OPG'S COMMENTS ON A BOARD STAFF PROPOSAL TO CHANGE THE METHODOLGY FOR CARRYING CHARGES FOR THE REGULATORY ACCOUNTS OF UTILITIES (EB-2006-0117)

By letter of May 26, 2006 the Board indicated that it plans to implement a new approach to formulate interest rates for use by Ontario natural gas and electric utilities for regulatory accounts under the Uniform System of Accounts. In this regard, the Board issued a staff paper containing proposed interest rates for regulatory accounts and requested written comments by June 9, 2006 on the following issues:

1) General comments on the proposal;
2) Appropriateness of the proposed interest rate methodology;
3) The timing of the effective date: and,
4) Ease of administration

OPG has provided comments on the four issues identified. These comments separately address the treatment of variance/deferral accounts and Construction Work In Progress (CWIP). OPG has used the standard terminology of carrying charges to reflect the fact that the application of interest rates is an alternative method of applying carrying charges, but certainly not the only method.

SUMMARY OF OPG's COMMENTS

While OPG supports the goal of regulatory efficiency, referenced by Board staff as one of the drivers of its proposed changes, it does not support any of the specific changes included in the staff proposal.

OPG recommends that the Board reject the staff proposals on the grounds that they create inappropriate incentives; are not consistent with regulatory principles; are counter to government policy; do not appropriately consider the practices in other regulatory jurisdictions; and, are unnecessarily burdensome to implement. In summary, the staff proposals fail the Board's stated intent in establishing carrying charges as stated in the 2006 Electricity Distribution Rate Handbook Report of the Board, May 11, 2005 (the 2006 EDR Board Report): "the Board seeks to find an approach that balances equity and ease of application".

Board staff is proposing the use of a Board-prescribed one-year interest rate based on the one-year Canada treasury bill, which could be updated every quarter. One exception to this approach would be for CWIP accounts where the length of the construction period is more than one year. In this circumstance, a mid-term interest rate is proposed

From OPG's perspective, Board staff appears to be proposing wholesale changes to the carrying charge methodologies approved by the Board in a number of regulatory forums. OPG opposes these changes because it is of the view that the Board generally had things right already, which is not surprising given that their decisions were based on evidentiary processes supported by expert witnesses and stakeholder examination and argument. OPG supports the Board's historic use of the utility-specific capital structure

reflected in a utility's approved revenue requirement. To meet the stated goal of regulatory efficiency, OPG has proposed the application of a default methodology for both deferral and variance accounts and CWIP, with utilities required to show why they should receive an exception to the default approach.

OPG is mindful of the regulatory burden that is directly associated with regulating the large number of LDC's in the province. The benefits associated with having to approve a utility-specific capital structure for each electricity distributor are not warranted; therefore generic solutions are required for those utilities. OPG appreciates that the use of a generic capital structure raises some of the same issues as the Board Staff proposal; however the use of a generic capital structure and related returns is a closer proxy for a utility–specific capital structure and return on capital and therefore would most likely be superior to the approach provided by Board Staff. The use of a generic structure also has the advantage of consistency in treatment with the OPG's proposals for utilities whose capital structures are reviewed in revenue requirement.

OPG's comments focus on utilities whose capital structures and embedded capital costs are approved by the Board. These utilities will tend to be larger utilities and utilities subject to a forecast test year ratemaking approaches, as these are the circumstances which will impact OPG's future ratemaking determinations. Specifically, OPG recommends the following approach:

Deferral and Variance Accounts:
OPG recommends using the embedded cost of long term debt in a utility's Board approved capital structure as the "default" carrying charge, subject to a few predefined exceptions.

Use of the utility-specific embedded long-term debt rate eliminates forecast bias, keeps the utility whole, is consistent with the longer account balance accumulation and recovery periods associated with performance based regulation, is the easiest method to administer, and the use of an embedded utility–specific rate has a long history of acceptance by stakeholders and the Board.

OPG is mindful of the Board's comments in the 2006 EDR Board Report in which it confirmed its "practice to refrain from establishing a one-size-fits-all interest rate for deferral and variance accounts" (pg 24). In support of its conclusion that this practice was appropriate, the Board noted that there were "a number of instances witnesses commented that it was most appropriate to consider the specifics of the content of the deferral account when establishing the interest rate" (pg 24-25). Consistent with this approach and in the interests of regulatory efficiency, OPG proposes that the Board pre-approve a few specific exceptions to the utility-specific embedded long-term debt rate such as:

- Deferral and variance accounts are normally non-capital in nature. However, if these accounts reflect activity that is fundamentally capital in nature, the appropriate carrying charges for that specific account should reflect carrying charges associated with capital assets. The deferral account should form part of rate base and therefore

the weighted average cost of capital (WACC) in the utility's approved capital structure should be used.

- The size of the deferral and variance account balances, and the duration of recovery should be considered. For large account balances to be recovered over extended periods, the utility should have the opportunity to propose the use of WACC.
- For deferral and variance accounts that contain balances to be recovered in less than 1 year, the short-term debt rate in the utility's approved capital structure should be the applicable carrying charge. In the absence of a short term debt rate in the utility's capital structure, OPG supports Board Staff's market proxy proposal (1 year T-Bill rate plus a spread; albeit without a quarterly adjustment.

CWIP

OPG's proposal for CWIP is similar to our proposal for deferral and variance accounts outlined above, for many of the same reasons (e.g. inappropriate incentives). Staff's proposal on CWIP also raises the issue of financial streaming and creates a much greater regulatory burden than Staff's other proposal on variance and deferral accounts.

OPG recommends using the utility-specific embedded cost of capital, and a Board approved "default" carrying charges to improve regulatory efficiency. The default carrying charges for larger utilities would be the WACC in the utility's approved capital structure to reflect the typical financing approach of these utilities, while the embedded cost of long term debt would apply as the default carrying charge for smaller utilities. Smaller utilities should also be given the opportunity to demonstrate that their utility specific capital budget financing is consistent with the application of WACC.

ISSUE 1: GENERAL COMMENTS

Deferral and Variance Accounts

The staff proposal appears inconsistent with the Board's pronouncements during the past year, including the following statements and conclusions of the Board on the issue of "Interest rates for deferral accounts" reflected in the 2006 EDR Board Report:

- "the purpose underlying the setting of a rate for deferral and variance accounts is to ensure that distributors neither gain no lose inordinately in carrying the balances in these accounts" (pg 24)

- "The truly critical element of deferral management is the timely recovery of deferral or disposal of the principle amount captured in the deferral or variance account, not the interest rate attached to it." (pg 24)

- "In considering this, issue the Board seeks to find an approach that balances equity with ease of administration" (pg 24)

- “A longer term rate is most appropriate when the account contains funds accumulated with an expectation of clearance over a number of years. In other cases, a short-term interest rate is most appropriate because the deferral or variance account is expected to be cleared within a year.” (pg 25)

The Board stated in the 2006 EDR Board Report that the interest rate issue was not a significant consideration, and the Board cautioned that “a distributor may find it cost effective to await the review rather than engage in trying to establish novel approaches…” (pg 25) Given that “market” interest rates have increased since the Board’s statement (i.e. lowering variances between the rates approved for distributor and the “market” rates proposed by staff) and the cost of capital issue remains to be addressed, staff’s novel proposal seems out of step with the views of the Board.

In addition, the staff proposal can be summarized as using a “short-term rate updated regularly” (pg 24). This methodology was specifically highlighted as one option that the Board considered and rejected in retaining its practice of setting carrying charges when accounts are established.

As noted above, the Board concluded that a short-term rate is most appropriate if balances are to be cleared within a year. The Performance Based Ratemaking approaches that the Board is actively examining result in longer time frames between rate setting periods. Deferral and variance account balances may be accumulated (and therefore financed) over a longer period of time and indeed could be recovered over a longer period of time. Longer term carrying charges would seem to be more appropriate going forward.

In reaching its conclusion to “tailor the interest rate to circumstances of the account and, where applicable, the distributor” (pg 25), the Board indicated that its approach is to balance equity with ease of administration while noting that utilities generally supported the use of their embedded cost of debt. OPG’s proposal to apply a utility specific embedded long-term debt rate subject to pre-approved exceptions is consistent with the Boards conclusions. The embedded long-term debt rate has the support of electric LDCs, and the rate remains stable for the test period, therefore it is far easier for the utility to apply, and presumably for the OEB to monitor, than a rate that may change quarterly.

CWIP

The following references are taken from the section dealing with “Interest rates for construction work in progress” in the 2006 EDR Board Report:

- The Board noted “the expert evidence of Mr. G. Matwichuk” a witness representing the Vulnerable Energy Consumer’s Coalition (VECC)”. “Mr. Matwichuk’s proposition involves the use of the Weighted Average Cost of Capital for distributors with an appropriate debt/equity ratio, or, in the case of

distributors financed primarily by debt, the use of the prevailing Interest During Construction (IDC) rate." (pg 25-26)

- "The proposed methodology has the advantage of providing some definitive direction to distributors with respect to an appropriate rate, and introduces enhanced consistency over the distribution industry in the Province. The use of the WACC is appropriate given the capital nature of the assets produced through such projects. It reflects the predictable cost of capital experienced by the distributor, should it have to, or want to, finance the project in the market." (pg 26)

- "The Board considers the methodology proposed by Mr. Matwichuk to be appropriate, and will adopt it for use in the Handbook." (pg 26)

OPG submits that Mr. Matwichuk and the Board in the 2006 EDR Board Report have it right. The use of WACC as the carrying charge for CWIP reflects the current regulatory reality—there is a need to encourage infrastructure development and regulators are looking at various ways to meet this growing need. The trend towards including CWIP in rate base in order to support infrastructure financing requirements effectively results in the application of WACC as the rate for CWIP.

Board Staff's proposal doesn't reflect the financing circumstances of utilities, and would act to discourage needed infrastructure investment for specific utilities that must finance capital at rates higher than the "market" rate. In OPG's submission the proposal seems out of step with the needs of Ontario, and ultimately, ratepayers who will bear the "catch up" costs associated with infrastructure investments necessitated by immediate needs as opposed to prudent planning.

OPG notes that the staff proposal did not highlight the use of such approaches in other jurisdictions. OPG submits that consideration of the extent their approach is used in other regulatory jurisdictions, and the rationale for it is relevant.

ISSUE 2: APPROPRIATENESS OF THE PROPOSED INTEREST RATE METHODLOGY

<u>Deferral and Variance Accounts</u>

Creation of forecasting Bias

The applicable rate should be utility-specific as market rates create inappropriate incentives.

The use of a "market" rate for deferral accounts that is different from the utility-specific interest rate can create an incentive to bias a rate-setting forecast, when the underlying activity being forecast is subject to a variance account. For example, a utility may have a variance account for the purpose of recording differences between forecast ancillary

services and the actual cost of those services. If the market rate accruing to a variance account is greater than the utility's actual borrowing cost, it could be beneficial to the utility to "under-forecast" costs so that a credit balance will accumulate The balance in this account will attract the higher market rate (for regulatory purposes) but can be financed at the utility's lower actual financial cost. To illustrate, assume a utility has a 3% embedded cost of debt in its capital structure, and the "market" forecast T-Bill rate is 4%. The utility has a deferral account to reflect differences in the commodity it delivers to customers (e.g. a Purchased Gas Variation Account). When a utility has "under-forecast" its costs, they finance the balance at 3%; however since the regulator allows the utility to recover 4%, the utility has the incentive to "profit" by maximizing the size of the deferral account balance (i.e. under-forecasting costs or over-forecasting revenues). The utility will be able to "profit" from the interest rate difference and collect it in conjunction with the $10 million variance account disposition.

Consistency with OEB's Regulatory Efficiency Objective

The OEB is actively considering the use of Performance Based Regulation for natural gas and electric utilities. One of the fundamental aspects of a PBR methodology is the term over which the rates and performance incentive will apply. Common terms are from three to five years. Unless there is regular regulatory intervention, deferral and variance account balances will accumulate over the PBR term approved by the regulator. Activity recorded in the first year will need to be financed over several years. Indeed one option available to the regulator is to include recovery in the revenue requirement of the subsequent PBR period, further extending the period over which these balances are recovered. Use of a short term rate is inconsistent with implementation of PBR.

The base forecast is used for all aspects of revenue requirement, including interest rates. The utilities embedded cost of long-term debt is reflected in this approval. As it reflects the utility specific costs, it best reflects the Board's objective "to ensure that distributors neither gain nor lose inordinately in carrying the balances in these accounts."

A short-term rate is inconsistent with the longer balance accumulation and disposition timeframes reflected in the implementation of a PBR regime. The utility's approved embedded cost of long-term debt is consistent with PBR. It best reflects the cost of the utility's long term financing; thereby minimizing the potential a utility would neither gain nor lose inordinately in carrying balances in these accounts.

Consistency with Rate Making Principles

In establishing rates for deferral and variance accounts, an important consideration is whether a utility is essentially "kept whole". The question to ask is "what would have happened to the approved revenue requirement if the variance never occurred (i.e. the forecast activity subject to the variance account treatment was correct) ?" The answer can be determined by changing the forecast utility income used to determine revenue requirement. For example, if an account ultimately produces a credit balance (the forecast was too low), reflecting these higher costs in the original forecast would have

produced a larger revenue deficiency. If that deficiency were appropriately reflected in the approved revenue requirement, it would have reflected the utilities embedded cost of capital.

Application of the utilities embedded cost of capital is consistent with the treatment of the underlying costs that are reflected in the OEB's approval of utility revenue requirement. Utilities are "kept whole" and there is no inappropriate forecast bias created.

Regulatory Efficiency:
OPG supports this objective, and understands that the Board Staff proposal was intended to achieve this result through the application of a standard rate. For a variety of reasons, the application of a generic market based rate is inappropriate. However, regulatory efficiency can be achieved in a manner consistent with the Board's approach in the 2006 EDR Board Report by establishing a default rate and providing for pre-approved categories of exceptions. OPG has proposed the use of the utility specific embedded long-term debt costs as the default rate. Preauthorized exemptions should include the use of WACC for large accounts, accounts recovered over an extended period and accounts that record activity that is primarily capital in nature, and short term rate (the utility specific embedded debt rate if it exists, or Board Staff's proposed a one year T-Bill rate if it doesn't) for accounts that are cleared within a year.

OPG submits that the Board's approach to using utility-specific embedded rates is appropriate where the opportunity to consider utility specific rates is afforded by the regulatory methodology applied by the OEB to the specific utility. While the direct consideration of utility specific embedded costs is not possible when an industry-wide generic ratemaking approach is applied, the approved generic structure is directionally constant with ratemaking principles.

CWIP

The Introduction of Financial Streaming into OEB Regulation
To date, the OEB has not embraced the use of financial streaming. Board Staff's proposal requires a capital budget to be segregated into two categories, and each category is financed using different proxy rates for incremental capital. OPG understands that financial streaming is not generally used in energy regulation. The one exception relates to project specific financing where some jurisdictions in the U.S. have allowed the financing to be included at the approved AFUDC rate, in part to encourage infrastructure development.

The OEB has traditionally used a hypothetical capital structure or pool of funds to finance a utility's approved rate base (and the capital budget reflected therein). While OPG is not necessarily opposed to financial streaming, it believes that with CWIP having broad application to the majority of a utility's rate base, financial streaming would become the rule rather than the exception. The OEB would then be faced with deciding

whether separate categories should be developed for project specific financing, projects financed by capital lease funding streams, utilities financing of other obligations, etc. The OEB should consider the broader implications of accepting financial streaming before adopting it here. One way would be for the Board to engage an expert to examine the use of financial streaming in other jurisdictions.

Consistency with OEB Objectives
Board Staff's proposal results in inappropriate incentives, is not consistent with ratemaking principles, and doesn't support the OEB's business objectives

OPG's comments on the issue of the Appropriateness of the Proposed Interest Rate Methodology in the Variance and Deferral account regarding inappropriate incentives generally apply to CWIP as well.

Use of an embedded utility specific cost of capital where the review of capitalization and cost of capital is included in regulatory methodology applied to that utility continues to be the best method to meet the Board objective to find "an approach that balances equity and ease of application". Today the embedded utility specific rate may be higher than the rate Board Staff feels is an appropriate "market" proxy; however a few years from now perhaps the opposite would apply. In the long-run, if the "market" rate is truly reflective of a utility's long-term borrowing costs, there should be minimal differences.

The OEB should note that the market rate proposed by staff is significantly below OPG's borrowing costs. Any consideration of market rates should, at an absolute minimum, reflect the utilities actual borrowing costs through some form of relative risk assessment. In much the same fashion as the return on equity has been established for natural gas utilities, a relative risk could be layered onto an objective and appropriate "market" instrument (e.g. 10 year long-term Government Bond rates). However; OPG reiterates that, where a utility capital structure is considered as part of the regulatory rate making methodology, utility specific embedded costs are used.

The OEB has a long history of using the long-term debt rate in the utilities approved capital structure as rate for CWIP. This Interest During Construction (IDC) methodology is a widely accepted approach. The embedded long-term debt cost is an average cost (not incremental), so there is no financial streaming.

Another utility-specific embedded cost approach involves the use of the weighted average cost of capital (WACC) as an Allowance for Funds Used During Construction (AFUDC). As noted previously, the Board recently accepted the use of WACC as an AFUDC in the 2006 EDR Board Report.

OPG endorses the use of WACC. The WACC methodology more closely reflects OPG's general capital budget financing (although project specific financing is becoming common for large projects), and is consistent with the approaches regulator's are introducing to encourage infrastructure development.

OPG appreciates and understands the rationale behind the long-standing OEB history of using the embedded cost of long-term debt. Frankly, it is everything Board Staff's proposal is not. It is consistent with widely accepted regulatory principles such as promoting rate stability, doesn't introduce forecast bias, is easier to administer, etc. However, OPG is of the view that the use of WACC is consistent with the way larger utilities generally finance their capital budgets.

In response to the legitimate concern to promote regulatory efficiency reflected in Board Staff's proposal, OPG recommends using a default approach. OPG is of the view that capitalization policy for larger utilities should reflect the utility-specific weighted average cost of capital, as this method is the best reflection of how these assets are generally financed by larger utilities. For smaller utilities, the utility-specific embedded cost of long term debt could be used. Smaller utilities should be given the opportunity to demonstrate that their utility specific capital budget financing is consistent with the application of WACC

ISSUE 3: TIMING OF THE EFFECTIVE DATE

OPG has no comment on this issue.

ISSUE 4: EASE OF ADMINISTRATION

Deferral And Variance Accounts

OPG proposes applying the embedded cost of long-term debt in the capital structure. The rate is known and constant until a subsequent rate proceeding. Board Staff's proposal to apply "market" rates requires a small incremental amount of effort to determine whether a change in market rate is required.

OPG supports the use of market rates in the limited circumstance where a utility's approved capital structure does not include a short term debt component, and the deferral or variance account is expected to accumulate a balance in one year and dispose of the balance in the following year. OPG is of the view that PBR and similar approaches to improve regulatory efficiency will reduce the number of accounts to which a short-term rate would apply. The short life cycle of these balances (one year accumulation and recovery period) would not generally result in large balances. In such circumstances, the application of the "market" rate prevailing when rates are established is consistent with the Board's objective of ensuring the utility doesn't gain or lose *inordinately* in carrying the balances in such accounts.

However, quarterly adjustments require that the utility determine whether a change is required (or be notified by Board Staff that a change is required) and, if so, apply cut-off procedures in such a manner as to be able to demonstrate that certain activity occurred in one quarter and other activity occurred in the subsequent quarter, and apply the

adjusted interest rates. Quarterly rate adjustments will result in more detailed reporting in rate cases as utilities need to demonstrate that carrying charges have been appropriately applied. The electric and natural gas utilities are currently required to regularly report deferral and variance accounts to the OEB pursuant to the OEB's Reporting and Recordkeeping Requirements; therefore quarterly interest rate changes will require more detailed reporting. Presumably if such detail is requested, the regulator will naturally incur additional costs to review the application of quarterly adjustments.

OPG does not support quarterly adjustments. Once the carrying charge is established it is no different than the multitude of other forecast items reflected in the approved revenue requirement. As noted above, OPG's proposals generally limit the application of a "market" rate and the short life cycle of these balances (one year accumulation and recovery period) would not generally result in large balances. In addition, it is expected that a short-term "market" rate will apply to fewer accounts under PBR. In these circumstances, OPG is of the view that quarterly adjustments add unnecessary complication for limited benefit.

CWIP

The financial streaming reflected in Board's Staff's proposal to apply different rates for short term (< 1 year) and long term (>1 year) construction projects will require segmentation of the capital budget by project lifetimes. This may prove logistically difficult for utilities with large capital project portfolios given the dynamic nature of portfolio project management (i.e. resources may need to be diverted to priority projects before project completion) As indicated earlier, OPG does not have a business purpose for segmenting its capital budget into short and long term components, therefore business processes and systems would need to be implemented to meet this purely regulatory requirement.

The segmentation of the capital budget into short and long term construction projects also creates a financial incentive for utilities to stretch the forecast project completion horizons ("year plus a day" forecasting), since short-term rates are generally lower than long term rates. Larger utilities with multiple projects could simply forecast to start projects earlier. The incentives created by segmenting the capital budget and applying tiered carrying charges may also impact project management on an actual basis (i.e. project managers delaying the actual completion of useful projects to ensure the higher CWIP applies). Given the existence of these inappropriate incentives, there would be a need for the OEB to develop very detailed project specific reporting and analysis comparing actual to forecast start and completion dates to assess whether utilities were not acting inappropriately based on the incentives created by Staff's tiered financing proposal. If such reporting and recordkeeping is required of utilities, the OEB would then have the administrative burden of reviewing this information