PUBLIC INTEREST ADVOCACY CENTRE
LE CENTRE POUR LA DEFENSE DE L'INTERET PUBLIC
ONE Nicholas Street, Suite 1204, Ottawa, Ontario, Canada K1N 7B7
Tel: (613) 562-4002. Fax: (613) 562-0007. e-mail: piac@piac.ca. http://www.piac.ca

Michael Buonaguro
Counsel for VECC
(416) 767-1666

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VIA MAIL and E-Mail

Ms. Kirsten Walli
Board Secretary
P.O. Box 2319
2300 Yonge St.
Toronto, ON
M4P 1E4

Dear Ms. Walli

Re: 3rd Generation Incentive Regulation for Electricity Distributors
Board File No.: EB-2007-0673
Comments on Staff's May 2008 Proposal

As Counsel to the Vulnerable Energy Consumer's Coalition (VECC), I am writing to provide comments on the Board Staff's May 2008 Proposal regarding the 3rd Generation Incentive Regulation Mechanism (3GIRM) for Ontario's Electricity Distributors.

VECC's comments are structured in accordance with the key elements of the Staff Proposal. In each case, VECC has set out its understanding of the Staff proposal prior to providing comment.

Inflation Factor

Staff Proposal

Staff' current proposal is to use GDP-IPI-FDD (updated annually in March) as the inflation adjustment factor in the 3GIRM. OEB Staff asked their consultant (Dr. Lawrence Kaufmann) to estimate the appropriate input price differential. Analyzing US and Ontario data, Dr. Kaufmann obtained widely different results regarding the estimated input price differential and concluded that the best estimate for the inflation differential was zero (TC, page 104).

Comments

Staff noted during the May 6th Technical Conference (TC, pages 10-11) that the proposal to use the GDP-IPI FDD as opposed to an industry-specific IPI is based on feedback received from participants regarding the specification of the IPI, particularly the capital price sub-index. VECC notes that it was one of these parties.

Given the current limitations on Ontario data availability it appears that the creation of an appropriate capital price index is not possible for the 3GIRM. As result, VECC concurs with Staff's current proposal. However, VECC also agrees with the suggestion that an industry specific IPI should be a longer term objective.

Adoption of a macro-economic inflation factor gives rise to the issues regarding the need for an appropriate input price and productivity differentials. The Staff proposal regarding the input price differential will be discussed in this section, while the matter of a productivity differential is discussed as part of the comments on the productivity factor.

In VECC's view more analysis is required before one can establish an appropriate input price differential. The major reason for the difference between the US and Ontario results appears to be the difference in the average IPI growth rates. It would be useful to understand what the reasons were for the two industry specific price indexes escalating at vastly different rates over generally the same historic period. VECC suspects that the problems noted earlier regarding the construction of an industry-specific IPI may be confounding the results for Ontario and, perhaps, also for the US. However, at this point in the process there is limited time to adequately address these issues. As result, and strictly for pragmatic reasons, VECC agrees with the proposal that there be no input price differential adjustment.

Productivity (X) Factor

Staff Proposal

Board Staff and their consultant continue to support the use of a 0.88% productivity factor as initially suggested in Dr. Kaufmann's February 2008 Report (page 62).

Comments

This issue has attracted considerable debate from both the stakeholders and their expert consultants. The key reason for this is that there is limited Ontario data with which to perform an historical TFP analysis (TC, page 73). To address this issue Dr. Kaufmann estimated historical TFP values for US utilities and compared the trends with Ontario values for periods where data was available. His overall conclusion was that "the US trend is probably a conservative estimate of what's happened in Ontario" (TC, page 89). The overall US trend value calculated by Dr. Kaufmann was 0.72% (TC, page 78).

However, the values vary from year to year and there tends to be a cyclical trend. To account for this Dr. Kaufmann undertook a start date analysis to determine a starting year for estimating the trend value that was reasonably similar to 2006 – the end year (TC, page 91). This resulted in using the period 1995-2006 for purposes of doing the TFP analysis and an estimated value of 0.88% (TC, page 85). Overall, VECC considers Dr. Kaufmann's approach and conclusions to be reasonable given the available time and data.

Some stakeholders have suggested that TFP results calculated for Ontario for the period 2002-2006 should be given significant weight in establishing the X-factor for the 3GIRM. VECC does not agree for a number of reasons:

- First, there is general agreement amongst the experts (TC, pages 94 and 96) that four years is too short a period to capture a good estimate of TFP.
- There are fundamental problems with the Ontario data, in terms of capital additions and the 2006 values (TC, pages 73-74)
- There is no indication that the next 4 years will look like the last four years in terms of TFP performance.

With regard to the need for a productivity differential, Dr. Kaufmann's February, 2008 report demonstrated (pages 11-12) why such an adjustment is not required if the macro-economic measure of inflation was measuring the growth in output prices (as the GDPIPI FDD does) as opposed to input prices.

Stretch Factor

Staff Proposal

At the request of Board Staff, Dr. Kaufmann has simplified his earlier recommendations regarding the stretch factor. Under the revised proposal 2/3's of the utilities would have a stretch factor of 0.25%; 1/6th would have a stretch factor of zero and the other 1/6th would have a value of 0.5% (TC, page 137). The utilities falling into the upper and lower categories would be those that were identified as superior and inferior performers (respectively) using <u>both</u> Dr. Lowry's benchmarking analysis and Dr. Kauffman's econometric analysis (TC, page 130).

Comments

VECC supports the concept of differentiated stretch factors based on the demonstrated performance of Ontario's electricity distributors. Also, in VECC's view, the current proposal is relatively modest when compared with that first suggested.

Despite the more simplified approach now suggested, considerable concern was still expressed by those distributors present at the Technical Conference regarding the introduction of stretch factors that varied across the industry. Interlinked with this were concerns over whether a stretch factor was appropriate at all. The main concern regarding the application of a "varying" stretch factor was whether the two analyses used to categorize the utilities were sufficiently robust, particularly in their treatment of capital costs.

VECC notes that it was the utilities themselves that first introduced the idea that they should not all be treated the same in terms of future productivity expectations, as some were already more efficient than others. If the utilities are uncomfortable with the current analysis used to identify superior/inferior performers, then VECC is open to applying a standard stretch factor to all distributors. However, in VECC's view, there should be stretch factor.

As Dr. Kaufmann noted stretch factors are a standard element of incentive regulation plans (TC, page 146). Furthermore, VECC notes that the 0.25% average value proposed is less than the value typically included in such plans (TC, page 106).

Some parties have taken the position that utilities have been under a form of "price cap" regulation for a number of years and that a stretch factor only applies as one transitions from cost of service to incentive regulation. However, Dr. Kaufmann has noted that such factors are also common in plans that have been in place for over a decade (TC, page 116). Also, there are a number of safeguards built into the 3GIRM including the ability of the distributor to request an "off-ramp" or to make its own proposal (TC, page 167) if they consider the proposed stretch factor to make the 3GIRM unworkable.

Finally, if one steps back and looks at the big picture the overall X-Factor (including the stretch factor) averages out at 1.13% which is at the lower end of the range established by the values used in the first (1.5%) and second (1%) generation IRM plans. On this basis, VECC is of the view that the value is conservative.

Z-Factor

Staff Proposal

The Staff's current Z-factor proposal differs from that in its original discussion paper in two aspects. First, the materiality criterion has been changed to 0.5% of revenue requirement as opposed to there being separate criteria for costs that are capitalized versus costs that are expensed (TC, pages 19 & 32). Second, the treatment of tax changes as a Z-factor will be informed by the current Union Gas proceeding that is dealing with a similar issue (TC, page 20). Otherwise, the requirements are unchanged and similar to those used in the current IRM plan.

Comments

VECC agrees with the Staff Proposal regarding materiality. The Board's generic proceeding into the ice storm related Z-factor claims revealed a range of capitalization policies for repair related activities such that there was no standard distinction between costs that are capitalized versus those that are expensed.

Off-Ramps

Staff Proposal

Staff is proposing that off-ramps should be allowed based on an application from the distributor and/or stakeholders and be considered on a case by case basis (TC, page 15).

Comments

VECC is supportive of this approach and notes that allowing stakeholders the opportunity to raise the utility's performance under the plan is important if consumer interests are to be protected. However, for such an approach to work there will have to be a timely release of utility performance and financial data and, even then, there will be a time lag. VECC notes that such time lags will be significantly less for utilities who have ready access to their own performance.

VECC also agrees with the suggestion (TC, page 15) that an application for an off-ramp doesn't necessarily mean that one occurs. The "off-ramp application" provides an opportunity for the distributor's circumstances to be reviewed and a determination made as to whether an alternative approach is needed.

Incremental Capital Module

Staff Proposal

At the Technical Conference, Board Staff tabled a proposal that would permit distributors to apply for an incremental capital module during the term of the 3GIRM. The eligibility criteria would include:

- Causation – must be linked to an individual cost driver and be outside what's in the utility's rebasing (TC, pages 18 & 23)
- Materiality – expenditures on an individual project or driver basis would have to exceed 25% of the capital budget that's reflected in the base year's rates (TC, page 18)
- Prudence – costs would be included in rate base at the next rebasing proceeding (TC, page 38)

Following the Technical Conference, a revised Staff proposal was circulated on May 15th that:

- Changed the materiality threshold such that distributors could apply for the module if their average capital spending in the IR years since rebasing exceeded 150% of the Board-approved base year's depreciation expense.
- Broadened the scope of eligible capital expenditures such that the threshold was not linked to a specific capital project or driver.

In terms of implementation, Staff indicated that if the Board approved the provision for incremental capital then “some form of rate rider treatment would come into play during the term to provide the distributor with the revenue requirement that would have been associated with that capital” (TC, page 17). It was also explained that the actual spending would be included in rate base at the time of rebasing (page 36). However, when asked if there would be any form of “true-up” at the time of rebasing, Board Staff indicated that the proposal did not “declare whether there would or would not be a true-up” and “that’s something that’s left as a matter for individual application in the circumstances at hand” (TC, page 38).

Finally, Staff indicated that there would be an annual reporting requirement for actual capital spending.

Comments

VECC comments regarding the incremental capital module address three areas: Eligibility, Application Requirements and Implementation.

<u>Eligibility</u>

VECC agrees that any capital expenditure adjustment “module” must be based on individual utility applications. Such adjustments can not be relegated to a simple formula or K-factor adjustment.

During the course of the Technical Conference utility representatives argued (TC, pages 25 & 29-30) that as soon as capital spending exceeded depreciation costs they would be incurring costs for which they are not getting recovery. VECC disagrees:

- To the extent the utility is experiencing load growth, a price cap mechanism such as that proposed by Board Staff will provide additional revenues to recover costs over and above those associated with the rate base approved at the initial rebasing.
- As Dr. Kaufmann indicated, there is a level of capital spending reflected in the TFP trend and what’s important is how expected capital spending relates to the level of real capital spending in the TFP (TC, page 26).

Having made these points, VECC acknowledges that a materiality criteria based on required capital spending as a percentage of approved (base year) capital spending is not appropriate. In this regard, Staff’s May 15th proposal is an improvement.

With regard to the 150% proposed threshold value, in VECC’s view there is no perfect number. However, based on the preceding points, the value clearly needs to be significantly higher than 100%. Also, as Board Staff has noted, it should also be set high enough to ensure that only the most serious cases are considered. Having said this, VECC believes it is important for the Board to emphasize that meeting the 150% threshold does not guarantee one will obtain approval for a capital module. What it "ensures" is that the distributor's application will be considered. At the end of day, even if the eligibility criteria are met and the capital spending is determined to be justified, the Board may find that the circumstances of the individual utility are such that the 3GIRM is still appropriate.

Board Staff suggests that the use of average capital spending will create incentives for utilities to invest efficiently in all years of the IR plan and to not concentrate spending in a given year. While the use of an average is an improvement over the original proposal it can still lead to perverse results. This can be illustrated by the following examples:

- Example #1: If a utility's optimum capital spending levels were 130% of depreciation in the first IRM year and 180% in the second year, it would not qualify for the incremental capital module until year two. However, if it was to readjust its budget levels to 160% in the first year and 150% in the second it would qualify for the adjustment in year one and again in year two.
- Example #2: If a utility's optimum capital spending levels are 130% of depreciation for all four years (per Staff's proposal) of the IRM, there would be an incentive to front end load the spending in year one in order to meet the threshold and qualify for the incremental capital module.

For those utilities that do meet the materiality threshold the application requirements will need to provide sufficient information to test these issues.

Application Requirements

In its May 15th proposal, Staff set out a more comprehensive listing of issues a distributor would have to address in its application for rate relief due to incremental capital spending. In VECC's view the application requirements need to address five areas:

i) Demonstration that the materiality threshold is met. This item is addressed by the first bullet in Staff's proposed list.
ii) Justification of the Proposed Capital Spending. This item is addressed in the second, fifth and seventh bullets in Staff's list
iii) Calculation of the incremental Revenue Requirement Impact. This item is addressed in the third bullet in Staff's list.
iv) Demonstration that the incremental Revenue Requirement Impact is not covered by the IRM. This item is only partially addressed by the fourth and sixth bullets in Staff's list. In order to satisfy this requirement, the key issue is not whether the impact is incremental to

what was included in the base year's revenue requirement but whether the incremental revenue requirement is recovered through the anticipated IRM adjustment to the base year's rates. This will require that the distributor also provide:

- A forecast of customer count and volumes for the years the module is being requested
- A forecast of the anticipated revenue to be earned through the IRM for the years the module is being requested – based on the capital-related portion of the base year's revenue requirement and past/anticipated IRM adjustments.
- A forecast of the revenue requirement associated with the capital assets included in the base year's revenue requirement for the those years the capital module is being requested. It should be noted that this value will likely be less that the capital-related portion of the base year's revenue requirement as the existing assets are subject to annual depreciation and therefore their contribution to rate base is declining.
- A forecast of the incremental revenue requirement impacts of any actual capital spending in the IRM years prior to those for which the module is being requested.

v) Calculation of the "rate adder" associated with the incremental revenue requirement. This issue is not addressed in the Board Staff's list and will require evidence regarding how the costs are to be attributed and recovered from the various customer classes. It will also require the distributor to provide appropriate billing quantities so that the costs can be translated into rates.

Implementation

In terms of the rate adjustment itself, Board Staff has indicated that the approved incremental revenue requirements would be treated as a "rate adder". However, there is no further indication as to how rate relief for incremental capital spending would be implemented.

In VECC's view there are three alternatives:

a) Treat it as a "rate rider" similar to the recovery of regulatory assets with a separately approved rate and a deferral/variance account to track both costs and revenues
b) Treat it as a "rate adder" similar to smart meters where the adder is included in the approved distribution rates but there is still a deferral/variance account to track both costs and revenues.
c) Treat it as a "rate adder" but without any associated deferral/account.

VECC acknowledges that the third alternative is the simplest one to implement and administer on a going forward basis. It does however raise two issues. The first is that if there is no "true-up" for the much closer scrutiny that will be required of certain elements of the Application, such as the level of capital spending, the load forecast and the determination of the rate adder itself. Second, without a "true-up" VECC believes rate payers are at increased risk (relative to the distributor's shareholders) from forecast error, as the distributor is in a better position to know if the forecast used was incorrect and can apply for a further incremental capital module if need be.

Also, it is not immediately clear from the materials and comments provided by Staff whether utilities have to apply for the incremental capital module on an annual basis or whether the application can address more than one forward year of the IRM period. In VECC's view, if the application is going to address more than one year (looking forward) then forecasting accuracy (in terms of both capital spending and load) as well as the potential for variances between forecast and actual spending amounts again become more significant matters and there is an increased need for ratepayer protection.

VECC submits that if the utilities are permitted to apply for a multi-year incremental capital in a single application then there needs to be either a true-up between actual and forecast revenue requirement impacts or an asymmetric earnings sharing mechanism with a fairly tight dead band (i.e., materially less than the 200 basis points proposed by Board Staff). This may be an issue that is best managed on a case by case basis depending upon the reasonableness and confidence that can be attached to the distributor's forecasts.

In VECC's view, one way to manage this issue is to limit the applicability of the incremental capital module to no for more than two years (i.e., the test year plus one more) and to apply an asymmetric earning sharing mechanism with only a nominal dead band (i.e., less than 100 basis points) in the second year. After this period, the distributor could re-apply for an incremental capital module if warranted and the materiality threshold is met.

Earnings Sharing Mechanism (ESM)

Staff Proposal

Board Staff is proposing an asymmetrical earnings sharing mechanism with a dead band of 200 basis points above the calculated ROE, on a non-weather normalized basis. Furthermore the calculation will be done looking at the cumulative excess over the term of the Plan (TC, pages 39-40).

Comments

VECC generally agrees with Staff's proposal. VECC notes that there were questions during the Technical Conference regarding the calculation of actual ROE (TC, page 41). VECC would suggest that the Board adopt a fairly straightforward approach – based on distributors' audited statements – similar to that ultimately adopted by the Board for Hydro One Networks' Transmission business in EB-2006-0501.

The ESM mechanism proposed by Board Staff would apply to all distributors. However, under certain circumstances, a "tighter" ESM should be applied. These circumstances would include where a distributor has an approved incremental capital module that either covers more than one year and is not subject to a true-up.

Term

Staff Proposal

The Staff Proposal calls for a four year term for 3GIRM, that is the test year plus four years of IRM adjustments prior to the next rebasing (TC, pages 9-10).

Comments

VECC can accept the four year term provided it is accompanied by an earnings sharing mechanism as discussed above. However, if work programs designed to improve the Ontario data (see below) and refine the IRM parameters (e.g., develop a robust IPI) are completed earlier there may be merit in shortening the period. The one exception would be those distributors who are applying for an incremental capital module, where the need for earlier rebasing should be considered during the Board's review of the Application.

Other Issues

VECC's April 2008 Comments

In its April 2008 comments VECC also raised issues regarding Service Quality Regulation, Reporting Requirements and Implementation of Cost Allocation Adjustments. None of these issues were addressed in the Staff's May proposal. VECC still believes these issues have merit and would ask that the Board review and consider its comments in these areas.

Future IRM Development Work

All parties participating in the Technical Conference acknowledged the current information/data problems and the limitations this placed on construction of the

3GIRM. There is clearly a need for the Board to develop and implement a work program that will help inform future refinements to the 3GIRM.

VECC appreciates the opportunity to make these comments. If there are any questions or if clarification is required regarding please contact either Bill Harper (416-348-0193) or myself (416-767-1666).

Yours truly,

Michael Buonaguro
Counsel for VECC