

1 **INTERROGATORY RESPONSE - OEB-4**

2 **1-Staff-4**

3 EXHIBIT REFERENCE:

4 **Updated Exhibit 1/Tab 1/Schedule 8**

5 **Exhibit 1/Tab 1/Schedule 10**

6 ***Handbook for Utility Rate Applications, October 13, 2016, pp. 25-26***

7

8 SUBJECT AREA: Custom Incentive Rate-Setting Framework

9

10 Preamble:

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12 Subsequent to the approval of Hydro Ottawa's first Custom IR plan for 2016-2020,<sup>1</sup> the OEB  
13 issued the *Handbook for Utility Rate Applications* (Rate Handbook) on October 13, 2016. The  
14 Rate Handbook extended the Renewed Regulatory Framework to rate-regulated utilities, in  
15 order to establish greater consistency in rate-setting methodologies to the extent possible and  
16 appropriate. The Rate Handbook also added greater clarification on the OEB's policies,  
17 principles and expectations with respect to rate-setting options, including for the Custom IR; a  
18 section is devoted to the Custom IR option. The Rate Handbook states, on pages 25-26:

19

20 Index for the Annual Rate Adjustment: The annual rate adjustment must be  
21 based on a custom index supported by empirical evidence (using third party  
22 and/or internal resources) that can be tested. Custom IR is not a multi-year cost  
23 of service; explicit financial incentives for continuous improvement and cost  
24 control targets must be included in the application. These incentive elements,  
25 including a productivity factor, must be incorporated through a custom index or  
26 an explicit revenue reduction over the term of the plan (not built into the cost  
27 forecast).

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28 <sup>1</sup> EB-2015-0019

1 The index must be informed by an analysis of the trade-offs between capital and  
 2 operating costs, which may be presented through a five-year forecast of  
 3 operating and capital costs and volumes. If a five-year forecast is provided, it is  
 4 to be used to inform the derivation of the custom index, not solely to set rates on  
 5 the basis of multi-year cost of service. An application containing a proposed  
 6 custom index which lacks the required supporting empirical information may be  
 7 considered to be incomplete and not processed until that information is provided.

8  
 9 It is insufficient to simply adopt the stretch factor that the OEB has established for  
 10 electricity distribution IRM applications. Given a utility's ability to customize the  
 11 approach to rate-setting to meet its specific circumstances, the OEB would  
 12 generally expect the custom index to be higher, and certainly no lower, than the  
 13 OEB-approved X factor for Price Cap IR (productivity and stretch factors) that is  
 14 used for electricity distributors.

15  
 16 OEB staff have compiled the following table of cohorts and stretch factors for Hydro Ottawa for  
 17 the period from 2014 to 2020, based on the annual Ontario distributor benchmarking. These are  
 18 based on the annual reports for the study conducted by Pacific Economics Research Group  
 19 LLC (PEG), as commissioned by the OEB. The studies are publicly available on the OEB's  
 20 website.<sup>2</sup>

21  
 22 **Table 1-Staff-4-1: Hydro Ottawa's Cohort Ranking and Stretch Factor by Year**

Rate Year	3-year data range	Cohort	Stretch Factor
2014	2010-12	3	0.30%
2015	2011-13	3	0.30%
2016	2012-14	3	0.30%
2017	2013-15	4	0.45%
2018	2014-16	4	0.45%
2019	2015-17	4	0.45%
2020	2016-18	4	0.45%

23 <sup>2</sup> <https://www.oeb.ca/industry/rules-codes-and-requirements/performance-assessment>

1 Question(s):

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3 a) Please confirm or correct Hydro Ottawa's cohort ranking and stretch factor for each year  
4 from 2014 to 2020, as shown in the above table.

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6 b) Since Hydro Ottawa's proposed Custom IR plan only applies the  
7 (inflation-less-productivity-plus-growth) adjustment to OM&A expenses, while capital  
8 additions are passed-through through the annual rate base and capital-related revenue  
9 requirement update, please explain how Hydro Ottawa's proposed Custom IR plan  
10 satisfies the Rate Handbook expectation that the "incentive elements, including a  
11 productivity factor, must be incorporated through a custom index or an explicit revenue  
12 reduction over the term of the plan (not built into the cost forecast)".

13

14 c) Hydro Ottawa is proposing a stretch factor lower than what the PEG model would  
15 forecast or has been Hydro Ottawa's stretch factor for the period 2014-2020. Please  
16 explain how Hydro Ottawa's proposal is consistent with the OEB's general expectation  
17 that "the custom index to be higher, and certainly no lower, than the OEB-approved X  
18 factor for Price Cap IR (productivity and stretch factors) that is used for electricity  
19 distributors".

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21 **RESPONSE:**

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23 a) Hydro Ottawa confirms the cohort ranking and stretch factor information for each year  
24 from 2014-2020, as shown in the table prepared and referenced by OEB Staff.

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26 b) Hydro Ottawa's capital expenditure forecast is the product of a rigorous asset  
27 rationalization process that the utility undertook as a prerequisite to the formulation of its  
28 capital expenditure plan. This process resulted in reductions to planned capital spending  
29 in the amount of \$50M per year, for the 2021-2025 period. Please see the response to  
30 part (a) of interrogatory OEB-3 for more details.

1 In addition, Hydro Ottawa observes that its proposed Custom IR formula for 2021-2025  
2 is largely similar in scope and structure to that which the OEB approved for purposes of  
3 the utility's 2016-2020 rates. In approving Hydro Ottawa's Custom IR approach for  
4 2016-2020, the OEB deemed the utility's proposal to be consistent with the Renewed  
5 Regulatory Framework ("RRF") and with the RRF's expectations for Custom Incentive  
6 Rate-setting applications.<sup>3</sup>

7

8 c) Hydro Ottawa believes that the first sentence in the excerpt from the *Handbook for Utility*  
9 *Rate Applications* quoted by OEB Staff is instructive: "The annual rate adjustment must  
10 be based on a custom index supported by empirical evidence (using third party and/or  
11 internal resources) that can be tested." The inference that Hydro Ottawa draws from this  
12 statement is that the custom index, as the sum of its parts, constitutes the annual rate  
13 adjustment. i.e. it is the aggregation of the custom index's components that serves as  
14 the rate adjustment mechanism, as opposed to any individual component doing so on its  
15 own.

16

17 Accordingly, Hydro Ottawa has interpreted this section of the *Handbook for Utility Rate*  
18 *Applications* to mean that the total value of the custom index annual rate adjustment  
19 mechanism that is developed by a Custom IR applicant ought to be higher, and certainly  
20 no lower, than the total value of the annual rate adjustment mechanism that would  
21 otherwise be determined through the 4<sup>th</sup> Generation IR Price Cap IR formula.

22

23 If Hydro Ottawa had opted to establish its 2021-2025 rates using the Price Cap IR  
24 approach, its annual rate adjustment mechanism would have been 1.55%, as per the  
25 following calculations:

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27 
$$IRM^4 = \text{Inflation} - (\text{Total Productivity Factor} + \text{Stretch Factor})$$

28 
$$IRM = 2.0\% - (0\% + 0.45\% \text{ Cohort 4 Stretch Factor})$$

29 <sup>3</sup> Ontario Energy Board, *Decision and Rate Order*, EB-2015-0004 (December 22, 2015), page 1.

30 <sup>4</sup> IRM stands for "incentive rate-setting mechanism."

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***IRM = 1.55%***

~~As detailed in UPDATED Exhibit 1-1-10: Alignment with the Renewed Regulatory Framework, Hydro Ottawa is proposing to utilize a custom escalator of 2.51% for purposes of its 2021-2025 Custom IR rate-setting formula. As 2.51% is greater than 1.55%, Hydro Ottawa believes that it has fulfilled the general policy expectations set forth in the *Handbook for Utility Rate Applications* regarding the establishment of a custom index for Custom IR rate applications.~~

Hydro Ottawa acknowledges that it calculated the value for its custom escalator using a stretch factor other than the 0.45% assigned to utilities which are grouped within Cohort 4, as per the PEG model. Hydro Ottawa believes that it has provided strong evidence in support of its proposed approach, as outlined in the following pieces of evidence in this Application:

- UPDATED Exhibit 1-1-10: Alignment with the Renewed Regulatory Framework;
- Attachment 1-1-12(A): Econometric Benchmarking Study of Hydro Ottawa's Total Cost and Reliability; and
- Attachment 1-1-12(E): PEG Benchmarking Forecast.