ONTARIO ENERGY BOARD

Report Back to the Minister

Utility Remuneration

September 27, 2024

Ontario

Ontario Energy Board

INTRODUCTION

In his November 29, 2023, Letter of Direction to the Ontario Energy Board (OEB), Minister Todd Smith asked the OEB to consider whether utilities' remuneration based on traditional capital infrastructure deployment remains the most cost-effective model. The Minister asked the OEB to take steps to consider what changes may be required to ensure timely investment is made to support the right outcome and that a report back on this work incorporate a review of models deployed in other jurisdictions.

Energy regulators have long considered how to rate-regulate utilities in ways that encourage efficiency, cost-effectiveness and the achievement of outcomes that are important to consumers. One drawback of traditional cost-of-service rate regulation is that it incentivizes capital expenditures; the more utilities build, the more they earn. Ontario and many other jurisdictions have evolved their approaches to economic regulation – from cost-of-service to incentive regulation to performance-based regulation – to encourage utilities to make the best investment decisions on behalf of customers. Now, the energy transition is driving new utility investments and expenditures, different market structures and new business models. Distributors are increasingly expected to serve new, electrification-driven demand and integrate Distributed Energy Resources (DERs), while maintaining reliability, resilience and affordability for customers. In addition to these new spending drivers, innovative technologies are expanding the utility toolbox, offering more solutions and operating strategies that forego capital infrastructure in the delivery of electricity to customers. These changes are prompting energy regulators to take a fresh look at how utilities are remunerated, to ensure rate-regulation frameworks are encouraging deployment of the right solutions, including conservation and demand management, and appropriately balancing the trade-offs between facilitating an ambitious and efficient energy transition through traditional and non-traditional approaches while keeping distribution rates affordable for customers. As a first step, the OEB retained a consultant to develop a review of innovative utility remuneration models used in other jurisdictions.

METHODOLOGY

The OEB retained Christensen Associates to undertake a jurisdictional scan as the catalyst for taking action on opportunities related to utility remuneration. As was the case with the development of the OEB's Renewed Regulatory Framework, the OEB plans to consider changes to the remuneration model for electricity distributors in Ontario first before considering the inclusion of all utilities.

Christensen Associates' report, attached, provides an overview of Ontario's current utility remuneration model and reviews utility remuneration models, including the use of performance incentive mechanisms and other measures, in five jurisdictions: Australia, California, Hawaii, New York and Great Britain. While the industry organization and regulatory constructs of the five jurisdictions do not perfectly match industry conditions in Ontario, particularly Ontario's relatively unique distribution sector, Christensen Associates believes they may be informative to the OEB's work.

OEB CONCLUSIONS

The report finds that regulators in the jurisdictions reviewed are each considering how evolving approaches to rate regulation can help utilities meet the demands of the energy transition and facilitate new investments and innovative solutions, while maintaining a clean, reliable and affordable energy system. They do so by recognizing that traditional rate base rate-of-return remuneration will not incent utilities to leverage non-wires solutions that do not generate, and may in fact reduce, returns to utility shareholders. To offset this misalignment of incentives, each of the jurisdictions has, after considering their own unique circumstances, undertaken some mix of performance incentives, mandated activities or mechanisms to reward shareholders for non-capital related expenditures. The report shows that while some successes have been achieved, none of these regulatory changes have, at this point, proven wholly effective. Further, it shows there is no clear path or consensus on how to create the right incentives to ensure utilities optimally undertake non-traditional activities that are in the best interests of their customers and energy systems.

The findings of the jurisdictional scan, and consideration of the OEB's current approach to rate regulation, as well as ongoing initiatives related to rate regulation and utility performance, have led the OEB to three conclusions regarding opportunities for changes to Ontario's utility remuneration model:

1. Diverse remuneration approaches may be used to achieve fundamentally similar goals of enabling utilities to cost-effectively meet the demands of the energy transition and innovation, while maintaining reliability and affordability for customers. As there is no clear successful way to create the right incentives for utilities to optimally engage in non-traditional and innovative activities, a made-in-Ontario solution is needed. One that considers the nature of Ontario's energy sector (for example, its 59 electricity distributors with widely varying customer counts and service area characteristics) and builds on the current approach to rate regulation as the starting point.

2. The current rate-setting framework, referred to as the Renewed Regulatory Framework, provides the OEB with the opportunity to, at minimum and on a

short timeline, introduce performance incentive mechanisms as an initial evolutionary measure to encourage non-traditional activities by utilities. Performance incentives can strengthen the link between what utilities earn and the achievement of outcomes that customers value. The OEB has already taken some action regarding incentives for electricity distributors. Under the Framework for Energy Innovation, the OEB developed guidelines for electricity distributors to seek incentives for the use of third-party DERs as non-wires solutions. The OEB must now work with electricity distributors and other stakeholders to enhance the effectiveness and breadth of these incentives, and consider whether they should be supplemented by mandates.

3. As the Christensen report shows that performance incentives and mandates have had only limited success in obtaining optimal non-traditional utility activities, there is no assurance that evolutionary performance incentives (or mandates) in Ontario will optimize the potential benefits of demand management, DERs and other non-wires solutions. It is possible that a more revolutionary approach will be required. Comprehensively reconsidering the fundamental approach to rate regulation may provide a more complete and enduring realization of desired outcomes in the long run. Fundamental change would require lengthier, more complex design and implementation processes. Therefore, in addition to pursuing an evolutionary approach, the OEB will consult with stakeholders on whether to undertake, as a longer-term goal, a parallel path to develop a rate-setting model that is no longer primarily premised on rate base rate-of-return. Such a longer-term goal could be explored while ensuring financing and investment stability for the sector in the short term.

KEY FINDINGS FROM THE REPORT

Each of the jurisdictions covered in the report – Australia, California, Hawaii, New York and Great Britain – employ some form of incentive or performance-based regulation. Each of these jurisdictions have also pursued regulatory reforms to meet policy goals associated with the energy transition.

Key findings are as follows:

- **Performance Incentives**: The report shows that four of the jurisdictions (Australia, Hawaii, New York and Great Britain) have implemented targeted performance incentives to align utilities' incentives with policy goals. In some cases, these incentives are penalty-only. Others are symmetrical or reward-only. Some incentives were used transitionally, until a new activity became business-as-usual for utilities. California, and in some instances Great Britain, used mandates instead of financial incentives to achieve policy goals, requiring utilities to take certain actions while providing revenue recovery, as in a traditional regulatory framework.

- **Basis for Rate-of-Return**: The report also shows that although some jurisdictions (e.g., New York and Hawaii) considered adopting a utility remuneration model that would provide a rate-of-return to operating expenses, only one jurisdiction (Great Britain) has adopted a form of total expenditure (totex) cost recovery. Under the totex approach, an annual rate-of-return is earned on a subset of operating expenditures grouped together with capital expenditures. This is intended to address a perceived capital spending bias. In both New York and Hawaii, regulators cited accounting issues with transitioning to totex. The report suggests that investigation is required to determine whether the same accounting obstacles or other issues would exist for Ontario.

- **Implementation Timelines**: Across each jurisdiction, the report found that changes to utility remuneration often occur over lengthy time horizons to allow for consultation and adoption. For example, the Renewed Energy Visions proceeding in New York was initiated in 2014 and after a decade, the visions set out in the proceeding are still not fully realized. Formulation of new elements of the rate-regulation framework, followed by stakeholder engagement, generally constitute the first stage in a multi-year process that concludes with changes implemented in utility rate proceedings.

The report observes that each jurisdiction uses mechanisms that could be added to Ontario's current framework. For example, targeted performance incentives could be designed to address specific goals (such as acquiring grid services from DERs). In other cases, specific policy-oriented programs with funding or mandates requiring certain actions while providing revenue recovery were used instead of performance incentives.

The report highlights that there are diverse approaches used in other jurisdictions to achieve a similar set of policy goals to Ontario and that there are many tools available to the OEB as it seeks to evolve its current approach to ensure consumers have access to clean, reliable and affordable energy.

NEXT STEPS

The OEB will launch an initiative to enhance performance-based rate regulation by considering whether additional targeted performance incentives (or mandates) can create better incentives for electricity utilities to engage in activities like demand management, DER deployment and other non-wires solutions. The goal of this work will be to strengthen the link between what electricity utilities earn and the achievement of outcomes consumers value, ensuring utilities are motivated to pursue the right solutions for their customers and energy systems, against the backdrop of the energy transition and the need for innovation.

As an immediate next step, the OEB will conduct a stakeholder consultation this winter to discuss:

- the findings of the jurisdictional scan;
- the approach the OEB will take to evolving its performance-based rate regulation with additional incentives or mandates; and
- the potential for a more fundamental, longer-term review of the OEB rate-regulation regime.

Evolving the current approach through incremental reforms would include incorporating performance incentives into the existing framework. In the 2025-2026 fiscal year, the OEB would engage stakeholders to determine the design of performance incentive mechanisms, including identifying the outcomes to which penalties or rewards would be attached, and to consider if mandated requirements should be added. This work would be carried out in close co-ordination with OEB initiatives examining other changes to the current framework, specifically reforms to Total Cost Benchmarking and the Incremental Capital Module. It would also be informed by the Cost of Capital and Other Matters generic proceeding.

If, after the winter 2025 stakeholder consultation, the OEB determines that a more fundamental change to utility remuneration should be considered, the OEB will set a path forward, including whether more research and analysis is required before engaging stakeholders on the design of a new framework.

The OEB is committed to advancing its performance-based approach to rate regulation and ensuring that the most cost-effective model to support the energy transition and innovation creates the right incentives for utilities. OEB actions through this important initiative will support utilities in cost-effectively meeting the demands of the energy transition through traditional activities and innovation, and in enabling a clean, reliable and affordable energy system for Ontarians.