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ONTARIO ENERGY ASSOCIATION RENEWED REGULATORY FRAMEWORK FOR ELECTRICITY SUBMISSION

APRIL 20, 2012

April 20, 2012

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

Attention: Ms. Kirsten Walli, Board Secretary

**Re: Renewed Regulatory Framework for Electricity
Board Files: EB-2010-0377, EB-2010-0378, EB-2010-0379, EB-2011-0004, EB-2011-0043
Written Comments of the Ontario Energy Association**

Dear Ms. Walli:

On behalf of the Ontario Energy Association (the “OEA”), I am pleased to provide the following comments to assist the Ontario Energy Board (the “Board” or “OEB”) in its development of a renewed regulatory framework for electricity distributors and transmitters (“RRFE”). The OEA’s comments are primarily focused on how the Board, through the RRFE, should improve the capital spending model for regulated entities in Ontario to the benefit of consumers and regulated utilities. Although this issue is not specifically addressed in any of the staff discussion papers, it is an area of critical concern for rate-regulated transmitters and distributors and is perhaps most closely related to EB-2010-0377 (Distribution Network Investment Planning). We also note that this issue is referred to in the “straw man” model regulatory framework included at Attachment A to the Board’s February 6, 2012 letter to RRFE participants.

About the OEA

The OEA has more than 150 corporate members who represent the full diversity of the energy industry in Ontario – power producers, firms that transport, transmit, and deliver natural gas and electricity, marketers and retailers, manufacturers, contractors, service providers, and energy consultants. Such diversity allows us to offer a broad perspective on the RRFE and its impact on a range of market participants, including consumers.

Recommendations

In preparing its comments and recommendations on the RRFE, the OEA conducted one-on-one interviews with executives from each of our OEB-regulated member companies and received additional input from our Utility Sector Committee and Board of Directors. In our presentation at the March 28 stakeholder conference, the OEA presented the Board with a series of recommendations that our members believe are important for the development of a sustainable regulatory framework in Ontario. The details supporting these recommendations will need to be developed in close consultation with industry stakeholders as part of the OEB’s

technical working group process. The recommendations we provided, and which we continue to endorse, are that the Board should:

- With respect to the need for a renewed capital spending model,
 - eliminate uncertainties related to the recovery of capital investments,
 - allow all regulated entities to execute pre-approved capital plans, and
 - use a transitional model to bridge the gap between where we are today and the new model that needs to be developed;
- With respect to incentive regulation,
 - consult with industry in setting performance benchmarks,
 - ensure that desired outcomes are coordinated with appropriate reporting requirements and necessary lead times, and
 - implement simplified and expedited reporting for high-performing regulated entities so as to incent and reward desired behaviour;
- With respect to rate mitigation,
 - apply mitigation only to costs that regulated businesses directly manage, and
 - always permit regulated entities to recover mandated investments;
- With respect to regional planning,
 - make its objective the achievement of integrated/optimized energy solutions for communities,
 - define and be transparent about what ‘integrated/optimized’ means, and
 - improve coordination of regional energy planning among all involved parties; and
- With respect to smart grid implementation,
 - ensure that data access rules are expeditiously clarified to enable innovation and the commercialization of behind-the-meter services.

Through dialogue with our OEB-regulated members, the OEA has determined that the issue of greatest concern to regulated utilities is, by an overwhelming degree, the need for the timely recovery of capital investments. The OEA strongly urges the Board to regard this issue as the top priority within the RRFE review.

The Need for Annual Capital Spending Adjustments

As the Board is aware, under the current regulatory framework, electricity distributors are typically subject to a four-year rate-setting cycle that commences with a cost of service application and is followed by three years of adjustments through the Incentive Regulation Mechanism (“IRM”). During the IRM period, rates are typically only adjusted to account for a narrow range of factors, including inflation, productivity changes, stretch factors and events that are beyond management’s control. Where a distributor has significant capital needs that arise during the IRM period, such distributor may use the Incremental Capital Module (“ICM”) to request additional funding without having to wait for its next cost of service rebasing. However,

under the ICM, a distributor will only be granted increased funding if it can demonstrate that the amounts being sought (a) exceed the Board's materiality threshold, (b) clearly have a significant influence on the operation of the distributor, (c) are outside of the base upon which rates were derived, (d) are clearly non-discretionary, and (e) represent the most cost-effective option for ratepayers. The Board may also require such amounts to be "extraordinary and unanticipated" and discrete.

An electricity distributor may also be able to apply for an early cost of service rebasing if it meets certain criteria established by the Board and can demonstrate why it cannot adequately manage its resources through the IRM adjustment process. In particular, such early rebasing may be granted if the distributor can demonstrate a significant change in its return on equity.

Within this framework, regulated entities are frequently unable to make all of the investments they believe are necessary. This is because the adjustments made under the IRM are very limited and, on an annual basis, most capital investments required by distributors do not meet the Board's materiality thresholds or other criteria that must be met under the ICM or for purposes of applying for an early cost of service rebasing. As a consequence of unanticipated capital spending requirements that arise during the IRM period, the utility is then faced with the options of significantly reducing its O&M expenses, reducing its effective return on equity or foregoing/deferring capital investments until such time as the distributor is scheduled for its next cost of service rebasing. None of these options are in the long-term best interests of either the utilities or their customers.

Where the utility opts to undertake capital investments during the IRM period in the hopes of being granted the right to recover such amounts through a subsequent cost of service rebasing, the utility and its shareholder will be forced to carry such costs until rebasing occurs and to take on the added risk that such costs may not be fully recovered. Moreover, as depreciation costs are fixed only through the cost of service review, any incremental depreciation costs incurred by a utility during the IRM period will be forgone. Such incremental depreciation costs can be significant and can result, for instance, from increased or unanticipated capital requirements that arise during the IRM period. As there are no mechanisms that permit rate-regulated utilities to record or track such incremental depreciation costs for future recovery, this can impact the utility's shareholders while incenting utilities to defer necessary capital investments until after a cost of service review is carried out.

Where the utility opts to reduce its O&M expenses or to defer the capital investments that it otherwise regards as necessary, quality of service, reliability and other key performance attributes may be affected. This will be particularly true where a high proportion of a utility's assets are nearing the end of their useful life. Moreover, deferring the recovery of financing costs (debt and equity) creates uncertainties for utilities and may result in the deferral of much needed infrastructure. This in turn may jeopardise system reliability, reduce service quality and expose consumers to sharp rate increases arising from periodic cost of service reviews. Indeed, under the existing framework consumers are frequently subject to sharp rate increases following the rebasing of a regulated utility.

The OEA has a strong appreciation for the need to mitigate increases to consumer bills. However, in our view, it is critical that this objective is appropriately balanced with the need to ensure that rate-regulated utilities can recover their capital investments on a timely basis. This

will enable utilities to make the necessary investments in their systems while reducing the sharp rate increases that tend to be experienced by consumers following cost of service rebasings. It is the OEA's view that the Board should work towards a new regulatory framework that allows for annual rate base adjustments for rate-regulated electricity distributors and transmitters. This will address the growing need for new and replacement infrastructure and technology while ensuring that the impact of such investments on consumer bills is kept at reasonable and more predictable levels.

Long-term Recommendation

Ultimately, the Board should allow rate-regulated utilities to seek approval for multi-year capital investment plans in their cost-of-service proceedings and allow those utilities to adjust their rates during the IRM period. A multi-year capital plan can be particularly effective where there are unique investments or marked departures (up or down) from previously approved investment levels (i.e. where the capital budget in a rebasing year is no longer reflective of the capital spending needs in the current period).

Given that some distributors may have difficulty forecasting and delivering on multi-year plans, the Board may consider a gradual approach to phasing in the multi-year framework approach.

Interim Recommendation

In the interim, until the Board can develop and implement a multi-year framework, the Board should consider options that would enable utilities to promptly incorporate all necessary and prudent capital investments made during IRM periods into their then-current rates. This may require a review of the ICM approach. Utilities should have the ability to recover costs for all prudent capital investments in the year in which the investments are made (e.g. through capital spending rate riders/adders). As such, a revised approach to the ICM would provide utilities with the opportunity to seek cost recovery within the IRM period until a new long-term capital investment model can be developed and implemented.

The OEA therefore recommends that the Board should revise the ICM criteria as soon as possible to allow regulated entities to file 2013 applications under the "new IRM/ICM" rules in 2012. The experience gained during the interim period will provide useful insights and will assist with the development of a more sustainable and effective long-term solution.

Mitigation Policies

When considering rate mitigation policies, the Board should be mindful that costs associated with government-mandated initiatives (i.e. smart meters, connecting renewable generation) may not be at the discretion of or within the control of regulated entities. In the OEA's view, such government-mandated investments that utilities must make should always be recoverable through rates and should not be subject to mitigation. Moreover, where the Board requires a particular approach to implementing government-mandated investments, a presumption of prudence should apply to those investments when they are reviewed by the Board.

Sound rate mitigation should always be sensitive to the fact that regulated entities need to be able to recover prudent costs to maintain reliable and high-quality service for their customers.

Rate mitigation should always ensure that regulated entities can invest in infrastructure that supports the utility's objectives of providing safe and reliable service while smoothing rate changes by avoiding sharp increases.

Conclusions

Further to the comments set out herein, the OEA respectfully recommends that the Board move forward expeditiously with the development of a transitional capital investment model that will allow rate-regulated utilities to both recover the cost of investments in a timely manner and smooth rate increases to consumers.

For the longer term, the OEA recommends that the Board adopt a framework that would integrate multi-year capital investment planning with rate regulation in a manner that allows rate-regulated utilities to upgrade, modernize, and expand the infrastructure needed to service existing and new customers while concurrently continuing with prudence reviews of proposed capital projects and ensuring gradual rate adjustments so as to minimize impacts on customers.

If you have any questions in respect to our comments or recommendations, please contact Svetlana Diomin, Vice President, Policy at 416-961-2339 ext. 226 or sdiomin@energyontario.ca.

Yours truly,

A handwritten signature in black ink, appearing to read 'Elise Herzig', with a stylized flourish at the end.

Elise Herzig
President and CEO
Ontario Energy Association

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