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BY EMAIL AND PERSONAL DELIVERY

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Ontario Energy Board
2300 Yonge Street
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Attn: Lynne Anderson, Vice-President, Applications

Dear Ms. Anderson:

Re: EB-2014-0116 – Gas DSM Framework – Working Group

We are counsel for the School Energy Coalition. As a followup to the meetings of the DSM Working Group, and the description by Board Staff of their plans to present a DSM Framework proposal to the Board in August, this letter provides some of SEC's initial comments and concerns. We would appreciate it if you would bring these concerns to the attention of the Board when it is considering Staff's proposal.

"Taking Ownership"

The overriding theme of the Staff proposal is that the Board would "take ownership" of the front and back ends of the DSM process. That is, the Board would initiate and supervise a potential study (perhaps duplicating work already being done by the utilities) and unilaterally establish targets for the 2016-2020 period. As the utility programs were implemented, Staff would then be in control of the evaluation and audit process, including determining assumptions to be used, and ensuring independent audits of the results. The Staff approach appears to be modeled on the OPA's involvement in CDM by electricity distributors.

This significant change stands in sharp contrast to the current model, in which ratepayer groups, environmental groups, and utilities work together collaboratively to produce both front end structures (targets, budgets, program arcs, etc.), and back end supervision through consensus assumptions and independent audits.

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The current model has certainly not been perfect. There have been stresses and disagreements, and the parties are not always ecstatic with the results. This is in large part because they come from very different perspectives, but it is also because collaborative processes are naturally imprecise. There is a fair bit of "muddling along".

On the other hand, the Board has not had to spend much time refereeing debates on DSM (once or twice a year over the last three or four years), and the disparate interest groups have managed to find common ground almost all of the time. This is a marked improvement over the situation ten years ago, when the collaborative approach was still being developed, and the Board was knee-deep in DSM disputes.

The proposal from Staff proposes to inject Staff into this mix in a key, central role. It is not clear whether this is intended to reduce the role of ratepayer and environmental groups, but it will certainly change their role substantially, in one of two ways.

If the intention is to maintain the role of the ratepayers (who pay for all of this, and for whose benefit this is all being done) and the environmentalists (who have been the prime movers of gas conservation for more than twenty years), Staff appears not to understand that adding Staff into the mix makes the process much less collaborative, and more adversarial. Right now, when ratepayer, environmental and utility reps discuss issues, they are trying to convince each other. Under Staff's proposal, the certain result is that they will be trying to convince Staff. "Discussion" becomes "submissions". As long as Staff are perceived to be the arbiters of issues, they will be approached as adjudicators, and collaboration will be lost. (This is the precise reason why the role of Staff in ADR is tightly prescribed. You need people to talk to each other, with no "judge" in the room.)

Of course, in this more adversarial model, the additional result is that failure to convince Staff on an issue is simply a first step. The issue will then go to a Board process, such as a hearing. More and more, under this model, utilities, ratepayers, and environmentalists will be back in the hearing room, forcing the real adjudicators – Board panels – to decide issues where consensus was eminently achievable. The hidden danger of this direction is that it may harden the positions of some ratepayer groups already skeptical of DSM, and the positions of some environmental groups wanting massive increases in DSM spending. (Why seek compromise if you are going to have to fight anyway?)

On the other hand, if the intention is to reduce the role of stakeholders in the DSM process, that would be a stunning reversal of Board policy, and runs the risk of generating perverse results. Ratepayer groups forced to bear increasing DSM budgets will, in fact, have their say somewhere. The biggest concern of schools is that the most hard-line of the ratepayer groups will, if cut out of the DSM process, look for political solutions instead of regulatory ones. This is dangerous because their logical approach is not just to challenge the $750 million or so proposed cost of the six year gas DSM framework, but also the $2.2 billion cost of the six year electricity CDM framework supervised by the OPA. The last thing that schools want to see is a concerted attack on the Conservation First policy of the government.

The current collaborative model for DSM is not perfect, by any means. However, it would appear to us that injecting Staff into the process would be a retrograde step. Whether it is carrying out a potential study that may be duplicative of work already being done by the utilities with stakeholder involvement, or whether it is taking charge of the independent audit process, we have not heard anything from Staff to indicate why their expanded role is necessary, or would add more value than it erodes.

It is notable that, during the three meetings of the DSM Working Group, and in all of the communications between the parties between meetings, not once did any of those divergent interests suggest that more Staff involvement would be a solution to any issue facing gas DSM. For Staff to propose this central element of their plan, having received no input supporting it, and lots of input opposing it, suggests that the "input" of parties at the working group was less meaningful than perhaps it should have been.

The Board has a key role in supervision of gas DSM. In recent years it has been largely as "court of last resort", either adjudicating disputes that can't be resolved by consensus, or giving outliers their right to be heard and make their case.

That could change at any time. Intransigence by any of the utilities, the ratepayers, or the environmental groups, could kill the collaborative model as the best option, and signal a need for the Board to return to an expanded role. That hasn't happened yet, despite all of the tensions inherent in the collaborative model. In our view, it is the preferred model unless and until it fails. Only then should a restructuring of the roles be considered.

We note that the Staff proposal is almost identical (down to some of the charts) to the OPA approach to CDM. It is not clear to all stakeholders that the OPA model will produce the kind of stellar results that the collaborative model has already produced in gas.

Budgets

Staff's proposal will include an increase in the budgets for DSM from $33 million each to $53 million each. With incentives, the total DSM cost would increase from the current $83 million per year to about $117 million per year, a 41% increase. It would continue to be indexed to inflation after that, reaching about $130 million by 2020. Estimated total cost over six years is about $740 million, or more than 6% of gas distribution revenues for the period.

Staff's math starts with the ratio of the electricity market to the gas market. They compare the $14.4 billion size of the electricity market (including commodity) to the $4.2 billion size of the gas market (including commodity). They then apply that ratio to the $2.2 billion CDM budget for 2015-2020, to get the "correct" level of gas DSM spending over the same period.

There are at least two problems with the Staff approach.

First, the OPA number of $2.2 billion is really only $1.8 billion to the utilities. The remainder is the OPA's costs to manage the process. Further, the $1.8 billion includes both the costs to deliver programs, and the profit incentives for the utilities for their successful participation. If you correct for both of these factors, the Staff math produces a budget of $39.5 million per year

for each of the gas distributors. When the incentive is added in, that would reduce the annual target cost from $117 million per year to $87 million per year.

Second, this approach assumes that gas and electricity conservation are equivalent, when they clearly are not. The gas distributors have been delivering successful conservation programs for more than twenty years. Not only are they pretty good at it by now, delivering results with fairly efficient use of funds, but they are doing that in the face of the disappearance of the "low hanging fruit". After twenty years, the easy stuff is gone. That is especially true in the residential sector, where gas DSM programs increasingly focus on deeper savings for a smaller number of participants, and where the gas company's value added is mostly as an integrator of interested players, rather than as the delivery vehicle for incentive cheques.

Contrast that with the electricity sector. For the most part, LDCs are pretty new at the game, and there will be inevitable inefficiencies as they develop their skills in this area. On the other hand, there remains some low hanging fruit in electricity, which can be dislodged by incentives. That is one reason why electricity conservation programs in residential remain vibrant.

To suggest that a simple ratio of spending between CDM and DSM – even if calculated correctly – is the best way to set budgets appears to us to be false. It may well be that increasing the gas DSM budgets is warranted, but this simplistic approach does not appear to be the right answer.

In our view, the better approach is to invite the gas utilities to do two things:

- For their existing budgets, show how they can continue to spend at that level and continue to add significant value in an increasingly crowded conservation market. The premium should be on innovation, building on the gas distributors' years of experience.

- If they want budget increases, they should show how each additional dollar will produce incremental benefits for their customers. New money should not be more of the same. It should fund added value, and fresh thinking. Utilities should be expected to show that they will use that money to accomplish something that they are uniquely positioned to deliver.

SEC strongly supports conservation efforts by utilities. Budget levels of $39.5 million per year for each utility, as the Staff math would require, may be right, or too high, or too low. This should be driven by what they can do with the ratepayers' money.

Shareholder Incentives

Staff is proposing that shareholder incentives be set at 9-10% of budgets, on the theory that this makes the profitability of DSM equivalent to the profitability of the gas utility's core business of gas distribution. This is less than half of current levels.

This is a fundamentally incorrect calculation, on several levels.

First, the profitability of the core business is not based on a 9-10% margin. Annual operating spending (which is the nature of DSM) does not generate profits directly. Utilities generate

incremental profits by adding rate base, and by managing that infrastructure at less cost than the assumptions included in rates.

If a utility lays $100 of pipe, it receives an annual profit on that pipe of $3.42 (9.5% ROE on 36% of the cost), and continues to receive that (declining annually) for 40-50 years. The net present value of that profit is thus $33.30 (discounted at a 6% discount rate for 40 years). The Staff proposal of $10.00 on $100 of spending is not close.

Second, both gas distributors assume for operating purposes that they will actually achieve a profit level of at least 100 basis points higher than the Board-approved level, net of any earnings sharing. If that is added into the core business side of the equation, spending $100 nets $36.81 in profits on an NPV basis. Further, that is not a maximum. The Staff proposal would have the $10.00 profit for $100 of DSM spending as a maximum.

Third, the Staff proposal assumes that the correct comparison is $100 of spending to $100 of spending. That is not the equation for the gas utilities. From their point of view, the question is how much capital spending are they <u>avoiding</u> by their DSM programs. It is the profit on that potential new rate base that they are actually losing by doing DSM. If they are to be made completely whole, that is the incentive they must receive for successful DSM programs.

This, of course, is a non-starter. Since most good DSM programs can replace several times their cost in conventional infrastructure spending, gas distributors would have to get shareholder incentives equal to their entire DSM budget, or even higher, under this paradigm being proposed by Staff. This is most certainly not going to be acceptable to ratepayers.

If the Staff approach is to work at all, it would have to be through capitalizing DSM spending as a type of quasi rate base. That money would not be provided by the ratepayers, but would be financed by the utility as with all other capital spending. It would then be depreciated over time (presumably based on results achieved), and the utility would earn a return on the declining balance, just as they do with infrastructure spending.

The utilities are not clamouring to move in that direction, and it would be a major change in the structure of DSM spending, yet that is really the only way to achieve the equivalency goal that Staff is proposing.

The alternative is much more pragmatic. Instead of pretending that gas distributors will prefer an investment in DSM (i.e. contrary to their basic business model) to an investment in rate base (i.e. the core of their business model), we should ask, as we have in the past, how many dollars are necessary to get the attention of utility management. Right now, their maximum profit on DSM is around $9 million a year each, and that appears to be enough. Staff is proposing around $4 million each.

Is that enough?

SEC argued in past years that the incentives should not be reduced. In 2006 we argued for substantial increases in incentives, and in 2011 we argued that they should be restructured so that there is no cap, but that efficiency is promoted.

In this case, it would appear to us that the Staff proposal is much like saying to an employee: "We want you to perform better, and we are going to give you a bigger budget to do so, but we're also going to cut your salary in half."

SEC are the last ratepayers to argue for profligate use of ratepayer money, of course. However, if the gas utilities are not sufficiently incented (and that essentially means profits) to do DSM, they will not be successful at it, and ratepayers will be wasting all of their DSM money.

In our view, the better approach is to keep incentive levels at current levels of just under $9 million per year (which we know already is enough), but make it more difficult to achieve those levels. This does not just mean increasing targets. It also means refocusing on measures that are more challenging, where the utilities' expertise is best leveraged. And, it means ensuring that there is even tighter control over evaluation and verification, with greater transparency and more demonstration that current programs are producing the claimed results.

In this, as with the "taking ownership" issue, we note that not once during the working group process did any stakeholder propose reduced shareholder incentives. This appears to be entirely the result of Staff analysis, but may be out of step with the views of the stakeholders.

We do note that Staff will be proposing an incentive for achieving targets at lower than expected cost. This is tricky to design and implement, but SEC has long supported this approach.

Conclusion

Staff has advised that the report expected in the next few weeks may be a draft Board report, i.e. expressing a direction that the Board has already reviewed and accepted, in at least a general way. SEC believes that, if Staff is to be allowed to proceed with the proposals they outlined to the working group, that should be done through a Staff Paper, so that the Board can see the full range of input on these issues before choosing a direction for Board policy in this important area.

All of which is respectfully submitted.

Yours very truly,
JAY SHEPHERD P. C.

Jay Shepherd

cc: Wayne McNally, SEC