

**Ontario Energy Board**



**EB-2009-0152**

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# **Report of the Board**

**The Regulatory Treatment of Infrastructure Investment in connection with the Rate-regulated Activities of Distributors and Transmitters in Ontario**

**January 15, 2010**

## Executive Summary

On April 3, 2009, the Chair of the Ontario Energy Board issued a Statement confirming the Board's commitment to creating conditions that will foster timely and appropriate investment in electricity distribution and transmission infrastructure while ensuring that the interests of ratepayers continue to be protected. On June 1, 2009, in a second Statement the Chair advised of the development of three initiatives, one of which is to consider more innovative approaches to cost recovery, primarily in relation to infrastructure investments relating to the accommodation of renewable generation and smart grid development but potentially also applicable in relation to other types of projects in appropriate circumstances.

On June 10, 2009, the Board released a Board staff Discussion Paper on "The Regulatory Treatment of Infrastructure Investment for Ontario's Electricity Transmitters and Distributors" (the "Discussion Paper") for comment. The Discussion Paper described "conventional" mechanisms that the Board has used to address capital expenditures in the past, and identified a range of "alternative" mechanisms for the regulatory treatment of infrastructure investment that could be used to support the setting of rates in the future.

The Board acknowledges that, with the advent of the *Green Energy and Green Economy Act, 2009* (the "Green Energy Act"), it is anticipated that electricity distributors and transmitters will undertake significant new infrastructure investment, particularly to accommodate new renewable generation. Accordingly, the Board recognizes the need for a regulatory framework that provides further flexibility which utilities may need, in appropriate circumstances, to make these infrastructure investments.

Alternative mechanisms should be available in appropriate cases in relation to investments driven by the Green Energy Act and potentially in appropriate circumstances in relation to other types of investments.

The Board emphasizes that conventional mechanisms continue to be appropriate and should therefore remain the core component of the Board's regulatory treatment of infrastructure investment. These conventional mechanisms include: a) provision for unforeseen events<sup>1</sup>, b) deferral accounts, c) provision for Z-factors, d) provision for an incremental capital spending module, and e) a cost-of-service based application.

The alternative cost recovery mechanisms identified in the Report are listed below:

- **Accelerated cost recovery mechanisms:** construction work in progress ("CWIP") and pre-commercial expenses, and adjusting depreciation; and
- **Incentive mechanisms:** project-specific return on equity and project-specific capital structure.

The Board will consider applications for one, or a combination of, these alternative mechanisms on a case-by-case basis provided that the investment is undertaken by a utility as part of its rate-regulated activity. The list above is not exhaustive of the types of mechanisms which the Board may consider and applicants may propose additional mechanisms in a particular case.

Applicants seeking Board approval of an alternative mechanism must satisfy the "requisite relationship test". Specifically, the applicant will be required to: a) establish the need for the infrastructure investment, and b) demonstrate that a

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<sup>1</sup> As discussed in section 3.1 of this Report, the Board considers this to be a "conventional" mechanism; not an "alternative" mechanism as identified in the Discussion Paper.

requisite relationship exists between the alternative mechanisms requested and the demonstrable risks and challenges faced by the applicant in relation to the investment being made.

The remainder of this Report sets out in greater detail the parameters of the Board's policy as summarized above, as well as the considerations underlying the different features of the Board's approach.

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# 1 Introduction

On April 3, 2009, the Chair of the Ontario Energy Board issued a Statement confirming the Board's commitment to creating conditions that will foster timely and appropriate investment in electricity distribution and transmission infrastructure while ensuring that the interests of ratepayers continue to be protected. On June 1, 2009, in a second Statement the Chair advised of the development of three initiatives, one of which is to consider more innovative approaches to cost recovery, primarily in relation to infrastructure investments relating to the accommodation of renewable generation and smart grid development but potentially also applicable in relation to other types of projects in appropriate circumstances.

## 1.1 Government Policy Context

The Statements from the Chair recognize and reflect an expectation that the *Green Energy and Green Economy Act, 2009* (the "Green Energy Act") will increase infrastructure investment by electricity utilities in particular. The Green Energy Act confirms that connection of renewable energy generation facilities and the development of a smart grid are priorities for the Government. To that end, the Green Energy Act has amended the *Ontario Energy Board Act, 1998* to, among other things:

- add to the Board's statutory objectives those of facilitating the implementation of a smart grid and of promoting the use and generation of electricity from renewable resources;
- confirm the authority of the Board to adopt rate-setting methods or techniques that provide incentives or that make provision for the recovery of costs incurred or to be incurred, with reference in particular to specific activities of electricity distributors and transmitters; and

- require electricity distributors and transmitters to plan for and implement infrastructure investments designed to accommodate the connection of anticipated increased levels of renewable generation or to develop and implement a smart grid in the manner and at the times mandated by the Board.

Accordingly, the Board has established a regulatory framework that provides further flexibility for utilities seeking to make these infrastructure investments.

## 1.2 The Consultation

With Government policy driving increased capital investment, the Board engaged stakeholders in a consultation to assist the Board in determining whether more innovative approaches to cost recovery are warranted and, if so, in relation to which type(s) of investment. To that end, the Board released the Discussion Paper for comment.

The Discussion Paper identified a number of cost recovery mechanisms, some of which are in current use (“conventional” mechanisms) and others of which represent more innovative approaches (“alternative” mechanisms). The Discussion Paper also included a list of issues designed to elicit and facilitate comment. That list is set out in Appendix A to this Report. Among the issues the Discussion Paper identified were:

- whether conventional cost recovery mechanisms should be augmented with alternative mechanisms to provide for unforeseen events, to accelerate cost recovery, and/or to provide certain incentives;
- whether certain investments should qualify for such alternative mechanisms and under what circumstances; and
- whether the Board should establish certain conditions for approval (i.e., conditions precedent to approval) and conditions of approval (i.e., conditions that

may apply to an approval) in cases where the Board might approve one or more of the alternative mechanisms.

The Board received comments from the 26 stakeholders listed in Appendix B to this Report. Those stakeholders represent electricity distributors and transmitters, generators, gas distributors, and ratepayers. The Board has benefited from these written comments in determining the policy set out in this Report, and thanks all stakeholders for their thoughtful input.



## 2 The Discussion Paper and Overview of Stakeholder Comments

### 2.1 Conventional and Alternative Mechanisms

The Discussion Paper identified several cost recovery mechanisms that are currently in place to allow utilities to address their infrastructure investment needs and costs:

- The ability to apply for deferral accounts;
- The provision for Z-factors under the current incentive regulation framework;
- The provision for an incremental capital spending module under the current incentive regulation framework; and
- The ability to request consideration of a cost-of-service based application any time during the term of an incentive regulation plan.

The Discussion Paper also discussed a number of alternative mechanisms that could be used to support the setting of rates in the future:

- **Provision for unforeseen events.** The recovery of costs of abandoned projects. This mechanism would allow an applicant to request confirmation from the Board that prudently-incurred costs associated with abandoned projects would be included in rates if such abandonment is caused by events outside the control of the utility.
- **Accelerated cost recovery.** These mechanisms include the following:

- Construction work in progress (“CWIP”): This mechanism would allow CWIP to be included in rate base prior to the asset coming into service, thereby allowing the applicant to recover the carrying cost on the capital investment, typically interest costs on debt and a return on the investment.
- Adjusting depreciation: This mechanism would allow an applicant to adjust depreciation to reflect a contract term related to the utility’s facility (such as the term of a power purchase agreement entered into by the first generator to connect to the utility’s facility) rather than the useful life of the utility’s facility.
- **Incentive mechanisms.** These mechanisms provide compensation to a utility for its investment beyond that which the utility would normally be allowed, and include the following:
  - Project-specific return on equity (“ROE”): This mechanism would provide an applicant with an ROE for a given project that is different (higher) than the ROE applicable generally to the applicant’s investments.
  - Project-specific capital structure: This mechanism would allow an applicant to use a capital structure for a given project that is different from the deemed capital structure that is otherwise used when setting the applicant’s overall rate of return.

The Discussion Paper suggested that all of these alternative mechanisms could be considered by the Board on a case-by-case basis and applied to qualifying investments in circumstances where the applicant has demonstrated that there is a nexus between the mechanism sought and the investment being made.

Stakeholder comments on the Discussion Paper revealed a clear difference of opinion between rate-regulated entities, on the one hand, and representatives of ratepayers, on the other, with regard to the need for the alternative mechanisms identified in the Discussion Paper.

Rate-regulated entities agreed with the need for alternative cost recovery mechanisms. Ratepayer groups took the position that electricity utilities do not need incentives to undertake these investments since they are already mandated under the Green Energy Act to expand or reinforce their systems to accommodate the connection of renewable generation and to develop and implement the smart grid. The view of the ratepayer groups is that conventional mechanisms remain appropriate and should continue to be the basis on which the Board addresses infrastructure investment.

## 2.2 Qualifying Investments

The Discussion Paper briefly describes the different types of investments to which the alternative mechanisms may apply. The Discussion Paper classified investments as falling into the following categories:

- **Routine:** system sustainment, system enhancement and system expansion;
- **Non-routine incremental:** an investment that represents an extraordinary and unanticipated capital spending requirement – in other words, something other than the normal course of business; and
- **Green Energy Act-related:** investments by electricity utilities to accommodate the connection of renewable generation or to develop and implement a smart grid.

The Discussion Paper suggested that investments related to the Green Energy Act should qualify for alternative mechanisms, but that it would be premature to attempt to identify more definitively which other types of investments may also qualify. The Discussion Paper also raised, as an issue, the question of whether the alternative mechanisms should be presumed to apply to certain types of investment.

A number of stakeholders suggested that the classification of projects into these different categories for the purposes of determining eligibility for alternative mechanisms was problematic. These stakeholders observed that a project can be undertaken for more than one purpose and that it would, in at least some cases, be difficult and impractical to break a complex project down by reference to the nature of the driver (routine, non-routine incremental, or Green-Energy Act-related). A number of stakeholders also suggested that eligibility for alternative mechanisms should be based on risk, and not on the type of investment or driver.

One stakeholder expressed the view that the Green Energy Act has created a shift away from economic efficiency and towards “green economics”, and that the Board’s approach to cost recovery should evolve accordingly.

## **2.3 Considerations and Conditions**

The Discussion Paper suggested a number of factors that the Board might consider in determining whether or not to exercise its discretion to make an alternative mechanism available to an applicant. These included: a) the impact on efficient utility management, b) planning and access to capital, and c) the appropriate allocation of responsibility and risk.<sup>2</sup> In their comments, stakeholders identified a number of other factors that should be considered by the Board. These include: a) whether the alternative mechanism requested would, if granted, encourage new sources of capital and technological expertise, b) whether the utility has considered debt financing or partnership arrangements, and c) whether the utility is over-earning at the relevant time.

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<sup>2</sup> A more complete discussion of these elements can be found in Hempling and Strauss, National Regulatory Research Institute, *Pre-Approval Commitments: When and Under What Conditions Should Regulators Commit Ratepayer Dollars to Utility-Proposed Capital Projects?* November 2008, pp. 24-26.

The Discussion Paper also identified certain conditions that the Board might consider attaching to any approval of an alternative mechanism, including conditions relating to: a) project performance or progress, and b) reporting requirements. Many stakeholders commented that performance conditions should be tailored to the nature of the project and the specific mechanism requested. As a result, these stakeholders proposed that performance conditions should be determined on a case-by-case basis.

Finally, the Discussion Paper addressed the different regulatory processes in which the alternative mechanisms might be considered by the Board. These included: a) a cost-of-service review, b) a single issue rate hearing, and c) a proceeding to approve a distributor or transmitter plan. A number of stakeholders suggested that applications may be most effectively dealt with in conjunction with an infrastructure investment plan at the time of rebasing. Several stakeholders noted that single-issue rate reviews are costly and burdensome and should only be used in exceptional cases.

## 3 The Board's Approach

The Board recognizes the need for a regulatory framework that provides the flexibility which utilities may need, in appropriate circumstances, to make infrastructure investments. This framework must be implemented in a manner that supports the achievement of the policy objectives reflected in the Green Energy Act, while protecting the interests of ratepayers. Therefore, the framework set out in this Report builds on the Board's existing regulatory framework by augmenting conventional cost recovery mechanisms with alternative mechanisms to facilitate appropriate investment.

### 3.1 Conventional Mechanisms Remain Appropriate

Conventional mechanisms continue to be appropriate and should therefore remain the core component of the Board's regulatory treatment of infrastructure investment. Utilities are encouraged to use these conventional mechanisms where appropriate.

Conventional mechanisms not only allow for "business as usual" investments but also provide the means by which a utility's unforeseen capital investment needs can be accommodated (as outlined in section 3.1.1 below). The Board believes that in most instances conventional mechanisms will likely be sufficient to address investment risk.

In the event that a utility considers that the conventional mechanisms are inadequate in connection with a proposed investment, the utility may apply for one or more alternative mechanisms in accordance with the framework set out in section 3.2 below.

The Board also notes that another conventional mechanism that the Board has used is that of funding adders for appropriate activities. Funding adders have been made available for Green Energy Act-related investments (see the Board's "Guidelines: Deemed Conditions of Licence: Distribution System Planning" (G-2009-

0087)) and for smart metering activities (see the Board's "Guideline: Smart Meter Funding and Cost Recovery" (G-2008-0002)).

### 3.1.1 Provision for Unforeseen Events

As noted above, the Discussion Paper identified the recovery of costs of abandoned projects as a potential alternative mechanism. The Board's existing regulatory approach already makes provision for the recovery of prudently-incurred costs, including carrying costs where applicable, in circumstances where the abandonment was outside the control of the utility's management (e.g., a Z-factor application). As such, the Board does not consider the recovery of such costs to be properly characterized as an alternative mechanism. Such cost recovery remains available as a conventional mechanism.

The Board has traditionally held that a utility may earn a return only on an asset that is "used and useful". The Board does not believe that it is necessary or desirable to depart from that approach in relation to abandoned projects even in the case of Green Energy Act-related investments. The Board will evaluate the utility's cost recovery to ensure no double recovery of costs. For example, if a utility already recovered survey costs by expensing these costs as a pre-commercial cost, it would be unjust and unreasonable for the utility to recover those costs again if the project was subsequently abandoned.

This approach also applies to the recovery of costs associated with assets that become obsolete or stranded as a result of Green Energy Act-related investments in advanced technologies. As noted also, the Board already makes provision for the recovery of prudently-incurred costs, including carrying costs where applicable, in circumstances where an asset has become obsolete or stranded.<sup>3</sup>

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<sup>3</sup> Among other things, O. Reg. 426/06 makes provision for the recovery, subject to a Board order, of costs associated with meters that have been replaced in furtherance of the Province's smart metering initiative.

## **3.2 Alternative Mechanisms will be Available**

As set out further below, alternative mechanisms will be considered by the Board on a case-by-case basis for Green Energy Act-related investments in circumstances where the applicant has demonstrated that there is a requisite relationship between the mechanism sought and the investment being made. The Board will not, at this point, eliminate any of the alternative mechanisms identified in the Discussion Paper. The Board also remains open to considering additional alternative mechanisms that may be identified by applicants in a particular case.

### **3.2.1 Qualifying Investments**

The Board recognizes that the Green Energy Act will increase the need for capital investment by distributors and transmitters. That investment is incremental to the more routine or traditional investments aimed at maintaining adequate levels of service and reliability, deploying smart meters and accommodating load growth. The Board also acknowledges that Green Energy Act-related investments may increase the risks that rate-regulated entities encounter. These risks, noted by stakeholders, include those related to project delays, landowner issues, public controversy, siting uncertainties, the recovery of costs, and the cancellation of the renewable generation projects that were to be served by the new investment.

The Board notes the comments made in respect of the Discussion Paper to the effect that alternative mechanisms are not needed in the context of a statutory and regulatory framework under which utilities are or can be mandated to make certain investments. The Board's view is that the existence of such a framework does not warrant closing the



door on alternative approaches to cost recovery. The Board also notes that state regulators in the U.S. have allowed utilities to apply for alternative mechanisms.<sup>4</sup>

It is anticipated that the Green Energy Act will increase the magnitude and complexity of infrastructure investment by distributors and transmitters. The availability of the alternative mechanisms provides the Board with a broad range of cost recovery mechanisms it can use, in appropriate circumstances, to enable distributors and transmitters, to raise capital on reasonable terms.

The Board is of the view therefore that alternative mechanisms should be available in appropriate cases in relation to Green Energy Act-related investments. Alternative mechanisms can serve to address the unique risks that may arise with respect to those investments. Such mechanisms can also facilitate the timely development of the needed infrastructure, without the Board being required to mandate those investments. The Board is also of the view that the alternative mechanisms should be available in respect of a Green Energy Act-related investment regardless of whether the cost of the investment may be recovered from ratepayers throughout the Province under the mechanism set out in section 79.1 of the *Ontario Energy Board Act, 1998*.

Typically, Green Energy Act-related investments relate to investments by electricity distributors and transmitters to accommodate the connection of renewable generation or to develop and implement a smart grid (as described in the Board's "Guidelines – Deemed Conditions of Licence: Distribution System Planning" (G-2009-0087))<sup>5</sup>. However, the Board will consider applications for one or more alternative mechanisms for any Green Energy Act-related investment provided that the investment is undertaken

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<sup>4</sup> As outlined in Hempling and Strauss, National Regulatory Research Institute, *Pre-Approval Commitments: When and Under What Conditions Should Regulators Commit Ratepayer Dollars to Utility-Proposed Capital Projects?* November 2008, pp. 15-18.

<sup>5</sup> On December 18, 2009, the Board issued for comment draft "Filing Requirements: Distribution System Plans under the Green Energy Act" (EB-2009-0397). These Filing Guidelines will, when finalized, supersede the initial Guidelines.

by an entity as part of its rate-regulated activity. References in this Report to “utilities” should be construed accordingly. The alternative mechanism may also be available to other types of projects in appropriate circumstances.

The Board’s approach to alternative mechanisms should not be viewed, as one stakeholder commented, as a significant departure from many of the well-established and fundamental principles of utility regulation. Utilities will still be expected to demonstrate that the investment is needed, that it is prudent, and that it is economically feasible. Rate impacts will also be assessed. Further, the need to ensure that shareholder risk and reward are properly matched will continue to guide the Board's approach to rate-making.

The Board emphasizes that alternative mechanisms will not be granted as a matter of course for all such investments. An applicant must demonstrate that there is a requisite relationship between the alternative mechanism proposed and the investment project, in the sense that the proposal is tailored to address the demonstrable risks and challenges faced by the applicant.

### **3.2.2 Accelerated Cost Recovery: CWIP and Pre-Commercial Expenses**

CWIP is a temporary holding account that captures the expended costs incurred in the design and construction of facilities that meet general capitalization rules and thresholds. During the construction period, the capitalized expenditures and the associated carrying charges are accumulated and included into CWIP. Traditionally, when the project enters into service, these expenditures and carrying charges are included in rate base and recovered in rates over the useful life of the asset.

The long lead times required to plan and construct new facilities can affect utility cash flow, in turn affecting the overall financial health of a company and its ability to attract

capital on reasonable terms. As noted in the Discussion Paper, many U.S. states have passed legislation and/or put in place regulations to allow for full or partial CWIP to be placed in rate base during the construction of certain facilities. Including CWIP in rate base provides two principal benefits. First, it provides a smoothing, or phased-in, effect on rates and thereby mitigates the rate impact that might otherwise take place when large new plant is placed into service. Second, it can reduce borrowing costs. Permitting a utility to recover CWIP funding can also reduce a project's total net present value cost, although it can raise intergenerational inequity issues.

The Board will allow utilities to apply to include up to 100 percent of prudently incurred CWIP costs in rate base. This approach allows utilities to recover the interest costs on debt and a return on equity (i.e., the weighted cost of capital) during the construction period.<sup>6</sup> The depreciation or return of the investment will continue to be recovered once the project goes into service. The Board may also consider: a) applying a cap on the CWIP amount allowed or b) allowing the CWIP amount into rate base on a staged basis as construction proceeds. The Board will also allow utilities to apply to expense prudently incurred pre-commercial costs<sup>7</sup>.

The Board agrees with the comments made in the Discussion Paper that this alternative mechanism is likely to be most suitable in relation to the construction of capital intensive multi-year projects. This mechanism will provide greater up-front regulatory predictability, rate stability and improved cash flow for utilities.

The Board acknowledges the concern, expressed by stakeholders, that including CWIP in rate base is a departure from traditional rate-making principles under which rate base is limited to plant that is "used and useful". The Board notes, however, that the existing

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<sup>6</sup> Once capitalized expenditures are included in rate base, the associated carrying charges will not be allowed to be accrued and recorded in the CWIP account.

<sup>7</sup> Examples of these costs include expenditures for preliminary surveys, plans and investigations made for the purpose of determining the feasibility of the projects.

incremental capital module already allows for the prospective collection in rates of relief associated with approved projects prior to the associated facilities being in service.

The fact that utilities have the opportunity to recover CWIP in rates before the facility goes into service does not mean that the costs will not be subject to a review (i.e., review of variance between actual and forecast costs) once the facility is in service. If the facility never enters service due to circumstances that are beyond the control of the utility, then in accordance with the Board's approach to abandoned projects discussed above, the Board would allow the recovery of prudently-incurred costs.

To mitigate concerns that CWIP may shift the risks of plant construction to the ratepayer, the Board may monitor project progress and whether a utility is meeting its milestones. For example, the Board may require a utility to propose metrics and status reports in its application for its project/plan to measure progress. Other conditions may be appropriate as discussed further in section 3.6 below.

### **3.2.3 Accelerated Cost Recovery: Adjusting Depreciation**

Traditionally, depreciation has been based on the useful life of a utility asset (in other words, the expected period of time during which it will be productive). Adjusting depreciation to reflect a contract term that is related to the use of a utility asset (such as a power purchase agreement executed by a connecting generator), or to align it with the life of a related non-utility asset (such as a connecting generation facility), is another way to reduce risk, thereby facilitating timely investment. In addition, allowing shorter depreciation periods where appropriate not only improves cash flow for the utility but should also result in a lower aggregate cost of capital over the life of the asset as the result of an accelerated decline in rate base.

The Board will therefore consider allowing utilities some flexibility in the useful life assumptions and thus the depreciation rates. Specifically, a utility may apply to use depreciation for rate purposes as follows:

- over a period of time equivalent to a particular contract term related to the subject facility (for example, the term of the power purchase agreement with the first generator to connect to a transmission or distribution facility);
- over a period of time equivalent to the useful life of one or more connecting facilities;
- a hybrid approach, under which: a) accelerated depreciation is allowed for a pre-determined period (e.g., up to the length of the incentive regulation plan term that the utility is entering) and b) at the end of that period, the depreciation reverts to a rate determined by the remaining expected life of the asset; or
- any other reasonable and generally accepted regulatory method for estimating the project-specific depreciation.

The Board will allow the depreciation established on a shorter useful life to be recovered in rates, and the resulting lower asset net book value to be added to rate base in a future cost of service proceeding.

### **3.2.4 Incentives: Project-specific Return on Equity**

When projects compete for capital in infrastructure investment planning, return on equity (“ROE”) incentives may encourage investment by making certain projects more attractive and therefore more likely to proceed. More specifically, ROE incentives may encourage appropriate proactive investment, especially in those cases where the project is perceived to be particularly risky. Even when a project can be a mandated

project, the investment may entail certain risks and challenges, and a project-specific ROE may provide regulatory flexibility commensurate with any demonstrable risks and challenges being faced by the applicant.

The Board will therefore allow utilities to apply for a project-specific ROE. Where a utility applies for a project-specific ROE in relation to a project for which other alternative mechanisms are also requested, the Board will take the risk-mitigating impact of those other mechanisms into account in its determination of an appropriate ROE for the project.

As noted above, the Board will remain mindful of stakeholder concerns that project-specific ROEs can make some projects more attractive than others to a utility, and therefore have the potential to skew utility decision-making.

### **3.2.5 Incentives: Project-specific Capital Structure**

Project-specific capital structures are a means of providing additional flexibility with regard to financing arrangements. A project or its proponent(s) may have unique financial and cash flow requirements, and too rigid an approach to acceptable capital structures may affect the viability of some projects.

Project-specific capital structures may be particularly effective for the development of consortium projects. This can be especially important for projects with a diverse set of sponsors, some of which have different capital structures. Such consortia may become more common under the Green Energy Act. For example, major transmission projects may involve diverse sponsors (private, public, and First Nations and Métis interests). Greater flexibility in capital structures could serve to facilitate these partnerships.

The Board will therefore consider applications for a project-specific capital structure for significant infrastructure investments that require additional flexibility with regard to financing.

### **3.3 Case-by-Case Approach**

The Discussion Paper suggested, and stakeholders generally agreed, that alternative mechanisms should be considered by the Board on a case-by-case basis upon application.

The Board believes that the case-by-case approach will be most effective to ensure that an appropriate balance is achieved between, on the one hand, mitigating the risks associated with unique investment challenges and, on the other, protecting the interests of ratepayers. This approach will provide an appropriate level of public scrutiny in relation to any proposal to use an alternative mechanism.

Given the Board's decision: a) that the alternative mechanisms will be available in respect of Green Energy Act-related investments, and b) that the use of alternative mechanisms will be assessed on a case-by-case basis, the Board's view is that it is neither necessary or appropriate at this time to further identify specific types of projects that may be eligible for one or more of the alternative mechanisms.

### **3.4 Criteria or Considerations in Assessing Applications**

The Board has developed criteria for the application of conventional mechanisms. These are set out in the Board's existing filing guidelines. For example, in order for costs to be considered for recovery as a Z-factor, the project or costs must satisfy four criteria – causation, materiality, exogeneity (or the inability for the utility to control), and prudence.

The question arises as to whether the alternative mechanisms described in this Report require different or additional criteria. The Discussion Paper noted the approach used by the FERC, namely that the “the applicant must demonstrate a nexus between its proposal and the facts of its particular case”.<sup>8</sup> The Board agrees that such a test is appropriate and adopts it for use in Ontario. The applicant therefore must demonstrate that there is a requisite relationship between the alternative mechanism proposed and the investment project, in the sense that the proposal is tailored to address the demonstrable risks and challenges faced by the applicant.

Where an application requests more than one alternative mechanism, the Board will apply this test to the whole of the applicant’s proposal. In other words, in such cases, the requisite relationship must be demonstrated in relation to the whole of the proposal, and not in relation to each alternative mechanism individually. This approach will ensure that any interrelationships between the alternative mechanisms are taken into account; for example, the impact of one alternative mechanism may reduce the need for another.

The Board will not impose a “but for” requirement in assessing the requisite relationship between the alternative mechanisms requested and the risks and challenges associated with the project. In other words, it will not be necessary for the applicant to demonstrate that the project will not, or is likely not, to proceed unless an alternative mechanism is granted in support of the project. This is consistent with the approach taken by the FERC, where the “but for” approach was rejected because it would create an evidentiary hurdle that could only be satisfied in very rare cases.<sup>9</sup>

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<sup>8</sup> FERC Order No. 679 and the December 21, 2006 statement by Joseph T. Kelliher, then Chairman of the FERC.

<sup>9</sup> “There are many impediments to investing in new transmission, including siting concerns, financing challenges, rate recovery concerns, etc. It is therefore unreasonable to expect or require an applicant to show that a facility could not be constructed “but for” the removal of a single impediment – e.g., increased cash flow through 100 percent construction work-in-progress (CWIP) or an enhanced ROE. This test



In considering a proposal for one or more alternative mechanisms, the Board will evaluate the following factors, among others:

- the need for the project (if not already demonstrated through another process as discussed in section 3.5 below);
- the public interest benefits of the project and of granting the alternative mechanism(s) requested;
- the overall cost of the project in absolute terms;
- the cost of the project in proportion to the current rate base of the utility;
- the risks or particular challenges associated with the completion of the project;
- the reasons given for not relying on conventional cost recovery mechanisms; and
- whether the utility is otherwise obligated to undertake the project.<sup>10</sup>

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could rarely, if ever, be satisfied, particularly given that incentives are ordinarily sought before investment decisions are made and, hence, before any siting impediments are even confronted.” FERC Order No. 679-A, ¶ 61,345.

<sup>10</sup> As noted by a representative of ratepayer groups, these matters are similar to the six characteristics of a project that the FERC identified in separate statements attached to decisions on transmission investment incentives. Specifically, in separate statements attached to decisions on transmission investment incentives and on the topic of the framework for judging incentive proposals when reviewing an applicant's evidence, FERC identified six characteristics of any transmission project required to make reasoned and consistent decisions on requests for incentives for the project. FERC Commissioner Suedeem Kelly stated as follows: “The comments submitted in connection with Order Nos. 679 and 679-A, and the experience gained in working on individual incentive cases over the past year lead me to conclude that these particular characteristics are most relevant to deciding whether to award incentives”.

Applicants should prepare their filings in a manner that will allow the Board to consider the above.

The Board believes that it is premature at this time to establish further or more prescriptive criteria to be applied in considering whether or not an applicant has demonstrated the requisite relationship or nexus referred to above. The Board acknowledges and understands the desire of stakeholders for predictability regarding the application of the policy described in this Report, but also sees merit in retaining a measure of flexibility to refine its approach as experience warrants. With the benefit of that experience, the Board will be better positioned to provide further guidance regarding its approach to the availability of alternative mechanisms.

### **3.5 Applying for Alternative Mechanisms**

As indicated earlier, the Board will require an applicant to establish the need for a project in respect of which alternative mechanism is being sought. In addition, in the case where the Board allows the use of an alternative mechanism, the Board will address the issue of rate recovery. These two issues (need and rate recovery) can be addressed and the relevant determinations made in separate processes.

The need for a capital investment can be established through a number of the Board's regulatory processes, provided that the applicant brings forward sufficient evidence regarding the specific project. These processes include: a) a leave to construct proceeding, b) a proceeding to approve an Integrated Power System Plan, c) a process to approve a distribution or transmission plan, or d) a proceeding to set rates on a cost-of-service basis.

The costs of the investment can only be incorporated into rates in the context of a rates proceeding. For that reason, the Board's view is that, in most cases, an application for an alternative mechanism is most effectively addressed in conjunction with an

application for approval of a system development plan at the time of rebasing and prior to construction of the project.

The Board prefers to reserve single-issue rate reviews for unusual or exceptional circumstances. A single-issue rate review entails a cost-based review of a single matter and results in the issuance of an order that adjusts rates. Single-issue rate reviews do not allow a complete and balanced consideration of all aspects of a utility's operations that influence rates. In addition, there are significant financial and resource costs associated with such reviews. Accordingly, the Board believes that they should be used sparingly.

Nonetheless, the Board wishes to provide applicants with appropriate flexibility in terms of the timing of applications for an alternative mechanism. The Board will therefore not preclude the filing of an application at a time other than the time of rebasing.

### **3.6 Conditions on Approval**

As indicated earlier, the Discussion Paper outlined a number of conditions that the Board might impose when it approves an application for one or more alternative mechanisms.

The Board agrees that conditions may be warranted but believes that these are best identified on a case-by-case basis having regard to all of the relevant factors. These factors include: a) the specific alternative mechanism granted, b) the circumstances under and for which the alternative mechanism was granted, and c) the anticipated impact on ratepayers.

For example, in some cases, it may be appropriate for the Board to monitor project progress and whether a utility is meeting its milestones. The Board therefore may require a utility to establish metrics and provide status reports at key stages of the

project. In other cases, it may be appropriate for an alternative mechanism to be triggered only after a specified percentage of the project costs have been incurred. As is always the case when the Board provides conditional approval, the Board will expect an applicant to comply with all such conditions included in an order allowing an alternative mechanism and may take remedial action as appropriate in respect of any failure to comply with those conditions.

Moreover, it may be necessary for the utility to provide reconciliation between financial reporting under the alternative mechanism and its existing regulatory accounting information, in order to support future benchmarking work relating to the development of the Board's incentive regulation mechanism.

## Appendix A: Consultation – List of Issues

Staff Discussion Paper Chapter	Issue for Comment
1 Overview	1. Should the framework and mechanisms identified in this Discussion Paper apply to other rate-regulated entities? If so, why and for what types of projects?
2 Infrastructure Investment in Ontario	2. Are there other broad classifications for investment, beyond “routine”, “non-routine incremental”, and/or “Green Energy Act-related” that should be considered? If so, what are they and what are the specific underlying drivers for such investment?
3 Treatment of Infrastructure Investment	<p data-bbox="467 720 1170 741"><b>Investments that May Qualify for Alternative Mechanisms</b></p> <p data-bbox="467 779 1445 905">3. Should the mechanisms identified in this Discussion Paper apply to the recovery of costs incurred by electricity transmitters or distributors for investments to accommodate renewable generation or to develop the smart grid, or both? Why or why not?</p> <p data-bbox="467 942 1445 1068">4. Should the mechanisms set out in this Discussion Paper be applied to infrastructure investment if the cost of the investment is potentially recoverable through a Province-wide cost recovery mechanism? Why, or why not?</p> <p data-bbox="467 1106 1445 1232">5. Should the mechanisms set out in this Discussion Paper be applied to infrastructure investment in smart grid technology while it is at an early stage of development and where governing standards are yet to be developed? Why or why not?</p> <p data-bbox="467 1270 1445 1354">6. Should “routine” investment made by a transmitter or distributor be eligible for one or more of the alternative treatments identified in this Discussion Paper? Why or why not?</p> <p data-bbox="467 1392 1445 1476">7. Should the mechanisms identified in this Discussion Paper be presumed to apply to certain types of investments (for example, to accommodate renewable generation)? Why or why not? If so, to which investments?</p> <p data-bbox="467 1514 1445 1598">8. Should the Board be more prescriptive as to which type of investment may qualify and which will not? If so, what criteria might the Board use to make a determination on which type of investment would qualify?</p> <p data-bbox="467 1644 867 1665"><b>Provision for Unforeseen Events</b></p> <p data-bbox="467 1711 1445 1837">9. Should the Board permit applicants to request confirmation from the Board that prudently-incurred costs associated with any abandoned projects will be recoverable in rates if such abandonment is outside the control of management? Why or why not?</p>

Staff Discussion Paper Chapter	Issue for Comment
	<p><b>Accelerated Cost Recovery</b></p> <p>10. Should the Board allow for full or partial CWIP to be placed in rate base during the construction of transmission facilities to accommodate the connection of renewable generation and/or develop the smart grid? Why or why not? Should the Board allow this particular treatment for distribution investment? If so, on what basis?</p> <p>11. Should the Board allow depreciation to be adjusted to match a contract term or the useful life of the connecting renewable generation facility? Why or why not?</p> <p><b>Incentive Mechanisms</b></p> <p>12. In light of a legislative context in which the Board may mandate infrastructure investments, are incentives necessary or appropriate in Ontario?</p> <p>13. If the Board were to provide for incentives, should it allow project-specific ROE? If so, should the Board consider adopting a range rather than a specific adder? Further, how might the Board determine an appropriate range or ROE adder?</p> <p>14. If the Board were to provide for incentives, should it allow project-specific capital structures?</p> <p><b>General</b></p> <p>15. What other alternative mechanisms, if any, might the Board consider be made available to applicants? Why?</p>
<p>4 Considerations and Conditions That May Apply</p>	<p>16. In addition to the potential considerations identified, are there any other matters that the Board might consider in making decisions on requests for alternative treatment?</p> <p>17. What performance conditions, if any, should be established?</p> <p>18. Are the reporting requirements suggested appropriate and adequate?</p> <p>19. Are there any other conditions that the Board might need to establish in relation to an approved alternative mechanism referred to in this Discussion Paper to protect ratepayer interests?</p> <p>20. Beyond those already reflected in the Board's existing filing guidelines (e.g., the Z-factor test of causation, materiality, and prudence) and in the Board's jurisprudence, is there a specific test that successful applicants should be required to meet in order to be granted an alternative treatment?</p>

Staff Discussion Paper Chapter	Issue for Comment
5 Implementation Considerations	<p>21. Are the Board's existing filing guidelines for electricity transmitters and distributors sufficient to support the case-by-case approach discussed in this Discussion Paper? If not, what additional information should an applicant provide?</p> <p>22. Should the process for applying for the regulatory treatment of infrastructure investment discussed in this Discussion Paper be more prescriptive (e.g., the timing, sequencing, and/or combining of applications)? Should it be combined with the process for approving infrastructure investment plans? If so, why and in what way?</p> <p>23. Should the Board permit applicants to seek approval prior to construction of the facilities to determine whether the facilities qualify for the requested alternative treatment(s)? Why or why not?</p> <p>24. What are the implications, if any, of using the single-issue rate review process?</p> <p>25. Is the use of rate riders an appropriate approach for implementing rate adjustments associated with the alternate treatments identified in this Discussion Paper? Alternatively, should the adjustments be made directly to base rates?</p> <p>26. Should the Board allow applicants to seek approval of multi-year rate riders or should the applicant be required to apply every year to adjust its rate riders to reflect any changes in project costs?</p>

## Appendix B: List of Stakeholders

The June 5, 2009 Staff Discussion Paper (“Discussion Paper”) on the Regulatory Treatment of Infrastructure Investment for Ontario’s Electricity Transmitters and Distributors is available on the Board’s web site at

<http://www.oeb.gov.on.ca/OEB/Industry+Relations/OEB+Key+Initiatives/Regulatory+Treatment+of+Infrastructure+Investment>.

Below is the list of stakeholders that provided written comments on the Discussion Paper.

### Interested Stakeholders and Links to Comments

1. [Anbaric Power LLC \(Anbaric\)](#)
2. [Association of Power Producers of Ontario \(APPrO\)](#)
3. [Association of Major Power Consumers in Ontario \(AMPCO\)](#)
4. [Atikokan Hydro \(Atikokan\)](#)
5. [Canadian Manufacturers and Exporters \(CME\)](#)
6. [Canadian Wind Energy Association \(CanWEA\)](#)
7. [Chatham Kent Hydro Inc. and Middlesex Power Distribution Corporation \(CK-MP\)](#)
8. [Consumers Council of Canada \(CCC\)](#)
9. [Electricity Distributors Association \(EDA\)](#)
10. [Enbridge Gas Distribution Inc. \(EGDI\)](#)
11. [Energy Probe](#)
12. [GD Consulting and MCQ & Associates](#)
13. [Great Lakes Power Transmission \(GLPTLP\)](#)
14. [Green Energy Coalition \(GEC\)](#)
15. [Hydro One Networks Inc. \(HONI\)](#)
16. [Infrastructure Renewal Task Force \(IRTF\)](#)
17. [London Property Management Association \(LPMA\)](#)
18. [National Chief’s Office on Behalf of the Assembly of First Nations \(“NCO”\)](#)
19. [Northwatch](#)
20. [Ontario Power Authority \(OPA\)](#)
21. [Ontario Power Generation \(OPG\)](#)
22. [Pollution Probe](#)
23. [Power Workers’ Union \(PWU\)](#)
24. [School Energy Coalition \(SEC\)](#)
25. [Vulnerable Energy Consumers Coalition \(VECC\)](#)
26. [Union Gas Limited \(Union\)](#)