DEFINING AND MEASURING PERFORMANCE OF ELECTRICITY DISTRIBUTORS

EB-2010-0379

COMMENTS OF THE CONSUMERS COUNCIL OF CANADA

I. INTRODUCTION:

The Ontario Energy Board ("Board") is responsible for setting rates for over 70 electricity local distribution companies ("LDCs" or "distributors") in the Province of Ontario. Establishing a regulatory framework that allows for the efficient and effective regulation of these LDCs while balancing the interests of utility ratepayers and shareholders is a daunting task. It becomes more complicated as the Board and the LDCs must also strive to achieve a number of important public policy objectives, like facilitating the connection of renewable generation and promoting conservation.

In October 2010 the Board initiated the Renewed Regulatory Framework ("RRFE") for Electricity Distributors. In establishing the process the Board stated, "Over the last eighteen months, the Board has completed a number of initiatives to integrate the environmental objectives of the Green Energy Act with the Board's more traditional mandate regarding economic efficiency, cost-effectiveness and consumer protection. It is now time to further integrate its objectives into a renewed regulatory framework which reflects the significant role network investment will have in years to come." Since that initial announcement the RRFE process has evolved.

There were a number of stakeholder consultations and Board Staff reports. In addition, in February 2012, the Board released a model Regulatory Framework providing a high level illustration of one way in which the main components and outcomes discussed in the Board Staff reports might be brought together. A broad stakeholder conference was held on March 28-30, 2012. On October 18, 2012, the Board released its Report, "Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach" ("RRFE Report").

In establishing the RRFE the Board set out a comprehensive performance-based approach to regulation that is based on the achievement of outcomes that ensure that Ontario's electricity system provides value for money for customers. With respect to rates the Board established three rate-setting methods. They include a 4th Generation Incentive Rate-setting ("4th GIRM"), an Annual Incentive Rate-setting Index and Custom Incentive Rate-setting. A number of working groups were established to deal with some of the key issues and empirical analysis was undertaken by Pacific Economics Group ("PEG") resulting in recommendations for inflation, productivity and stretch factor parameters for incentive rate-setting and

for the benchmarking of electricity distributor total costs. The PEG Report entitled "Empirical Work in Support of Incentive Rate Setting in Ontario ("the PEG Report")

On May 27 and 28, 2013, a Stakeholder Conference was held to provide parties with an opportunity to better understand the PEG Report. Presentations were made by other experts and further expert reports filed by Adonis Yatchew (on behalf of the Electricity Distributors' Association), Steven Fenrick of Power System Engineering (on behalf of the Coalition of Large Distributors) and Frank Cronin (on behalf of the Power Workers Union) on June 13. PEG also filed Supplementary Empirical Analyses.

The Board has indicated, in its letter dated May 30, 2013, that it would be assisted by comments on a series of questions related to the benchmarking and rate adjustment parameters. These are the comments of the Consumers Council of Canada ("Council"). The Council will make some general observations about this part of the RRFE process and at a high level provide its submissions on the key elements of the 4th Generation IRM. In addition, we make suggestions as to how the Board should proceed, going forward. The Council does not intend to comment on the specific elements of the expert reports or delve into the contentious debates regarding alternative methodologies and the use of the historical data to determine a total factor productivity number for use in the 4th Generation IRM.

2. GENERAL COMMENTS

The Board has, since 2001, chosen to regulate the Ontario electric LDCs using an incentive based rate-setting model. This involves a cost-based approach to set base rates and a formula approach to adjust rates. The Board's current 3rd GIRM approach has been effective from the Council's perspective. It allows for a base rates to be established through a rigorous cost of service review. Rate adjustments are established through a formula that recognizes that utilities face inflationary pressures. In addition, it recognizes that LDCs should be expected to seek out productivity gains throughout the IRM term. It provides mechanisms such as deferral and variance accounts to deal with costs related to Government policy directives and initiatives that are truly beyond the control of the utilities (eg; smart meter deployment). It also allows for unforeseen capital requirements to be recognized in rates if justified through the incremental capital module ("ICM"). Lastly, it provides an off-ramp from the plan to the extent utility earnings are below a certain threshold.

The 4th Generation IRM being proposed by the Board is similar with the exception of the term of the plan. The Council submits that it would be preferable, and likely more fair to the LDCs, to maintain the current plan term, as history has demonstrated that this industry can undergo significant changes in four years. The Council has typically favoured plans shorter than five years recognizing these industries (natural gas and electric) evolve and are not necessarily "steady-state".

Having said that, we recognize that the term of the plan is not up for debate in this component of the RRFE process.

The Board has decided that a relatively simple price cap approach should be continued. The Council supports that approach as it achieves a number of key objectives like regulatory efficiency and the balancing of interests between ratepayers and shareholders. To the extent that type of plan is not attractive to some LDCs they have opportunity to develop a custom plan, which may well be better suited to individual circumstances.

So, the fundamental questions that the Board has set out to answer in this stage of the process are not related to the structure of IRM, but the primary parameters of an IRM plan related to inflation, productivity, stretch factors and benchmarking. Essentially the most important issues, from the Council's perspective are the following:

- What is an appropriate inflation factor?
- What is an appropriate productivity factor?
- Should there be stretch factors and how should they be applied?
- What is the appropriate approach to total cost benchmarking?

The Council intends to deal with these issues in turn, below.

IRM Parameters :

The Council has been generally supportive of the previous IRM models developed and implemented by the Board in both the Ontario electricity and natural gas sectors. A simple price cap plan recognizes inflationary increases, but assumes that the utilities need to be incented to pursue efficiency gains during the IRM term, that can flow through to the benefit of ratepayers upon rebasing. That is why so many IRM models assume a formula the reflects:

Inflation – Productivity (which typically includes a stretch value)

The Council recognizes that in the RRFE Report the Board has determined that the productivity factor should be based on Ontario Total Factor productivity trends. This assumes that productivity going forward should be reflective of productivity in the past. If the Board wishes to reflect in its IRM model productivity that is reflective of past performance it must wrestle with the statistical analyses provided and the relative critiques provided by each of the expert reports. As set out below, the Council is of the view that the process should allow for some further steps

regarding the expert reports if the Board intends to rely on those reports in establishing a TFP value.

The values derived by the experts range from .1% to -1.1% based on historical data. For the following reasons the Council does not believe the future will be reflective of the past and that a negative productivity factor is inappropriate:

1. As noted by PEG in its Updated Report, productivity has declined since 2007 due to reduced outputs resulting from the recession. This one-time event is not expected to recur during the 4th Generation IRM period;

2. Although Conservation and Demand Management ("CDM") has reduced output over the period LDCs are currently given the option to apply for a Lost Revenue Adjustment Mechanism which essentially mitigates any adverse impact on LDCs from the impact of CDM programs;

3. Deferral and Variance Accounts are available to LDCs to deal with government policy directives. To the extent LDCs are required to undertake initiatives like smart meter deployment, Green Energy Plans, smart grid development etc. the Board has allowed for recovery of these costs through deferral and variance accounts and rate adders. There is no reason for the Board not to continue to allow for such recovery. These types of initiatives should not limit the ability for LDCs to be productive;

4. The incremental capital module ("ICM") is available to deal with extraordinary capital requirements, and more recently in the Toronto Hydro-Electric System rate proceeding, (2012-2013) the Board allowed for recovery of costs related to asset renewal. The rules regarding the ICM have been evolving. (As noted below, the Council is of the view that the rules regarding the ICM be reviewed and clarified.)

5. Before moving to the IRM formula for setting rates, LDCs are subject to a comprehensive cost of service proceeding where they are given an opportunity to make a case for what they believe is an appropriate revenue requirement;

6. There are no IRM plans in place that use negative productivity factors.

In effect the 4th GIRM will allow for rate-making tools to be used to deal with circumstances in which costs may be incurred with no corresponding increase in output. Or, to be used in cases where output is declining (CDM).

For these reasons the Council does not support an IRM that incorporates a negative productivity value. The evidence is that many LDCs were productive during that period. Going forward there should be a requirement that LDCs pursue efficiency

gains. That is the point of incentive regulation. To allow for negative productivity going forward is simply counter-intuitive.

If the Board decides that some level of positive productivity is the right answer then it has a number of choices. It can look to the past and consider the productivity results of the best performers in Ontario and set the number on that basis. Or, in the alternative it could set a number, albeit arbitrary that recognizes some level of positive productivity is expected and should be incented going forward. Bringing back the experts (as proposed below) may assist the Board in this regard.

With respect to inflation the Council recognizes that the Board in the RRFE Report concluded that it was appropriate to adopt a more industry specific inflation factor for 4th Generation IRM. Furthermore, the Board indicated that the concerns with volatility would be mitigated by the methodology selected by the Board. The Council is of the view that given the analyses provided by PEG and PSE the issues regarding volatility around an industry specific inflation factor will continue to be a problem. In addition, the debates around how best to craft an industry specific inflation number are unresolved and the numbers widely divergent. In light of this the Board may well wish to consider the merits of maintaining the use of the GDI-IPI currently in place for 3rd GIRM. It is important to acknowledge that the inflation number that is proxy and will not necessarily be tied directly to actual inflation or to the actual cost of the inputs of the Ontario LDCs. Establishing a proxy that is recognized and accepted in the context of other IRM plans may well be the best approach. It is also, important, from the Council's perspective not to introduce parameters that are too complex.

In summary, the Council submits that going forward the Board should use GDP-IPI as an inflation factor, given the apparent volatility associated with an industry specific price index. Volatility in the index will only add to potential volatility in rates. Rate smoothing should always be a consideration for the Board. In addition, it has become clear that developing an industry specific index is both controversial and complex, as has been demonstrated through this stakeholder consultation process

As noted in the previous Board Report on 3rd Generation IRM, stretch factors are the component of the X-factor intended to reflect incremental productivity gains that distributors are expected to achieve under IRM and is a common feature of IRM plans. In the RRFE Report the Board concluded that the X-factors under 4th Generation IRM will continue to consist of an empirically derived industry productivity trend and a stretch factor. In addition, the Board noted the Board's use and assignment of stretch factors under 3rd Generation IRM will continue under 4th Generation IRM. The LDCs will be assigned to three efficiency cohorts based on total cost benchmarking evaluations each with its won stretch factor. The Council supports the continued employment of stretch factors in the model. The experts generally agree that stretch factors should be in the range of 0% to .5%. The Council accepts that those levels are reasonable.

Benchmarking:

The Board has set out in its RRFE Report that benchmarking models will continue to be used to inform rate-setting and that the Board will continue to build on its approach to benchmarking with further empirical work on the electricity distribution sector in relation to the distributor customer service and cost performance outcomes, including total cost benchmarking, an Ontario TFP study and input price trend research.

With respect to benchmarking the Council notes that there has been considerable disagreement amongst the experts. In addition, given the fact that the process has not allowed for the evidence of Dr. Yatchew and Mr. Fenrick to be tested the Council submits that the Board should bring the experts together to clarify and explain their approaches. In the short term, the Board needs this analysis in order to assign LDCs to efficiency cohorts for the purpose of applying stretch factors. In the longer term, benchmarking is an important tool for the Board in assessing utility performance.

The Council submits that the experts should be brought back to the Board to assist the Board in determining efficiency cohorts for 2014. That should be the first order of business for the Board. Over time, the Board can look at ways for the benchmarking analysis to evolve as data is refined. It is not a science and must remain one tool, in a larger set of tools for the Board to assess LDC performance.

3. FURTHER STEPS:

The Council suggests that in order to move this process ahead and allow for the establishment of the 4th GIRM for 2014 the Board should take the following steps:

1. The Board should reconvene the stakeholder session in order to allow for the Board to allow Dr. Kauffman to respond to the expert reports and allow for the Board and Board Staff to seek any clarification on the reports before applying them in the context of determining the TFP, inflation factor and efficiency cohorts. Although informative, the process has not allowed for the evidence by the other experts to be tested. Adding a further session will ensure that the record is clear and complete;

2. The Board should allow for reply submissions by the parties following the stakeholder session on issues where the Board requires additional input;

3. The Board should establish a process to review and clarify how the incremental capital module component of the 4th GIRM should apply. Parties should have an opportunity to provide input on how the ICM might be revised. Once that process is complete there will be no ambiguity regarding

the ICM "rules of the game". LDCs can then be in a better position to choose the IRM plan best suited to their circumstances.

4. CONCLUSIONS:

- The Council is supportive of the 4th GIRM model as proposed by the Board.

- LDCs, following rebasing, should have rates adjusted to reflect inflation and productivity. Productivity going forward should not be negative, as the point oF incentive regulation is to incent LDCs to pursue efficiency gains. Stretch factors should be in the range of 0% to .5%. The inflation factor should be GDP-IPI;

- LDCs should have continue to have access to rate-making tools like deferral and variance accounts, the ICM and off-ramps as part of the plan when required;

- The Board should undertake a review of the ICM given recent decisions that have expanded its applicability so that the ICM rules are clearly defined going forward. This may include expanding the scope, or adjusting how it is calculated:

- Before determining a productivity number, or numbers to use going forward, the Board should reconvene the stakeholder session to allow further examination of the expert reports and relative positions. This will allow for a clearer and more balanced record;

- The Board should also seek further advice from the experts in order to determine efficiency cohorts for 2014;

- Benchmarking analyses should continue to evolve over time as LDC data (which has proven not to be 100% correct) is refined and improved.

ALL OF WHICH IS RESPECTFULLY SUBMITTED