OEB Staff Submission
Kingston Hydro Corporation
Settlement Proposal
EB-2015-0083

Introduction

On November 3, 2015 Kingston Hydro Corporation (Kingston Hydro) filed a settlement proposal with respect to its Custom Incentive Rate-setting (Custom IR) application for an order approving just and reasonable rates and other charges for electricity distribution to be effective January 1, 2016, and each year thereafter until January 1, 2020. On November 10, 2015 Kingston Hydro filed an update to this settlement proposal.

The parties to the settlement proposal are Kingston Hydro and the following approved intervenors in the proceeding:

Consumers Council of Canada (CCC);
Energy Probe (EP);
School Energy Coalition (SEC);
Sustainable Infrastructure Alliance of Ontario (SIA); and
Vulnerable Energy Consumers Coalition (VECC)

Not all intervenors of record participated in the settlement conference. The Sustainable Infrastructure Alliance of Ontario did not attend or provide comments.

The settlement proposal represents a full settlement on all issues.

OEB staff notes that there have been a number of updates to the evidence in the course of this proceeding. This submission is based on the status of the record as of the filing of Kingston Hydro's settlement proposal and reflects observations which arise from OEB staff's review of the evidence and the settlement proposal.

It is intended to assist the OEB in deciding upon Kingston Hydro's application with respect to the issues laid out in the settlement proposal and in setting just and reasonable rates.

OEB Staff Submission

OEB staff has reviewed the settlement proposal in the context of the objectives of the Renewed Regulatory Framework for Electricity (RRFE), other applicable OEB policies, relevant OEB decisions, and the OEB's statutory obligations. The RRFE is a rate-setting option developed for distributors in the *Report of the Board, Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach* issued on October 18, 2012 (the RRFE Report). The parties considered the issues and outcomes of the RRFE in the context of Kingston Hydro's five-year Custom IR term. OEB staff is of the view that the settlement proposal reflects a reasonable evaluation of the distributor's planned outcomes in this proceeding, and appropriate consideration of relevant issues.

OEB staff submits that the OEB's approval of the proposal as filed would adequately reflect the public interest and would result in just and reasonable rates for customers. As such, OEB staff supports the proposal in its entirety.

As a supplement to OEB staff's overall position, OEB staff offers the following discussion on matters pertinent to the application and to OEB policy.

OEB staff has evaluated the settlement proposal by drawing upon the principles and expectations laid out in the RRFE Report, as an aid to the evaluation of the sufficiency of the settlement proposal from the perspective of the policy intent of the RRFE and the Custom IR filing option.

The OEB expressed its expectation that "the rate-setting process needed to put greater focus on delivering value for money, aligning the interests of customers and distributors, and serving both present and future customers"[1]. The OEB stated that "each rate method will be supported by: the fundamental principles of good asset management; coordinated, longer-term optimized planning; a common set of performance expectations; and benchmarking."[2]

While the RRFE Report stated that the OEB "expects that the specifics of how the costs approved by the OEB will be recovered through rates over the term will be determined in individual rate applications"[3], it nevertheless made certain expectations clear. According to the OEB's report[4], a distributor that applies under this method will:

- File robust evidence of its cost and revenue forecasts over a five year horizon,
- File detailed infrastructure investment plans over that same time frame.

[1] *Report of the OEB Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach October 18, 2012*, p. 1
[2] Ibid 1, p.10
[3] Ibid 1, p.18
[4] Ibid 1, p. 19

- Demonstrate its ability to manage within the rates set, given that actual costs and revenues will vary from forecast.[5]

In addition to these general expectations, the OEB specified the core elements of the approach to rate-setting, including regarding the use of benchmarking, productivity expectations, benefit-sharing and other considerations. A full list of these elements is available at Table 1: Rate-Setting Overview – Elements of Three Methods on page 13 of the RRFE Report and are summarized here:

1. "Going In" Rates
2. Form, Term & Coverage
3. Cost Forecast, Rate Trend and Adjustment Mechanisms
4. The Role of Benchmarking
5. Sharing of Benefits
6. Treatment of Unforeseen Events
7. Deferral and Variance Accounts
8. Performance Reporting and Monitoring
9. Other issues

1. "Going in" Rates

RRFE Expectation: Multi-year application review with a minimum 5 year term

Kingston Hydro's rates are proposed to be set on a full cost of service review for 2016 and agreed-to adjustments in each of the subsequent years of a five year plan. OEB staff submits that the term and rate horizon under consideration are consistent with the RRFE Report.

The Parties have agreed upon a revenue requirement that is forecast to increase by 2.76% in the first year of the plan relative to its last OEB-approved service revenue requirement (2011). In subsequent years, the annual average increase is 3.06%.

[5] Ibid 1 p.19

OEB staff has provided two tables: table 1 shows the impact of the settlement proposal on the service revenue requirement; table 2 below illustrates bill impacts of the proposed settlement relative to those for which Kingston Hydro applied. OEB staff notes that the bill impacts for the 2016 rate year do not take into account the expiry of the Ontario Clean Energy Benefit; no disposition of deferral and variance accounts is shown for years 2017 to 2020, as these are unknown.

Table 1

Revenue Requirement

Table 1						
	2016	**2017**	**2018**	**2019**	**2020**	**Total**
Submitted Revenue Requirement	$ 12,861,718	$ 13,315,580	$ 13,743,759	$ 14,190,880	$ 14,546,907	$ 68,658,844
Change	$ (761,488)	$ (782,309)	$ (788,888)	$ (821,477)	$ (854,107)	$ (4,008,269)
Final Revenue Requirement	$ 12,100,230	$ 12,533,271	$ 12,954,871	$ 13,369,403	$ 13,692,800	$ 64,650,575
Deficiency over 2015 Rates	$ (127,769)	$ (558,828)	$ (992,738)	$ (1,412,776)	$ (1,736,484)	$ (4,828,595)
Yearly Change in Deficiency	$ (127,769)	$ (431,059)	$ (433,910)	$ (420,038)	$ (323,708)	$ (1,736,484)
Average Increase over 2015 Rates	1.1%	4.7%	8.3%	11.8%	14.5%	8.1%
Average Change in Deficiency	1.1%	3.6%	3.6%	3.5%	2.7%	2.9%

Table 2
Bill Impacts – Residential Customers (800kWh/mo)

		2016		2017		2018		2019		2020	
		($)	(%)	($)	(%)	($)	(%)	($)	(%)	($)	(%)
Application	Distn A	1.05	3.84%	-0.74	-2.60%	0.09	0.32%	-0.09	-0.32%	0.61	2.20%
Per Settlement	Distn A	2.17	7.91%	-4.50	-15.20%	0.14	0.56%	-0.68	-2.24%	0.61	2.05%
Application	Total RPP	9.60	7.54%	-1.88	-1.37%	0.1	0.08%	-0.1	-0.08%	0.69	0.51%
Per Settlement	Total RPP	-11.15	-7.33%	4.05	2.87%	0.16	0.11%	-0.77	-0.53%	0.69	0.48%

The settlement proposal results in a decrease of $761,000 compared to the revenue requirement for the 2016 rate year for which Kingston Hydro applied. As the subsequent years are pegged to the 2016 rate year through an inflation escalator for the operations, maintenance and administration (OM&A) portion of the revenue requirement, this decrease will impact each of the five rate years.

The decrease is mainly due to the agreed-upon reduction in working capital allowance from 13% to 7.5%. This reduction, combined with the change in cost of capital parameters has an impact of $443,000. Other drivers include a reduction in OM&A of $150,000, depreciation expenses of $71,000, as well as a reduction in the 2016 opening rate base. The parties also agreed to fix cost of capital parameters for the Custom IR term at a lower rate than applied for. Parties agreed to fix the long-term debt rate for any new debt over the next five year at 3.75%. In addition, the parties agreed to reduce the cost of affiliated debt through the reduction of the existing debt rate of 5.87% on the promissory note to the OEB's deemed long-term debt rate of 4.54%. Lastly, a reduction to payment in lieu of taxes (PILs) amounts to a revenue requirement reduction of $96,000.

2. Form, Term and Coverage

RRFE Expectations: A comprehensive, custom index rate form

The RRFE Report indicates the expectation that a Custom IR application will be "based on a five year forecast of a distributor's revenue requirement and sales volumes"[6] that is comprehensive, i.e. both capital and OM&A. Distributors are expected to commit to performance improvements in not merely one area of their business, but in all aspects of it, including in the capital investments to renew and expand its system. Kingston Hydro did not provide a detailed forecast for OM&A beyond 2016.

OEB staff therefore takes the initial position when evaluating any Custom IR application that the decoupling of rates from costs that is fundamental to performance-based rate-making therefore should involve not just the form by which OM&A costs are established for a five year period but also the manner in which the revenue requirement recovers the cost of capital investments. At the same time, OEB staff recognizes that the RRFE policy explicitly states that for Custom IR applicants, "the specifics of how the costs approved by the Board will be recovered through rates over the term will be determined in individual rate applications."[7]

It is within this context that OEB staff evaluates the form of the rate proposal contained in the Kingston Hydro settlement document.

The parties' proposal includes a forecast of OM&A for 2017 – 2020 indexed from the 2016 budget, and a comprehensive 5-year distribution system plan upon which the distributor's capital spending is based.

As discussed by the parties in the Key Components section of the settlement proposal starting at page 14, the treatment of OM&A spending incorporates an escalator based on inflation, a deflator that mimics the function of the OEB's productivity and stretch factor, as well as a provision for the growth in OM&A that is the result of customer

[6] Ibid 1 p. 18
[7] RRFE report, p 18

additions. The parties agreed to apply Kingston Hydro's current stretch factor of -0.3% as well as a growth factor of +0.04% to the OEB's current 2-factor IPI of 2.1% to determine Kingston Hydro escalation factor. The net effect of the approach is to index OM&A by 1.84% annually, negligibly higher than the 1.8% that Kingston Hydro would be eligible for in 2016 under the Price Cap IR framework given its cost performance. The form of rate treatment, in staff's view, is therefore broadly consistent with the core tenets of RRFE policy: a cost envelope that is forecast to decline in real, constant-dollar terms, incenting productivity gains while providing sufficient revenues to serve customers and fund operations.

The approach to capital spending, however, does not necessarily accord so clearly with a performance-based rate form: costs to customers associated with capital investments are proposed to be recovered on a cost-of-service basis, based on a used or useful principle, forecast against a rate base agreed-upon for every year of the plan term. The capital expenditure-related component of rates is excluded from an explicit stretch or productivity commitment and is not subject to an index approach that has been informed by the company's investment plan commitments.

Such asymmetry between the treatment of OM&A and capital expenses was not the intent of the Custom IR option. Instead, with the onset of the RRFE, the OEB has advocated comprehensive, total cost incentive rate-setting, on the grounds that it creates stronger and more balanced incentives.[8] As has been argued elsewhere, including during RRFE consultations, an asymmetrical I-X framework applied to OM&A but not to capital may distort incentives, promote sub-optimal investments and alter a distributor's response to cost and revenue changes.

However, in staff's view, this inconsistency in form is no barrier to the reasonableness of the rate consequences for Kingston Hydro's customers that would ensue if the OEB approves the proposed settlement. In staff's view, the parties' proposal regarding capital spending, discussed on pages 10 to 13 of the proposal, provides an efficient framework for funding a capital plan that uses a number of variance accounts to protect Kingston Hydro's customers from cost and delivery risks while incenting the utility to maintain performance. The use of deferral accounts places greater emphasis on after-the-fact recoveries and reconciliation rather than ex-ante adjustments typically adopted in performance-based incentive rate-making. However, as in the settlement regarding Horizon Utilities[9] that was approved by the OEB, in OEB staff's view, this approach to

[8] Ibid 1 p.9
[9] EB-2014-0002

rate-setting provides a cost-recovery framework that results in acceptable rates and reasonably incents productivity gains while containing risks for customers. The parties' proposal is also implicitly consistent with the RRFE report's statement that the specifics of cost recovery through rates would be assessed in individual applications[10].

Additional commentary on the value and function of specific capital and performance-related deferral and variance accounts is provided further below, in section 5, Benefits Sharing.

3. Cost Forecast, Rate Trend and Adjustment Mechanisms

RRFE Expectation: Distributor-specific rate trend for the plan term to be determined by the OEB, informed by the distributor's forecasts, the OEB's inflation and productivity analyses.

The OEB's Custom IR plan is founded upon the expectation that a distributor will establish rates for five years and will manage within those rates for the duration of the term, given that actual costs will inevitably vary from those forecasts. In OEB staff's view, this approach implies that distributors should endeavour to keep the number of annual adjustments to a minimum.

This settlement proposal, in staff's view, represents a significant step toward that objective. Unlike past multi-year cost of service applications, Kingston Hydro will fix its rates for five years of its rate plan. It will not update its cost of capital over the term of the plan; its working capital allowance is based on the OEB's default value of 7.5% and will not be adjusted for changes in the cost of power, unless changes in the cost of power affects the allowance by a cumulative effect to revenue requirement in excess of Kingston Hydro's materiality threshold of $65,000. While the impact of changes in the cost of power on working capital allowance might not reach the threshold value in the first or second year, the cumulative increase year-over-year as compared to the 2016 values might. Should the threshold be reached in a subsequent year, an adjustment would be made for that rate year, which will then form the new base line.

Similarly, OEB staff is also satisfied that the commitments in Kingston Hydro's capital plan, coupled with indexed OM&A costs, are likely to provide a manageably smooth rate trend over the term. Kingston's capital budget focuses on system renewal with projects like pole replacements, underground cable replacement as well as preparatory engineering and structural work for the rebuild of Kingston Hydro's substation No.1. As

[10] Ibid 4, above.

noted by the parties, Kingston Hydro is experiencing minimal load growth, which leads to minimal investments in the areas of system access and system service.

The settlement proposal ensures that any capital spending related to long-term system renewal projects, such as the rebuilding of Kingston Hydro's downtown transformer station (MS1), will not be included in rate base over the term of this plan because the assets will not be used and useful.

In OEB staff's view, annual capital expenditures are smoothly paced. OM&A costs, as mentioned, are indexed evenly over the Custom IR term. These costs are therefore likely to result in smooth and predictable rates for customers. OEB staff is of the view that customers within Kingston Hydro's service area will benefit from the capital investments through increased reliability and reduced planned outages at the end of the Custom IR term.

Staff notes that in addition to agreeing on revenue requirement over the term of the Custom IR, the parties also agreed to a fixed load and customer forecast over five years. Annual adjustments will be kept to a minimum and include the following:

- Low Voltage charges
- Retail Transmission Service Rates
- Deferral and Variance account disposition based on current OEB policy

OEB staff notes that this approach will keep the number of annual updates to an absolute minimum. OEB staff commends the parties on lowering the number of annual updates and submits that this agreement has taken considerable steps towards the intent of the RRFE for a distributor to manage within the set rates, given that the actual costs and revenues may vary[11].

4. Role of Benchmarking

RRFE expectation: To employ benchmarking to assess the reasonableness of the distributor's forecasts

Benchmarking is a core element of the OEB's RRFE. In staff's view, whether by comparison against other utilities, or assessed against a distributor's own year-over-year performance, benchmarking is intended to help to establish whether costs – both overall and project or function-specific, are reasonable. Benchmarking can also incent

[11] RRFE report, p. 19

performance by providing an independent reference point for a distributor's overall efficiency.

While the parties to the settlement proposal do not express a conclusion on the adequacy of Kingston Hydro's benchmarking to assess the reasonableness of its cost forecasts, their proposal finds a means of connecting the OEB's ongoing benchmarking assessment of all distributors to Kingston Hydro's rate plan.

In addition, the asymmetrical efficiency variance account, described on page 15 and 16 of the settlement proposal, would decrease Kingston Hydro's revenue requirement by a formulaic adjustment in the event its efficiency deteriorated sufficiently to be assigned into a less efficient cohort. There is no increase in revenue requirement should the utility rise into a more efficient cohort. This element was first introduced in the settlement regarding Horizon Utilities' Custom IR for 2015-9.

OEB staff is of the view that while the dollar value of the consequence alone may be insufficient to motivate a distributor[12], there is significant merit in continuing to tie an evaluation of Kingston Hydro's performance to those in the rest of Ontario for the duration of the plan. While not explicitly contemplated in the Custom IR framework, OEB staff's view that it is appropriate to include the expectation that there continue to be consequences – both reputational and financial – for Kingston Hydro should its performance deteriorate relative to its peers during the custom rate-setting term in order to provide another means of ensuring a focus on outcomes.

5. Sharing of Benefits

RRFE Expectation: Benefits of efficiency improvements would be shared with customers through productivity gains; means and methods to do so would be evaluated on a case-by-case basis.

In addition to the benefit sharing inherent in the application of a productivity and stretch factor to OM&A costs, the parties have agreed upon two other measures to be included in the rate plan that are designed to align incentives for efficient cost performance and protect ratepayers from poor execution or cost control on the part of the distributor.

[12] The impact calculated in the settlement proposal based on the 2017 revenue requirement and a slippage to cohort 4 from cohort 3 is $18,800.

Earnings Sharing Mechanism (ESM)

An ESM will share all earnings above the OEB-approved regulated rate of return evenly with ratepayers and the shareholder; any under earnings are borne exclusively by the shareholder. While the absence of a dead band for overearning that would allow a distributor to retain all of the overearnings up to a certain point may dull the incentive for Kingston Hydro to invest in productivity gains, this arrangement is reasonable and consistent with past cases, such as Enbridge Gas Distribution (EB-2012-0459) and Horizon Utilities (EB-2014-0002).

Capital Investment Variance Account (CIVA)

Kingston Hydro has a five year capital plan. To recognize the challenges with respect to forecasting timing and costs over five years of capital investments in distribution assets, the parties have proposed an account that would track variances from the plan so that any over-recovery in rates that results from under-spending is returned to customers. The OEB first approved such an account in the Horizon Custom IR. The mechanism for Kingston Hydro is described on pages 13 and 14 of the settlement proposal.

A unique feature of this asymmetrical CIVA, which is different from the one approved in Horizon, is that the account tracks three distinct forecasts, rather than the single total forecast in the Horizon settlement agreement. The three categories tracked are System Renewal and System Service, System Access, and General Plant. OEB staff submits that this reporting allows for more precise monitoring of Kingston Hydro's ability to manage its capital expenditures and reflects the different drivers of the three categories. OEB staff submits that this measure effectively achieves two ends: it motivates Kingston Hydro to deliver on its plan while ensuring that customers' rates will, over time, accurately reflect the assets that are used or useful in providing them service. Given the volume of spending planned and the term of the plan, OEB staff submits that such an account is a useful provision.

6. Unforeseen Events

RRFE Expectation: The OEB's policies, as set out in the Report of the OEB on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors, will continue under all three menu options.

The OEB's chief mechanism for managing the consequences of material unforeseen events is the Z-factor, initially described in the *Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors* issued on July 14, 2008 (the 3GIRM Report).

Consistent with the RRFE for Custom IR, the Parties agreed that Kingston Hydro could apply for Z-factor relief for unforeseen events based on the current OEB policy. The settlement proposal recognizes that the current threshold would be $65,000, based on the OEB policy that a Z-factor threshold for a distributor of this size is 0.5% of its annual revenue requirement.

7. Deferral and Variance Accounts

RRFE Expectation: Status quo, plus as needed to track against plan.

With respect to deferral and variance accounts, the settlement proposal makes no changes to the process for deferral and variance accounts as set out in *Report of the Board on Electricity Distributors' Deferral and Variance Account Review Initiative (EDDVAR) issued on July 31, 2009*. Group 1 accounts will be evaluated annually, consistent with OEB policy, and disposition will be mandatory if the balances exceed the OEB's threshold. Likewise, existing Group 2 accounts will be reviewed in Kingston Hydro's 2021 rebasing application.

All new deferral and variance accounts noted below (including the CIVA noted above) are Group 2 accounts and considered for disposition only upon rebasing.

<u>Other Post Employment Benefits (OPEBs)</u>

As noted in the OEB's Decision with Reasons in the Ontario Power Generation Inc. (OPG) proceeding EB-2013-0321, the OEB approved the cash method for other post-employment benefits (OPEB) costs and established a new deferral account to track the differential between the accrued and cash valuations for pensions and OPEBs, which was material in the case of OPG until such time as the OEB establishes a policy on this matter. OEB staff notes that a consultation on the review of pensions and OPEBs was initiated earlier this year.

As per the settlement proposal, Kingston Hydro confirmed that the amount included in OM&A with respect to post-employment benefits approximates the cash amount of $46,512 paid in 2014. Kingston Hydro noted that the amount should be based on an accrual amount of $96,806.

Recognizing that the OEB intends to address the method for accounting of OPEBs in rates as part of a generic policy process, the parties have agreed to an deferral account for the applicant to record the difference between the OPEBs amount forecasted to be expensed (accrual method) as per modified IFRS and the forecasted cash amount related to employee benefits commencing in 2016.

The parties further agreed that Kingston Hydro will not seek to dispose of any balance in this account and discontinue it if the OEB determines through its generic policy process that rates shall include OPEBs expenses on a cash basis. If the OEB instead determines that LDCs may recover OPEBs using an accrual methodology, the parties agreed that Kingston Hydro will be permitted to seek disposition of this account to recover the amount recorded as part of its next rebasing application.

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OEB staff submits that the OEB established the following eligibility criteria for the establishment of a new deferral/variance account:

- Causation – The forecasted expense must be clearly outside of the base upon which rates were derived
- Materiality – The forecasted amounts must exceed the OEB-defined materiality threshold and have a significant influence on the operation of the distributor, otherwise they must be expensed in the normal course and addressed through organizational productivity improvements
- Prudence – The nature of the cost and forecasted quantum must be reasonably incurred although the final determination of prudence will be made at the time of disposition. In terms of the quantum, this means that the applicant must provide evidence demonstrating why the option selected represents a cost-effective option (not necessarily least initial cost) for ratepayers.

While OEB staff supports the settlement agreement in its entirety, it is not clear to staff that this deferral account meets the above cited eligibility criteria of materiality. OEB staff notes that the differential between the cash amount embedded in rates and the forecasted OPEBs expense based on the accrual methodology is approximately $50,000 annually. OEB staff submits that this amount is well below Kingston Hydro's materiality threshold of $65,000, though it is acknowledged that the cumulative amount would be $250,000 over the five year term. However, for the very reason that the difference is not material, OEB staff does not have concerns with including the accrual expense number in rates for this applicant. The applicant's evidence demonstrates that the immaterial difference between cash and accrual will persist on an annual basis throughout the Custom IR period.

Specific Service Charge Variance Account

In the settlement agreement, the parties noted that in a letter of December 11, 2014, the OEB signaled its intention to review the appropriateness of Specific Service Charges in a generic process. Specific service charges, including any change to the prevailing wireless or pole attachment rate, form part of Kingston Hydro's service revenue requirement and affect the base revenue requirement. In view of the possibility that Kingston Hydro's service charges may be changed as a result of the generic hearing, the parties agreed to establish a new variance account to capture the increase or decrease in other revenues.

In a letter issued November 5, 2015, the OEB announced that it is initiating a comprehensive policy review of miscellaneous rates and charges applied by electricity distributors. While the activity is in its very early stages, the letter makes no indication about the manner of implementation of any changes.

OEB staff notes that in the normal course, OEB policy reviews are implemented on a going-forward basis, typically only at the time of rebasing. The June, 2015 implementation of changes to streetlighting cost allocation generally followed this approach, but provided specific exceptions for distributors where the topic had arisen as an issue in a recent proceeding[13]. In still other policy consultations[14], the OEB established generic deferral or variance accounts to track the impact of the new policy.

Consequently in OEB staff's view there is no need to establish a specific variance account for this distributor in this instance so that adjustments could be made to any service charges retrospectively to 2016. In OEB staff's view, it would be more

[13] EB-2012-0383, *New Cost Allocation Policy for Street Lighting Rate Class*, June 12, 2015
[14] EB-2009-0397, *Filing Requirements: Distribution System Plans – Filing under Deemed Conditions of Licence,* May 17, 2012

appropriate to allow the implications of any policy to be implemented in the next annual update following the policy change, with an associated variance account for any impact to revenue. This prospective approach to policy change is consistent with the OEB's decision for Horizon Utilities related to streetlighting[15], which found that that a reopener clause included in the settlement proposal would allow the utility to apply to adjust its streetlighting rates, if warranted, without needing to await rebasing. On this basis, any policy decision on specific service charges would still apply to any remaining term in Kingston Hydro's five year rate plan.

8. Performance Reporting and Monitoring

RRFE Expectation: A regulatory review may be initiated if a distributor's annual reports show performance outside of the +/- 300 basis points earnings dead band or if performance erodes to unacceptable levels.

The RRFE expects that distributors will measure and report on their performance annually in order that the OEB can continue to evaluate the utility's effectiveness, especially with regard to service quality, reliability and financial performance.

The settlement proposal states that Kingston Hydro intends to file the OEB's scorecard and RRR reports annually. In addition, the parties agreed to the following outcomes metrics:

1. impact of specific replacement of equipment on planned outages
2. impact of vegetation management on forced outages due to weather
3. system responsiveness to extreme weather

Attachment 1 of the settlement proposal provides a detailed description on the specifics of each metric. As per the agreement, Kingston Hydro will report on these metrics as soon as possible, but no later than its next rebasing application. OEB staff submits that these metrics will be beneficial in evaluating the utility's capital programs.

In addition, the parties agreed to develop benchmarking metrics that will compare its performance over time, and its performance relative to peers, on recurring capital and operating activities. This investigation may include, but is not limited to consideration of unit cost, job duration, and other such metrics, with the intent of identifying areas where continuous improvement in recurring capital and operating activities can be achieved. Kingston Hydro has agreed to consult with the parties on its progress and provide

[15] EB-2014-0002, Decision, October 29, 2014, p. 5-6

results by 2018. The parties have also agreed that these metrics will be shared with peers in the industry. Final reporting to the OEB will occur as soon as possible, but no later than at the time of its next rebasing.

It is OEB staff's view that the development of specific benchmarking and outcomes metrics as described in Attachment 1 and 2 are consistent with general principles of a Custom IR. OEB staff submits that the custom benchmarking and outcomes metrics, which will be developed by Kingston Hydro over the next few years, reflect the RRFE's goal to align customer and utility interests and will allow Kingston Hydro to place greater focus on delivering value for money to its customers through targeted capital and operational spending.

OEB staff submits that the reporting timeframe is appropriate and notes that anything proposed by the parties would be incremental to the metrics and reporting requirements set by the OEB.

Other Issues

Confidentiality vs. Privilege

The settlement proposal as originally filed includes a paragraph detailing the parties' understanding of the confidentiality provisions of the Practice Direction on Settlement Conferences and the OEB's Rules of Practice and Procedure:

> The Parties acknowledge that this settlement proceeding is confidential in accordance with the Board's Practice Direction on Settlement Conferences (the "Practice Direction"). The Parties understand that confidentiality in that context does not have the same meaning as confidentiality in the Board's Practice Direction on Confidential Filings, and the rules of that latter document do not apply. Instead, in this settlement conference, and in this Agreement, the Parties have interpreted "confidential" to mean that the documents and other information provided during the course of the settlement proceeding, the discussion of each issue, the offers and counter-offers, and the negotiations leading to the settlement – or not – of each issue during the settlement conference are strictly privileged and without prejudice. None of the foregoing is admissible as evidence in this proceeding, or otherwise, with one exception, the need to resolve a subsequent dispute over the interpretation of any provision of this Settlement Proposal. Further, the Parties shall not disclose those documents or other information to persons who were not attendees at the settlement conference. However, the Parties agree that "attendees" is deemed to include, in this context,

persons who were not physically in attendance at the settlement conference but were a) any persons or entities that the Parties engage to assist them with the settlement conference, b) any persons or entities from whom they seek instructions with respect to the negotiations, and c) any persons or entities to whom they are expected to report the results of the negotiations, and/or the reasons for positions they have taken; in each case provided that any such persons or entities have agreed to be bound by the same confidentiality provisions.

Following the OEB's decision in two different cases, Guelph Hydro (EB-2015-0073) and Waterloo North Hydro (EB-2015-0108), the parties re-filed the settlement proposal removing the third exception (c) – "any persons or entities to whom they are expected to report the results of the negotiations, and/or the reasons for positions they have taken"

OEB staff submits that the amended settlement proposal is consistent with the OEB's findings in the case of Guelph Hydro and Waterloo North Hydro. In the Guelph decision, the OEB found that "Parties are free to discuss settlement discussions with their direct instructing client (this is covered by exemption (b)); however, the OEB does not see a strong reason to allow for a broader disclosure of settlement discussions. In order to be effective, it is important that parties to settlement discussions have confidence that their discussions will not be widely disclosed."

Using the Guelph and Waterloo North Hydro decisions as a guide, OEB staff is satisfied with the revised wording as filed by the parties. The parties are responsible for ensuring that they comply with the confidentiality provisions.

Cost of Capital

On page 19 of the RRFE, the OEB stated its expectations that a distributor's application under Custom IR demonstrates its ability to manage within the rates set, given that actual costs and revenues will vary from forecast. While Kingston Hydro originally proposed to fix its long-term debt rate at the April 2015 deemed rate of 4.77%, it requested annual updates for the short-term debt rates as well as the ROE on an annual basis.

As part of the settlement proposal, the parties agreed to fix all cost of capital parameters for the term of the Custom IR. The parties agreed that Kingston Hydro's ROE and short-term debt rate from 2016 until 2020 will be the rates established by the OEB on October 15, 2015 as follows:

- ROE 9.19%
- Short-term debt rate 1.65%

For the cost of long-term debt, the parties agreed that Kingston Hydro will:

- adjust its costs for affiliated debt of $10.9M to the OEB's current deemed debt rate of 4.54%
- assume a future forecast debt rate of 3.75% for all new debt during the 2015-2020 period

OEB staff submits that the agreed-upon reduction and fixing of the cost of capital over the term provides rate stability for customers. OEB staff also submits that the minimization of annual updates is aligned with the intent of a Custom IR.

Transition to Fixed Rates for Residential Customers

On April 2, 2015 the OEB released the *OEB Policy, A New Distribution Rate Design for Residential Electricity Customers*, which calls for distributors to transition rates so as to recover costs from the residential class exclusively through fixed charges. The transition would be phased-in over four years, starting in the 2016 rate year, to reduce the impact on those customers whose bills will increase.

In the settlement proposal, Kingston Hydro committed to transition to fully fixed rates for residential customers by 2019. In order to mitigate any impacts for low volume customers in the residential rate class, the parties agreed to an asymmetric transition over the 2016 and 2017 rate years, since 2016 bill impacts due to other cost drivers are higher. In 2016, the increase in the fixed charge is $1.17; in 2017, the increase rises by a further $3.12. The final two transition years, 2018 and 2019, feature nearly equal changes of $2.69 and $2.73 respectively.

According to the settlement, the smaller change in 2016 relates to the interest of containing cost increases for customers at the 10th percentile of consumption to less than 10%.

OEB staff submits that this approach is reasonable and likely to be a good fit for Kingston Hydro's customers. OEB staff further notes that although these increases are not equal steps, they achieve a 100% fixed rate in 2019.

All of which is respectfully submitted