CONSUMERS COUNCIL OF CANADA

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

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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. Stakeholders were asked to provide comments on the papers by April 14, 2008.

On April 23, 2008, the Board issued a letter announcing a stakeholder meeting to allow participants in the consultation process to explore the implications of new positions and alternative mechanisms advanced by other participants in response to the PEG Report and the Staff Paper. That meeting was held on May 6. Following the meeting Board Staff revised its specific proposal regarding the treatment of capital expenditures and is now seeking comments on the elements of that proposal.

These are the comments of the Consumers Council of Canada ("Council"). The Council will comment on the overall Board Staff Proposal and then provide, under separate cover, specific submissions on the incremental capital module.

GENERAL COMMENTS:

The Board is facing a significant challenge in that it must develop a framework to facilitate the on-going regulation of more than 80 electric local distribution companies ("LDCs"). The 3rd Generation Incentive Regulation ("3rdGIRM") consultation process that began last September has, in our view, been very productive and parties have had many opportunities to express their various perspectives on the issues. Having said several things became apparent at the meeting on May 6:

1. There still remains considerable disagreement among the various stakeholders as to what model the Board should move forward with;

2. The expert consultants retained by Board Staff, the Power Workers Union, the Electricity Distributors's Association and the Coalition of Large Distributors substantially disagree on how to compute the X-factors, inflation and the need for stretch factors.

3. All parties have very different views as to what data is, or is not, appropriate or reliable. This includes whether U.S data is relevant, what historical time periods should be used and how to incorporate data related to both capital and operations and maintenance costs.

4. There is substantial disagreement about what might be required to facilitate the recovery of capital project costs during the term of the plan.

5. There is a recognition by most parties that the need to develop and maintain a database for Ontario LDCs is essential for the on-going regulation of the sector. This will, in the future, allow for a more robust and sustainable incentive regulation framework.

6. There is more work required to develop the details of each of the components of the plan proposed by Board Staff. This includes how a capital adjustment mechanism would actually work and how the impacts of having that mechanism flow through to rates.

The above observations have influenced the Council's positions on the issues, but after having considered the positions advanced by the other stakeholders and their experts the Council has not fundamentally changed its positions that were filed on April 14. Those positions are outlined below supplemented by some additional comments in response to the submissions of others and the discussions that were held at the May 6 stakeholder meeting.

SPECIFIC ISSUES:

Form:

The Council continues to support the use of a comprehensive price cap index. Some parties have advanced a view that they would prefer a revenue cap approach or some other model. Although applications for other forms of regulation cannot be precluded, it would be unfortunate, and potentially unmanageable, if a large percentage of the LDCs elected to apply for alternative methods for setting rates. One of the main reasons for developing the 3rdGIRM framework is to streamline the Board's regulatory processes.

The Board must make it clear that except in exceptional circumstances LDCs should adhere to the price cap approach. In effect, the onus on LDCs that are applying for an alternative rate-setting methodology should be significant in order for them to demonstrate that the price cap approach is not appropriate. Ultimately, the number of LDCs applying for alternative methods for setting rates will depend upon the attractiveness of the price cap approach to the LDCs. The Council is of the view that the approach set out by Board Staff, which potentially allows for the recognition of on-going capital requirements, should be sufficient for most LDCs in the Province.

Term:

The Council continues to support a three-year term. The Council's support for a three-year term is based on a number of considerations:

1. The industry continues to go through substantial changes. Initiatives like the smart meter program, the development of LDC delivered conservation and demand management programs, and increases in distributed generation projects all present administrative challenges and potential cost pressures for LDCs. Other government driven initiatives may arise over the next several years that could further impact the operations of the LDCs. Economic conditions are also expected to change. Putting in place an IRM for four or five years would better suit an industry operating in a steady state environment. From the Council's perspective three years represents an appropriate balance given the political, economic and regulatory environment that the LDCs operate in.

2. If the plan term is for three years it is less important to have the parameters precise. For example, under a three year plan the variability between inflation indexes may be less significant than under a longer plan. In addition, for many LDCs under a three-year plan the need for a capital adjustment mechanism may not be required whereas the need may be greater under a five year plan.

3. There is considerable debate amongst the stakeholders and their experts regarding the development of an X-factor(s), the need for a stretch factor and how best to measure inflation. A compromise approach to put in place values for three years allows for a reconsideration of the parameters based on better data in three years.

Inflation:

As noted in its previous submission, the Council supports the use of GDP-IPI FDD for the three year term of the plan. The Council also agrees that if a three-year plan is adopted the development and adoption of an Input Price Index may not be necessary.

X-factor:

The Council supports the use of the X-factor as proposed by PEG. It is recognized by all parties that the data used to support the .88% is not perfect and the analysis arguably may have flaws. However, from the Council's perspective it is in the range of reasonableness and would represent an appropriate value for a three-year plan.

The Council also supports the use of a stretch factor. As noted by PEG this is a common element in incentive regulation models throughout the world. The Council is of the view that a .5% stretch factor should be used and does not support the tiered stretch factor approach selected by PEG. The implementation of a three-tiered approach adds complexity to the model. In addition many parties took issue with the basis for the three values and how distributors would be slotted into the three groups.

A .5% stretch factor represents the average level adopted in approved North American plans. From the Council's perspective this represents a good precedent and together with the base X-factor of .88% will result in a formula that allows rates to be increased having regard to both inflation and productivity.

Earnings Sharing:

The Council continues to be supportive of an earnings sharing mechanism ("ESM"). As noted before, if a three-year plan is adopted 200 basis points above the allowed ROE should be the threshold after which earnings are shared on a 50:50 basis.

If the Board adopts a longer term plan then the Council advocates sharing above 100 basis points.

Several parties expressed concern about earnings sharing and the difficulty in deriving the actual earnings to be shared. The Board has approved historically, and now under 5-year incentive regulation plans, earnings sharing mechanisms. In addition, there is a precedent in the electricity sector with Hydro One Transmission.

The Council has long been a supporter of earnings sharing mechanisms primarily as protection for ratepayers. They also allow for ratepayers to share, during an incentive regulation plan, in any efficiency gains that have been realized. Both Enbridge Gas Distribution and Union Gas Limited have agreed, with subsequent approval by the Board, to ESMs. Given most Ontario electric LDCs are publicly owned it is puzzling as to why they would not support sharing any earnings above their allowed ROE with their electricity ratepayers. Their role is to supply distribution services to their customers. If they earn significantly above their ROE why should those earnings not go back to their customers?

The Council is of the view that earings sharing should occur on an annual basis and not wait until rebasing. This will ensure that any efficiency gains are shared with customers as they occur.

Off Ramps:

The Council supports the incorporation of an off-ramp as part of the overall plan. The model that should be employed is the one adopted for each of the natural gas LDCs as part of their recent IRM plans. It would require an automatic application to the Board in the event an LDC exceeded its ROE by 300 basis points. The review would be prospective and could result in modifications to the plan, a termination of the plan or its continuation.

Z-factors:

The Council supports the Board Staff proposal to create a materiality threshold of .5% of the total revenue requirement for Z-factors. This would apply to each event and not be a cumulative amount.

Incremental Capital Module:

The Council will provide comments on the new proposal advanced by Board Staff under separate cover.