

OEB Webinar - Summary of Staff Proposal

EB-2020-0133 Consultation on the Deferral
Account – Impacts Arising from the COVID-19
Emergency

January 14, 2021

Purpose of Presentation

- The purpose of the presentation is to provide stakeholders with an overview of the Staff Proposal, including some of the thinking and rationale that guided OEB staff in its development
- This is intended to assist stakeholders in their understanding of the Staff Proposal, to ultimately enhance their written submissions
- Stakeholders will have an opportunity to ask clarifying questions to OEB staff with respect to the Staff Proposal

Overview of Presentation

- **Introduction and Progress to Date**
- **Overview of the Pandemic's Impact on the Sector**
- **Staff Proposal:**
 - Overall Approach
 - Examination of Existing OEB Policy
 - Criteria for Recording Amounts
 - Measuring Incremental Impacts
 - Recovery Rate of Eligible Amounts (Net Cost-Sharing)
 - Application of a Means Test for Recoverability
- **Summary of Staff Proposal and Consultation Next Steps**

Introduction and Progress to Date

Introduction and Progress to Date

- March 17, 2020 - Government of Ontario declared a state of emergency
 - March 25, 2020 - OEB established a deferral account (the Account) for utilities to track the impacts of the COVID-19 pandemic
 - nature, degree, and mechanism of any recoverability to be determined in due course
- May 14, 2020 - OEB commenced this consultation on the Account
- July 17, 2020 - OEB provided for a Staff Proposal
- September 24, 2020 - OEB announced procurement of LEI to prepare several independent research studies, supporting multiple consultations, on the impacts of the pandemic on the sector
- December 16, 2020 – OEB posted Staff Proposal and LEI’s reports – which have been informative in the development of the Staff Proposal.
- Staff Proposal is not intended to pre-determine the outcome of the issues
 - reflects OEB staff’s view of what the OEB’s regulatory guidance should be with respect to the nature, purpose, and operation of the Account
 - a starting point for rules surrounding the Account, with justification, but is also intended to elicit stakeholder comments and perspectives.

Overview of the Pandemic's Impact on the Sector

Overview of the Pandemic's Impact on the Sector

- Once-in-a-century event – far-reaching societal and economic impacts
- Q2 2020 was the largest quarterly economic decline recorded (Ontario seasonally adjusted real GDP); utilities – providers of essential services – seemed to have fared better financially relative to other businesses
- OEB staff collects monthly cash flow data from electricity distributors – have generally managed well during the pandemic to date, no immediate liquidity issues. Data collected on Account balances indicates bad debt and lost revenue as substantial components reported.
- OEB Staff's expectation is that Ontario's utilities are likely experiencing, to some degree, the following impacts attributable to the pandemic:
 - Incremental Bad debt
 - Revenue losses and gains from changes in load or production
 - Support for remote work capabilities
 - Personal protective equipment, enhanced sanitation, physical distancing compliance
 - Financing impacts from changes in cash flows (and borrowing rates)
 - Costs/savings associated with the reprioritization of capital and/or maintenance programs
 - Costs from complying with government and OEB actions to support ratepayers

Overview of the Pandemic's Impact on the Sector

- The impacts are not unique to Ontario - similar conditions for utilities across North America
- Range of regulatory responses on rate relief; generally divided in thirds as:
 - Establishment of generic deferral account
 - Utility-specific proceedings
 - No definitive action/still pending
- Lost revenue from consumption/demand changes does not appear to be a component that has garnered much acceptance by utility regulators with respect to cost recovery
- Customer impact from the pandemic:
 - Shuttered commercial and industrial customers, compliance with government rules, reduced ability to generate revenue
 - In May 2020, Ontario unemployment rates reaching 10.8% (previously 5.3%) following the initial lockdown

Staff Proposal: Overall Approach

Overall Approach

- An approach that recognizes the unique nature of the pandemic, articulating a fair balance between utility and ratepayer interests, with due consideration to:
 1. The nature of the pandemic's impacts on utilities, and to what degree those impacts should be recorded in the Account:
 - **Utility operations impacts** – including adhering to government-mandated rules, physical distancing, and enhanced health protocols for employees and customers that are necessary to maintain reliable utility services
 - **Customer-driven impacts** – including changes in consumption patterns and closures of various businesses (i.e., lost revenue), and increases in customer account defaults arising from financial hardship (i.e., bad debt)
 2. Whether a means test should apply. If so, how should one be structured?
 3. The nature of the Account – established to enable utilities to claim their incremental impacts resulting from the pandemic.
 4. Predictability of guidance

Overall Approach

- The role of the OEB: balancing of legislative objectives, including protecting consumers with respect to prices and maintaining financially viable electricity and natural gas industries, must be done in the context of a global pandemic.
- Recovery of the Account balance requires:
 - Preservation of financial incentives
 - Recognition of the fact that both utilities and their customers are adversely impacted from the same events
 - Demonstration that earnings are beyond reasonable fluctuations
- A principled approach:
 - Well established regulatory principles have informed OEB staff's approach
 - In addition, the principle of necessity, which largely underpins the Staff Proposal, can be described as follows: *Recovery of any balances recorded in the Account should be subject to evidence that the costs are not only reasonable, but also necessary to the maintenance of the utility's financial viability.*

Examination of Existing OEB Policy

Examination of Existing OEB Policy

- Z-factor
 - Cost recovery mechanism for incremental impacts from uncontrollable events and outside the basis in which rates are derived
 - Generally used by utilities for cost recovery of extreme weather events
 - Difference between typical z-factor events and the pandemic is the impact on customers – weather events are temporary disruptions, requiring restorative expenditures, and customers are generally unaffected financially by the event, which is not the case with the pandemic's impacts
 - The pandemic is a long-term in nature, rather than acute or temporary – warrants consideration towards whether financial incentives can be preserved through cost-sharing or a similar mechanism
 - For the reasons noted above, OEB staff does not view the pandemic as directly comparable to other unforeseen events typically subject to a z-factor application

Examination of Existing OEB Policy

- Means Tests – ACM/ICM, Inflationary Increases, Off-Ramps
 - To access incremental capital funding, a utility must qualify for it by demonstrating that its achieved earnings have not exceeded its approved rate of return by more than 300 basis points (bps)
 - Achieved ROE > 300 bps over approved is a sign of over-earnings when assessing the need for an increase. In OEB staff's view, it is also an indication that the utility's earnings have exceeded the range of fluctuations that can be reasonably expected year over year.
 - Utility earning in excess of the dead band is expected to either refrain from seeking an inflationary adjustment to its base rates or provide justification for why an increase is warranted despite over-earnings.
 - Off-ramps: regulatory review by the OEB may be triggered if earnings fall outside of a dead band of +/- 300 bps from the OEB-approved ROE – the lower end of this dead band is an important indicator for putting the necessity principle into quantifiable terms.

Criteria for Recording Amounts

Criteria for Recording Amounts

- OEB staff has considered the following two approaches in articulating what types of impacts may be recoverable through the Account for utilities that expect to meet the means test:
 - A prescriptive approach that specifies what kinds of incremental impacts may be recorded (particularly regarding utility operations)
 - A flexible approach that allows the utility to record what it has deemed to be a discrete, incremental impact and directly attributable to the pandemic
- OEB staff's view – it is appropriate to allow for flexibility, providing utilities the latitude to record what they assess as incremental and attributable to the pandemic, given their own circumstances.
 - Benefits of increased granularity in guidance expected to be informed by stakeholder feedback

Criteria for Inclusion

1. Causation

The criteria for which amounts are eligible for recording in the Account should not be based on the nature of the impacts, but on the drivers. OEB staff suggests that the impacts recorded must be determined to have only been incurred as a result of the pandemic. A utility should demonstrate that when it records amounts in the Account, an appropriate baseline and incremental impact measurement can be established.

2. Prudence

Final amounts may be recorded in the Account when the utility can demonstrate that it has acted prudently to minimize those impacts and has fully exploited all available cost-reductions and savings, including those that have become available in light of the pandemic

3. Materiality

The amounts recorded in the Account should have a material impact on the utility's operations based on the established materiality thresholds.

Measuring Incremental Impacts

Measuring Incremental Impacts

- To define incrementality, for each discretely identifiable cost driver, the amounts recorded in the Account should be calculated using a baseline comparison to the greater of:
 1. The amount embedded in base rates (adjusted for inflationary increases less productivity)
 2. The highest actual annual amount over the past five years (2015 to 2019)
- A greater-of baseline test ensures that utilities only record amounts that are both:
 1. In excess of what is already provided for in rates (adjusted for inflation less productivity), and
 2. In excess of what the utility has experienced in the past during non-pandemic years (i.e., evidence that the cost increase is beyond that of a typical fluctuation, supporting its attribution to the pandemic).
- Likewise, when measuring discretely identifiable incremental savings to be recorded in the Account, OEB staff suggests that the baseline be established as the lower of:
 1. The amount embedded in base rates (adjusted for inflation less productivity), and
 2. The lowest actual annual amount over the past five years (2015 to 2019)
- OEB staff supports LEI's approach to measuring incremental revenue impacts associated with pandemic, as explained in the *Report on Gains and Losses from Differences in Load and Production*

Recovery Rate of Eligible Amounts (Net Cost-Sharing)

Recovery Rate of Eligible Amounts (Net Cost-Sharing)

- Subject to the means test, 50% of incremental impacts should be eligible for recovery:
 - Preservation of financial incentives
 - Recognition of ratepayer economic hardship
 - Balance between two potentially opposite positions
 - The need for regulation to serve as a proxy for competition
- Exception to the 50% recovery rate: costs necessary to comply with government or OEB actions aimed at providing relief to ratepayers in response to the pandemic, including:
 - Implementation costs of emergency time-of-use rates and deferred global adjustment charges for electricity distributors
 - Implementation and administration costs of CEAP and CEAP-SB
 - Increased LEAP EFA funding
 - Lost revenues from certain reduced/waived specific service charges
 - Incremental bad debt directly attributable to the extension of the winter disconnection ban
- The impacts above are proposed to be recoverable at a rate of 100%, subject to materiality, causation, prudence tests, as well as a specified means test
- the OEB should consider recoveries at a rate of greater than 50% on a case-by-case basis if those constraints impede financial viability, after passing the proposed means test

Recovery Rate of Eligible Amounts (Net Cost-Sharing) – Consideration for Customer-driven Impacts

Bad Debt

- A large portion of bad debt includes the flow-through commodity costs that electricity distributors pass on to consumers without mark-up
- Prior OEB decisions have opined that even though there is no explicit risk premium associated with the commodity element of bad debt, the overall premium is sufficient to provide adequate compensation to the utility's shareholders

Lost Load

- Past precedent of OEB disallowing z-factor related to the lost load associated with revenue losses due to a significant reduction in electricity consumption by a business customer – stated that the z-factor criteria were not intended for recovery of revenue losses
- The OEB has also opined on lost load as a business risk that the approved ROE of a utility is designed to compensate them for – noting that utilities are entitled the opportunity to earn a fair return, and not a guarantee of it.

OEB staff recognizes that this pandemic may be viewed as materially different circumstances than the precedent cases reviewed by OEB staff, and that the potential magnitude of bad debt and lost load at play may be a differentiating factor warranting inclusion in the Account.

Application of a Means Test for Recoverability

Application of a Means Test

- OEB staff proposes that a means test should apply to recoverability of the Account:
 - Should operate to ensure utilities do not face undue financial hardship—utilities operating within the dead band are effectively managing within a reasonable degree of earnings fluctuation and therefore have maintained their opportunity for fair and adequate compensation
 - Was established to recognize exceptional nature of pandemic—utilities should only be able to make use of it after demonstrating a need for it
- OEB staff's view is ROE is the most appropriate metric to use in structuring a means test
- Recovery of balances in the Account should be anchored to an ROE-based means test of the lower end of 300 bps from a utility's approved ROE—appropriate comparator for the OEB in determining at what point the utility's cost structure is substantially misaligned from its revenue stream
- OEB staff's proposal also recommends that recoveries do not result in utilities exceeding the lower-end of the dead band after having their claims approved
- ROE to be used as the threshold test is the actual performance in the year for which the impacts recorded in the Account are attributable to (e.g., for claims made for 2020 impacts, the test will be on the 2020 ROE results)
- Exception to the means test: compliance costs (or lost revenue) associated with government or OEB actions taken to assist ratepayers should be based on a means test of the upper end of the OEB's dead band of approved ROE +300 bps.

2019 Electricity Distributors ROE

	Achieved ROE%	Deemed ROE%
Average	7.95	8.90
Median	8.46	9.00
Maximum	16.54	9.85
Minimum	(9.46)	-
ROE Status	# of distributors	Average Achieved ROE %
Over Earners	5	14.27
Under Earners	11	3.47
Within	43	8.37

Summary of Staff Proposal and Consultation Next Steps

Summary of Staff Proposal

- Means test based on approved ROE less 300 bps; a need for recovery due to financial viability concerns
- For utilities that qualify, any material and prudently incurred incremental impacts, directly attributable to the pandemic, should be eligible for 50% recovery, recognizing:
 - Preservation of financial incentives
 - Ratepayer economic hardship
 - Balance between two potentially opposite positions
 - The need for regulation to serve as a proxy for competition
- Measuring incrementality requires comparing actuals against the higher of the amounts embedded in rates and the historical five-year high
- Expectation that realized savings incremental to the pandemic are recorded in the Account as an offset – but not a requirement to return net gains (if any)
- Exceptions:
 - compliance costs (or lost revenue) associated with government or OEB actions taken to assist ratepayers should be recoverable in full and the means test applicable to those amounts should be limited to the upper end of the OEB's dead band of approved ROE +300 bps.
 - the OEB should consider recoveries at a rate of greater than 50% on a case-by-case basis if those constraints impede financial viability (after passing means test)

Consultation Next Steps

Consultation Step	Scheduled Dates
Stakeholder comments	January 25, 2021
Stakeholder reply comments	February 11, 2021

Thank You