor possible, to define such a long-term approach for implementation in the next several months. As noted in the Staff Paper, developing a comprehensive long-term view is premature given the lack of available data for comprehensive benchmarking and the fact that the Board is currently undertaking a detailed review of rate design alternatives.

The Council supports the position advanced by Board Staff that taking an incremental approach towards a long term vision of comprehensive IR for electricity distributors is a practical approach for Ontario. For example, as set out below, the Council supports the continuation of a price cap model. The model for the future should build on the model currently in place for 2nd Generation IRM. With experience the Board can put in place elements to enhance the durability of the approach. There is no point at this time, given that the price cap approach has been used for the past several years, to change course and move to a completely different approach (eg; revenue cap). The Board needs to maintain elements of the current price cap approach that have "worked", while being open to enhancing certain elements or adding new components.

The Staff Paper discusses the fact that there is no long-term data set available regarding utility costs for Ontario distributors. PEG relied on data for the period 2002-2006 for its comparative cost work for the Board, as comparable data for earlier periods was not available. This lack of data makes it difficult to undertake empirical studies to assess service quality and productivity. Furthermore, it compromises the ability for the Board to undertake meaningful benchmarking studies. The Council sees value in this work continuing. In order to support a longer term IRM the Board will need to continue to collect data from the LDCs, and ensure that data is accounted for across LDCs in a consistent and meaningful manner.

3. ISSUES AND OPTIONS:

Capital Investment:

The current 2nd Generation IRM framework does not deal explicitly with capital investment issues. As a transition mechanism the model has been kept simple, allowing for rate adjustments as each LDC goes through a cost of service rebasing. The working group was charged with considering whether there is a need for special treatment of capital spending in an incentive framework going forward. As noted in the Staff Paper working group members were not all fully convinced that special treatment for capital is required.(p. 18)

The Council agrees that some LDCs may be faced with exceptional capital cost pressures during an IRM term. The question becomes whether or not the plan parameters allow for the recognition of some implicit growth in capital investment. Dr. Kauffman, in his presentation to the working group and Board Staff, indicated that the longer the period of time between rate rebasings, the greater the potential need for some form of special treatment of materially significant investment needs. Alternatively, shorter terms may eliminate the need for explicit treatment for capital expenditures.

As set out below, the Council is of the view that the 3rd GIRM plans should be for a term of three years. Under a plan with a three year term, rates are rebased every three years. All distributors will be rebased in the period 2008-2010. LDCs have been able to self select the year if they have required rebasing earlier in the period. For most LDCs this should establish rates that, through the term of the plan, are sufficient to accommodate normal capital expenditures. If the plan term is longer the need for some capital adjustment mechanism becomes more important.

The Board has established mechanisms to deal with capital expenditures such as smart meters that have been mandated by the Provincial government. Those expenditures have been dealt with through the establishment of deferral accounts and subsequent prudence reviews. Going forward, it is assumed that capital expenditures required by government policy would be treated in the same manner. The Council would support the continuation of such an approach.

To the extent LDCs find, during the term of the plan that the formula is not sufficient to support incremental capital expenditures they should have an opportunity to apply for the Board for relief. The onus would be on the utility to demonstrate why its rates, derived using the formula, would not be sufficient to support the incremental capital investment. Under a three-year plan the Council would expect that such requests would be the exception, and not the norm.

With respect to the other approaches discussed in the Staff Paper such as the multi-year cost of service approach the Council views these as too complex for implementation in Ontario. The Staff paper sets out many of the potential implementation problems.

There is an expectation that the experts retained by other stakeholders (ie; PWU, EDA and the CLD) will be proposing alternative approaches to those set out in the Staff Paper. To the extent they do, it would be useful to allow parties an opportunity to explore those approaches, perhaps though a technical conference, and for the Board to provide a process for further comments.

Lost Revenue Due to Changes in Consumption:

With respect to the issue of revenue erosion the Board has approved the use of a lost revenue adjustment mechanism ("LRAM") to allow distributors to apply for recovery of revenue variances resulting from their conservation and demand management initiatives ("CDM"). Board Staff is seeking comments whether there is a need to address alternative mechanisms.

One alternative advanced by the Electricity Distributors Association ("EDA") is a revenue stabilization adjustment mechanism ("RSAM") that would eliminate all variances from forecast in electricity demand whether from CDM, the economy, weather or from customer growth. The Council does not support the implementation of an RCAM at this time on the basis that it is premature, and more importantly because represents a significant shift in the regulation of the sector. Implementation of such a mechanism would require LDCs to undertake comprehensive load forecasting. In addition, given the resulting change in risk profile for the LDCs an adjustment to their capital structure or return on equity would be required.

Hydro One Networks Inc. ("HON") has proposed a mechanism that would reflect the Government of Ontario and/or the Ontario Power Authority's CDM targets in the IR formula. Like the RCAM the Council views this model as premature. If the targets are not achieved the shareholders would receive a windfall. In addition, there is the difficulty associated with attempting to allocate the targets across the Province.

From the Council's perspective, if a three-year plan term is adopted the need for an RCAM type of approach or the model advanced by HON is minimized. LDCs have the LRAM mechanism available to them if they are experiencing revenue erosion due to their own CDM programs. Going forward, if there is evidence that revenue erosion during the term of an IR plan is increasing, adjustment mechanisms may be considered by the Board. This could be part of a longer term framework.

With respect to CDM generally, the Council supports continuation of the current regulatory framework. As noted in the Staff Paper, this framework is particularly appropriate in light of the fact that responsibility for coordination and funding of CDM in the Province has largely been assumed by the OPA. As the pursuit of CDM in the Province evolves it may be necessary for the Board to revisit the various elements of the overall framework.

4. ELEMENTS OF A CORE PLAN:

Form:

The Council supports continuation of a price cap approach for 3rd Generation IRM for the following reasons:

- A price cap approach has been the model used by the Board in the previous two iterations of incentive regulation for Ontario's electric LDCs;

- From a regulatory perspective price caps are generally less cumbersome and involve less regulatory burden that the other models discussed in the Staff Paper;

- The LDCs and other stakeholders are becoming increasingly familiar with how price caps function;

- As Board Staff notes a price cap model is sustainable, predictable, effective, and practical relative to other approaches.

Term:

As noted earlier in these submissions, the Council supports moving incrementally to a long-term comprehensive approach to incentive regulation. The lack of a comprehensive utility data base and the fact that government policy continues to mandate new roles for Ontario LDCs are factors inconsistent with a the determination of a long-term approach at this time. The fact that the Board is undertaking a review of rate design policies is also relevant. Accordingly, the Council supports the implementation of a price cap model for a three-year term. This assumes that cost of service rebasing will continue to be staggered.

If the Board is of the view that 3rd Generation IRM terms should be five years or longer, the Council would urge the Board to consider mandating earnings sharing. Earnings sharing would act as an important and necessary ratepayer protection mechanism in the context of longer plans.

Inflation Factor:

The Staff Paper discusses a number of approaches to determining the inflation factor that would be incorporated into a price cap formula. The current 2nd Generation plan uses a macroeconomic index, the GDP-IPI-FDD. As Board Staff notes, an economy wide index does not accurately represent the changes in input costs for electricity distributors. Even with input pricing differential ("IPD") and productivity ("PD") adjustment factors using the macroeconomic index does not track input cost trends as well as an industry specific price index. Board Staff has, therefore recommended the use of an industry specific IP1 for the 3rd GIRM plans.

Concerns have been raised by Board Staff and the working group members regarding the volatility associated with an industry specific IPI. In order to address the volatility concerns Board Staff has proposed a smoothing approach.

Given the fact that the Council is proposing a three-year plan term it may be easier to use the macroeconomic approach. If, in the alternative, the experts are of the view that an industry-specific IPI would be a superior approach, and the mechanics are not too complex, the Council would support the use of the industry-specific IPI. The Council would be interested in reviewing the input provided by the other experts on the merits of each approach. As noted above, the use of a Technical Conference for parties to explore, in more detail, the submissions of other parties and their experts would be a useful next step in this process.

Productivity Factor:

The most important component of any price cap plan is arguably the productivity factor. Determination of the X-factor is also the most contentious part of developing a price cap plan. X-factors can vary considerably depending upon the data used. Specifically, results may vary based on whether or not U.S or Canadian data is used, the length of the analysis, and how the various inputs are treated.

The Board has a number of choices regarding the X-factor. It could continue with the current 2nd Generation IRM model which employs an X-factor of 1%. It could adopt the recent recommendation of PEG which assumes an X-factor of .88% coupled with a range of consumer dividends based on comparative cost research gathered from Ontario LDCs. Alternatively, the Board may be convinced that it is appropriate to use an X-factor or factors based on the submissions of other experts that have been a part of this process.

The Council is not convinced there is a perfect way to construct an X-factor. As noted above, empirical results can vary considerable depending upon the inputs used to derive the results. Although PEG’s analysis, as set out in its report, does not represent an approach accepted by all parties, it does derive results that appear to be in the range of reasonableness relative to other such studies and other IR plans. PEG’s approach would set rates assuming an adjustment for inflation and an adjustment for productivity. It would also set rates assuming an efficiency benchmark-based stretch factor. Although clearly not an empirically "pure" approach the Council is of the view that it represents an approach that should be seriously considered by the Board for 3rd Generation IRM.

The Council recognizes the importance of the determination of the X-factor in the context of IRM plans. Given many other stakeholders have retained experts to comment on the PEG analysis the Council reiterates its request for the Board to proceed with a Technical Conference to allow parties to understand and consider the proposals of others.

Incremental Capital Investment:

As noted above, the Council is supportive of allowing for some mechanism to accommodate incremental capital investment beyond that accounted for through rebasing or through the formula. A review of the Staff Paper indicates that Board Staff's proposal is consistent with such an approach. In effect, incremental capital expenditures could be considered in the same way Z-factors are typically treated in most price cap plans.

Under a three-year plan the expectation would be that these applications would be the exception, not the norm. All of the LDCs will have been rebased prior to having their rates set by the formula. These applications should be accompanied by comprehensive evidence to support the claim for incremental capital, and not be treated as simple pass-throughs. From the Council's perspective the most appropriate approach would be for the Board to review the appropriateness of allowing for recovery of prudently incurred costs on a case-by-case basis.

Treatment of Unforseen Events:

Z-factors are common components of a price cap plan. The Council supports the use of Z-factors in the 3rd Generation IRM. Board Staff has proposed materiality thresholds of 3% for both capital and distribution expenses. This represents a reasonable approach. The disposition of the Z-factor amounts should be considered by the Board on a case-by-case basis. The overall amounts and the particular circumstances of a utility will ultimately impact how the Board chooses to dispose of the costs.

From the Council's perspective it is important that Z-factor treatment be symmetrical. To the extent that a cost reduction meets the criteria, LDCs should be required to bring a Z-factor application forward. A reduction in tax rates is an obvious example of a cost reduction that would qualify as a Z-factor.

Off-Ramps:

Like Z-factors off-ramps are common component of a price cap regime. In the absence of an earnings sharing mechanism the need for an off-ramp at a pre-determined dead band around the ROE is essential. The Council supports an off-ramp that would require an LDC to come into the Board if earnings in a given year exceeded 300 basis points over the allowed ROE. At that point the Board can determine whether a review of the plan parameters for that LDC is required.

Earnings Sharing:

From the Council's perspective an earnings sharing mechanism can be an important component of any IR plan. To the extent that the Board decides to allow for five year terms, the Council submits that an earnings sharing mechanism will be an essential component of the plans. Earnings sharing mechanisms provide ratepayers protection to the extent there is some level of uncertainty in the plan parameters. In addition, to the extent that a utility is able to achieve significant efficiency gains during the plan period, it allows for ratepayers to share in those gains.

Some LDCs have expressed concern about the use of earnings sharing mechanisms. The Council questions why publicly owned LDCs would object to earnings sharing. These mechanisms protect ratepayers on the one hand, and ensure that they are able to share in efficiency gains on the other hand. It is puzzling why an LDC would not want to benefit its ratepayers in this way. In the absence of earnings sharing, utility shareholders may gain at the expense of their ratepayers.

The specific type of earnings sharing will depend upon where the Board lands with respect to plan term. The Council supports an asymmetric earnings sharing mechanism given the fact that LDCs can opt out of the IRM plan at any point and apply for rates based on a cost of service determination by the Board. If the Board advocates a five-year term, the Council would support earnings sharing with a dead band of 100 basis points, consistent with the recent Enbridge Gas Distribution Settlement Agreement. For three-year plans the Council would support earnings sharing around a dead band of 200 basis points. Earnings sharing mechanisms are, from the Council's perspective, important element of any IR plan.

Service Quality:

The Board is currently undertaking a consultation process to deal specifically with service quality regulation. The Councils is satisfied that process will result in mechanisms sufficient to ensure that service quality for Ontario electricity customers will not be compromised in the context of an IRM plans.

Reporting Requirements:

With respect to reporting requirements the Council acknowledges that the Staff Paper has not defined any additional reporting requirements beyond those currently in place. The Council submits that to the extent that the Board accepts earnings sharing mechanisms as components of the plan, additional reporting requirements may need to be defined.

5. IMPLEMENTATION CONSIDERATIONS:

The Staff Paper does not outline a detailed comprehensive plan for the Board's 3rd GIRM frmaework. It provides a useful and extensive discussion of the issues. Following the receipt of submissions by parties it may be necessary for both a Technical Conference and a further round of submissions. To the extent new positions and alternative mechanisms are being advanced by parties, the Board will need to understand the implications of those alternatives. The Council urges the Board to allow for further consultation prior to finalizing the ultimate 3rd GIRM plans. Although Board Staff has set out many important points and issues, there are many details that would need to be established before implementation of the final framework. Further consultation will enhance the Board's ability to develop a detailed plan.