Elson Advocacy

January 8, 2025

BY RESS

Ms. Nancy Marconi
Registrar
Ontario Energy Board
2300 Yonge Street, Suite 2700, P.O. Box 2319
Toronto, Ontario M4P 1E4

Dear Ms. Marconi:

Re: Advancing Performance-based Regulation
EB-2024-0129

I am writing on behalf of Environmental Defence to provide comments on the discussion questions in the performance-based regulation ("PBR") consultation process.

Performance Incentive Measures

a. What do you see as the advantages and disadvantages (or opportunities and risks) of incorporating PIMs?

The main advantage of performance incentive measures ("PIMs") is that they can provide an incentive for utilities to achieve outcomes that are either not incented through the existing PBR framework or are actually subject to disincentives through the PBR framework. Under the current PBR framework, utilities have an incentive to cut costs. However, this can create disincentives to pursue certain objectives that are important for customers, such as improving reliability or making investments to reduce electricity system losses.

The only real disadvantages of PIMs arise if they are not designed or calibrated appropriately. For example, an overly generous PIM tied to reliability could lead to excessive spending on reliability. PIMs also add complexity to the regulatory structure and regulatory costs. However, those costs will be outweighed by the benefits of appropriately designed PIMs.

b. From your perspective, what are the most important considerations to keep in mind when developing PIMs? (e.g., measurability, simplicity, transparency)

The development of PIMs involves identifying the outcomes, metrics, targets, and incentive structures. Throughout those steps, the most important consideration is the likely impact of the PIM on the behaviour of the utility. Although measurability, simplicity, and transparency are

important, those considerations are secondary to an analysis of the behavioural impact. A PIM could be measurable, simple, and transparent and yet entirely fail to incent the behaviour that customers need.

When analyzing the behavioural impact, it is important to consider a variety of aspects, including the following:

- *Interplay with other incentives:* A PIM cannot be considered in isolation. It needs to be considered in combination with other aspects of the PBR framework. For instance, an incentive to reduce losses in the electricity system needs to be considered alongside the countervailing inventive to cut costs.

- *Temporal impacts:* An incentive to maintain reliability may not sufficiently incent utilities to invest in *long-term* maintenance because the benefits of that maintenance will be far into the future whereas literature on executive behaviour finds a strong bias toward short-term horizons.

- *Executive incentives:* It can be important to consider impacts on executive behaviour and decisions. For example, executives have a much stronger incentive to achieve results during their tenure rather than invest in long-term solutions. PIMs may be needed to encourage a longer-term focus. For example, additional incentives are needed to ensure utilities appropriately size assets today to avoid premature retirement of assets that prove to have insufficient capacity to meet Ontario's increasing demand decades from now.

In addition to the behavioural impact, other important considerations include measurability, simplicity, and transparency.

c. In your opinion, what outcomes do consumers value? (e.g., cost-effectiveness, reliability, customer service, enabling electrification, EVs, and/or DERs/NWSs)

Customers value all the outcomes listed in the question - cost-effectiveness, reliability, customer service, enabling electrification, EVs, and/or DERs/NWSs. We will focus on a number of outcomes and aspects of outcomes that are commonly overlooked in the regulatory community.

Customers value cost-effectiveness, but it is important to clearly define that outcome in a way that align with customer interests. In particular, it is important to focus on the ultimate cost containment goal for customers – lowering their household energy bills. There is an important distinction between lowering rates versus lowering total household energy bills. For instance, cost-effective energy efficiency programs raise rates (which fund the incentives), but lower overall energy bills via energy savings. There is also an important distinction between lowering electricity bills and lowering household energy costs. For example, beneficial electrification (e.g. heat pumps and electric vehicles) result in higher electricity bills, but lower energy bills overall due to the greater savings in avoided petroleum and gas costs.

It is also important to define the energy bill reduction outcome in terms of both present and future customers in order to inadvertently avoid prioritizing benefits for today's customers at the

expense of tomorrow's customers. For example, today's customers may be able to save when an electricity distributor installs a comparatively smaller transformer or conductor. However, if it is sized such that it needs to be prematurely replaced due to increasing demand, future customers will be saddled with unnecessarily high costs. Similarly, current incentives mechanisms discourage spending on ongoing maintenance, which lowers costs for existing customers but raises them for future customers.

Customers also value timely and affordable processes to connect distributed energy resources ("DERs") such as solar and batteries to the grid in their homes and businesses. As it stands now, utility rates cases pay little attention to performance and costs for these connections. This needs to change, and PIMs are one potential tool. Customers installing DERs face a monopoly and have no choice but to pay the costs and take the time required by their local utility. The current rate-making mechanisms focus on costs recouped in rates, which excludes these connection costs in most cases. An adjustment in incentives is needed to appropriately protect customers from this monopoly situation.

Customers also value timely and affordable processes to upgrade their electrical service where necessary for beneficial electrification. They also face a monopoly situation and need protection from the regulator.

Customers value reducing carbon emissions and decarbonizing the electricity system. For example, over 70% of Canadians support achieving net zero in the electricity system by 2035.[1] Ontario's electricity distributors can support this objective in a number of ways, including programs and rate designs that cost-effectively reduce peak demand (when gas generation is highest) as well as efforts to facilitate beneficial electrification by customers.

d. To which outcomes or performance measures do you believe PIMs should be tied?

PIMs should be selected by focusing on behaviours that would bring about pro-customer outcomes that are currently subject to disincentives in the current regulatory framework. Some examples are as follows:

- **DER connection costs and timelines:** A PIM should be developed to incent utilities to connect DERs quickly and at a low cost. In the current regulatory framework there are virtually no financial incentives to do this and performance in this area receives little to no attention in rate cases. As a result, the cost and timelines to connect DERs vary widely among distributors. A PIM is needed in this area to incent better outcomes for customers in this important area.

- **Electricity system losses**: A PIM should be developed to encourage utilities to appropriately invest in cost-effective mechanisms to reduce transmission and distribution system losses. This would support the customer objective of reducing overall energy bills. The electricity lost in the transmission system alone is worth approximately $400

[1] Abacus Data Poll, July 4, 2023 (https://abacusdata.ca/clean-electricity-regulations/).

million each year.[2] Losses across all local electricity distributors are even higher. This is a major cost that requires additional attention.

Adding a system losses PIM would address a current mismatch in incentives between utilities and customers. To remain within their budget envelops, utilities have an incentive when allocating capital and O&M spending to cut corners on efforts to reduce system losses. The economic savings from loss reductions are not reflected in utility rates; instead, they are reflected in the commodity portion of the bill. Utilities therefore do not have appropriate incentives to address losses.

A potential metric could be the losses in a utility's system in a year divided by the throughput in that year. This would reduce some but not all the factors that are outside of the utility's control. Although the metric would be impacted by factors outside of the utility's control, that is acceptable if the measure is designed appropriately and is additive, not punitive. This PIM would incent positive action on losses and result in lower energy bills.

- **Beneficial electrification levels:** A PIM should be developed to incent utilities to encourage beneficial electrification. Beneficial electrification is an important consumer objective, including as a means to lower energy bills and carbon emissions. Ontario Government policy also supports incenting beneficial electrification.[3]

  This PIM could be based on the Government of Ontario's definition of beneficial electrification, which is as follows: "the use of electricity instead of other fuels to reduce overall energy use and emissions and subsequently reduce costs for high consumption activities such as home heating and cooling, regardless of fuel type."[4] A potential metric could be the percent of a utility's customers that have installed an electric vehicle or heat pump.

  Although beneficial electrification will occur due to many factors, electricity distributors have an important role to play, such as facilitating fast and affordable connection of charging stations in their service area, facilitating fast and affordable electrical service upgrades where necessary, implementing appropriate rate design, and so on. These activities run counter to the cost cutting incentive inherent in the current framework but would benefit customers.

- **Appropriate infrastructure sizing:** A PIM should be developed that would encourage utilities to build infrastructure today that is large enough to avoid the need for premature retirements due to demand growth. As noted above, there are a number of incentives for utilities to favour near-term outcomes, which inevitably leads to insufficient consideration of the possibility of long-term capacity shortages. This is an incredibly important issue as the energy transition results in a huge expansion in electricity demand.

[2] EB-2021-0110, Exhibit I, Schedule B3-ED-019b.
[3] See e.g. ERO Posting, New Proposal for An Electricity Energy Efficiency Programming to Promote Beneficial Electrification. (https://ero.ontario.ca/notice/019-9373)
[4] *Ibid*.

More focus in needed in this area to ensure customers' interests are protected, including future customers.

e. *What PIM structure/design is likely to be most effective and most suited to Ontario, considering the existing rate-regulation framework? (e.g., $ value per participant/ installation etc., awarded basis points if targets are met)*

The PIM structure and design should depend on the PIM in question. Most importantly, PIMs that are nearly 100% in the control of the utility can be designed as part of how a utility is expected to earn its rate of return. PIMs that involve more risk and more factors outside of a utility's control should be based more on incremental financial rewards that can be earned in addition to the utility's rate of return. Although incremental incentives come at a cost, in almost all cases the incremental returns to utilities are returned to customers due to public ownership.

f. *Should PIMs be applied uniformly to all utilities, or should they be utility specific? Elaborate.*

Some PIMs should be utility specific, and some should be uniform. For instance, utilities would need utility-specific targets with respect to electricity system losses because losses depend on how dense the development is within a utility's service area. On the other hand, utilities should be held to the same expectations when it comes to time and cost of DER connections.

Smaller utilities should not be allowed to have more lax PIMs due to their smaller size. All customers across the province deserve the same level of service regardless of the size of their utility. Holding small utilities to the same expectations of large utilities will encourage the smaller utilities to find ways to meet those expectations through improved performance, collaboration with other utilities, or amalgamation.

g. *What timeline would be appropriate for PIM implementation, and should there be a phased approach?*

PIMs that are based on incentives that are incremental to the rate of return can be implemented as soon as possible. PIMs that are tied to the rate of return may need to wait until rebasing.

h. *How should baseline performance levels be established, and how frequently should targets be reviewed?*

Baseline performance levels can be established by past outcomes and professional judgement, likely via a study by a consultant. They should be reviewed one or two years after being implemented.

i. How should PIMs account for factors outside utility control (e.g., weather events)?

It will often be impossible to design PIMs that only include factors within the utility's control. However, this can be addressed by carefully choosing the incentive design. As noted above, PIMs that involve more risk and more factors outside of a utility's control should focus more on additional rewards that can be earned in addition to the utility's rate of return. Although incremental incentives come at a cost, in almost all cases the incremental returns to utilities are returned to customers due to public ownership. By providing incremental earning opportunities in these areas, the regulator can avoid treading inappropriately on the fair return standard.

2. Moving Beyond a Rate Base Rate-of-Return.

a. Is this fundamental change required? Why or why not?

Customers would benefit from fundamental changes to the rate framework in Ontario, including changes away from the rate base rate-of-return approach. There are fundamental flaws in this approach, most of which flow from the strong incentive to spend on capital instead of O&M. This represents a barrier to the implementation of cost-effective third-party DERs and a disincentive to undertake appropriate preventative maintenance. We believe this should be explored further.

The Ontario Government also supports more fundamental changes to the utility remuneration model. For instance, the most recent Letter of Direction states as follows:

> In 2023, I requested the OEB to evaluate potential changes to our province's utility remuneration model. I have received your report, which includes a review of models implemented in other jurisdictions. It is crucial that we sustain this momentum to ensure a resilient and adaptive energy sector.

The gas sector should be included in any consideration of more fundamental changes to the utility remuneration model. Very different considerations apply in the gas sector. The gas sector should be included up front to avoid the possibility that changes developed for the electricity sector are adopted in the gas sector without full and detailed consideration.

In addition, the current remuneration model is even more problematic for the gas sector than it is for the electricity sector. Whereas the energy transition is expected to drive massive growth in the electricity sector, it could have the opposite impact in the gas sector over the 40-60 year lifetime of the gas infrastructure being built today. Gas utilities should be able to earn a fair and appropriate return even if the gas system serves a smaller customer base over time. The current model of remuneration is inconsistent with that outcome and instead encourages investments in fossil fuel infrastructure despite the risks that that infrastructure could be stranded or underutilized in the future. These are important issues to consider as part of any next steps examining remuneration models.

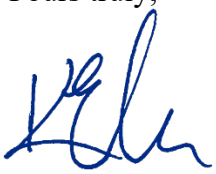
e. Are there quick wins that the OEB can advance in the short term?

The OEB could take small steps in the right direction by allowing some additional spending to be included in rate base (e.g. certain long-term preventative maintenance activities). This could be counterbalanced by modestly accelerating depreciation to the extent necessary to avoid undue rate base growth. This could help address the bias against this subset of spending without requiring fundamental changes.

Conclusion

Environmental Defence strongly supports this initiative. The energy transition is bringing about significant changes to the electricity and gas sectors that put the appropriateness of the current utility remuneration model into question. We hope that this work will be prioritized so that utility incentives can be better aligned with customer interests in the future.

Yours truly,



Kent Elson