DISCUSSION OF THE COST ALLOCATION STUDY AND PROPOSAL FOR ONE USAGE FEE

In its January 19, 2016 filing, the IESO included a cost allocation study prepared by Elenchus Research Associates Inc. ("Elenchus") (Exhibit B-1-1, Attachment 1). At the outset, there were difficulties in the preparation of the study as the IESO's costs are predominantly staff compensation costs that would typically be included in the Administrative and General ("A&G") category of costs in an LDC's cost allocation study. A&G costs are not easily allocated to a particular type or class of customer. Unlike an LDC, which can attribute the majority of its capital-related costs and its operating and maintenance costs to customer classes based on causality, the IESO's costs are not easily apportioned based on standard cost drivers such as causal demand or energy requirements. Section 2.4 of the Elenchus 2016 update report (Exhibit B-1-1, Attachment 3) discusses that the IESO's costs are akin to operational overhead or A&G costs as follows:

> *The assignment given to Elenchus by the IESO was to develop a cost allocation model that would allocate the IESO's costs in a manner consistent with standard regulatory cost allocation principles and practices, in particular the principle of cost causality. In conducting this work, Elenchus has observed that the IESO's costs that are recovered through its Usage Fee consist largely of costs that would be treated as operational overhead or administrative and general (A&G) costs in the cost allocation models that are typically used by regulated electric utilities for their rate setting processes.*
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> *These costs are not viewed as costs that are directly caused by customers in the process of providing service. The causal relationship is far less direct than the capacity of a distribution system or the customer service support provided by a call centre. As a result, A&G costs are commonly allocated essentially as an overhead to other operating and capital costs that are caused more directly by customers.*

As stated in the Elenchus update report, A&G costs are typically treated as an adder to allocated costs, essentially spread out as overhead, as the causal relationship for these costs

are not closely related to the normal cost allocation classification factors of demand, energy and customers.

Despite the challenges identified above, Elenchus developed a methodology that would allow the IESO's costs to be parsed in the manner required to conduct a cost allocation study. As IESO departments are typically based on the function they perform, departmental costs were allocated based on whether the department's functions were seen to be triggered by domestic customers, export customers, or both. The IESO and Elenchus recognize that this method is not what is used for a traditional cost allocation study where assets are typically allocated to the various customer classes based on causality. Nevertheless, the work was completed in order to be responsive to previous guidance from the Board in its decision of August 10, 2011 (EB-2010-0279).

As provided in Exhibit B-1-1, Attachment 4, the Elenchus cost allocation model was rerun with forecast 2016 volumes and the IESO's 2016 budget. The IESO expected the outputs of the model for 2016 to be similar to those from 2015 as the work to be performed by the IESO is not expected to change dramatically in 2016. However, the outputs were significantly different from those produced using 2015 figures. Specifically, a 1% change in exports as a percentage of domestic volumes between 2015 and 2016 resulted in a 5% change in the resulting revenue to cost ratio. This clearly demonstrates that slight variations in exports as a percentage of total withdrawals, have a disproportionate impact on the results from the model. The IESO and Elenchus recognize that sensitivity to year-over-year changes in forecast energy volumes, including volumes that are driven primarily by the value of electricity in neighboring markets, illustrates that the model used by Elenchus to produce the IESO's cost allocation study is not robust. Variances in Ontario demand or export volumes, such as those captured in the forecast change between 2015

and 2016, do not impact the IESO's work or costs. The IESO's activities do not fluctuate in the short run or the long run based on domestic and export volumes, and there is no discernible link between domestic and export volumes and work levels/expenditures at the IESO. For example, the number of staff in the control room does not increase or decrease based on the forecast volume of exports. For clarity, the IESO focuses its efforts on ensuring efficient trade for the overall benefit of the market. This role involves essentially fixed costs that are an overhead for the Ontario electricity system.

While the results of the updated cost allocation study indicate that the revenue to cost ratios are within the range approved by the Board for electricity distributors , the IESO continues to believe that a traditional cost allocation model should not be relied on as a basis for setting the IESO fee. The IESO does not believe a traditional cost allocation model is the appropriate tool to examine or support how the IESO fee is set as it is not representative of cost causality within the IESO.

To summarize, the IESO does not believe a traditional cost allocation model is appropriate for the IESO as:

- Small changes to the inputs result in dramatically different outputs when the amount and type of work performed by the IESO has not altered. This indicates there is a lack of cost causality between the model and the operations of the IESO.
- All costs for the IESO had to be allocated by department based strictly on judgment rather than based on the customer class the assets served (as an LDC would do with the majority of its costs).

The IESO continues to believe that it is appropriate to move to a single IESO usage fee to be charged equally to all market participants, and that this proposal should be accepted on its own merits. As both domestic and export customers benefit from the work that the IESO carries out, and the IESO performs its work equally for the benefit of all market

participants, both domestic and export customers should pay equally for the work performed by the IESO. The work planned for and performed by the IESO is not dependent or related to the participation level of an individual market participant or a 'class' or type of market participant, and this work serves all types of customers. The Ontario electricity system is not designed or operated for one particular market participant type. The IESO cannot accept the premise that if the system was not specifically built for one particular class of customer, they shouldn't pay for it. The Ontario electricity system, planned and operated by the IESO, is an integrated framework – it includes multiple resources with different operating characteristics – demand response, nuclear generation, wind generation, gas generation, etc. - transmission lines, interconnections, and the control centre. Given the integrated nature of the system, the IESO's costs cannot be separated in an accurate or administratively simple manner, and therefore, the IESO believes it is appropriate to charge all market participants one fee on a similar basis to how the IESO has historically charged its fee.