EB-2017-0150

Ontario Energy Board

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch. B, as amended;

AND IN THE MATTER OF IN THE MATTER OF the Independent Electricity System Operator (IESO) 2017 Expenditure and Revenue Requirement

ENERGY PROBE RESEARCH FOUNDATION ("ENERGY PROBE")

ARGUMENT

Background

In the EB-2017-0150 Settlement Agreement ("Settlement") two issues remained unsettled:

4.4 Should the IESO establish a separate Market Renewal Program Deferral Account?

5.1 Is the IESO's proposed Regulatory Scorecard appropriate?

Issue 4.4. Should the IESO establish a separate Market Renewal Program (MRP) Deferral Account?

Energy Probe has already made submissions in context of the Issues List as to why we believe IESO should be directed to set up a deferral account to track costs associated with the project. We will expand on those positions here.

4.1 For starters, the current Forecast Variance Deferral Account (FVDA) is used to track general operating and capital costs that IESO incurs over a one-year period. It was not set up to track long-term capital projects such as the MRP. Running MRP costs and any variances through the FVDA is, in Energy Probe's view, contrary to the FVDA's role in the context of IESO's revenues and costs and limits both public and Board oversight of the MRP.

4.2 The MRP is a much a broader and extensive project than that typically undertaken by IESO. It's expected to be the largest capital expenditure ever undertaken by the agency, totaling more than $189 million from inception to completion and its implementation is expected to run well into the next decade. As such, it will require a more detailed review – rather than the very limited review regarding any variances in the FVDA – done by the Board and other parties to ensure all spending needed to complete it was prudent. Blending the costs of the MRP, which will occur over the span of multiple revenue applications by IESO, through the FVDA, which is cleared annually, will make that review, in our opinion, highly inaccurate and impossible. It also leads us to ask: why would anyone want to blend IESO's core operating and capital costs with the MRP, which is clearly a distinct project and has been highlighted – most recently 26 times in the 2017 Long-Term Energy Plan (LTEP) – as a transformative project? It's clearly well beyond IESO's normal operations and, as is standard regulatory practice, should be tracked separately from those costs, which will continue to be subjected to the FVDA and reviewed annually.

4.3 Furthermore, the clearing of the FVDA is, largely, a routine matter, with any over or underspending either credited or debited to feepayers annually without much discussion (likely due to the fact that the balances in the FVDA have been small and to the benefit of feepayers). Determining what, if any, costs should or should or should not be recovered from feepayers in relation to the MRP will likely be a more extensive affair, given the size – in dollar terms – and complexity of the project. If, for example, there is a net credit to feepayers in the FVDA as a result of higher-than forecast revenues or lower operating costs, but at the same time costs for the MRP were higher than anticipated to the same amount, does that work out to a wash for feepayers? Energy Probe thinks that such a situation works

against transparency and benefits-follow-costs regulatory principles, as the costs and benefits of IESO's core operations may not be the same as those of the MRP and blending the two costs into one bucket eradicates this important distinction

4.4 A deferral account for the MRP is similar to those established for LDCs, OPG and other utilities for large capital projects that are expected to span multiple years and/or revenue applications. Energy Probe sees no reason why IESO should be exempt from that same level of reporting, particularly now that it's moving ahead with a capital project that is of similar size, scale and complexity as those of some of the province's largest utilities.

4.5 The MRP is already facing cost uncertainty. In its revenue application, IESO initially forecast to spend $12 million on the MRP.[1] In an update, IESO admitted that, in fact, it was only expected to spend $8 million on the MRP in 2017 – or 66% of its original forecast.[2] This revelation is worrying to Energy Probe. IESO admits that the MRP is in the early stages of planning and many of the cost estimates, schedules and other business activities relating to it are far from complete. Yet, even with a very limited amount of work to be completed in 2017, IESO failed to come even marginally close to hitting its own targets and forecasts. Had IESO not updated its evidence, it would have been able to collect that $4 million in surplus revenue on work that it had not completed. To date, IESO has offered no indication that it was underspent in 2017 on the MRP because it found cost efficiencies or determined some work was unnecessary – it appears to be, simply, a matter of IESO being behind schedule or some other organizational issue that prevented the work from being completed.

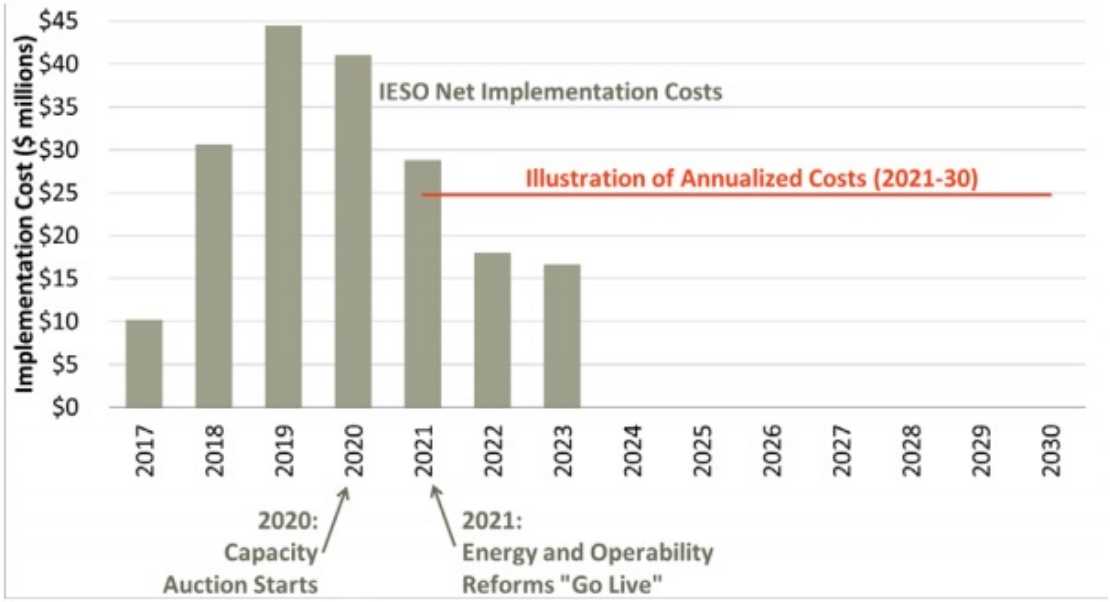
4.6 It's not clear to Energy Probe that the surplus $4 million from MRP spending that never materialized in 2017, would have ever made its way to the FDVA. As such, it's a very likely that IESO's customers, the Board and parties to this proceeding would have never known that the MRP was missing its own targets regarding expected costs. Worse still, that $4 million could have been used by IESO to cover other operating costs unrelated to the MRP and then, in future years when the scope, budget and schedule for the MRP is further established, that money could have been recovered once again from feepayers. The risk to feepayers of not having a deferral account to accurately track, monitor and ring-fence MRP spending from the rest of IESO's budget is already evident.

4.7 This risk to feepayers of IESO missing its spending targets increases dramatically going forward. While IESO is expected to spend $8 million on the MRP in 2017, that figure increases to $34 million in 2018 and $46 million in 2019.[3] If IESO were to underspend in those years to the same degree it did in 2017, feepayers would be overcharged by more than $11 million in 2018 and $15 million in 2019 – or $26 million over two years. Spending on the MRP in years beyond 2019 will continue to total in the tens of millions of dollars

[1] Exhibit A-2-2, Page 13 of 31
[2] Exhibit I, Tab 1.6, Schedule 6.02 PWU 2
[3] Exhibit A-2-2, Page 13 of 31, those numbers come from adding forecast operating and capital costs.

annually.[4] If those figures were to flow through to the FVDA, they would more than double or triple the amount of money in that account and dwarf variances that have occurred due to higher than expected revenues or lower costs throughout IESO's core operations.

Figure 21
IESO Implementation Costs



Notes:
The baseline estimate is based on the best current information on expected costs and parameters. We use a 5% discount rate to annualize the costs.

4.8 IESO's evidence in regards to the MRP, as detailed in the "The Future of Ontario's Electricity Market: A Benefits Case Assessment of the Market Renewal Project" report ("Brattle report"), was very clear that nearly every facet of the MRP is highly uncertain. As such, annual costs over the next decade could be significantly higher than current estimates and should be tracked in their own deferral account to ensure the agency's core operating and capital costs aren't blended into the MRP. We – IESO included – simply have very limited data and accurate forecasts on what the MRP will ultimately cost. The Brattle report repeatedly stresses this point:

- "We also recognize that there is an **uncertainty range** around the estimated efficiency benefits that should be considered in the Benefits Case. This range is driven by **uncertainties** in the scope of Market Renewal and uncertainties in translating benefits into the Ontario context."[5]

[4] The Future of Ontario's Electricity Market: A Benefits Case Assessment of the Market Renewal Project, page 89.
[5] The Future of Ontario's Electricity Market: A Benefits Case Assessment of the Market Renewal Project, page 39.

- "We describe here the primary assumptions and approach used to develop our estimates, findings from our review of experience in other markets, a qualitative assessment of stakeholders' business costs, and recommendations based on experiences from other ISOs. These cost estimates should be interpreted as early-stage and indicative estimates. **For example, the cost estimates are not reflective of actual vendor quotes for software enhancements, which are not possible to develop until the scope of design requirements is better defined**."[6]
- "Given the early stage of planning and scoping for Market Renewal, **this cost estimate should be interpreted as a preliminary indication, but one that is reasonable given present uncertainties**. The IESO will be able to update these estimates with more accurate information as the scope, timeframe, and vendor costs associated with Market Renewal are more fully established."[7]
- "[8]**There is substantial uncertainty in this estimate given the early indicative stage of the initiative, with a bigger uncertainty on the high end than on the low end**. We therefore provide an upper-end estimate of $300 million.142 This upper-end estimate incorporates higher-end assumptions regarding technology costs and project schedule."

4.9 Tracking the MRP through a deferral account is in line with previous decisions and policies released by the Board.

- In its most recent filing guidelines for natural gas distributors, the Board laid out a number of criteria for establishing a new deferral account (these criteria are also used to establish deferral accounts for LDCs, OPG and transmitters). The three reasons are: causation, with the forecasted expenses clearly outside base rates; materiality, with the amounts beyond an OEB-defined materiality threshold and having a "significant influence" on the operation of the utility; and prudence, as the forecasted costs must be reasonably incurred. The MRP hits all of those criteria. First, it's clearly outside the normal revenue requirement of IESO, as it's the largest and most complex undertaking the agency has completed. Second, it will be greater than the materiality threshold, as beginning next year the MRP could account for 20-30% of IESO's budget (and it may move higher in subsequent years). Third, IESO is acting prudently in moving ahead with the MRP as the government has clearly called for it and it undertook an extensive analysis on costs (the Brattle report), even if those estimates are highly uncertain.
- The Board recently approved a deferral account for the Hydro One's North West Bulk Transmission Line for the reasons outlined above and, in Energy Probe's view, are clearly applicable for the MRP.
- The Board also approved a number of deferral accounts in its decision on the EB-2012-0451, EB-2012-0433 and EB-2013-0074 proceedings. In the case of Union Gas' Parkway West project, the Board explicitly stated that any "excess costs" would be "examined" at Union's next rates application. In Energy Probe's view, this is

[6] Ibid., page 86.
[7] Ibid., page 87.
[8] Ibid., page 89.

exactly how the MRP deferral account should be viewed – as a way to ensure any excess costs are thoroughly reviewed.

- Recently, the Board's recent report on Regulatory Treatment of the Pension and Post-employment Benefits (OPEBs) Costs (May 18, 2017) has also reiterated the established regulatory principles regarding deferral and variance account, including: fairness, minimizing intergenerational inequity, minimizing rate volatility, appropriate allocation of risk, transparency and providing value to customers. The Board concluded that "adherence to these principles should achieve a stable, reasonable and efficient level of (these) costs for ratepayers, and a predictable and fair recovery of (these) costs (for utilities)." Energy Probe believes these same principles apply to the MRP.

4.10 The major difference between IESO and LDCs – and what the difference would mean for a deferral account – is that IESO has, in reality, no shareholder to hold account for any imprudent spending or cost overruns. IESO may argue that, as such, there's no point in establishing a deferral account, as it will fail to achieve any of the regulatory principles typically associated with such an account. Energy Probe disagrees with that premise. By clearly tracking any over or underspending of the MRP in its own deferral account, IESO is providing transparency both to its shareholder (the Minister of Energy), as well as the public. More importantly, a deferral account that clearly tracks any variance in spending or scheduled spending related to the MRP provides the Minister with the necessary information to establish a reasonable budget for IESO – one that accounts for spending on core operations, but also considers budgets related to special, one-time projects such as the MRP. If any MRP over or underspend simply flows through the FVDA or IESO's reserve account, it becomes difficult (as argued previously) to establish a budget for IESO that is cost effective and provides good value for feepayers.

4.11 How will an MRP deferral account work? The MRP deferral account should, at the outset, distinguish between salaries and capital costs. While operating costs for the MRP constitute all MRP-related spending in 2017, they account for a smaller share going forward and so may not need to be tracked in an MRP deferral account.

4.12 That said, going forward, as the estimates for MRP costs become more detailed and the Board has a reasonable level of confidence in the IESO's projections, it may be appropriate to establish a ***variance account (MRPVA)*** based on variations from forecast *MRP operating costs,* if there are any. This would allow IESO recovery of the majority of operating costs in its Minister-approved fees, with any variances to that approved amount recorded in the MRVPA – similar to how the FVDA currently operates. Having a MRVPA decreases intergenerational inequity, as it ensures operating costs are recovered from current fee payers and not kicked to the future. As stated above, Energy Probe opposes running variances in MRP costs through the FVDA, as it undermines transparency and makes it difficult for feepayers and other interested parties to track IESO's costs drivers.

4.13 However, we submit that there should be a continuation of the capital deferral account that defers recovery of capital costs to future periods. The reasons for that are, unlike operating costs, capital costs should be amortized and appropriately allocated to user classes. IESO currently has no evidence on whether the MRP benefits some feepayers more than others and, as such, that allocation should not be determined in this proceeding.

4.14 Any MRP deferral or variance account should be established in IESO's 2017 fees and include the $4 million rebate agreed to as part of the Settlement Agreement between IESO and parties in this proceeding.

4.15 Energy Probe also disagrees with IESO's characterization that, unlike LDCs and other utilities in Ontario, it submits its fees to the Board annually and, as such, there's no need for the additional oversight of a deferral account.[9] First, IESO's fee application is totally dependent on the Minister's approval, which could result in unexpected delays in the application being filed before the Board. It's not a certainty that IESO will file its fee applications without signification delays – we note that we're only now approving 2017 fees at the end of the year. Secondly, LDCs – even those on five-year incentive rate application – typically come before the Board annually for minor adjustments. Furthermore, most LDCs also clear their deferral accounts on an annual basis. IESO's situation isn't much different than a typical LDC and, as such, it's reasoning that because it comes before the Board annually should exempt it from a deferral account should be discounted.

Issue 5.1 Is the IESO's proposed Regulatory Scorecard appropriate?

5.1 The scorecards developed as part of RRFE for distribution and transmission utilities are based on outcomes that the Board has determined to be important for electricity consumers in Ontario. Primary among these outcomes are system reliability and organizational and operational cost effectiveness.[10] In Energy Probe's view, IESO's regulatory scorecard metrics should reflect these outcomes.

5.2 The IESO Corporate Performance Measures (CPMs) and the balanced scorecards do not use the same goals and objectives Elenchus has set out in the proposed regulatory scorecard. There are similarities only at high level. We note, for example, that in IESO's Business Plan, the only quantitative corporate performance measure or cost-effectiveness target is for conservation. There is no quantitative corporate performance measure for the IESO-administered markets, as is now proposed in the scorecard.

5.3 IESO's proposed scorecard is also lacking in cost-effectiveness measures. Energy Probe repeats its position that cost-effectiveness targets are essential and should be based on external benchmarking, rather than IESO historic performance. IESO has declined to pursue benchmarking, so Ontario electricity consumers will not know, for example, if

[9] IESO AIC page 4
[10] OEB Scorecard Performance Measures. https://www.oeb.ca/sites/default/files/2016-consolidated-scorecard.pdf

IESO's administrative costs are more or less on a per MWh basis than comparable organizations, such as Alberta Electric System Operator (AESO), Midcontinent Independent System Operator (MISO) and other Independent System Operators (ISOs).

5.4 In short, IESO's proposed scorecard leaves feepayers in the dark on whether they are receiving good value for money in regards to the cost of operating the province's electricity market.

5.5 As part of its application, IESO provided evidence from Elenchus, which recommended an internal metric – a three-year rolling average of total expenses over MWh or TWh. While we find this measure far from perfect, Energy Probe recommends that until benchmarking is done, IESO include this metric in its scorecard.

5.6 However, this is an aggregate measure, so in addition to this overall metric, Energy Probe recommends a metric or measure that specifically relates to core market operations. This would include, as an example, the cost to feepayers of IESO of operating the Ontario electricity market based on costs and actual transactions per MWh. Determining what costs to include is the main challenge. Energy Probe recognizes that, while IESO's direct costs would be fairly straightforward to track, indirect costs may prove more difficult. Nonetheless, this problem persists when completing benchmarking studies and IESO's method could be explained to parties and the Board for how they split those costs.

5.7 IESO's 2017 fees application provides a perfect example for why a metric tracking core operation costs per TWh or MWh of energy is needed. The specific 2017 fee request is $1.2187 per MWh for domestic customers and $0.9872 per MWh based on the proposed charge determinants. This translates to an aggregate cost per TWh of $1.191 per MWh – based on the requested 2017 revenue requirement of $190.8 million and a volume of 160.2 TWh. IESO has suggested that the increase in costs per MWh over 2016, is due to the costs of the MRP. If IESO were to have a separate measure tracking core operating costs, it would allow feepayers a better look at what is driving changes in IESO's current and future revenue applications – internal costs or other one-time expenditures.

5.8 Also, Energy Probe maintains – as it did during the consultation process – that IESO's regulatory scorecard should be linked directly to applicable corporate and individual performance goals and targets, and, in the latter case, to Short-Term Incentive Plan (STIP) payments, as is the case for AESO and MISO.[11] The connection between corporate performance and STIP compensation is absent in the Elenchus Report and IESO Stakeholder and Regulatory Processes.[12]

[11] See AESO Annual Report 2016 Corporate Governance and Financial Results, page 6 and MISO Human Resources committee, Item 04 2017 STI Metrics Draft Document. https://misoenergy.org/Library/Repository/Meeting%20Material/Stakeholder/BOD/Human%20Resources%20Committee/2016/20161206/20161206%20Human%20Resources%20Committee%20of%20the%20BOD%20Item%2004%202017%20STI%20Metrics%20Draft.pdf

[12] Exhibit C-1-1 Elenchus Report IESO Scorecard- Best Practices Page 44.