First Tracks Consulting Service, Inc.

Amortization and Performance Incentives as Business Models for Utility DSM Portfolios

Recommendations for Enbridge Gas

Presented to: Ontario Energy Board

March 24, 2022

Overview

First Tracks evidence covered three areas:

- Amortization
- Performance Incentives
- Context on Benchmark Data from Other Utilities

First Tracks evidence responded to evidence from two experts

- Optimal Energy (Amortization and Performance Incentives)
- Energy Futures Group (Performance Incentives and Benchmark Data)

DSM Business Model

Amortization…

- Facilitates paying for DSM expenditures over multiple years
- Repays utility investors for the cost of financing

Performance Incentives…

- Tell senior management to prioritize DSM activities over other options
  - ✓ Other investments (if amortized)
  - ✓ Other non-capital activities (if expensed)

Performance Incentives…

- Tell DSM managers to optimize key objectives

Amortization

Amortization Background

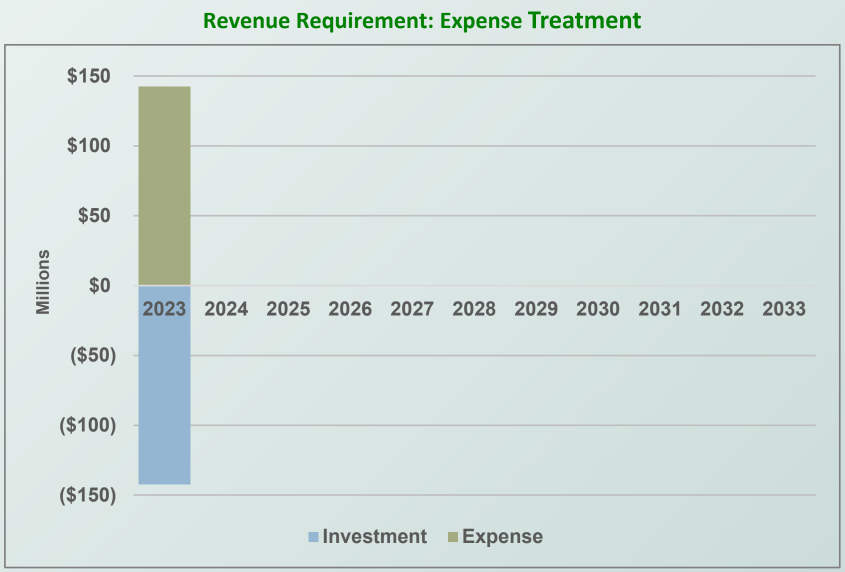
- First Tracks responded to the considerations Optimal Energy presented to the OEB regarding amortization as a cost recovery approach
- Overall consideration:

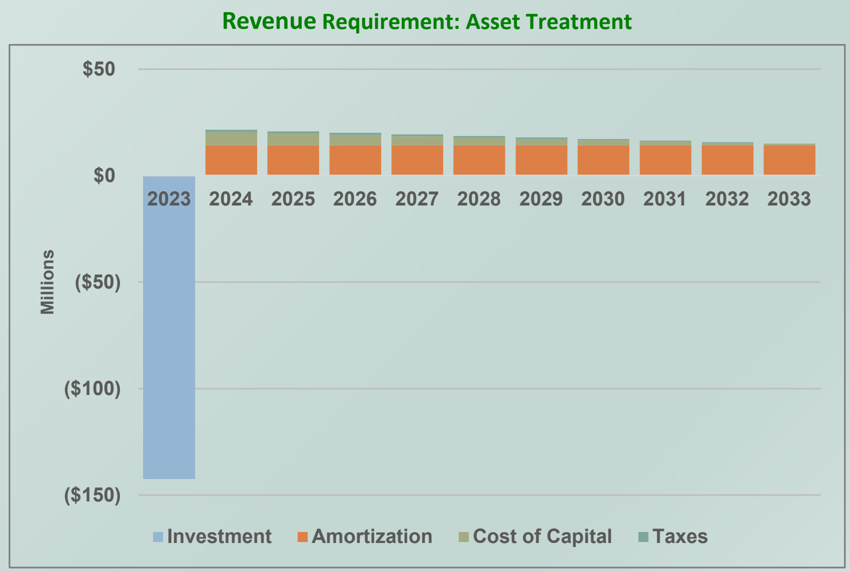
  "…amortization could be a good tool to enable program expansion, if that is desired, while minimizing short term rate impact." (Optimal Energy Report, page 16)

- Additional implementation considerations (term, cost of capital, etc.)

Amortization Basics

- Amortization recovers DSM expenditures as a “regulatory asset” rather than an expense
  - Same basic revenue requirement treatment as physical asset (with amortization instead of depreciation)
  - Recovered over *amortization term,* adjusted for *cost of capital*
  - Utility recovers same NPV of revenue under both asset and expense treatment

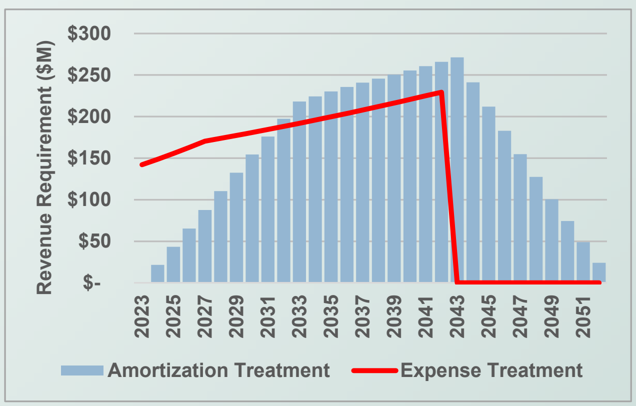




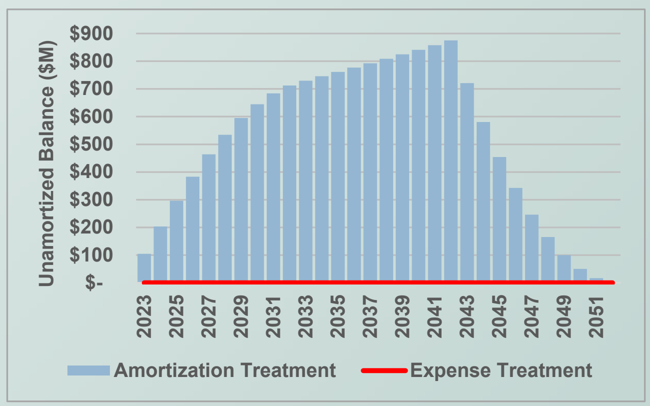
Amortization Impacts

- Advantages of Amortization
  - Recovers costs over timeframe and from customers who benefit from DSM investments ("Intergenerational Equity")
  - Lowers revenue requirement in early years (could allow higher DSM investment)
  - Smooths out rate impacts of new or expanded portfolios (gradualism)
- Drawbacks of Amortization
  - Increases revenue requirement in later years
  - Regulatory asset may raise concerns with investors and ratings agencies

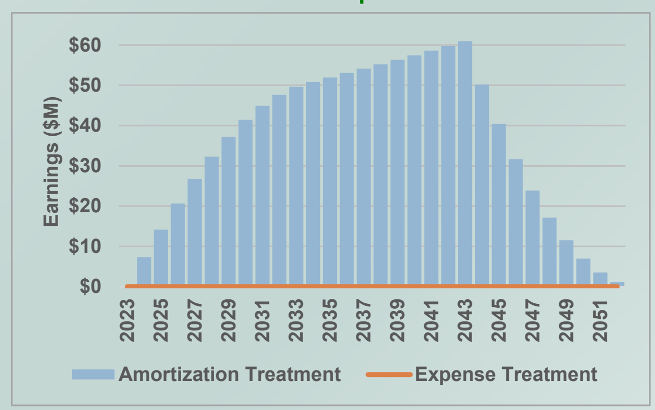
Revenue Requirement



Unamortized Asset Balance



Cost of Capital



Impact of Amortization Term

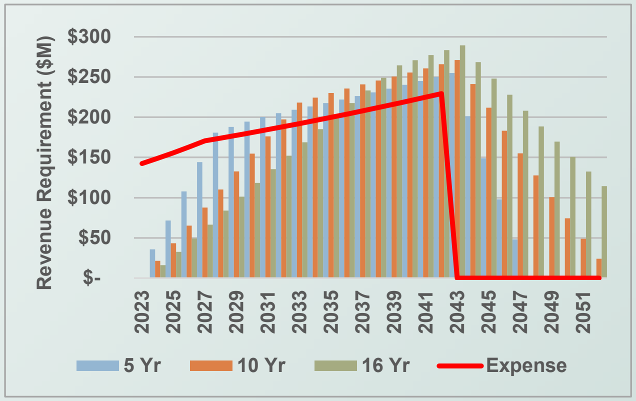
- Most jurisdictions amortizing DSM costs use terms of 5 or 10 years
- Illinois electric utilities amortize costs over the weighted average measure life (WAML) of equipment installed by customers through the programs.
  - Enbridge WAML life is around 16 years.

Jurisdiction	Amortization Term
BC	10 years
DE	5 years
IL	Weighted Average Measure Life
MD	5 years
NJ	10 years 5 years for IT
NY	10 years
UT	10 years

Impact of Amortization Term

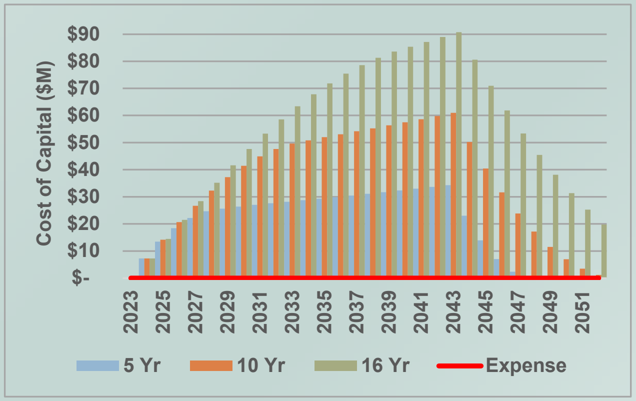
- Longer amortization terms:
  - Decrease revenue requirements in early years (allowing more head room for larger DSM budgets)
  - Increase revenue requirement in later years (but delaying crossover point against expense treatment)
  - Increase unamortized asset balances (and utility earnings)

Revenue Requirement



Unamortized Asset Balance

Cost of Capital



Impact of Cost of Capital

- Most other jurisdictions apply the utility's weighted average cost of capital (WACC)
- Some jurisdictions incorporate performance incentives into the return on equity used to calculate cost of capital

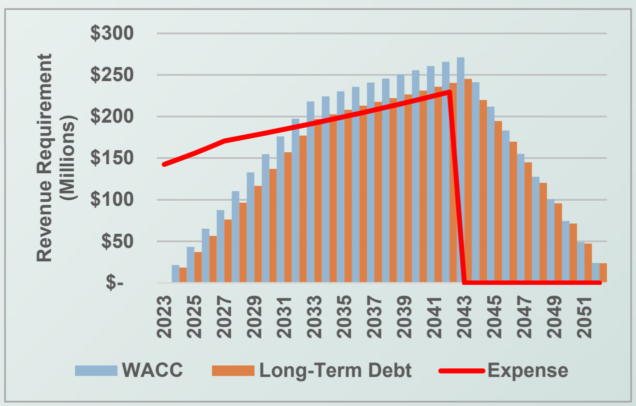
Jurisdiction	Amortization Cost of Capital
Jurisdictions wo/Performance Adjustment	
BC	Approved WACC
DE	Approved WACC
MD	Approved WACC
NJ*	Approved WACC
UT	Approved WACC
Jurisdictions w/Performance Adjustment	
IL	Formula WACC
NY	PBR WACC

* NJ has deferred performance adjustment until at least 2025

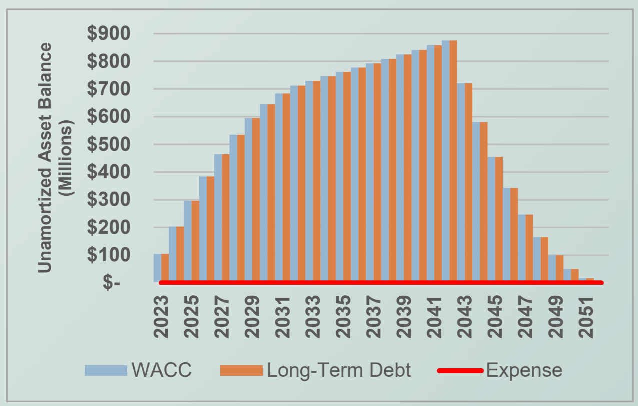
Impact of Cost of Capital

- Shorter amortization terms:
  - Decrease revenue requirements in all years (and delay crossover point against expense treatment)
  - Have no impact on unamortized asset balance
  - Decrease cost of capital in all years

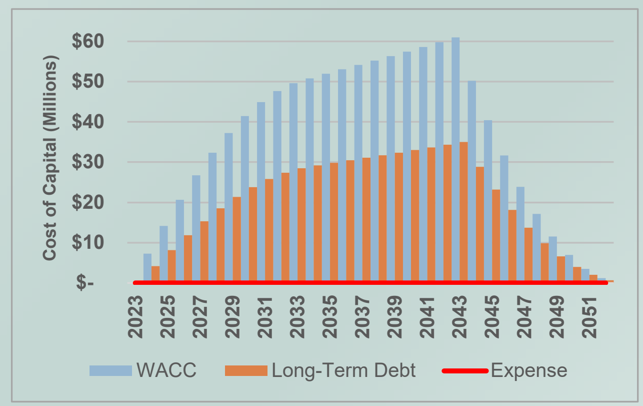
Revenue Requirement



Unamortized Asset Balance



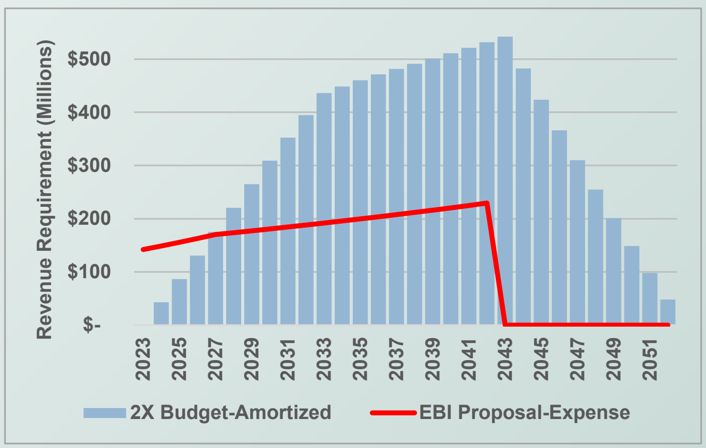
Cost of Capital



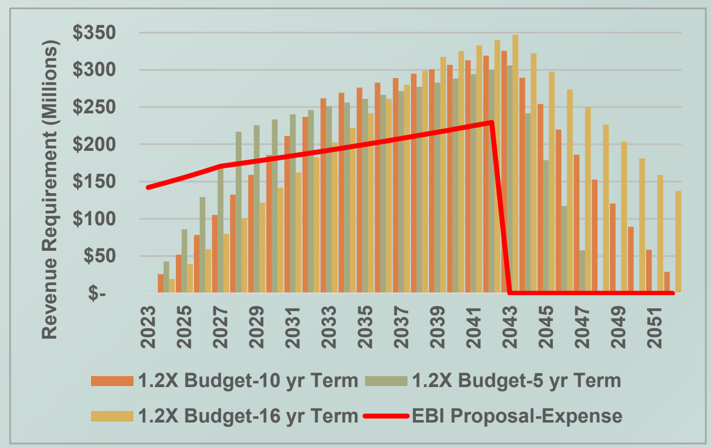
Can Amortization Support Larger DSM Budgets?

- Amortization creates head room for larger budgets, but increases revenue requirements in the long term
  - Doubling budgets decreases initial revenue requirements, but greatly increases long term revenues
  - Increasing budgets by 20% decreases initial revenue requirements, with smaller long-term increases
  - Other scenarios of could be constructed if OEB desires to manage within a strict rate impact limit
    - ✓ e.g., higher near-term spending, paired with lower long-term spending
    - ✓ Consider ramping up large budget increases over several years

Revenue Requirement: 2X Budget Scenario, 10-Year Term



Revenue Requirement: 1.2X Budget Scenarios



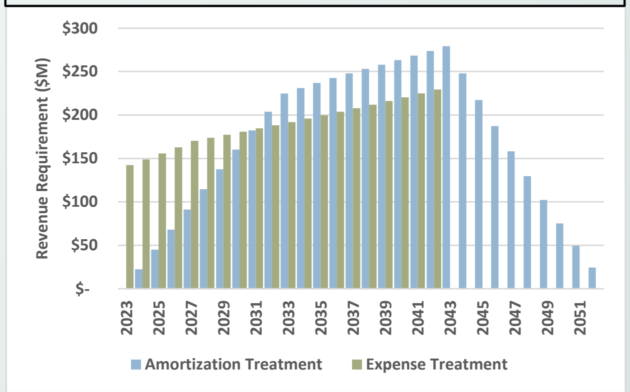
How Should the OEB Proceed?

Three key questions to consider:

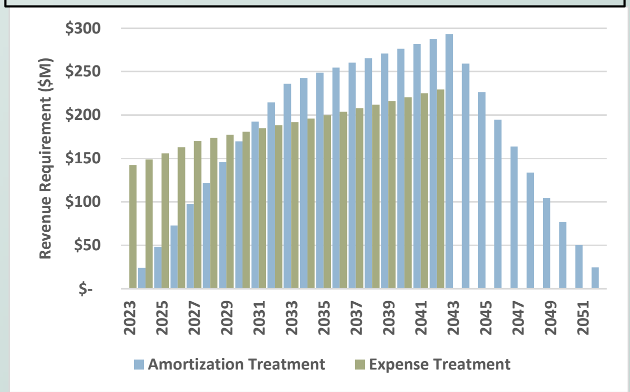
- What level of budget increases are desired?
- What amortization structure will the OEB implement, specifically what amortization term and what cost of capital?
- How should competing policy objectives be balanced, specifically, increases in DSM budgets, short- and long-term rate levels, and acceptable regulatory asset balances.

Tax Impacts

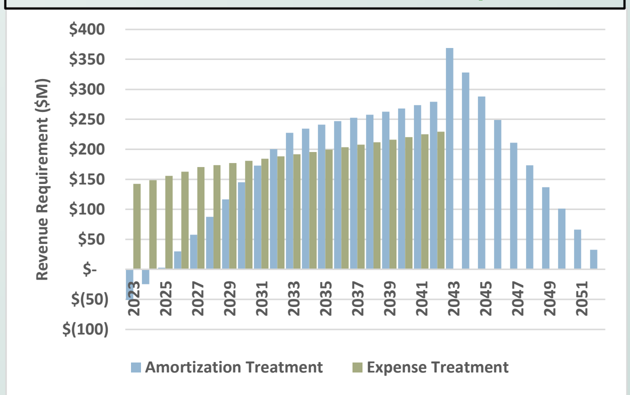
No Taxes



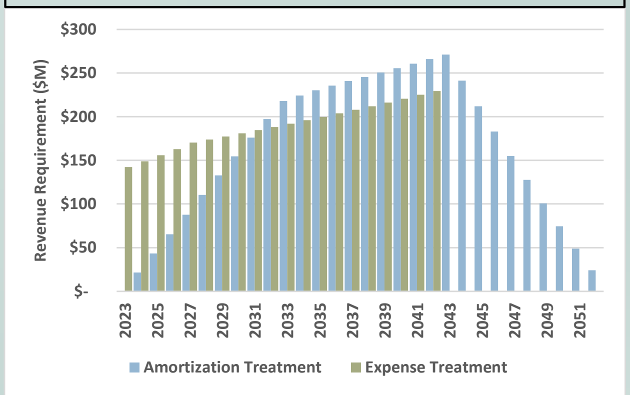
Taxed Like Capital Asset (No Deferred Tax)



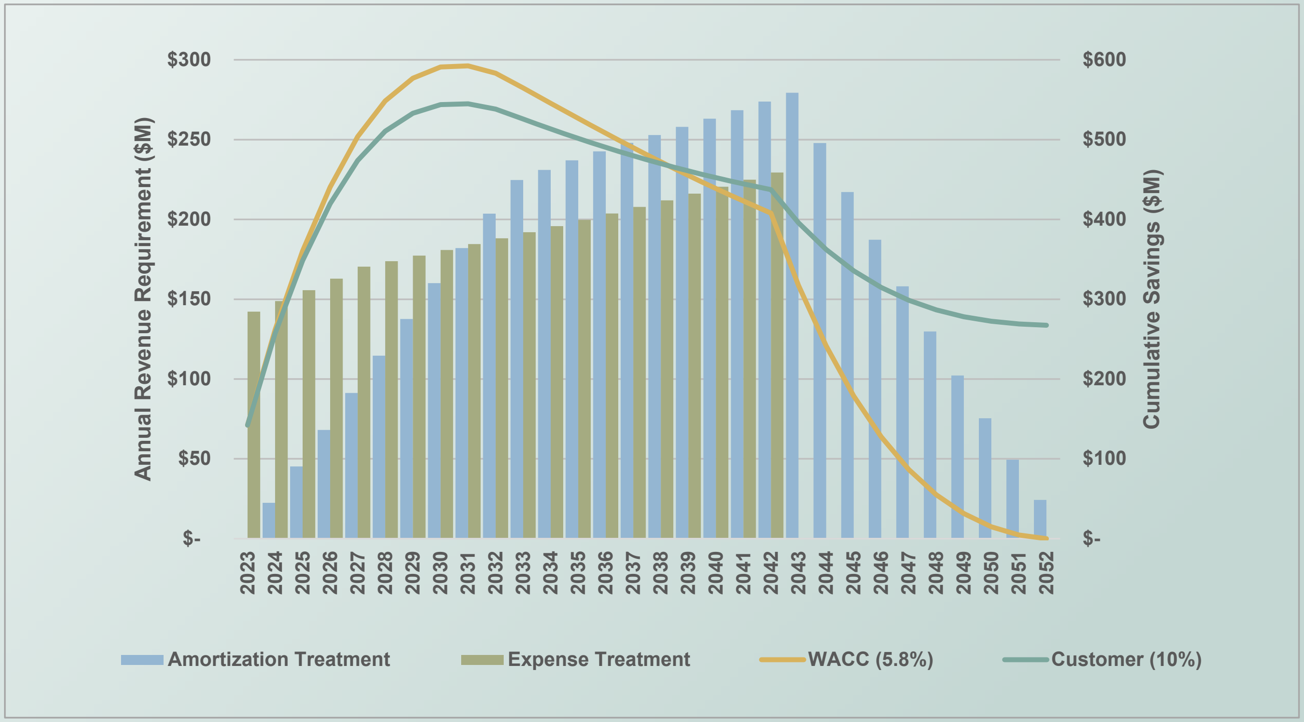
Deferred Tax Reduces Revenue Requirement



Deferred Tax Reduces Regulatory Asset



Cumulative Customer Savings



Response to Optimal Energy's Considerations

Issue	Optimal Energy Recommendation	First Tracks Recommendation	Discussion
Expense/ Amortization Treatment	Single cost recovery approach for all programs/expenditures	Agree	
Lost Revenue Recovery	Expense treatment in year occurring	Agree	
Performance Incentive	Separate performance incentive from amortization cost recovery Amortize recovery	Agree with separation Disagree with amortized recovery	Amortized recovery: • Reduces ROE from ~9% authorized return to ~6% • Lowers incentive from recent years, sending wrong management signal
Amortization Term	WAML (~16 years) Or perhaps shorter as compromise	5 years	Shorter term reduces regulatory asset risk
Cost of Capital	Cost of Debt	WACC	Cost of debt reduces ROE from ~9% authorized return to ~4% Creating new debt structures impractical and inconsistent with OEB capitalization guidance Performance incentive is not large enough to make up difference; and adds risk

Performance Incentives

Performance Incentive Background

- First Tracks responded to Performance Incentive Mechanisms proposed by
  - Enbridge
  - Optimal Energy
  - Energy Futures Group (EFG)
- Performance Incentive Mechanism proposals covered:
  - Calculations (Enbridge, Optimal and EFG)
  - Process (Enbridge and Optimal)
- First Tracks approach
  - Present potential compromise for OEB to consider

First Tracks Compromise Proposal

Compromise Performance Incentive Proposal

Component	Metric	Sub-Target	Frequency	5-Year Incentive Payment ($M)		Threshold (% of Proposed Plan)	
				Max	Share	Min	Max
Annual Scorecards: RA*	Net Annual Savings	7 Sub-Targets	Annual	$ 102.3	93%	50%	150%
Annual Scorecards: MY#	Participants	8 Sub-Targets	Annual	$ 6.2	6%	50%	150%
Low Carbon Transition+	MT Metrics	4 Sub-Targets	Year 2, 5	$ 2.0	2%	50%	150%
Net Benefits	------	*Eliminate*	------				
GHG Reduction	------	*Eliminate*	------				
Total				**$ 110.5**	**100%**		
Total as % of Budget				**14.2%**			

*RA=Resource Acquisition

#MY=Multi Year

Changes Recommended to Performance Incentive Management Process:

- Maintain TAM.
- Maintain Mid-Point Assessment.
- Maintain ring-fenced budgets.
- Manage 5-year budgets.
- Maintain DSMVA 15% budget increases..
- Increase maximum incentive pool if savings targets increase.
- Simplify evaluation measurements and verification requirements.

Key Performance Incentive Issues

- **Net Benefits Component**
  - **Enbridge** proposed Net Benefits component for around 31% of bonus pool
  - **Optimal Energy** proposed Net Benefits component for 70% of bonus pool
  - **EFG** proposed shifting Net Benefits pool to savings scorecards

  - **First Tracks Compromise:** Agree with EFG:
    - ✓ Savings scorecards already provide incentive to increase net benefits, by increasing savings within available budgets.
    - ✓ Separate metric adds complexity without substantially improving management incentive.
    - ✓ (Note this change reduces Enbridge's management flexibility.)

- **Long-Term GHG Reduction Component**
  - **Enbridge** proposed GHG Reduction component for around 5% of bonus pool
  - **Optimal Energy** proposed eliminating GHG Reduction component
  - **EFG** proposed eliminating GHG Reduction component

  - **First Tracks Compromise:** Agree with Optimal and EFG:
    - ✓ GHG Reduction metric mostly track annual savings.
    - ✓ Separate metric adds complexity without substantially improving management incentive.

Key Performance Incentive Issues

- **Scorecard Threshold**
  - Enbridge proposed scorecard floors/ceilings of 50%/150%
  - Optimal Energy proposed scorecard floors/ceilings of 75%/125%
  - EFG proposed scorecard floors/ceilings of 75%/125%

  - First Tracks Compromise: Disagree with Optimal/EFG that 75%/125% thresholds at other utilities apply to Enbridge:
    - ✓ These utilities measure *portfolio* performance, while Enbridge's thresholds apply to *individual programs*.
    - ✓ Other utilities can achieve 75% portfolio performance, with individual programs achieving lower savings.
    - ✓ Thresholds of 75%/125% constrain Enbridge flexibility too much. Especially with net benefits component removed.

- **Resource Acquisition Scorecard Metrics**
  - Enbridge proposed annual savings
  - Optimal Energy proposed lifecycle savings (if included in mechanism)
  - EFG proposed lifecycle savings

  - First Tracks Compromise: Disagree with Optimal/EFG that lifecycle approach adds significant value:
    - ✓ For Enbridge, annual savings track extremely close to lifecycle savings, so both metrics drive same management outcomes
    - ✓ Lifecycle savings calculations create contention and risk, without substantially improving management incentive
    - ✓ Concerns over Enbridge adjusting measure mix could be mitigated by setting minimum portfolio WAML (using IL model)

Key Performance Incentive Issues

- **Multi Year Scorecard Metrics**
  - **Enbridge** proposed market actor engagement/participation metrics (with some savings metrics)
  - **Optimal Energy** proposed lifecycle savings (if included)
  - **EFG** proposed market actor engagement/participation (when included)

  - **First Tracks Compromise:** Disagree with Optimal:
    - ✓ Savings understate value to portfolio of multi year, market transformation activities.

- **Target Adjustment Mechanism (TAM)**
  - **Enbridge** proposed continuation of TAM currently in use
  - **Optimal Energy** proposed eliminating TAM

  - **First Tracks Compromise:** Disagree with Optimal:
    - ✓ Most other jurisdictions have used some mechanism to adjust targets (e.g., MA, MI, MN, NY, IL, PA, VT).
    - ✓ TAM especially important in current inflationary economic environment.

Key Performance Incentive Issues

- **5-Year Goals**
  - **Enbridge** proposed 5-year budgets and goals for 2023, with future budgets/goals set by TAM and “15% rule”
  - **Optimal Energy** proposed 5-year budgets and 5-year targets, translated into fixed annual targets

  - **First Tracks Compromise:**
    - ✓ Agreed with Enbridge target approach, consistent with TAM recommendations.
    - ✓ Combined Enbridge (15% rule) and Optimal (5-year budget) approaches to maximize budget flexibility and portfolio benefits.

- **Maximum Incentive Pool**
  - **Optimal Energy** proposed increasing incentive pool if OEG expands portfolio (in this proceeding or future proceedings).
  - **EFG** proposed increasing incentive pool if OEG expands portfolio (in this proceeding or future proceedings).

  - **First Tracks Compromise:** Agreed with Optimal and EFG.

Context on Benchmark Comparisons

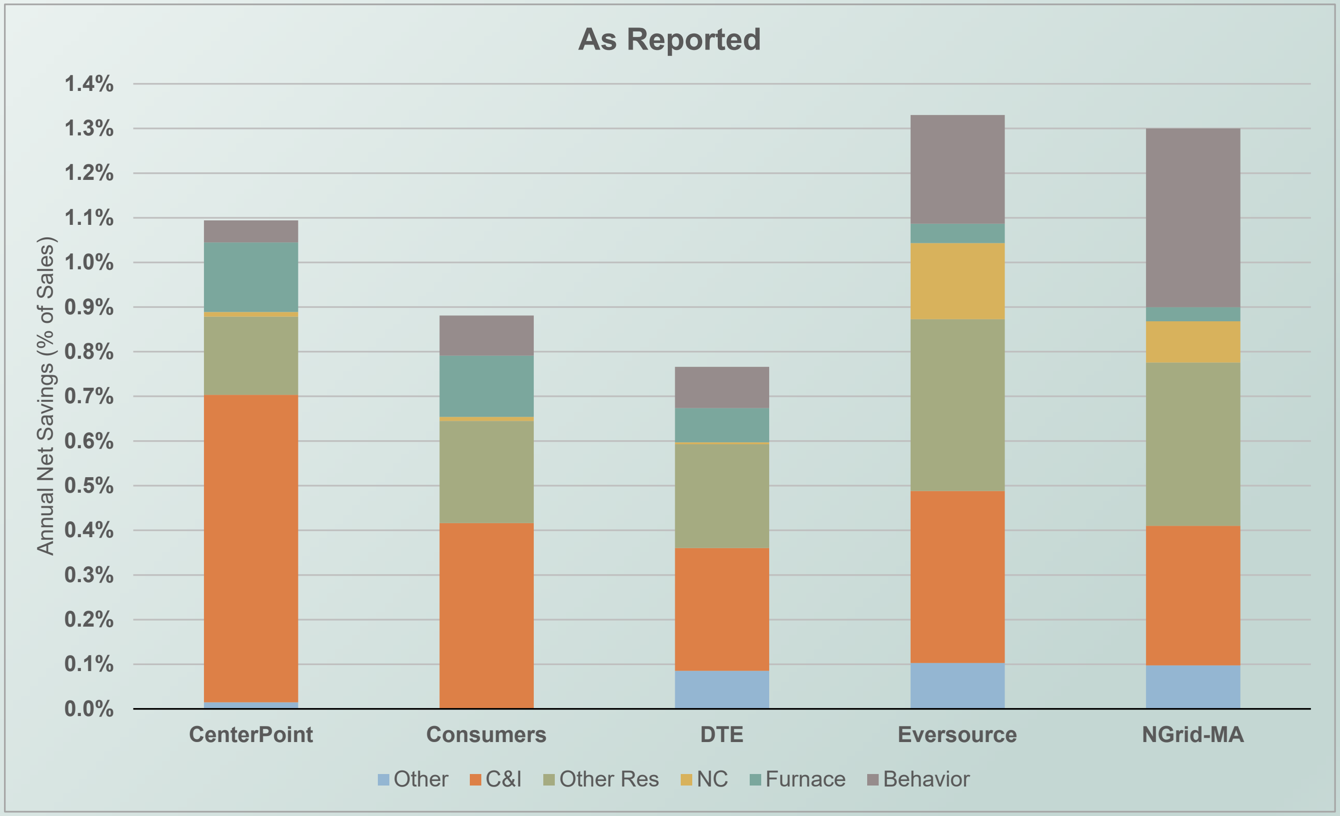
Benchmark Background

- Energy Futures Group presented top line savings for five utilities:

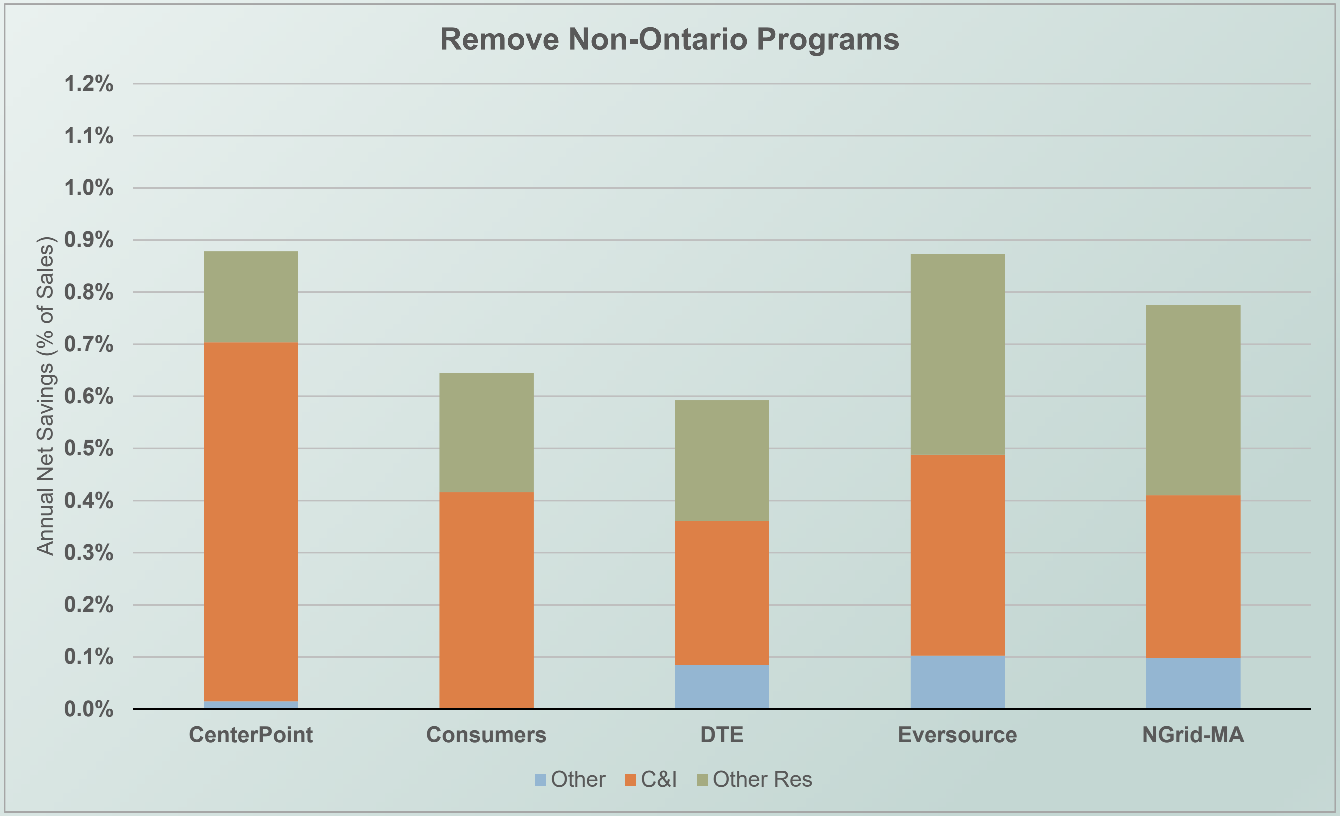
Utility	Jurisdiction	Savings as % of Eligible Sales
Centerpoint	MN	1.14%
DTE	MI	1.08%
Consumers Energy	MI	1.05%
Eversource	MA	1.33%
National Grid	MA	1.30%
National Grid	RI	1.14%

- First Tracks cautioned OEB to consider benchmarks within the context of conditions in other jurisdictions
  - Program offerings (e.g., behavior, furnaces, new construction/codes)
  - Evaluation policies (e.g., NTG ratios, TRM updates, evaluation approaches/rigor)
  - Budgets

Benchmark Context:
Savings By Program Group

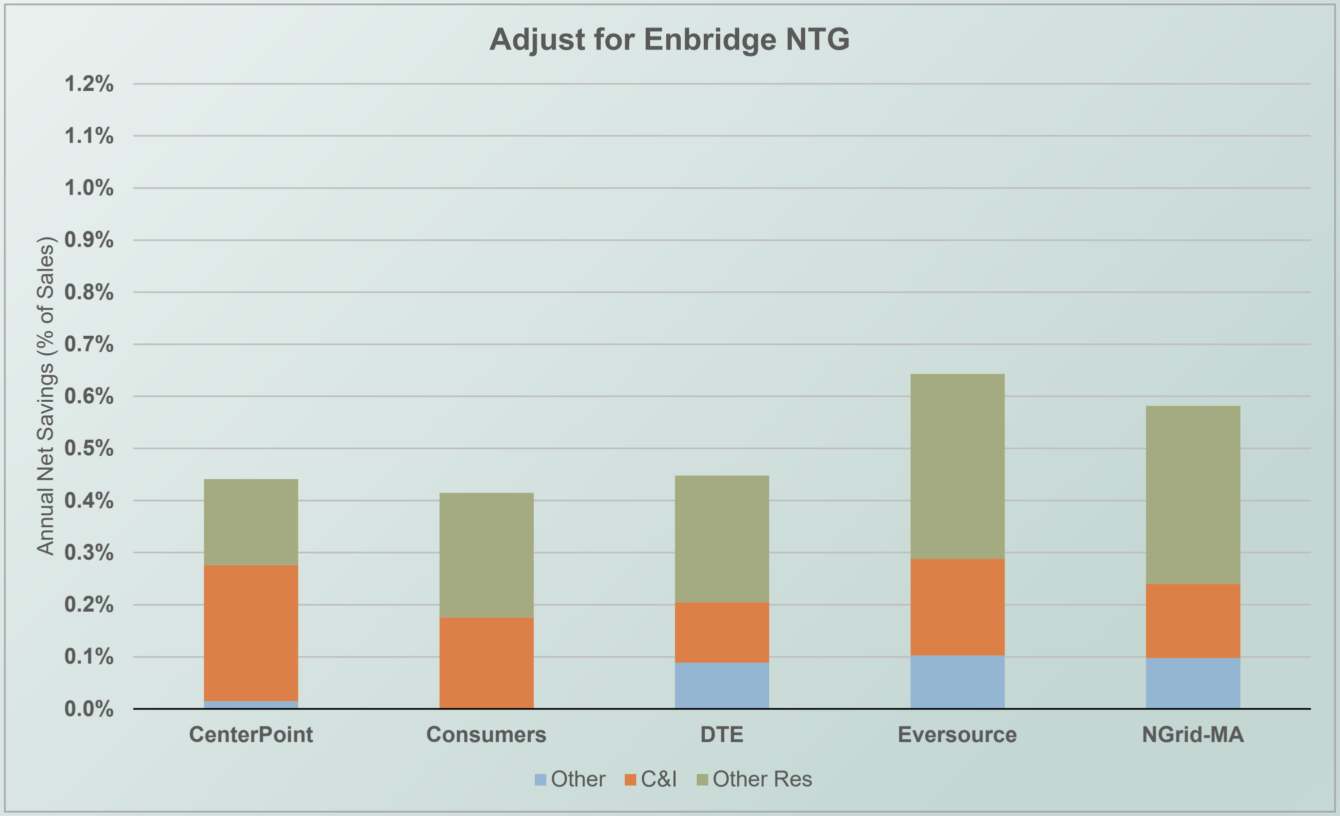


Benchmark Context:
Eliminate Offerings Not Viable in Ontario

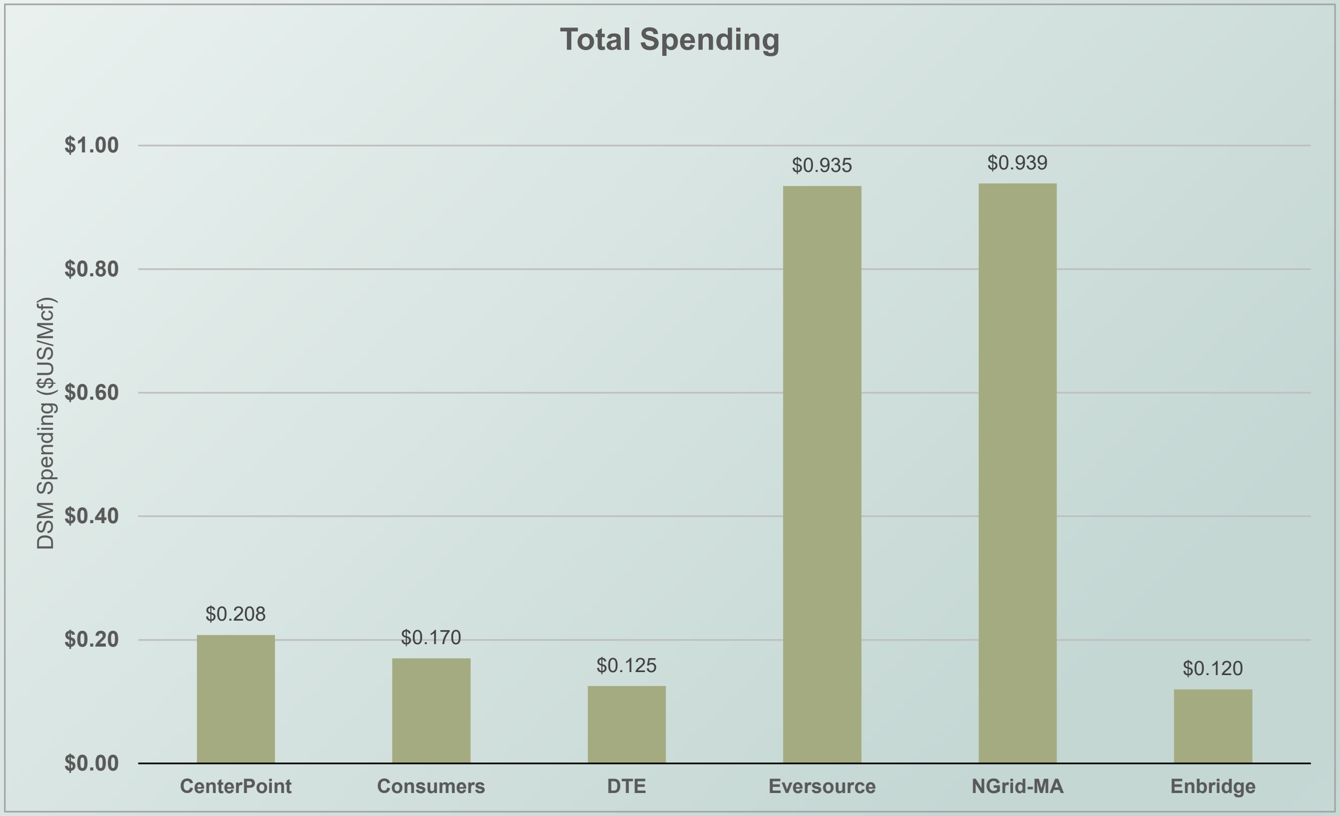


Benchmark Context:

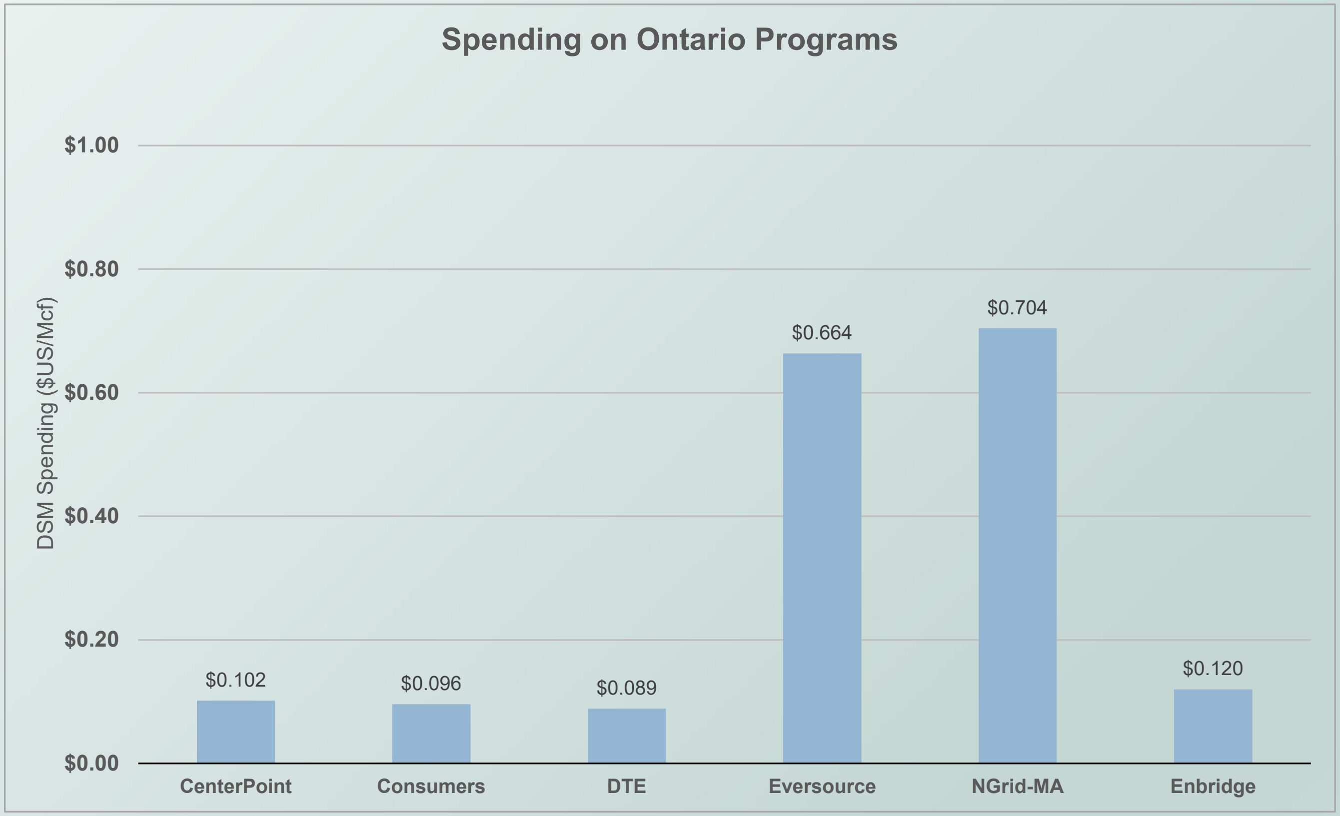
Adjust for Enbridge NTG Ratios



Benchmark Context:
Total Spending, Per Unit of Throughput

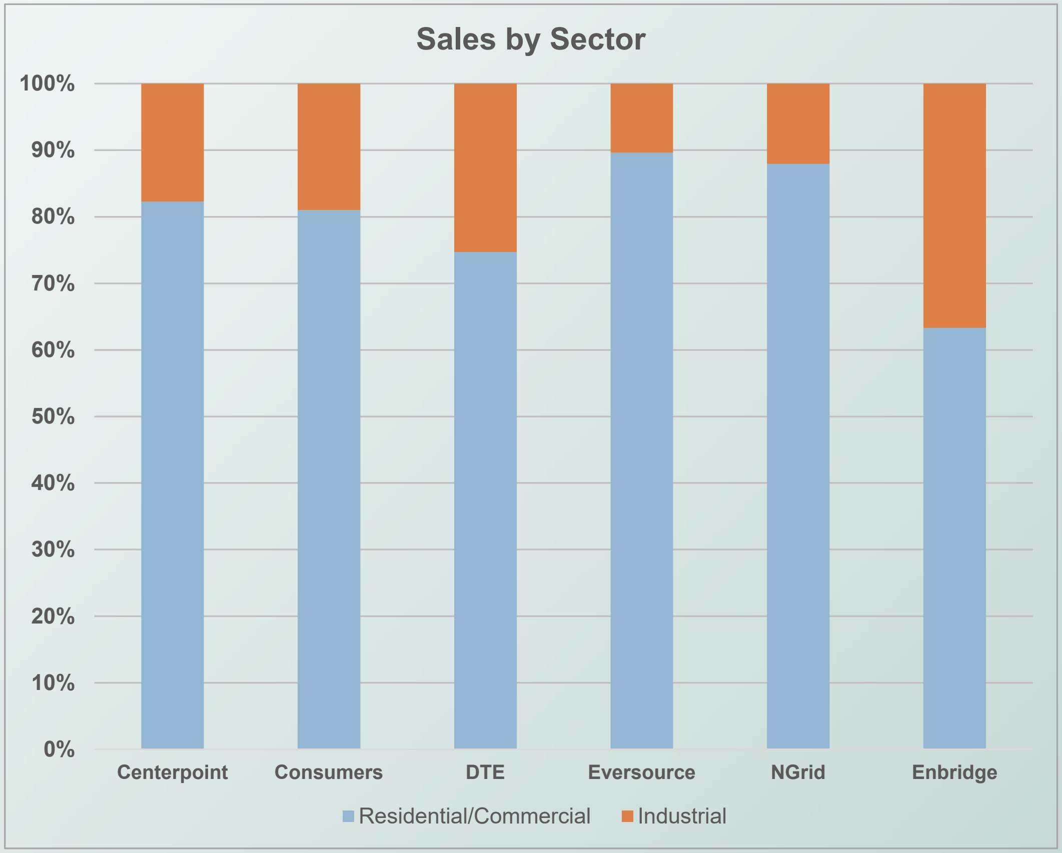


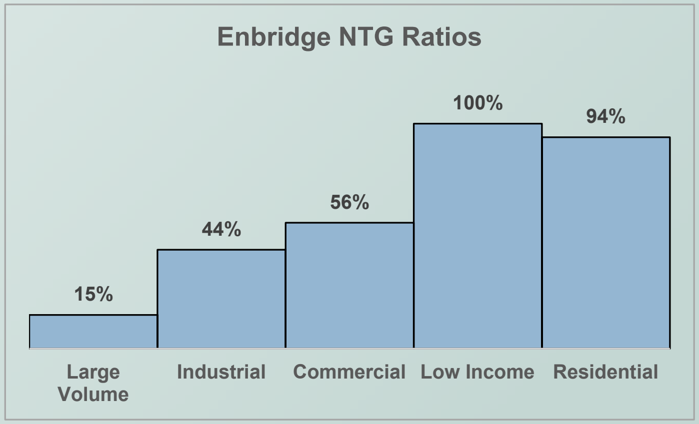
Spending on Programs Viable in Ontario

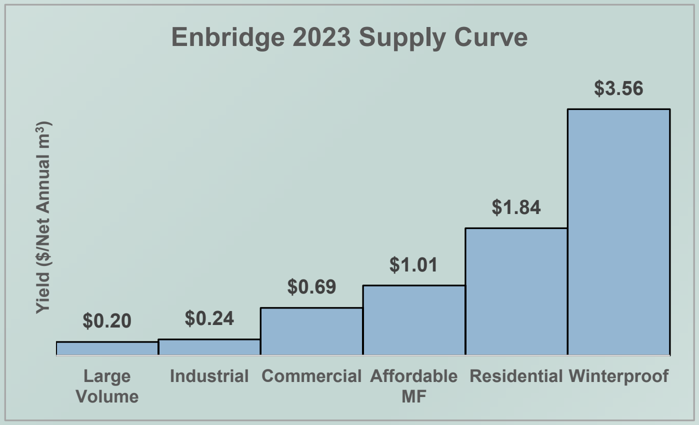


Benchmark Context:

Sales and Spending, by Sector







Key Takeaways

- Enbridge reports lower savings less than utilities in other jurisdictions.
- Some jurisdictions offer programs with little or no opportunity in Ontario.
  - Behavior
  - Small furnaces
  - New construction/codes
- Some other jurisdictions don't measure NTG.
  - Minnesota assigns NTG of 1.0 to all programs.
  - Michigan assigns NTG of 0.90 to most programs; 1.0 to low-income programs.
  - Massachusetts assigned fixed NTG values to programs in 2019.
- Some jurisdictions report savings using creative accounting.
  - Michigan lowers sales basis for transportation customers in reporting % savings.
- Enbridge gross savings are generally consistent with performance in other jurisdictions.
  - Enbridge has lower NTG than other jurisdictions, driven mostly by its very high mix of industrial sales.
- Some other jurisdictions spend more than Enbridge
  - Massachusetts utilities spend 5X-8X more than Enbridge on the programs offered in Ontario.
  - Enbridge spends slightly more than Michigan and Minnesota utilities when normalized for throughput.

Key Takeaways

- Don’t set Enbridge targets from top line savings estimates in other jurisdictions
- Set Enbridge targets:
  - From programs proposed by Enbridge and specific recommendations for design changes (if appropriate)
  - Consistent with budget resources
- Set reasonable targets
  - Don’t set stretch targets; that’s what the performance incentive is for
  - Set Enbridge up for success