McCarthy Tétrault LLP
Box 48, Suite 5300
Toronto Dominion Bank Tower
Toronto ON M5K 1E6
Canada
Tel: 416-362-1812
Fax: 416-868-0673

mccarthy tetrault

George Vegh
Direct Line: 416 601-7709
Direct Fax: 416 868-0673
Email: gvegh@mccarthy.ca

December 6, 2010

Ontario Energy Board
2300 Yonge Street
P.O. Box 2319
Suite 2700
Toronto ON M4P 1E4

Attention: Ms Kirsten Walli
Board Secretary

Dear Ms. Walli:

Re: Renewed Regulatory Framework

Introduction and Summary

This letter is written on behalf of the members of the Distribution Regulation Review Task-Force (the "DRRTF"). The DRRTF is an initiative of the leading gas and electric distribution utilities in Ontario aimed at encouraging thought and discussion on how the OEB's approach to regulating energy distribution can be enhanced. These utilities are: the Coalition of Large Distributors (which consists of Enersource Hydro Mississauga, Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro Electric System Limited, and Veridian Connections Inc.), Enbridge Gas Distribution Inc., Hydro One Networks (Distribution), and Union Gas Limited.

This review is timely in light of the Board's letter of October 27, 2010 announcing a "Renewed Regulatory Framework for Electricity" (the "Framework Review"). The OEB has also indicated in its 2010-2013 Business Plan that the Board will:

- "issue guidance examining possible alternative approaches to the rate regulation of Ontario's distribution sector";
- "issue guidance for the incentive regulation plan effective 2012 rate year based on total cost benchmarking"; and
- "review the incentive regulation mechanism in preparation for the next generation of incentive regulation plans for gas distributors."

Ontario is not alone in identifying the need to conduct a review of how energy networks are regulated. In October, 2010, the UK Office of Generation and Energy Markets ("Ofgem") released its final decision, "RIIO: A New Way to Regulate Energy Networks."1 The focus of

[1] Ofgem, *RIIO: A New Way to Regulate Energy Networks*, October, 2010.

the Ofgem review is on how to develop a more results-oriented approach to regulation while maintaining the basic structure of the inflation minus productivity rate regulation model. The driver for the UK reform is how to address the increased capital investment required in light of energy sustainability requirements. This investment is required in Ontario as well.

The Board has indicated that the Framework Review will involve three policy initiatives:

- A re-examination of its approach to network investment planning to prioritize network investments on a cost effectiveness basis that takes into account both the cost of generation and the cost of network investments (the "**Total Bill Impact Initiative**");
- A review of its rate mitigation policy to examine alternative approaches and rate treatments to smooth the impact to consumers of rate or bill increases (the "**Rate Mitigation Initiative**"); and
- A review of its rate-making policies to establish a regulatory framework that sets appropriate standards for performance and efficiency and rewards distributors that exceed these standards (the "**Performance Standards Initiative**").

The members of the DRRTF welcome and look forward to participating in this review. They also recognize that all three of these initiatives contain issues that should be addressed. In doing so, it is important that they be addressed within an appropriate context and process. Specifically, the Board has many regulatory instruments to address these issues and it is important to focus on which instruments are the most relevant and appropriate.

In summary, the DRRTF offers the following suggestions and observations on both the scope of issues that the Board may consider in each initiative and the process for considering these issues:

- **The Total Bill Impact Initiative**: The DRRTF appreciates that the Board considers it important to address the costs of new generation as well as the cost of utility investment. The Board has the power to do that directly by establishing rules respecting economic connection. Given that the largest impact on the total new costs on the bill will be driven by the costs of new generation, the DRRTF suggests that it is more appropriate to review new generation costs in the context of rules for economic connection and not in distribution rate cases.

- **The Rate Mitigation Initiative**: In addition to case by case reviews of rate mitigation proposals, the most important utility rate smoothing policy that the Board can adopt is incorporating incremental additions to rate base, including recovery through rates, during the term of an IR program in order to manage rate impacts over time, resulting in a more gradual approach to rate increases. There are also considerable opportunities available to providing a simplified and effective framework for utilities to engage in activities that develop cleaner energy and conservation activities in a cost effective manner.

- **The Performance Standards Initiative**: This is an important initiative; it is also complex and must be thoroughly thought through. Taking this initiative seriously will require developing meaningful performance standards and focussing regulatory resources on measuring and achieving results that have an impact on consumers and other stakeholders.

Each of these points is addressed in greater detail below.

Total Bill Impact Initiative

The Total Bill Impact Initiative involves "an assessment of the combined cost of both the proposed network investment and the generation that would be connected to that investment." In virtually all cases, the cost of network investment will be a fraction of the combined cost of network and generation costs. The Board's powers should therefore be exercised in the context of the major cost that is to be controlled: generation costs.

The Board's power to address generation costs is explicitly addressed in s. 25.36 (1) (b) of the Electricity Act, 1998 which provides that a transmitter or distributor shall connect a renewable energy generator provided that "the applicable technical, economic and other requirements prescribed by regulation or mandated by the market rules or by an order or code issued by the Board have been met in respect of the connection."2

Thus, the Board has the mandate to develop rules for the economic connection of generation through an order or code under s. 25.36 (1)(b) of the Electricity Act, 1998. Once those rules are in place, they will provide distributors and transmitters with direction on what types of generation connection the Board considers to be economic. Those rules will then, of course, be complied with by distributors and transmitters and the cost of meeting the connection obligations that result from those rules will be incorporated into distribution plans that are filed with the Board. Those plans are likely to be filed as part of rate applications.

The DRRTF suggests that proceeding under the Board's authority to set economic requirements for connection under s. 25.36(1)(b) of the Electricity Act, 1998 is more appropriate than reviewing the economics of connections as part of distribution rates applications. Given that the network component of these costs is relatively minor, and that the rates case process involves other issues and participants, the rates case process would not provide the optimal forum to directly address the issue of generation costs.

Rate Mitigation Initiative

The Rate Mitigation Initiative contains two fairly discrete components.

First, as the Framework Review document notes, the Board has already considered rate mitigation approaches on a case by case basis. Presumably, panels will continue to do so, perhaps guided by some general policy direction from the Board.

Second, and more fundamentally, the Rate Mitigation Initiative will include a review of "alternative approaches and rate treatments that might smooth the impact to consumers of rate or bill increases." This is an important issue that deserves serious consideration of some fundamentally new approaches to the OEB's current approach to rate regulation.

It is necessary to acknowledge and deal with the fact of aging assets to ensure reliability of supply and to facilitate energy infrastructure investments required to achieve a sustainable energy future. This involves both (i) managing the rate impact of capital investment to avoid step change rate increases upon rebasing; and (ii) acknowledging the contribution that utilities can make to ensuring that green investments are made.

Avoiding step changes in rates upon rebasing involves incorporating rate changes attributable to incremental capital projects during the term of an IR program, not just as "Z Factor Events" or

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[2] *Electricity Act,* s. 25.36 (1)(b).

between IR programs. This rate gradualism can help dispel the possible misperception that customer bill increases are caused by inordinate distribution infrastructure investments. As the energy sector continues to evolve (through, for example, investments in renewable power and the introduction of the HST to energy), the issue of bill increases becomes even more significant. It is important that distributors are not punished or restricted from obtaining appropriate rate increases due to bill impacts that are related to other elements of the energy sector.

With respect to the role of utilities in making green investments, as the Chair noted in his speech announcing the Framework Initiative, addressing utility investment in green energy projects (including renewable generation and district energy) requires the Board to carry out a meaningful policy review. This review has not been started. Instead, Board panels have addressed it on a case by case basis in the absence of an overall framework. This policy review should be incorporated into the Framework Initiative.

In the DRRTF's view, the key issues to be addressed in this area include encouraging the Board and utilities to take a longer term, sustainable perspective by:

- incorporating incremental additions to rate base, including recovery through rates, during the term of an IR program in order to manage rate impacts over time, resulting in a more gradual approach to rate increases;
- assessing the reasonableness of distribution costs and rates on their own merits, independently of other cost pressures on the customers' bill;
- smoothing out regulatory activity over a rebasing or IR cycle, so that distributor and Board resources can be optimally employed; and
- providing a simplified and effective framework for utilities to engage in activities that develop cleaner energy and conservation activities.

The Performance Standard Initiative

The statement in the Framework Review document that the new framework should set "appropriate standards for performance and efficiency and reward distributors and transmitters that exceed these standards" is particularly important. Taking this initiative seriously can lead to an outcomes-based approach to regulation that focuses more strongly on how well utilities achieve results. This requires a focus of regulatory resources on measuring and achieving results that have an impact on consumers and other stakeholders.

On the electricity side in particular, the optimal industry structure has not yet emerged. Although regulatory decisions should not be the driver for structural change, at the same time, they should not be designed to reflectively maintain the status quo without regard to whether that structure is optimal. Regulatory approaches should be considered on their merits in light of the broader public interest (including customers, communities, businesses, employees and public agencies). The public interest in this regard is served by rewarding efficiency and discouraging inefficiency, both in industry structure and in utility operations.

The key issues to be addressed in this area include:

- developing more meaningful outcome-based criteria to measure utility performance than more narrow indicators, such as current cost per customer metrics. The limitations of this metric were explicitly recognized by the Chair of the OEB in a speech announcing the Framework Review, where he stated his expectation that the Board "will go beyond simple measurements like current cost per customer metrics."3

- focussing regulatory review on areas where a utility's performance should be improved – this will ensure that the regulatory resources of the Board and the sector are directed in proportion to the challenges they are meant to address. This is an important component of Ofgem's revised approach;4
- recognizing that utility plans and proposals are often informed by stakeholders (such as customers, municipalities, and other public agencies). The Board should take this into account in informing its view of the broader public interest and the interest of consumers and intervenors in a regulatory review;
- simplifying and streamlining regulatory reviews to resolve issues that are common to many distributors on a generic and prospective basis;
- a dramatic simplification of the way in which conservation is measured and accounted for, including a simplified approach to LRAM – this may include granting flexibility to pursue revenue decoupling where appropriate. A more simplified and formulaic approach is required that would define how the savings will be measured at the outset of the implementation of the CDM program; and
- more consistent and transparent monitoring of utility performance.

Conclusion

The DRRTF offers these observations and suggestions to remind all stakeholders that energy distribution provides value to energy consumers and society as a whole, including communities, businesses and employees. It recognizes that energy distribution, like all other services, involves making trade-offs between cost and service quality. While continued high service comes at a cost, the relative cost of energy distribution when compared to other network services in our modern economy – telecommunications and broadband cable in particular – is reasonable given the important value of the service to the businesses and communities it serves.

The members of the DRRTF look forward to working with the OEB and other energy sector leaders to discuss and develop these issues.

Sincerely,

George Vegh
Chair, Distribution Regulation Review Task-Force
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[3] Ontario Energy Board Chair, Speech to Ontario Energy Association, September 21, 2010, p. 5.

[4] Ofgem put it as follows:

"**Proportionate Assessment:** We will adopt a transparent and proportionate approach to assessing the price control package, with the intensity and timescale of assessment reflecting the quality of an individual company's business plan and its record for efficient output delivery. Under this approach, we would be able to conclude the price control process early for some companies." (Ofgem, *RIIO: A New Way to Regulate Energy Networks*, October, 2010, at p. 30)

c: Norm Ryckman – Enbridge Gas Distribution Inc.
Gia DeJulio – Enersource Corporation
Indy Butany-DeSouza – Horizon utilities Corporation
Ian Malpass – Hydro One Networks Inc.
Jane Scott – Hydro Ottawa Limited
Colin Macdonald – PowerStream Inc.
Colin McLorg – Toronto Hydro Electric System Limited
Mark Kitchen – Union Gas Limited
George Armstrong – Veridian Connections Inc.