EDA
The Voice Of Ontario's Electricity Distributors

May 17, 2010

Board Secretary
Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto, ON M4P 1E4

Via web portal and by courier

Dear Board Secretary:

Re: Board File No. EB- 2010- 0060; Consultation on Distribution Revenue Decoupling

The Electricity Distributors Association (EDA) is the voice of Ontario's local distribution companies (LDCs). The EDA represents the interests of the over 80 publicly and privately owned LDCs in Ontario.

The EDA greatly appreciates the Board's initiative to launch a consultation process to address distribution revenue erosion resulting from unforecasted changes in the volume of energy sold by electricity distributors. The attached submission has been prepared in consultation with members of the EDA Regulatory Council.

The EDA would like thank the Board for giving the opportunity to provide comments on this important initiative and looks forward to working with Board members and staff in this regard.

Yours truly,

"Original Signed"

Maurice Tucci
Policy Director, Distribution Regulation

Attached: EDA submission

dp:

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Distribution Revenue Decoupling Mechanisms

General comments

The rationale for revenue decoupling as suggested in the PEG report is rooted in the way that Local Distribution Companies (LDCs) charge for their services.

LDCs presently recover their fixed distribution-related costs through a variable distribution charge (¢/kWh or $/kW). Consequently, LDCs recover less than their approved revenue requirement in the years when the actual electricity consumption is less than the forecast (forecast for a future test year) that was used for rate-setting purposes at the time of rebasing or cost of service application review. On the other hand, in years when consumption exceeds the forecast, the LDC's actual revenue exceeds the allowed revenue requirement. Regulators generally expect these variances to cancel out over time so that, on average, each LDC will collect revenue that roughly equals its revenue requirement.

Thus, the fluctuations in system use will drive the base rate revenue to be low in periods of low demand and high in periods of high demand, whereas the cost of base rate inputs does not vary with respect to these fluctuations in system usage. Utilities with a high proportion of revenue recovery through usage charges have earnings that are unusually sensitive to usage fluctuations.

In 2004, the Board adopted the Lost Revenue Adjustment Mechanism (LRAM) to mitigate the negative financial impact (on LDCs) of unforecasted declining usage caused by the implementation of Conservation and Demand Management (CDM) programs. However, most LDCs have not filed LRAM claims to date due to the high cost of preparing such a filing. In addition, the LRAM approach does not work effectively for LDCs because of following reasons:

- An LRAM application requires complex calculations for estimates of energy savings and other quantitative impacts of the CDM programs; and
- Since most LDCs do not have a CDM specialist on staff, they are required to engage an independent expert to prepare an LRAM application resulting in a sizable cost.

The current price cap index available to LDCs (the IRM plan) is designed to reflect only the trend in cost efficiency. It does not provide relief for revenue erosion when average use is markedly declining. However, since considerable time and resources have already been spent to develop and implement an IRM plan for Ontario LDCs, it may be worthwhile to address revenue erosion between rate cases by implementing some form of decoupling.

The EDA has conducted an analysis of volume per customer trend for the period 2006 to 2008 which indicates that the average deliveries of power to both Residential and General Service (GS <50 kw) class customers declined in the case of about 50 LDCs in the province. As brought out in the PEG report, numbers for individual LDCs are considerably different from the industry trend and some LDCs in fact have increasing average usage for both the residential and GS customer classes.

The EDA is mindful that it is difficult to draw any meaningful conclusions from this analysis about the declining trends in average usage since the volume data used is not weather normalized and in addition, the sample data is too small.

Therefore, the EDA members believe that revenue variability can be better addressed (and that distributors can better promote efficient use of the distribution system) by way of an appropriate distribution rate design rather than through any other approach. Therefore, the EDA urges the Board to focus its investigation of decoupling on distribution rate design at this time rather than trying to fix the problem of revenue variability and erosion through other means.

It should be noted that there would be reduced need for revenue decoupling in circumstances where accurate load forecasts exist and where utility cost of service applications are filed on a regular (e.g., annual) basis.

The PEG report suggested two other approaches to revenue decoupling which are:

- Decoupling true up plans
- Straight Fixed Variable Pricing (SFV)

Revenue Decoupling True Up Plans

The PEG Report discussed both a revenue decoupling mechanism (RDM) and a revenue adjustment mechanism (RAM). While RDM addresses *revenue-related* earnings attrition (i.e., erosion of earnings attributed to reduction in distribution revenue) between rate cases, RAM provides relief for *cost-related* earnings attrition (i.e., erosion of earnings due to increased distribution costs).

Currently, the RAM process is already available to Ontario LDCs in the form of 3rd generation incentive regulation price cap mechanism which adjusts revenue requirements and rates between rate cases to reflect changes in utility costs excluding adjustments for customer growth and for changes in average use trends.

On the other hand, the RDM component is intended to ensure that the approved revenue requirement is recovered through distribution rates. The need for RDM is largely related to distribution rate design since that determines the extent to which the approved revenue requirement is reliably recovered through base rates.

Using decoupling true up plans for revenue decoupling is not a practical and efficient approach because:

- True up plans lead to retroactive rate making where the distribution rates are never considered final. If an LDC experiences a revenue reduction in a particular year, the variance is added to a subsequent year's revenue requirement and is disposed of through a rate rider, resulting in rate instability.
- There would always be a considerable lag between the time of incurring costs and recovering them through rates.

- The distribution rate increases resulting from decoupling can be a problem particularly during a prolonged recession as rates will rise in the second year of the recession even though the economy has not yet bounced back.
- More importantly, during an IRM period, the variances in revenue collections arising from the decline in average usage would keep accumulating year after year until disposed of. Due to practical difficulties under the current regulatory approach, the disposition of the variance account may occur long after the LDC's revenue erosion.

For the reasons mentioned above, the EDA recommends discarding the true up plan approach to revenue decoupling.

Revenue Decoupling Through Straight Fixed Variable Pricing

Straight Fixed Variable Pricing (SFV) is an approach to rate design that recovers in usage charges (charges that vary with peak demand or the volume of energy delivered) only those costs that vary, in the *short* run, with system use.

Since almost all of a distributor's costs are fixed with respect to system usage, and those costs that do vary are largely a function of the addition or loss of customers rather than usage by individual customers, it follows that distribution rates should provide a stable source of revenue that varies little as a result of usage. Thus, a charge based on energy consumption that is likely to vary from year to year depending on the weather, is not the ideal basis for distribution rates.

EDA members strongly believe that distribution rates should be based on distributor costs, and not on any other factors, such as:

- Economic development (e.g., special rates for certain threatened industries)
- Conservation in other parts of the electricity sector (e.g., using distributor rates to encourage energy/kWh conservation)

There are other, more direct, means available to achieve these goals without distorting electricity distribution rates.

Further, the SFV pricing approach to decoupling promotes bill stability. A large increase in distribution bills for small volume customers within a service class can be avoided, if necessary, by implementing a "sliding scale" mechanism designed to allocate lower fixed charges to customers who have historically had low demand or volumes and higher fixed charges to those who have historically had higher demand or volumes.

Conclusion

As mentioned earlier, the decline in 'average usage' for individual LDCs is considerably different from the industry trend as each LDC operates under different circumstances from the other. Each LDC is expected to undertake different level and type of CDM initiatives that make sense for its customer base. Some LDCs may experience significant customer load growth while others may experience declining customer base. Therefore, one common approach to decoupling for all LDCs may not make sense at this time.

Therefore, the EDA recommends adopting, or moving toward, the SFV pricing approach for revenue decoupling as the most practical approach in Ontario circumstances. A shift to cost recovery through fixed charges will stabilize bills and reduce utility counter-incentives to conservation, and is administratively practical, in contrast to the regulatory burden that would be created by true-up decoupling. However, LDCs should be given the flexibility to adopt SFV pricing approach depending on each LDC's individual circumstances so that LDCs can tailor their rate design to suit the local customer circumstances.

Comments on specific questions

1. *In light of developments in metering, CDM and demand side management ("DSM"), among possible others, is the implementation of further or modified revenue decoupling mechanisms for electricity and/or gas distributors warranted at this time and if so, why? For example, is the Board's current Lost Revenue Adjustment Mechanism adequate in light of the contemplated introduction of CDM targets for all electricity distributors in the Province?*

   The current LRAM approach to address revenue erosion arising from CDM programs is not working. The administrative cost of preparing an LRAM application and processing it by the OEB is very high and is not cost effective for most LDCs in the province. In other words, LRAMs are only cost effective when LDCs experience an extremely high variance between forecast CDM volumes and the actual. LRAMs should be replaced with the SFV pricing approach to address revenue erosion arising from CDM programs between the rebasing years (during the IRM period).

2. *What factors should be considered when assessing the suitability of Ontario's current mechanisms and of alternative approaches? Are any of these factors more or less important than others? If so, why?*

   The important factors to be considered are:
   - Practicality – Whether the chosen decoupling approach is implementable without causing undue hardship to both the utility and its customers;
   - Cost effectiveness – The chosen decoupling approach should be the cost effective to administer and preferably the least cost approach;
   - Full cost recovery principle - The level of distribution rates should be sufficient to recover the revenue requirement of each distributor;
   - Fairness principle - Customers should pay rates (for distribution service) that reflect the costs they cause to the distribution system as they occur; and
   - Efficiency principle - Distribution rates should encourage customers to efficiently utilize the existing distribution system and should encourage new customers to use the system in ways that lead to rational growth.

3. *What, if any, are the implications of the wide-spread deployment of smart meters for the Board's approach to revenue decoupling?*

   The wide-spread deployment of smart meters will radically change the information available for residential and smaller general service customers (<50 kW) and this additional

information will provide an opportunity to re-examine the assumptions, simplifications and proxies that were used in the past for designing distribution rates. In particular, smart meters will enable the use of 'demand' measurement as billing determinants for residential and smaller general service customers. The 'demand' based pricing approach for any system usage based component of distribution rates would provide a strong signal to limit peak consumption in the long term and would better recognize the short term fixed costs of the distribution system.

4. *What scope for further or modified revenue decoupling might be appropriate? For example, should the impact of all variances from forecast in commodity demand be eliminated regardless of the cause (i.e., distributor-provided CDM/DSM programs, other CDM/DSM programs, the economy, weather, customer growth, etc.)? Why or why not?*

   The EDA recommends movement towards the SFV pricing approach to revenue decoupling because of its advantages already stated in this submission.

5. *Are there any alternative approaches, beyond those identified in the PEG Report, which better address revenue erosion due to changes in consumption? What are the costs, benefits and implications of implementing the alternative approach?*

   The EDA is not aware of any other alternative approach for revenue decoupling beyond those identified in the PEG Report.

6. *Is there a preferred approach (or elements of an approach) and if so, what are the important implementation matters that must be considered? What are the costs, benefits and implications of implementing the preferred approach or of refraining from doing so?*

   As explained above, the EDA recommends that a movement toward SFV pricing is the best approach to revenue decoupling due to its advantages already stated in this submission such as cost effectiveness; fairness, and administrative simplicity for over 80 distributors.

7. *Can or should the preferred approach need to be the same in both the gas sector and the electricity sector? Why or why not? Would any other form of differentiation based, for example, on a specific distributor characteristic(s) be appropriate? If so, what might be the defining characteristic(s)?*

   The EDA believes that the decoupling approach used for gas and electric sectors need not be the same because of inherent differences between the two sectors, such as the use of smart meters by distributors and the large difference in the number of distributors involved.