Ontario Energy Board

Commission de l'énergie de l'Ontario

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Report of the Board

New Policy Options for the Funding of Capital Investments: The Advanced Capital Module

September 18, 2014

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1 Introduction

On July 18, 2014, the Board released Chapter 2 of the Filing Requirements For Electricity Distribution Rate Applications (for applications filed under cost of service). In that document the Board continued its promotion of a change to the way electricity distributors think about the future. The Filing Requirements noted that the *Report of the Board, Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach* (the "RRFE Report") "emphasized the importance of good distribution system planning, including optimizing, prioritizing and pacing distributor's capital expenditures to control costs and promote rate predictability."

The Board also noted that it will "review the single test year application not just in the context of the projects and programs that are requested for the test year, but from the perspective of the distributor's plans for the subsequent four years until the next scheduled rebasing application. It is the Board's expectation that at a minimum, cost of service proceedings will consider the entire five year distribution system plan as a means of assessing the distributor's planning and whether the test year requests are appropriately aligned with the Distribution System Plan."

In this *Report of the Board, New Policy Options for the Funding of Capital Investments: The Advanced Capital Module* (the "ACM Report"), the Board continues its progress towards incenting electricity distributors to develop and justify a long-term strategy for delivering distribution services that their customers value and that reflect manageable rate impacts over the long term. Accordingly, this ACM Report establishes a new mechanism to assist electricity distributors in these efforts.

This ACM Report is the culmination of the first phase of a brief consultation initiated by the Board on June 20, 2014. The consultation was on *New Policy Options for the Funding of Capital Investments* (EB-2014-0219). In the letter initiating the consultation, the Board indicated that Board staff had developed two new policies on which it will be seeking comments before bringing the new policy options to the Board for consideration:

- The elimination of the effect of the half year rule on test year capital additions for the intervening years between rebasing applications; and

- The introduction of a new funding mechanism that would enable review during a cost of service application for the need and prudence of any incremental capital module funding requests for discrete projects that are part of a distributor's

Distribution System Plan, and that are planned to come into service during the IRM period (the Advanced Capital Module or "ACM").

It was the Board's intention that these policy options, if approved, would be available to distributors under the Price Cap IR option. They would not apply to distributors under the Annual Index option. Distributors that have specific needs for capital funding that cannot be accommodated under Price Cap IR, should consider whether their specific circumstances would be best addressed through an application for a 5-year Custom IR plan.

A working group consisting of several representatives from electricity distributors who had adopted the Price Cap IR option for 2015 rates, as well as other stakeholders, was convened on June 25, 2014. Based on the feedback provided by the working group, the Board has decided to establish the Advanced Capital Module mechanism.

The purpose of this ACM Report is to articulate the Board policy on the ACM, and how the current policy regarding the Incremental Capital Module ("ICM") mechanism is changing.

The Board does not intend to proceed with the elimination of the effect of the half year rule on test year capital additions for the IRM years at this time. The Board will continue to review this matter and may proceed with a further consultation at some point in the future.

2 Background

In July and September of 2008 the Board established its framework for 3rd Generation Incentive Regulation with the release of the *Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors (the "July 2008 Report of the Board")*, and the *Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors - EB-2007-0673)* (the "Supplemental Report"), respectively. As part of that framework, the Board introduced the approach for the ICM as a means by which a distributor could apply for and receive funding for significant capital projects that would be undertaken in years between cost of service applications.

The ICM was intended to address the treatment of capital investment needs that arise during the rate-setting plan which are incremental to a materiality threshold. The materiality threshold represented a distributor's financial capacities underpinned by existing rates, including growth. The requested amount for an ICM claim had to satisfy the eligibility criteria of materiality, need and prudence as set out in section 2.5 of the July 14, 2008 Report of the Board. Notably, the "need" criterion involved a demonstration that the amounts should be directly related to the claimed driver, which must be clearly non-discretionary.

The ICM was in essence a funding mechanism for significant capital projects for which a utility required rate recovery in advance of its next regularly scheduled cost of service application. Distributors were required to make specific requests for ICM funding as part of their incentive regulation mechanism ("IRM") applications. Applications were required to be accompanied by comprehensive evidence to support the claimed need as well as the proposed rate riders to establish the funding for the IRM period. Approved projects would then flow into the distributor's rate base at their remaining net book value, at the time of the next cost of service application.

Since 2008, the Board has reviewed 13 applications for ICM funding. Appendix C to this Report is a listing of these applications.

While the three key criteria of materiality, need and prudence have underpinned the review of all applications filed to date, the Board has evolved its approach to the ICM over the years, specifically with respect to its scope.

2.1 The Evolution of the Scope of the ICM

Preceding this ACM Report, the Board did not issue an updated policy paper on the ICM. The Board's policy and specifically, the criteria underpinning that policy have evolved and been refined in the Board's decisions which have in turn been incorporated into the Board's Filing Requirements over the years.

In the first application before the Board for an ICM, Hydro One Networks Inc.[1] identified its capital budget for the 2009 rate year and requested approval for ICM funding for the entire difference between the capital budget and the materiality threshold. In its decision, the Board noted that:

> *In considering Hydro One's application in this case it is apparent that Hydro One has conflated the calculation of the threshold and the eligibility criteria. While the relationship between depreciation expense and capital spending establishes the base materiality threshold, the relationship itself is not the determinative factor in assessing the appropriateness of the use of the incremental capital*

[1] *EB-2008-0187*

> *module. Hydro One has substantially predicated its application on the gap between its depreciation expense and its capital spending plan. In fact what the Board requires in considering an application under the incremental capital module is a demonstration that the distributor is facing <u>extraordinary and unanticipated</u> capital spending requirements; i.e. something other than the normal course of business. (Emphasis added)*

While the Board's September 2008 Supplemental Report specifically refers to unusual circumstances in giving rise to eligibility under the module, the Board noted that Hydro One's claim that the gap between its depreciation expense and its capital spending could not be considered unusual circumstances given that Hydro One had been operating since 2002 with a similar gap. While the Board afforded some relief to Hydro One, it did not consider Hydro One's application under the Incremental Capital Module. The Board thus evolved the ICM policy through this decision by clarifying that projects were not only required to be part of a capital budget that is incremental to the materiality threshold, but must also be driven by capital spending requirements that are extraordinary and unanticipated.

No ICM applications were filed for the 2010 rate year. For the 2011 rate year, two distributors filed requests for ICM funding in relation to new municipal transformer stations. In its decisions for Oakville Hydro Electricity Distribution Inc. and Guelph Hydro Electric Systems Inc.,[2] the Board approved ICM funding for both applications noting that the projects were non-discretionary expenditures that were clearly outside of the base upon which rates were derived.

These two decisions clarified two significant principles. First, they clarified that ICM requests must first establish the amount of <u>eligible capital</u> available to distributors by subtracting the materiality threshold result from the total non-discretionary capital budget for the subject year. This clarification was consistent with the Board's decision on Hydro One's 2009 application which noted that the mere existence of a gap between the threshold and the capital budget is not determinative for ICM funding.

Second, in approving ICM funding for transformer stations, which have longer lead times for design and construction as compared to most other distribution-related capital projects, the Board had in essence set aside the criteria of extraordinary and

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[2] *EB-2010-0104 and EB-2010-0130 respectively*

unanticipated. This was reflected in the Board's 2013 Filing Requirements[3] in which these criteria were removed.

To date, nine out of the 13 ICM applications filed have included transformer-related assets as the focal point of the funding request.

The one remaining notable application for ICM funding was that of Toronto Hydro-Electric System Ltd.'s[4] three year application for 2012 to 2014 inclusive. While Toronto Hydro proposed a number of unique approaches to the Board's ICM policy in effect at the time, the two most notable that were approved were the multi-year approach and the request for multiple projects encompassing most of the eligible incremental capital available to the company in each of the three years.[5]

In its decision, the Board determined that both proposed approaches for incremental funding were approved in light of Toronto Hydro's unique circumstances.[6] While the Board approved funding for both the 2013 and 2014 rate years, it stated its expectation that future IRM filings will only be for one year, unless there are appropriate circumstances that justify a multi-year approach to IRM.

Following are a number of excerpts from the Board's decision:

> *The Board finds that on a case by case basis, some projects that might be characterized as "business as usual" may be eligible for ICM. The criteria in the Reports do not require that capital expenditures are on an "emergency or urgency basis" but rather, that the work must be undertaken and that the existing capital in the rebasing year is insufficient to do so. The Board rejects the notion that projects that might be "routine" or "business as usual," are ineligible categorically for an incremental capital module […]*[7]
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> *The Board's Supplemental report (p. 31) does refer to unusual circumstances but does not refer to unanticipated circumstances. The Board finds that the aging infrastructure and the associated capital needs of the magnitude faced by*

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[3] *Chapter 3 of the Filing Requirements for Transmission and Distribution Applications (Incentive Regulation Mechanism)*

[4] *EB-2012-0064: This proceeding took place in two phases with Phase 1 reviewing 2012 and 2013, and Phase 2 reviewing 2014.*

[5] *It should be noted that for the 2012 rate year, no eligible capital was available once the Board established that Toronto Hydro's non-discretionary capital budget for the 2012 calendar year did not exceed the materiality threshold for that year. Therefore, no ICM recovery was approved for that year.*

[6] *In its Part 1 decision for the 2013 test year, the Board disallowed ICM treatment for certain planned capital projects, although the majority of capital projects and costs were approved. (Partial Decision and Order, April 2, 2013). The 2014 capital program was subject to a Settlement Agreement subsequently approved by the Board (Transcript, Vol. 11, December 19, 2013, pg. 5, ll. 3-8).*

[7] *EB-2012-0064, Partial Decision and Order, April 2, 2013, pg. 18*

> *THESL can be considered "unusual" in the broader context of Ontario utilities […]*[8]
>
> *The Board notes that most previous ICM applications approved by the Board have been for one or a few discrete large projects. While the Board will not adopt the suggestion of some parties that each project put forward by THESL should meet the overall materiality threshold, the Board does not expect that projects that are minor expenditures in comparison to the overall budget should be considered eligible for ICM treatment. A certain degree of project expenditure over and above the threshold calculation is expected to be absorbed within the total capital budget.*[9]

In summary, as of the end of the 2014 rate year, the scope of the Board's ICM policy, as implemented in its decisions (aside from the unique circumstances of Hydro One and Toronto Hydro), have involved discrete non-discretionary capital projects that have a significant influence on the operations of a distributor, that are not limited to extraordinary or unanticipated investments, and whose allowable cost is limited to the difference between the non-discretionary capital budget and the materiality threshold.

The above experiences, along with the outcomes of the June 25 Working Group session, and the impact of the adoption of the Renewed Regulatory Framework with its emphasis on planning, have informed the content of this ACM Report; specifically, why requests for incremental capital funding should be proposed much earlier in a distributor's planning horizon, and what criteria (both new and existing), should be established, revised or maintained given this shift.

The next section discusses the impact of the adoption of the Renewed Regulatory Framework.

[8] *Ibid., pg. 18*
[9] *Ibid., pp. 18-19*

3 The Need for a Revised Incremental Capital Module Mechanism

The Board's RRFE Report represented a significant evolution of the approaches for rate regulation of the sector. In the RRFE Report, the Board established three rate-setting options for electricity distributors:

- Price Cap Incentive Rate-Setting ("Price Cap IR"), under which rates are rebased through a cost of service application followed by four years of rate adjustments through an annual formulaic price cap adjustment;

- Annual Incentive Rate-setting ("Annual IR"), whereby the distributor files for annual rate adjustments under the price cap formula, without rebasing, but subject to rates being adjusted by the highest stretch factor; and

- Custom Incentive Rate-setting ("Custom IR"), whereby the distributor proposes a plan to be effective for rate setting for five years, and with an approach that the distributor feels would reflect its capital and operating needs more appropriately than would the other approaches.

The subsequent *Report of the Board on Rate Setting Parameters and Benchmarking under the Renewed Regulatory Framework for Ontario's Electricity Distributors (EB-2010-0379)* ("the Price Cap IR Report"), issued November 21, 2013 and updated December 4, 2013, provided further details on these three rate-setting mechanisms.

A risk for any form of regulation is the emergence of unintended consequences as a result of regulated entities responding to incentives that emerge inadvertently from the regulatory framework within which they operate. One such tension that has been observed is the regular pacing of capital projects at certain points within the rate-setting cycle. There appears to be a tendency for capital projects, particularly major ones, to be clustered around the test year when the distributor rebases its rates through a cost of service application. In subsequent years, capital expenditures and additions may be substantially less than the levels in the bridge and test year(s), possibly as a means of managing capital and operating expenses relative to the often smaller changes in revenues in those years where a price cap formula is used to adjust rates.

The concern is that this volatility (i.e. the "roller coaster" effect) of capital investments to fit the rate-regulation schedule does not necessarily align with when the investments should be made under prudent asset management practice. While a significant portion of capital investment may be "routine" (i.e., fairly predictable and levelized), some volatility and lumpiness is not uncommon. The nature of major capital projects, such as transformer station builds or replacement, is one reason that some "bumps" in capital spending may be unavoidable. However, while timing these around when the rate base is "reset" in a cost of service application provides greater assurance of recovery of the investments (if approved), such clustering of projects is often not optimal from an asset management perspective, nor desirable from a rate impact perspective.

As the Board has identified in the RRFE Report and other documents[10], the Board is of the view that the industry would be better served by a more disciplined approach to capital planning. In recent years, the Board established expectations that distributors conduct and file Asset Management Plans as part of cost of service applications. This has evolved into the current Distribution System Plan ("DSP") requirement. Under the RRFE, distributors are also expected to provide documentation on their efforts to engage customers on the necessary capital and operating costs and on the associated cost consequences that will be ultimately impacting customers.

Incenting distributors to adopt a longer term planning horizon for capital and operating projects should enable the distributor to optimize its resource requirements (financial, human and equipment) so as to be able to efficiently and effectively serve existing customers while planning for and making investments to serve future needs in a timely manner.

Accordingly, the Board has decided to advance the review and approval process for incremental capital from the year in which the proposed projects will be entering service (i.e. the IRM term) to the preceding cost of service application in which a distributor is required to file a five year Distribution System Plan encompassing the cost of service test year and the four subsequent incentive rate-setting[11] ("IR") years.

As will be explained further in section 5 of this ACM Report, the opportunity for requests for review and approvals of incremental capital during the IR term will be maintained for projects that were unanticipated at the time of the development of the Distribution System Plan, or for projects anticipated but for which sufficient rationale was not available at the time of the DSP to establish need and prudence.

[10] e.g., *Filing Requirements for Distribution Rate Applications – Chapter 5 - Consolidated Distribution System Plan Filing Requirements*.
[11] *This Report uses Incentive Regulation Mechanism ("IRM") and Incentive Rate-setting ("IR") interchangeably.*

4 The Revised Capital Module Policy

In light of the Board's expectations, as signalled in the RRFE Report and associated documents, the Board is establishing the following mechanism to assist distributors in aligning capital expenditure timing and prioritization with rate predictability and smoothing:

The review and approval of business cases for incremental capital requests that are subject to the criteria of materiality, need and prudence are advanced to coincide with the distributor's cost of service application. To distinguish this from the Incremental Capital Module ("ICM"), this new mechanism will be named the Advanced Capital Module (or "ACM").

The review and approval process of the rate riders intended to implement cost recovery of approved ACM projects, will be maintained as part of the IR application process.

This approach adapts and adds to the ICM mechanism**.** Advancing the reviews of eligible discrete capital projects, included as part of a distributor's Distribution System Plan and scheduled to go into service during the IR term, is expected to facilitate enhanced pacing and smoothing of rate impacts, as the distributor, the Board and other stakeholders will be examining the capital projects over the five-year horizon of the DSP.

The ACM approach should also facilitate regulatory efficiency by placing the requirement to establish the need and prudence for any additional incremental capital spending within a cost of service proceeding. This is well suited to such forms of review and when the five-year DSP is tested. Consequently, largely mathematical calculations of ACM/ICM-related matters, such as the determination of the rate riders, will remain part of the streamlined IR applications in subsequent years.

When coupled with the requirement for five-year DSPs and other policies that impose discipline upon distributors in their planning, the ACM should reduce incentives for clustering capital projects around the rebasing year. Further, this also provides options for distributors to recover costs for discrete capital projects when they are needed throughout the Price Cap IR cycle. While some lumpiness of capital projects may be unavoidable (particularly for distributors with smaller rate bases, where a single project such as a transformer station build or replacement would be a major fraction of any annual capital budget), the Board expects that the volatility that has been observed in some cost of service applications in recent years will be reduced.

The ACM approach will also assist in large part to preserve the regulatory efficiency of IR applications, as many qualifying capital projects should be identifiable through the DSP. More importantly, it provides greater assurance of recovery for prudent and appropriately prioritized capital projects regardless of when the investments might be made.

The Board would also expect improved performance with respect to capital forecasting both in terms of timing of and the level of projects, taking into account bill impacts on customers as well on the financial, human and other resources of the utility to carry out its capital projects as planned.

Following any approvals in a cost of service application, the distributor would still have to file information in the applicable IR application to confirm that the ACM is on schedule to be completed as planned, that the costs of the projects have not significantly changed from the original forecast, and to determine the appropriate rate riders for approval.

In general, the details and need for a project that has received ACM approval in a previous cost of service application should not need to be re-examined in an IR application; however, if the forecasted costs (or timing) are significantly different than what was in the DSP, the onus is on the distributor to support the changes.

In particular, if costs are 30% (or more) above what was documented in the DSP, the distributor has the option of seeking approval for the incremental costs but would typically treat the project as a new ICM and re-file the business cases and other relevant material in the applicable IR year. It is expected that the Board will include this condition as part of the ACM approval. This would provide the applicant and parties an opportunity to argue for a different (higher or lower) percentage depending on the nature of the project.

If costs are less than 30% above what was documented in the DSP, the distributor should still explain the need for the increased costs, whether and how re-prioritizing of capital projects has been considered, how impacts on the rates and bills of the distributor's ratepayers have been taken into account and finally, whether the project is still the best option. Any changes in project scope must be clearly explained and justified.

If the in-service date has been delayed to the following rate year (or beyond), distributors should identify this fact in the earliest possible IR application and confirm in which IR application the distributor expects to seek to commence funding for the project. Funding shall not commence for any projects that are not forecasted to be in service during the subject IR year.

Following a cost of service application, per the current ICM policy (which is now extended to ACMs), the actual costs and the recoveries would be reviewed for any material discrepancies. If there are significant variances between the revenue requirement based on actuals and the revenues collected through the ACM rate riders, the Board may decide to true up any differences. The following sections provide further discussion and details on ACM and ICM approvals during the IR period.

The Board will retain an incremental capital module (or "ICM") for the IR years for projects not included in the DSP filed with the most recent cost of service application, and for projects that were included in the DSP but which did not contain sufficient information at the time of the cost of service application to address need and prudence. Further information on the scope of the revised ICM are outlined in section 5 below.

4.1 New and Revised Criteria

The Board considers that the current ICM approach has been tested and, most importantly, is serving the purpose for which it is intended. The ACM concepts build on this experience and takes advantage of the information available in the DSP that is filed as part of a cost of service application.

Applications for requests for determination of the need and prudence for proposed projects to be included in ACMs as identified and documented in the DSP will use similar criteria as is required currently for an ICM project as part of an IR application. However, in this regard there have been some revisions to the current ICM criteria, as well as the adoption of new criteria, that will apply to both ACMs and ICMs. These are set out below. Criteria that will continue to apply unchanged to both an ACM and ICM are outlined in section 4.2.

4.1.1 The Adoption of the "Discrete" Project Criterion

The Board is of the view that projects proposed for incremental capital funding during the IR term must be discrete projects, and not part of typical annual capital programs. This would apply to both ACMs and ICMs going forward.

The Board will make a determination on whether projects are discrete on a case by case basis. However, there must be a clear distinction between a cost of service application under the Price Cap IR option (with ACM proposals beyond the test year), and the Custom IR method. The use of an ACM is most appropriate for a distributor that:

- does not have multiple discrete projects for each of the four IR years for which it requires incremental capital funding;
- is not seeking funding for a series of projects that are more related to recurring capital programs for replacements or refurbishments (i.e. "business as usual" type projects); or
- is not proposing to use the entire eligible incremental capital envelope available for a particular year.

4.1.2 The Adoption of a Preliminary Materiality Threshold Calculation

The Board will not require distributors to forecast final details of the ICM formula (i.e. the materiality threshold) for each of the IR years at the time of the cost of service application. Instead, any approvals sought at the time of the cost of service application will be based on need and prudence. The final assessment on whether or not the quantum of the approved project fits within the maximum allowable capital amount (i.e., the total eligible incremental capital amount) will take place at the time of the applicable Price Cap IR application. If the costs of the project(s) exceed the total available envelope for the subject year, the amount allowed for recovery will be limited to the maximum allowable capital amount.

However, **as part of the cost of service application, distributors must provide a preliminary estimate of the materiality threshold value (and consequently, the total eligible incremental capital amount) for the subject year in which the proposed project is planned to enter service in order to provide the Board with a degree of certainty that the distributor will meet the threshold criteria**. As noted above, the quantum of the threshold and the maximum allowable capital amount for the applicable year will be confirmed at the time of the IR application.

The Board has outlined in section 6 of this ACM Report a preliminary threshold calculation to be used for each IR year at the time of the COS application based on the current ICM formula. The Board is not making any substantive changes to the main ICM formula at this time. Some minor adjustments to the description of certain variables have been made to accommodate the timing of the preliminary threshold calculation. The Board intends to continue to review the formula and will determine a course of action, if any, in the future.

4.1.3 The Elimination of the Non-Discretionary Criterion

The Board is of the view that the availability of incremental capital funding during the IR term should no longer be limited to non-discretionary projects. **Any discrete project (discretionary or otherwise) adequately supported in the DSP is eligible for ACM funding subject to capital funding availability flowing from the formula results. The same approach shall apply going forward to new projects proposed as ICMs during the Price Cap IR term.**

With the establishment of a requirement to file a five year DSP, distributors will be expected to develop well-paced plans to maximize the efficiency and effectiveness of their distribution systems in serving customers, and smooth rate impacts where possible. The current approach of limiting incremental funding to non-discretionary projects could inappropriately incent a distributor to time certain projects in their DSP so that funding is available. By expanding the incremental funding to both discretionary and non-discretionary projects, distributors will have the opportunity to develop their most robust plans without limiting their opportunity for incremental funding.

Distributors are required to identify the total annual capital budget for each of the five years as part of their DSP, at the time of the cost of service application. This amount will now be used in the calculation of the total eligible incremental capital amount for any given year (as opposed to the current policy that requires the non-discretionary component to be used as the starting point in the calculation). The same approach shall apply going forward for new projects proposed as ICMs during the IR term.

4.1.4 The Adoption of a Means Test

The Board is of the view that establishing a means test would be prudent in qualifying distributors for incremental capital funding. Any distributor approved for an ACM in its most recent cost of service application must file its most recent calculation of its regulated return (RRR 2.1.5.6) at the time of the applicable Price Cap IR application in which funding for the project, and recovery through rate riders, would commence. **If the regulated return exceeds 300 basis points above the deemed return on equity embedded in the distributor's rates, the funding for any incremental capital project will not be allowed.** Therefore, any approvals provided for an ACM in a cost of service application will be subject to the distributor passing the means test in order to receive its funding during the IR term. The same means test shall also apply going forward for new projects proposed as ICMs during the Price Cap IR term.

While a means test that doesn't allow incremental funding if a distributor is earning more than its Board-approved ROE may be a barrier to a distributor seeking efficiency improvements during the IR term, a threshold of 300 basis points retains some flexibility for distributors to maximize their earnings while also recognizing that funding in advance of the next rebasing is likely not required from a cash flow perspective. Distributors will have the option of explaining any overearnings.

4.1.5 Revisions to the Eligibility Criteria

The eligibility criteria to recover amounts that are incremental to capital investment needs were first set out in section 2.5 of the July 14, 2008 Report of the Board.

The following are the current definitions of Materiality, Need and Prudence as they apply to ICMs.

Criteria	Description
Materiality	The amounts must exceed the Board-defined materiality threshold and clearly have a significant influence on the operation of the distributor; otherwise they should be dealt with at rebasing.
Need	Amounts should be directly related to the claimed driver, which must be clearly non-discretionary. The amounts must be clearly outside of the base upon which the rates were derived.
Prudence	The amounts to be incurred must be prudent. This means that the distributor's decision to incur the amounts must represent the most cost-effective option (no necessarily least initial cost) for ratepayers.

In order to reflect the new and revised criteria discussed above and to further clarify the purpose of the materiality threshold calculation, the Board has made revisions to the formal eligibility criteria applicable to both ACMs and ICMs.

Most notable of the changes is the Board's decision to revise the reference to amounts (i.e. referring to projects) "exceeding" the Board-defined materiality threshold. While this language has been used in the Board's past reports and in decisions, it has caused much confusion as to its meaning. Specifically, approved amounts do not "exceed" the materiality threshold, rather they must fit within the total eligible incremental capital, which is the difference between the total capital budget for the subject year and the result flowing from the materiality threshold calculation.

Any reference to "exceeding" the Board-defined materiality threshold is therefore in reference to the total capital budget, the starting point to the calculation of the total eligible incremental capital amount. Therefore, the materiality test would be met if there is a positive variance between a distributor's capital budget (typically the budget included in the previous cost of service application) and the Board-defined materiality threshold. The distributor would therefore be eligible to identify projects for ACM or ICM treatment if its capital budget for the subject year exceeds the Board-defined materiality threshold. The materiality threshold is in effect a capital expenditure threshold which serves to demonstrate the level of capital expenditures that a distributor should be able to manage with its current rates.

In addition, the Board has adopted a project-specific materiality threshold, as identified in the Toronto Hydro decision.[12]

Distributors proposing amounts for recovery by way of an ACM or ICM must meet all three of the following criteria, and their sub-parts.

Criteria	Description
Materiality	A capital budget will be deemed to be material, and as such reflect eligible projects, if it exceeds the Board-defined materiality threshold. Any incremental capital amounts approved for recovery must fit within the total eligible incremental capital amount (as defined in this ACM Report) and must clearly have a significant influence on the operation of the distributor; otherwise they should be dealt with at rebasing. Minor expenditures in comparison to the overall capital budget should be considered ineligible for ACM or ICM treatment. A certain degree of project expenditure over and above the Board-defined threshold calculation is expected to be absorbed within the total capital budget.
Need	The distributor must pass the Means Test (as defined in this ACM Report). Amounts must be based on discrete projects, and should be directly related to the claimed driver. The amounts must be clearly outside of the base upon which the rates were derived.
Prudence	The amounts to be incurred must be prudent. This means that the distributor's decision to incur the amounts must represent the most cost-effective option (not necessarily least initial cost) for ratepayers.

[12] EB-2012-0064, op.cit. pp. 18-19. Specific projects were not approved on the basis that they were minor expenditures in comparison to the overall capital budget.

4.2 Current Criteria That Continue to Apply Unchanged

Distributors must file, at the time of the cost of service application, a description of the actions the distributor would take in the event that the Board does not approve the ACM proposal. Similarly, distributors must file comparable information for any ICM requests at the time of the IR application.

Distributors must also include a discussion on any offsets associated with each incremental project for which ACM or ICM treatment is proposed due to revenue to be generated through other means (e.g. customer contributions in aid of construction), at the time of the cost of service application, along with an estimate of the revenue requirement impact associated with those offsets. The final offset amounts, if any, would be confirmed at the time of the IR application.

The ACM and ICM are only available to electricity distributors opting for Price Cap IR. The ACM/ICM approach is intended to address the treatment of capital investment needs that arise during the rate-setting plan which are incremental to the materiality threshold defined below, while allowing the distributor to obtain necessary recovery of capital investments on a planned and prioritized basis over the whole IR period. Applicants should note that custom approaches to rate-setting should be addressed through selecting the Custom IR option, not by customizing an ACM or ICM proposal. The ACM/ICM approach is not available to distributors filing under the Annual IR plan.

Finally, the Board notes that ACM and ICM mechanisms are intended to provide utilities with an opportunity to establish reasonable rate impacts for customers. In fact, with the longer-term planning horizon of the DSP and of engaging customers on their needs, expectations and willingness to pay, the Board continues to expect that distributors will exhibit greater discipline on the pacing and prioritization and hence on consistency in the levels of capital expenditures over time. At the same time, these options increase the assurance of recovery from when the investments are made and go into service, and the Board expects that distributors will take this into consideration in planning and managing their capital programs.

5 The Scope of the Incremental Capital Module

While the Board has advanced the opportunity for distributors to apply for early identification of projects during the cost of service application to be included for ACM treatment during the subsequent Price Cap IR terms, **the Board will retain the availability of new ICM requests in each of the IR years, with the same scope as exists with the current approach.** ICM projects will not be limited to those that are unanticipated, but will be subject to the revised criteria discussed in this paper such as the elimination of the non-discretionary requirement and the means test. The Board may revisit the criteria for the ICM in the future as experience is gained with the use of the ACM.

As one example of a situation that could trigger a capital project which may be identified in the DSP, but may not contain sufficient detail to address need and/or prudence at the time of the cost of service application, would be where a distributor is required to make a significant investment during its Price Cap IR term based on the outcome of a Regional Plan. The Regional Plan investment might not have been detailed sufficiently at the time of the DSP and cost of service application, but could become a significant capital project in which the distributor may have to invest during the later period of the IR term. ICM treatment would allow for recovery of costs beginning when the investment is made and goes into service, rather than awaiting the next cost of service application to rebase rates.

ICM proposals as part of Price Cap IR applications will result in a more involved Price Cap IR application. Since the nature and need for the ICM-qualifying project has not been pre-identified or pre-tested, all such information would need to be detailed in the Price Cap IR application.

For distributors currently under incentive rate-setting, the current scope, criteria and definitions of the ICM shall continue to apply, subject to the revisions noted in this paper. For example, the elimination of the non-discretionary criterion will apply not just to ACMs going forward, but also to all ICMs that may be filed by distributors currently on incentive rate-setting.

6 Materiality Threshold Calculation

The ICM materiality threshold is discussed in section 2.3 of the Supplemental Report. The Board determined that the following formula is to be used by a distributor to calculate the materiality threshold that will apply to it:

$$Threshold\ Value\ (\%) = 1 + \left[\left(\frac{RB}{d}\right) \times \left(g + PCI \times (1+g)\right)\right] + 20\%$$

This formula will continue to apply for IR years. The application of the formula for the final calculation to be provided at the time of approval of ACM rate riders, and ICM projects and associated rate riders in Price Cap IR applications remains unchanged.

This formula will also be used for the preliminary materiality threshold calculation to be provided at the time of an ACM request in a cost of service proceeding. The Board has made minor revisions to the definitions of the variables for the preliminary calculation to address the advanced timing of an ACM request, but does not expect that these changes will significantly alter the results from the previous formula. Appendix B of this ACM Report summarizes the definitions for both the preliminary and final calculations.

As noted earlier in this ACM Report, the Board intends to continue to review the components and applicability of the formula and will determine a course of action, if any, in the future.

Definitions of the terms are as follows:

RB is the rate base in the distributor's most recent cost of service application. This will be the Board-approved rate base in the most recent cost of service application for new ICM requests and for ACM rate rider approvals in a Price Cap IR application. For the preliminary materiality threshold calculation for a distributor is applying for an ACM in a cost of service application, the distributor should use its proposed rate base.

d is the depreciation expense approved in the distributor's most recent cost of service application. This will be the Board-approved depreciation expense in the most recent cost of service application for ICM requests and for ACM rate rider approvals in a Price Cap IR application. For the preliminary materiality threshold calculation for a distributor applying for an ACM in a cost of service application, the distributor should use its proposed depreciation expense.

The value for g is the percentage difference in distribution revenues between the most recent complete year and the approved base year, for ICM requests and for ACM rate rider approvals in a Price Cap IR application. In the first or second IR years following rebasing, a distributor may not have a complete year of data following the cost of service base year. Therefore, for these years, the growth factor may be updated to the difference between the Board approved distribution revenues from the last cost of service application and the most recent complete year prior to the rebasing year.

For the preliminary materiality threshold calculation for a distributor applying for an ACM in a cost of service application, the distributor should use its forecast distribution revenues as the base year and compare those with the most recent complete year.

Some concerns with respect to the current definition of the growth rate g have been identified previously, as it is derived comparing weather normalized (i.e., last Board-approved) to non-weather-normalized (i.e. actuals). This matter may be reviewed as part of any broader formula review in the future. For now, the Board does not view this discrepancy as materially affecting the formula results.

PCI is the price cap index, calculated as $PCI = IPI - X - stretch\_factor$ as defined in the Price Cap IR Report. Under the Price Cap IR, $X = 0$. For ICM requests and ACM rate rider approvals in a Price Cap IR application, distributors should use the most recently approved IPI and stretch factor as placeholders in their initial filings, and then update that information during the course of the proceeding once the Board establishes updated parameters for the subject year. For the preliminary materiality threshold calculation for a distributor applying for an ACM in a cost of service application, the distributor should use its most recently approved stretch factor and the most current version of the IPI.

The following is a numerical example of a preliminary calculation of a materiality threshold value for an IR year, but calculated at the time of the cost of service application.

Assumptions	Proposed Rate Base	RB	$100 million
	Proposed Depreciation Expense	d	$5 million
	Growth (forecasted dx revenues compared to dx revenues from most recent complete year)	g	(0.01275)
	Current IPI at the time of the application	IPI	1.7%
	Most recently approved Stretch Factor at the time of the application	$stretch\_factor$	0.4%
	Price Cap Index	$PCI = IPI - stretch\_factor$	1.7% - 0.4% = 1.3%
Calculation	$1 + \left(\frac{100{,}000{,}000}{5{,}000{,}000}\right) \times \left(0.01275 + 0.013 \times (1 + 0.01275)\right) + 0.20 = 171.8315\%$		
Result	The materiality threshold (Capex/Depreciation) is 1.718315 or 171.8315%. That is, given the assumptions in this example, the Board would expect the distributor to be able to fund capital expenditures (Capex) up to $8.591575		

	million ($5 million X 1.718315) during the Price Cap IR adjustment following rebasing before being eligible to apply to recover amounts for incremental capital expenditures for qualifying ACM capital projects.

Following the above calculation, the total incremental capital amount can then be calculated for each IR year by subtracting the threshold result from the proposed capital budget identified in a distributor's DSP for each of the four years.

For ACM requests at the time of a cost of service application, this preliminary threshold result may be used for each of the four IR years as an estimate for purposes of providing the Board some degree of comfort that a distributor has a capital budget that exceeds the materiality threshold. The preliminary calculation will demonstrate that the distributor is likely to be eligible to apply for incremental capital before the Board expends efforts in assessing need and prudence for the project.

6.1 The Eligible Incremental Capital Amount

In the Supplemental Report, the Board determined that eligible incremental capital amounts sought for recovery should be capital in excess of the materiality threshold. The materiality threshold value, as calculated using the formula set out above, establishes eligibility for incremental capital spending and also marks the base from which to calculate the maximum amount eligible for recovery. Section 4 of this ACM Report clarifies the reference to capital in excess of the materiality threshold.

The determination of the maximum allowable incremental capital amount has not changed from the guidance provided in the Board's recent Filing Requirements other than to remove the reference to non-discretionary. **It is now determined by taking the difference between the forecasted <u>total</u> capital expenditures for a subject year and the materiality threshold for that year.**

If the forecasted total capital expenditures identified in a Price Cap IR application, are higher than what the distributor documented in its DSP in its previous cost of service application, the distributor needs to document the increases and the reasons for these. This approach is unchanged from the current ICM policy.

For clarification, the Board's ICM models refer to a "threshold capex". This refers to the dollar value associated with the materiality threshold result and is subtracted from the total forecasted capital expenditures to determine the maximum amount eligible for recovery, for the applicable year.

7 Filing Requirements

Section 2.5.2 of Chapter 2 of the Filing Requirements contains additional information on filing requirements related to capital expenditures. In addition, Chapter 5 of the Filing Requirements deals with the 5-year Distribution System Plan, which will normally be dealt with as part of a cost of service application. An ACM/ICM is an application for recovery of needed and reasonable expenditures for a capital project, and a distributor making an application for an ACM/ICM should reflect the appropriate documentation as detailed in these sections of the Filing Requirements.

7.1 Revenue Requirement Calculation

Distributors must file the calculation of the revenue requirement (i.e. the cost of capital, depreciation, and PILs) associated with each approved ACM or proposed ICM, in the applicable Price Cap IR application. Distributors must also identify any revenue requirement offsets associated with each incremental project due to revenue to be generated through other means (e.g. customer contributions in aid of construction).

When calculating the revenue requirement associated with either an approved ACM or an ICM proposal at the time of the Price Cap IR application, a distributor should use the following parameters and methodologies.

7.1.1 Application of the Half-Year Rule

The Board's general guidance on the application of the half-year rule is provided in the Supplemental Report. In that report the Board determined that the half-year rule should not apply so as not to build a deficiency for the subsequent years of the IR plan term. In a subsequent decision with respect to the application of the half-year rule in the context of an ICM, the Board decided that the half-year rule would apply in the final year of the Price Cap IR plan term.[13] The Board adopted this as a clarification to the policy on ICM in the Filing Requirements. This approach is unchanged for the new ACM/ICM policy.

[13] EB-2010-0130, Guelph Hydro Electric Systems Inc., *Decision and Order*, p. 15. This is appropriate, as the full year of depreciation expense will be explicitly reflected in the determination of the rate base and revenue requirement in the cost of service application for the following test year. Full year treatment of a ICM capital addition in the last year before rebasing would increase the probability of a true-up being required when the actual capital project costs are reviewed and included in rate base to determine rebased rates.

7.1.2 Working Capital Allowance

A distributor shall use the WCA approach approved by the Board in the distributor's most recent cost of service application when calculating the revenue requirement associated with the ACM/ICM.

7.1.3 Cost of Capital

In the December 11, 2009 *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* (EB-2009-0084) the Board confirmed the continuation of a deemed 60/40 debt-equity ratio. A distributor filing for ACM or ICM rate riders shall use the cost of capital parameters approved by the Board in the distributor's most recent cost of service application when calculating the revenue requirement associated with the incremental funding.

7.1.4 Taxes / PILs

Since currently known legislated tax changes from the level reflected in the Board-approved base rates for a distributor will be reflected in the rate adjustments for Price Cap IR, a distributor filing for ACM or ICM rate riders should apply the current tax rates for calculating the revenue requirement associated with the incremental funding.

7.1.5 Rate Riders

Distributors must file the calculation supporting the proposed rate riders to recover the incremental revenue from each applicable customer class, and the rationale for the proposed approach.

7.1.6 Bill Impacts

Distributors must also provide bill impacts in a Price Cap IR application and the Board notes that its rate generator model used by most distributors in a Price Cap IR application contains detailed bill impacts for all classes.

7.2 Need and Prudence

A distributor requesting relief for incremental capital (both ACMs and ICMs) must include comprehensive evidence to support the need. If the ACM request is proposed as part of a cost of service application, it is expected that most of the following information would be included as part of the DSP, in any event:

- A preliminary threshold calculation demonstrating that there is a reasonable expectation that the final materiality threshold test at the time of the IR application will be met and that the amounts will have a significant influence on the operation of the distributor;

- A description of the proposed capital projects and expected in-service dates and their costs. In general, this would be satisfied by the filing of a business case and engineering study, as appropriate, for each capital project for which the applicant is seeking ACM or ICM approval;

- Details, by project, for the entire capital spending plan for the subject year. This analysis includes projects that are not being proposed for ACM or ICM treatment.

- Justification that the amounts to be incurred will be prudent. This means that the distributor’s decision to incur the amounts represents the most cost-effective option (but not necessarily the least initial cost) for ratepayers; and

- Evidence that the incremental revenue requested will not be recovered through other means (e.g., it is not, in full or in significant part, included in base rates or being funded by the expansion of service to include new customers and other load growth).

In the Price Cap IR application for the year in which the capital project(s) will go into service and the applicant is seeking to commence recovery through rate riders, the distributor should provide updated, current information with respect to the above for any approved ACMs for any material changes from what was reflected in the DSP.

In the case of an ICM proposal for recovery of an unanticipated capital project, or for a project for which a distributor did not have sufficient information to address need and prudence at the time of the cost of service application, this will be the first time that the distributor is providing such evidence. Therefore full and complete details of the project(s) must be filed, as is the current ICM policy and practice.

7.3 Confirmation of Cost and Timing

If the timing of an approved ACM project is advanced or deferred from when the distributor expected that it would incur the project (in the DSP reviewed in its cost of service application), the distributor must provide an explanation on the reasons for the change in timing, and on how the change in pacing and prioritization may have affected its five-year DSP overall, at the earliest opportunity as part of a Price Cap IR application.

7.4 Reporting Requirements

At the time of the next cost of service or Custom IR application, a distributor will need to file calculations showing the actual ACM/ICM amounts to be incorporated into the test year rate base. At that time, the Board will make a determination on the treatment of any difference between forecasted and actual capital spending under the ACM/ICM, if applicable, and the amounts recovered through ACM/ICM rate riders and what should have been recovered in the historical period during the preceding Price Cap IR plan term. Where there is a material difference between what was collected based on the approved ACM/ICM rate riders and what should have been recovered as the revenue requirement for the approved ACM/ICM project(s), based on actual amounts, the Board may direct that over- or under-collection be refunded or recovered from the distributor's ratepayers.

7.5 Accounting Treatment

The distributor will record eligible ACM/ICM amounts in Account 1508 – Other Regulatory Assets, Sub-account Incremental Capital Expenditures, subject to the assets being used or useful (i.e. in service). For incremental capital assets under construction, the normal accounting treatment will continue as construction work in progress ("CWIP") prior to these assets going into service and hence being eligible for recording in the 1508 sub-account listed below.

In its July 18, 2014 Filing Requirements applicable to 2015 cost of service applications for electricity distributors, the Board provided further guidance on the recording of amounts related to approved ICM projects and revenues received from approved rate riders.[14] Distributors shall record actual amounts in the following sub-accounts of Account 1508 – Other Regulatory Assets:

- Account 1508 – Other Regulatory Assets, Sub-account Incremental Capital Expenditures;
- Account 1508 – Other Regulatory Assets, Sub-account Depreciation Expense;
- Account 1508 – Other Regulatory Assets, Sub-account Accumulated Depreciation; and
- Account 1508 – Other Regulatory Assets, Sub-account Incremental Capital Expenditures Rate Rider Revenues.

[14] *Filing Requirements for Distribution Rate Applications – 2014 Edition for 2015 Rate Applications*, July 18, 2014, section 2.5,2.7: Addition of ICM Assets to Rate Base

The distributor shall also record monthly carrying charges in the following sub-accounts. Carrying charge amounts are calculated using simple interest applied to the monthly opening balances:

- Account 1508 – Other Regulatory Assets, Sub-account Incremental Capital Expenditures, Carrying charges.
- Account 1508 – Other Regulatory Assets, Sub-account Incremental Capital Expenditures Rate Rider Revenues, Carrying Charges;

The rate of interest shall be the rate prescribed by the Board for deferral and variance accounts for the respective quarterly period as published on the Board's web site.
All of these sub-accounts should be used for both approved ACM and ICM projects. If the Board approves the true-up of any variances for ACM/ICM projects at the next cost of service application, the recalculated revenue requirement relating to the actual ACM/ICM capital expenditures should be compared to the rate rider revenues collected in the same period, plus the carrying charges in the respective sub-accounts. These variances would then be refunded to, or collected from, customers through a rate rider.

7.6 Rate Models

The revised Capital Module work form (applicable to ACMs and ICMs) supporting the IRM Rate Generator model will assist distributors in calculating the distributor's final threshold at the time of the IR application. The distributor will then tabulate the value of its eligible investments and compare this to the threshold result to determine the amount that would be eligible for recovery. The tabulated revenue requirement will then be converted into class specific rate riders.

The work form has also been altered so that it can calculate the preliminary threshold and identify qualifying capital projects from the distributor's DSP for inclusion in the ACM request in the cost of service application.

Appendix A
The Revised Capital Module Policy

Capital Modules	Cost of Service Application	Price Cap IR Year (in which the capital project goes into service)	Next Cost of Service Application
ACM (Advanced Capital Module)	• Identify discrete projects in DSP which may qualify for ACM treatment. • Establish need for and prudence of these projects based on DSP information. • Provide preliminary calculation of materiality threshold based on information in cost of service application.	• Update materiality threshold based on current information to confirm that the project continues to qualify for ACM treatment. • Provide means test calculation and explanation if overearning in last historical actual year. • If costs are less than 30% above what was documented in the DSP, explain differences in cost forecasts from DSP forecast. • Explain any differences in project timing. • If costs are 30% or more above what was documented in the DSP, re-file business cases as new ICM if seeking recovery of incremental costs. • In all cases, explain any significant differences in capital budget forecast from DSP forecast. • Provide incremental revenue requirement calculation and proposed ACM rate riders.	• Review of actual (audited) costs of ACM project. • Explanation for material variances between actual and forecasted costs (and timing, if applicable). • Based on above, the Board may determine if any over- or under-recovery of ACM rate riders should be refunded to or recovered from ratepayers. • ACM capital assets reflected in new rate base based on January 1 actual NBV.
ICM (Incremental Capital Module)	• Not applicable	• Provide explanation for any ICM that could not have been foreseen or sufficiently planned as part of DSP. • Establish need for and prudence of proposed projects. • Provide materiality threshold calculation. • Provide means test calculation and explanation if overearning in last historical actual year. • Provide incremental revenue requirement calculation and proposed ICM rate riders. • Explain significant differences in capital budget forecast from DSP forecast.	• Same as above

Appendix B
Materiality Threshold Calculations

The following table explains the variables used to determine the preliminary materiality threshold, which will be updated in the Price Cap IR application to deal with the implementation of an ACM or ICM project and associated rate riders.

General Formula:		$$Threshold\ Value\ (\%) = 1 + \left[\left(\frac{RB}{d}\right) \times \left(g + PCI \times (1+g)\right)\right] + 20\%$$	
Parameters		**Preliminary Calculation for proposed ACM-qualifying capital projects (as part of a Cost of Service Application)**	**Final Calculation for pre-qualified ACM projects or for proposed ICM projects (as part of a Price Cap IR Application)**
Rate Base	RB	In its application, the utility should use its proposed test year rate base.	The distributor should use the approved rate base from its last cost of service application.
depreciation	d	In its application, the utility should use its proposed depreciation expense for the test year.	The distributor should use the approved depreciation expense from its last cost of service application.
Growth	g	g is always to be expressed as an annual growth rate. Growth should be calculated based on the percentage difference in distribution revenues between the forecast distribution revenues for the test year and the distribution revenues from the most recent complete year.	g is always to be expressed as an annual growth rate. Growth should be calculated based on the percentage difference in distribution revenues between the distribution revenues from the most recent complete year and the distribution revenues from the most recent approved test year. In the first and second IR years following rebasing, a distributor will likely not have a complete year of data following the cost of service base year. For these years, the growth factor may be updated to the difference between the Board approved distribution revenues from the last cost of service application and the most recent complete year prior to the rebasing year.
Price Cap Index	PCI	Distributors should use the Price Cap Index $(IPI - stretch\_factor)$ from its most recent Price Cap IR application.	Distributors should use the Price Cap Index from its most recent Price Cap IR application as a placeholder for the initial application filing. This information should be updated if updated parameters become available during the course of the proceeding.

Appendix C
List of ICM Decisions (to date)
Issued under the Board's previous policy

File Number	Applicant	Decision Date
EB-2008-0187	Hydro One Networks Inc.	May 13, 2009
EB-2008-0205	Oshawa PUC Networks Inc.	June 10, 2009
EB-2010-0104	Oakville Hydro Electricity Distribution Inc.	March 14, 2011
EB-2010-0130	Guelph Hydro Electric Systems Inc.	March 14, 2011
EB-2011-0178	Kingston Hydro Corporation	April 19, 2012
EB-2011-0207	Woodstock Hydro Services Inc.	March 22, 2012
EB-2011-0160	Centre Wellington Hydro Ltd.	March 22, 2012
EB-2011-0173	Hydro Hawkesbury Inc.	May 3, 2012
EB-2012-0064	Toronto Hydro Electric System Limited	April 2, 2012
EB-2012-0124	Festival Hydro Inc.	April 4, 2013
EB-2013-0166	PowerStream Inc.	February 20, 2014
EB-2013-0178	Wellington North Power Inc.	March 13, 2014
EB-2013-0127	Espanola Regional Hydro Distribution Corporation	March 13, 2014