ONTARIO ENERGY BOARD

OEB Staff Report

Review and Evaluation of the Incremental Capital Module Policy

(EB-2024-0236)

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Ontario Energy Board

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1. INTRODUCTION

The Ontario Energy Board (OEB) is reviewing its Incremental Capital Module (ICM) policy that addresses funding of capital investments in non-rebasing years of a distributor's rate term. This consultation is seeking comments on possible changes to the ICM policy, as it is a targeted improvement initiative, and not a wholistic 'bottom-up review' of the policy. The purpose of this consultation will be to produce a new consolidated document that outlines the OEB's ICM policy.

Requests for incremental capital investments to be funded during the intervening non-rebasing years of a distributor's rate term are covered under the ICM policy. The policy ensures that distributors can finance essential infrastructure without destabilizing their financial position or burdening customers with sudden price increases. ICM funding is available to distributors under Annual Incentive Rate-setting (Annual IR), if they are in an extended deferred rebasing period associated with a distributor consolidation, and Price Cap Incentive Rate-setting (Price Cap IR) options.

This report serves as a summary of the OEB's current ICM policy as set out in the 2014 Advanced Capital Module Report (2014 Report), the 2016 Supplemental Report (2016 Report), and the OEB's 2022 letter regarding ICMs During Extended Deferred Rebasing Periods (2022 Rebasing Letter). It also discusses possible changes to the ICM policy for which stakeholder comments are requested. These possible changes cover issues that have arisen in previous applications requesting ICM funding and/or ICM-related comments received from stakeholders during the OEB's consultation to review and update the *Handbook to Electricity Distributor and Transmitter Consolidations*.

2. ICM POLICY

The ICM is available for discretionary and non-discretionary projects, as well as for capital projects not included in the distributor's previously filed Distribution System Plan. ICMs are available to distributors under the Annual IR (if they are in an extended deferred rebasing period resulting from a distributor consolidation) and Price Cap IR options.

Under the current policy, ICM funding is to be requested as part of the incentive rate-setting mechanism (IRM) application for the year when the related capital project is forecast to go into service. To qualify for ICM funding, a request must satisfy the eligibility criteria of materiality, need and prudence.[1] Changes to the materiality threshold were made in the 2016 Report.

2.1. Materiality

To satisfy the materiality criterion, a request for ICM funding must meet three requirements. First, the request must satisfy the materiality threshold, which determines a distributor's maximum eligible capital funding. Secondly, the distributor must demonstrate that the project is not a minor expenditure in comparison to the overall capital budget. Lastly, the requested incremental funding must have a "significant influence on the operation of the distributor."

2.1.1. Materiality Threshold

The 2014 Report explained a capital budget will be deemed material, and as such reflect eligible projects, if it exceeds the OEB-defined materiality threshold. The OEB materiality threshold formula considers both the growth of the distributor and the inflationary increase(s) since the last rebasing year, to determine the level of capital expenditure that a distributor should be able to manage with its current rates.

The equation used to calculate the materiality threshold is as follows[2]:

$$Threshold\,Value(\%) = \left(1 + \left[\left(\frac{RB}{d}\right) \times \left(g + PCI \times (1+g)\right)\right]\right) \times \left((1+g) \times (1+PCI)\right)^{n-1} + X\%$$

Where: *n* = number of years since cost-of-service rebasing

RB = Rate Base included in base rates ($)

d = depreciation expense included in base rates ($)

g = distribution revenue change from load growth (%)

PCI = price cap index

X = dead band of 10%

[1] As set out in section 4.1.5 of the 2014 Report.

[2] The Price Cap Index (PCI) used in the formula is the Input Price Index less the stretch factor that is applicable to the distributor. The inflationary factor or Input Price Index to be used according to the ICM policy is the Input Price Index from the distributor's most recent Price Cap IR application.

ICM funding is available for eligible incremental capital amounts that exceed the materiality threshold. The maximum allowable incremental capital amount is determined by subtracting the materiality threshold result from the distributor's capital budget for the subject year.

When an ICM request is filed as part of an IRM application, the distributor should use the most recent Input Price Index (IPI) and stretch factor as placeholders in its initial filing, and then update that information in the proceeding once the OEB establishes updated parameters for the subject year.

2.1.2. Other Requirements

The other requirements to pass the materiality criterion are that: (i) the project must not be a minor expenditure in comparison to the overall capital budget; and (ii) the incremental funding must have a significant influence on the distributor's operations. OEB staff notes that in most proceedings these two requirements have been combined into one consideration. ICM decisions to date have assessed these requirements on a case-by-case basis without establishing a definite numeric threshold of what will/will not be considered a minor expenditure or have a significant influence on the distributor's operations.[3]

2.2. Need

To satisfy the need criterion, a request for ICM funding must meet three requirements. First, the distributor must pass the Means Test.[4] Second, the ICM amounts must be based on discrete projects, and should be directly related to the claimed driver. Third, the ICM amounts must be clearly outside of the base upon which the rates were derived.

2.2.1. Means Test

The OEB applies a Means Test for qualifying distributors seeking incremental capital funding. If the regulated return exceeds 300 basis points above the deemed return on equity embedded in the distributor's rates, ICM funding for the incremental capital project will not be approved under the policy.

[3] See, for example, EB-2017-0024, Decision and Order, April 5, 2018, p. 25 where the OEB stated that amending the ICM policy to include a mathematical materiality calculation for minor expenditures should only be done through a policy review.

[4] As defined in section 4.1.4 of the 2014 Report of the Board

2.2.2. Other Requirements

Except during a deferred rebasing term[5], the OEB's current policy is that requests for ICM funding between rebasing applications should be for discrete projects, rather than regular annual capital programs.

This is also reflected in consideration of the ICM funding request being for a project that is "outside of base rates." As part of this requirement, the project that is subject of the ICM funding request must not have been accounted for in the distributor's rebasing application. For instance, if the rebasing application establishes the normal level of spending for cable replacement by reference to the pattern of annual expenditures, the ICM funding request should clearly demonstrate that it does not fall into such expenditure and is "outside of base rates."

2.3. Prudence

To satisfy the prudence criterion, the ICM amounts must be prudent. This means that the distributor's decision to incur the amounts must represent the most cost-effective option for ratepayers.

3. ICMs DURING EXTENDED DEFERRED REBASING PERIODS

The OEB's 2022 Rebasing Letter expanded ICM availability beyond discrete capital projects to also allow for recovery of additional amounts for ongoing capital programs <u>but only</u> during extended rebasing periods arising from an electricity distributor consolidation. This move aimed to improve regulatory efficiency and provide a further incentive for distributors considering consolidation while ensuring necessary capital investments are made without compromising customer interests.

As noted above, electricity distributors can apply for ICM funding if they are on:

- A Price Cap IR plan, or
- An Annual IR plan during a deferred rebasing period resulting from a distributor consolidation

[5] See section 3, below, for discussion of special criteria for ICMs during extended rebasing periods.

The 2022 Rebasing Letter further expanded ICM availability to cover capital programs of electricity distributors during an extended deferred rebasing period following a distributor consolidation (i.e., years six to ten of their deferral period). These electricity distributors can apply for ICM funding for an annual capital program during the extended rebasing period if they can demonstrate all the following:

- An urgent need for additional funding that is based on new information that has arisen since the utility's most recent rebasing application related to the management of risk associated with asset condition, reliability and quality of service and public safety
- History of good utility practice in capital planning, capital program management and asset maintenance
- How the ICM investment addresses customer needs and preferences and delivers benefits to customers
- Exhaustion of other available options to manage its costs within the envelope provided by the existing price cap or another applicable formula

The three criteria of materiality, need and prudence would also need to be met.

4. FUTURE GROWTH AND FLEXIBILITY

According to the Independent Electricity System Operator's October 2024 forecast, demand for affordable, reliable and clean electricity is expected to increase by 75% by 2050. To meet this demand, the Government of Ontario has a pro-growth vision. This vision seeks to meet the identified increases in expected future energy demands, while ensuring more infrastructure and regulatory flexibility to support and facilitate this growth, while protecting ratepayers. As the regulator of Ontario's energy sector, the OEB plays a vital role as a vehicle for implementing government policy. One potential way to address the above noted need is through the OEB's ICM policy.

5. POSSIBLE ICM POLICY CHANGES

The review of the ICM policy will ensure that the policy continues to support prudent capital planning, regulatory efficiency, and fairness for both distributors and customers.

ICM-related comments received during the Evaluation of Policy on Utility Consolidations[6] and ICM-related submissions in a recent ICM application[7] highlight the need for a review of certain aspects of the current ICM policy. Stakeholders frequently raised the potential for recovery of incremental OM&A as part of an ICM request and considering options for how inflation should be accounted for (e.g., use of historical IPIs or geometric means).

Below, OEB staff sets out areas where possible changes could be made as part of the review and evaluation of the ICM policy. Stakeholders are invited to identify, with reasons, their views on the possible changes identified below. A summary of the questions/input sought from stakeholders is outlined in **Appendix A** of this report.

Stakeholders are also encouraged to include additional changes to the ICM policy for the OEB's consideration.

5.1. Materiality Threshold Calculation

Issue:

The OEB uses the materiality threshold formula, which considers both growth and inflationary increase(s) since the last rebasing year, to determine the level of capital expenditure that a distributor should be able to manage with its current rates. The materiality threshold is then used to calculate the maximum allowable incremental capital amount.

At the time of the 2014 Report, inflation was relatively stable. In recent years, there have been significant fluctuations in inflation. Table 1 below outlines the OEB-approved inflation values from 2018 to 2025.

Table 1. OEB-approved Inflation Values from 2018 to 2025

2018	2019	2020	2021	2022	2023	2024	2025
1.20%	1.50%	2.00%	2.20%	3.30%	3.70%	4.80%	3.60%

[6] EB-2023-0188, Elexicon Energy Inc., Alectra Utilities Corporation, Hydro One Networks Inc., and Energy Probe Research Foundation, Letters of Comment, February 29, 2024; School Energy Coalition, Letter of Comment, March 6, 2024; Consumers Council of Canada, Letter of Comment, March 7, 2024; and Vulnerable Energy Consumers Coalition and Association of Major Power Consumers in Ontario, Letters of Comment, March 7, 2024.

[7] EB-2022-0024, Elexicon Energy Inc. Application for 2023 Distribution Rates and Incremental Capital Funding

In some recent ICM applications, applicants have raised concerns about the use of a single year's IPI to calculate the materiality threshold. Applicants have made arguments for different approaches to calculate the materiality threshold.[8] They argued that a geometric means of IPIs from the first IRM application year or the historical years' actual IPIs issued by the OEB since the last rebasing year should be used.

As shown in the table above, there have been significant fluctuations in inflation values over the last few years. In that environment, the use of the current year's IPI to represent the growth in all years can skew the results of the materiality threshold calculation. The skewing of results can be exacerbated with time. When asked to alter the materiality threshold formula in the context of a specific application, the OEB has indicated that changes to the materiality threshold (including any changes to the use of the current year's IPI) are best considered as part of a review of the OEB's ICM policy.[9]

OEB Staff View:

OEB staff proposes to calculate the threshold using the actual historical IPI and then calculating the materiality threshold for each year since the distributor's cost-of-service application. By using this approach, the calculation could better reflect how much capital that a distributor can be able to fund through existing rates as it would reflect actual annual inflation values. OEB staff notes that details of the mechanics for this approach can be found in the OEB staff submission on an ICM request filed by Alectra Utilities Inc. in 2024.[10]

Question(s)/Input Sought from Stakeholders:

1. Should there be changes to the materiality threshold calculation and, if so, what should those changes be?

[8] EB-2023-0004, Alectra Utilities Corporation Reply Submission, November 2, 2023, pp. 7-12; and EB-2023-0039, Newmarket-Tay Power Distribution Ltd. Reply Submission, March 22, 2024, pp. 17-20

[9] EB-2022-0013, Decision and Order, November 17, 2022, p. 9; EB-2023-0004, Decision and Order, February 13, 2024, p. 10

[10] See EB-2023-0004, OEB Staff Submission, October 18, 2023, pp. 3-8

5.2. Capital Programs

Issue:

In its 2022 Rebasing Letter, the OEB allowed distributors to apply for ICM funding for annual capital programs during the extended rebasing period (i.e., years six to ten of their deferral period), where the following conditions are met:

- An urgent need for such additional funding that is based on new information that has arisen since the utility's most recent rebasing application related to the management of risk associated with asset condition, reliability and quality of service and public safety
- History of good utility practice in capital planning, capital program management and asset maintenance
- How this ICM investment addresses customer needs and preferences and delivers benefits to customers
- Exhaustion of other available options to manage its costs within the envelope provided by the existing price cap or another applicable formula

OEB Staff View:

OEB staff's view is that the above conditions established in the 2022 Rebasing Letter do not require any revisions at this time. The policy has only been implemented for three years, with only one distributor filing two applications related to capital programs. Based on a review of the OEB's Decision and Orders in such proceedings, OEB staff does not find it necessary to change any of the conditions listed above.

Question(s)/Input Sought from Stakeholders:

1. Please provide comments on how you think this change in policy is working in practice.
2. If you believe this policy should be revised or updated, please identify which elements should be revised and why.
3. Should consideration be given to further extending ICM availability to all distributors (e.g., when faced with a situation unforeseen during the last rebasing, such as the need to invest to address new operational risks or to support non-wires solutions), not just those in an extended rebasing period?

5.3. Significant Influence on Operations

Issue:

To satisfy the materiality criterion, the proposed ICM funding must not be for a minor expenditure in comparison to the distributor's overall capital budget (i.e., the funding amount must clearly have a significant influence on the operation of a distributor). To date, the OEB has not established a concrete threshold for this requirement but rather has assessed the materiality criterion on a case-by-case basis. In doing so, the OEB stated that amending the ICM policy to include a mathematically determined materiality calculation for minor expenditures should only be done through a policy review.[11]

OEB Staff View:

OEB staff does not believe that a materiality threshold/percentage for what will be considered a minor expenditure in relation to a distributor's overall capital budget needs to be established. The current practice of addressing such matters on a case-by-case basis provides the OEB with flexibility to address the various nuances and specifics of each ICM request.

Question(s)/Input Sought from Stakeholders:

1. Should the OEB establish a threshold/percentage for what will be considered a minor expenditure in relation to a distributor's overall capital budget? If so, why and at what level should that threshold/percentage be set? If not, why not?

5.4. Availability of OM&A Funding

Issue:

As part of the OEB's Evaluation of Policy on Utility Consolidations[12], comments were received supporting the potential recovery of incremental OM&A in a distributor's ICM request. The recovery of OM&A costs related to an ICM project would be a departure

[11] EB-2017-0024, Decision and Order, April 5, 2018, p. 25

[12] EB-2023-0188

from current policy which has restricted the use of the ICM to only fund *capital* needs between rebasing applications.[13]

OEB Staff View:

OEB staff's view is that requests for incremental OM&A, related to the project that is the subject of an ICM request, should not be included in the ICM policy. Incorporating such an element into the ICM policy would not be appropriate as a distributor should be able to prudently manage any incremental OM&A amount within its approved revenue requirement and any revenue it would be approved to collect through distribution rate riders for the ICM. OEB staff notes that there are other mechanisms (e.g., early rebasing) that a distributor can leverage if incremental OM&A is required and believes that addressing incremental OM&A would go beyond the scope of an ICM application.

Question(s)/Input Sought from Stakeholders:

1. Should the ICM policy be revised to include the recovery of incremental OM&A costs that are specifically related to an ICM project? If so, under what circumstances and why given the availability of other mechanisms (e.g., Z-factor and early rebasing)?

5.5. Multi-Phase Projects

Issue:

In recent years, there have been requests for ICM funding for multi-phase projects that span more than one rate year. An example of a project where this could apply is a multi-phase project related to transit expansion.[14] Under the current ICM policy, this type of project would require multiple ICM requests in successive years.

[13] In Halton Hills Hydro's 2019 IRM application, an ICM request was made, and considered but ultimately denied by the OEB, to recover an incremental amount of $131,515 per year in OM&A funding related to a new municipal transformer station. See EB-2018-0328, Decision and Rate Order, April 4, 2019, p. 9, upheld on appeal *Halton Hills Hydro Inc. v. Ontario Energy Board*, 2020 ONSC 6085.

[14] See, for example, EB-2017-0024, Decision and Order, April 5, 2018 and EB-2018-0016, Decision and Order, January 31, 2019, where the OEB approved ICM funding to relocate distribution assets to facilitate transportation infrastructure developments as part of a multi-year project to accommodate the York Region Rapid Transit Project.

OEB Staff View:

OEB staff's view is that if a distributor were able to apply for two subsequent years of work (i.e., two project phases), in one application, the need and prudence for both phases could be adjudicated in the initial application. If approved, the materiality and rates could be set for the first phase of the project in the initial application, and in the subsequent IRM application, the rates could be set for the second phase of the project. This would assist in reducing the regulatory burden for a distributor and provide greater certainty for capital funding. Also, this would align with the OEB's preferred approach that multi-phase pipeline projects be captured in a single comprehensive leave to construct application.[15]

Question(s)/Input Sought from Stakeholders:

1. Should the ICM policy be changed to permit a multi-phase ICM project to be addressed in a single application? Why or why not?
2. Please provide feedback on the adjudicative process/mechanisms suggested by OEB staff for a multi-phase ICM project.

5.6. Future Growth and Flexibility

Issue:

On January 19, 2024, the Electrification and Energy Transition Panel's final report, Ontario's Clean Energy Opportunity, was released. This report builds on the government's Powering Ontario's Growth plan and provides recommendations for future long-term integrated planning and energy transition. On May 16, 2024, the *Keeping Energy Costs Down Act, 2024* was passed and seeks to ensure energy costs are affordable for Ontarians and deliver policies that will support the province's growing economy. In the Minister of Energy and Electrification's Letter of Direction, dated December 19, 2024, the need for planning and regulatory frameworks that are flexible and will facilitate infrastructure and resources being built quickly and cost effectively to support the government's pro-growth agenda was further emphasized.

Under the current ICM policy, consideration is given to supporting the funding of capital investments in non-rebasing years of a distributor's rate term. The context in which the ICM policy was established is materially different than today. There are notable increases in expected future energy demands which are driving the need for

[15] Natural Gas Facilities Handbook, March 31, 2022, p. 24

more infrastructure and regulatory flexibility to support growth, while protecting ratepayers.

OEB Staff View:

OEB staff acknowledges that the regulatory environment is dynamic. As a result, OEB staff notes that it is worth consideration to how any possible changes to the ICM policy could be responsive to supporting appropriate infrastructure growth, while balancing the OEB's statutory objectives.

Question(s)/Input Sought from Stakeholders:

1. Is the ICM policy the appropriate way to facilitate this expected growth or are other OEB policies more suited for it?
2. If the ICM policy is your recommended way, then what changes to the policy are required to meet these new expectations?

Appendix A

Summary of Question(s)/Input Sought from Stakeholders

The table below provides a summary of the questions/input sought from stakeholders on possible changes to the ICM policy. Stakeholders are also encouraged to include additional changes to the ICM policy for the OEB's consideration.

Topic	Question(s)
Materiality Threshold Calculation	• Should there be changes to the materiality threshold calculation and, if so, what should those changes be?
Capital Programs	• Please provide comments on how you think this change in policy is working in practice. • If you believe this policy should be revised or updated, please identify which elements should be revised and why. • Should consideration be given to further extending ICM availability to all distributors (e.g., when faced with a situation unforeseen during the last rebasing, such as the need to invest to address new operational risks or to support non-wires solutions), not just those in an extended rebasing period?
Significant Influence on Operations	• Should the OEB establish a threshold/percentage for what will be considered a minor expenditure in relation to a distributor's overall capital budget? If so, why and at what level should that threshold/percentage be set? If not, why not?
Availability of OM&A Funding	• Should the ICM policy be revised to include the recovery of incremental OM&A costs that are specifically related to an ICM project? If so, under what circumstances and why given the availability of other mechanisms (e.g., Z-factor and early rebasing)?
Multi-Phase Projects	• Should the ICM policy be changed to permit a multi-phase ICM project to be addressed in a single application? Why or why not? • Please provide feedback on the adjudicative process/mechanisms suggested by OEB staff for a multi-phase ICM project.
Future Growth and Flexibility	• Is the ICM policy the appropriate way to facilitate this expected growth or are other OEB policies more suited for it? • If the ICM policy is your recommended way, then what changes to the policy are required to meet these new expectations?