



THE CASE FOR REFORM

How regulatory streamlining
could benefit Ontario's
electricity consumers

JULY 2011



ELECTRICITY DISTRIBUTORS ASSOCIATION



Executive Summary

The Electricity Distributors Association (EDA) is the voice of Ontario's 78 electricity utilities who safely and reliably deliver electricity to 4.7 million residential, business and institutional customers. In 2010, the Association initiated a project to consult with members on how to streamline the current regulatory framework. This work has resulted in a number of specific recommendations supported by LDCs.

The key recommendations include:

- Revising the IRM Application Process
- Revising the Cost of Service Application Process
- Revising the Intervenor Process

Adopting these recommendations would improve regulatory oversight, reduce regulatory costs and ultimately benefit customers. The EDA continues to examine further opportunities to streamline regulation for the sector.

Background

The regulatory framework for Ontario's local electricity distribution companies (LDCs) has undergone significant changes over the past decade. More recently, LDCs have taken on new responsibilities and roles related to the Green Energy and Green Economy Act (GEA) which has had further impact on the regulatory framework.

In the midst of these changes, LDCs have found that the regulatory burden is consistently increasing. LDCs have gained substantial experience and insight working under OEB oversight in the existing regulatory framework. At the same time, there are increasing pressures to address the rising costs of electricity.

Ontario LDCs firmly believe that now is the time to carefully review the regulatory processes to identify areas that could be streamlined. The result will be a more efficient and cost-effective regulatory framework that achieves policy objectives and has the potential to make electricity more affordable for electricity consumers.

Guiding Principles for Regulatory Streamlining

In early 2011, the EDA Board of Directors developed the following Guiding Principles, to assist in developing recommendations for streamlining regulation of the sector:

- *There is a need to balance costs of regulation with the benefits to customers;*
- *The amount of regulation and reporting requirements should be proportionate to the policy objective/outcome;*
- *More emphasis should be placed on policy outcomes, not process;*
- *Duplication and overlap of reporting requirements should be eliminated*
- *Administrative burden to LDCs should be minimized, streamlined;*
- *Distributors should be provided flexibility to address their local circumstances*
- *Distributors should not be involved in addressing social problems;*
- *Distributors should be allowed to recover their costs to address aging infrastructure in a timely manner;*
- *Increased certainty and transparency should be provided for cost recovery by distributors;*
- *Decision-making by regulators needs to be timely.*

The EDA Board appointed a committee which developed and brought forward proposals to all LDCs for input. The members indicated strong support for the proposed recommendations.

In order to fully realize the business opportunities that will bring value to customers and shareholders alike, LDCs need a regulatory model that builds efficiencies for utilities. There is a need to review the regulatory system to produce favourable rate outcomes, bring more efficiency into the rate process and create value to the customer and shareholders in terms of addressing the costs associated with the regulatory system.

The Committee's recommendations focus primarily on three significant burdensome areas:

- Incentive Regulation Mechanism (IRM) application process
- Cost of Service (COS) application process
- Intervenor process

Distribution Rate Application Process

Every four years an LDC brings forward an application to the OEB for a full review of its costs and proposed rates. This is called a COS application.

In the years between these COS applications, rates are adjusted through an IRM application process whereby rates are updated annually by a formula which adjusts upward for inflation and downward for anticipated productivity improvements plus possible LDC-specific adjustments.

These possible adjustments in the IRM application include materially significant cost changes and significant increases in capital investments. During each application process, intervenors (stakeholders who participate in the hearing process) and OEB staff can ask questions and can file submissions to the OEB with respect to its decision on the LDC's application. Many intervenors are eligible to recover their costs from the Applicant (LDC) for participating in the hearing process.

This process was established as a replacement of the more traditional rate approval process where LDCs would file for a COS application each year. The IRM period between COS applications is designed to encourage LDCs to achieve efficiencies through cost savings and be rewarded with higher returns.

The Case for Reform

The EDA Board Committee identified the following challenges created under the current regulatory process, and offers recommendations for change that would benefit LDCs, their shareholders, the regulator and ultimately all electricity consumers in Ontario.

Challenge:

The OEB's capital module materiality threshold in the IRM period is too high. This encourages deferral of infrastructure renewal and often results in sharp rate increases for customers once every four years.

Capital investments taken separately on a year-by-year basis are often too small to meet the OEB's materiality threshold and/or other screening criteria to be included in rates during the IRM application period. As a result, LDCs will often defer these capital investments and include them at the time they submit their COS applications when the materiality threshold does not apply.

This approach of excluding all capital investments in the interim rate adjustments has three consequences:

1. LDCs are compelled to defer the much-needed capital investments for up to three years during a time when infrastructure is in need of renewal.
2. LDCs that do undertake capital investments that do not meet the materiality threshold have no certainty that they will be able to recover these costs. Moreover, LDCs must carry these costs until their full cost-of-service application, thereby penalizing their shareholders.
3. Customers may ultimately experience sharper rate increase at the time the full COS application is submitted, since all capital investments are included at that time.

Recommendation: Revise the Capital Module

Allow LDCs to obtain approval for multi-year capital investment plans in COS proceedings – and then scrutinize applications for the capital module during the IRM period based on the approved multi-year capital investment plans.

All capital investments made during the IRM period should be incorporated into rates during the same period.

Key benefits:

Enabling LDCs to submit and receive approval for multi-year capital investment plans would ensure much needed capital investments are undertaken in a timely manner. This would streamline the annual process to review capital module applications for both the OEB and LDCs making it more timely and cost effective.

Challenge:

Generic inflation and productivity factors used to adjust rates during IRM period don't reflect the current LDC-industry reality.

In the IRM period rates are adjusted annually for inflation and downward for anticipated productivity improvements. The current inflation factor used is the Canada Gross Domestic Product Implicit Price Index (Canada GDP-IPI), which is a generic indicator and it does not reflect the inflation pressures on distribution industry in Ontario. Inflation factors that are more specific to the LDC industry would better reflect the recent changing higher labour costs in the industry which are different from other sectors in the economy.

The productivity factor used for LDCs in Ontario is based on the long-term total factor productivity (TFP) trend from a representative set of U.S. electricity distributors over a long period beginning in the late 1980s.

This long-term US TFP data was selected because reliable long-term productivity data from Ontario LDCs was not available at that time. At the time the US TFP data was selected, none foresaw the degree of change that the Ontario electricity industry and LDCs would undergo as a result of overall industry restructuring. The additional mandates to install smart meters, deliver conservation programs, implement Time of Use pricing, connect renewable generation and develop the smart grid mean that the comparison of US Distributors to Ontario LDCs is no longer valid and as such, the long-term past trends in the US have not proven to be an accurate indicator of the actual productivity experience of Ontario LDCs.

As a result of their additional mandates, LDCs' focus has been centered on responding to the constantly changing requirements placed upon them. These increasing new responsibilities, coupled with constant changes in the industry, have offset or delayed the expected improvements to productivity. Using the current productivity factor results in rate decreases that are not sustainable as LDC businesses take on increasingly broader scope.

IRM rate adjustments that are based on factors not reflective of the current industry reality result in a "true-up" when LDCs bring forward their COS applications. The amount of the true-up can be substantial over the period between COS applications, and as such can create price instability and uncertainty for customers.

Recommendation: Revise the Productivity Factor and Inflation Factor

Use Industry-specific inflation factor to reflect changing labour costs in the industry rather than using Canada GDP – IPI in the IRM formula.

Lower the current productivity factor in the IRM formula to reflect existing productivity in the industry impacted by constant ongoing changes to regulatory requirements.

The current productivity factor in the IRM formula should be lowered to be more reflective of current productivity levels in the industry which has been and will continue to be affected by ongoing industry changes.

The EDA proposes adjusting the inflation factor so it is more reflective of industry inflation and setting the productivity factor at a level reflective of recent Ontario trends.

Key benefits:

More gradual rate changes will help avoid customer “sticker shock” which occurs under the current approach where rates increase sharply. The revised IRM process could also allow longer periods between filings of COS applications, reducing the amount of resources allocated by both the regulator and the LDC to this labour and time-intensive process. The new approach would also reduce the financial burden currently placed on LDCs.

Challenge:

Existing COS templates are extensive and open to interpretation, leading to an unnecessarily burdensome amount of administrative work.

The COS application process involves a full review of all the LDC’s costs. The OEB notes that a COS application should provide sufficient detail to enable the OEB to determine whether the proposed rates are just and reasonable and the onus is on the LDC to provide sufficient evidence to prove the need for, justification and prudence of all its costs that are the basis for its proposed new rates.

The OEB has developed templates for filing COS applications that were designed to assist LDCs in organizing the information to be provided. LDCs are required to file an application which usually includes many volumes of information. However, the current existing COS templates are too extensive and open to interpretation which results in unnecessary administrative burden on LDCs to compile this information.

Recommendation: Revise the Cost of Service Application Process

Develop/revise the standardized templates for filing COS Applications to make the filing process as standardized as possible. Limit the textual component of the application to explaining cost increases or just variances in general, and reduce administrative paperwork by 30-50 per cent.

Develop metrics to evaluate an LDC’s application provided in the standardized format.

OEB should provide updates or revisions to filing requirements well before the application deadline (i.e. in January but not in June – just two months before the application is due for filing).

Evaluate LDC’s COS application based on the metrics developed:

- **If within a permissible range – limited review of application (Note: range should be based on defined variables/cost drivers such as urban/rural mix, geography, underground plant, etc.)**
- **If beyond the permissible range – review of the application**

LDCs request that the OEB develop new and revised templates for filing COS application to make the filing process more standardized and confine the textual component of the application to explaining cost increases or variances in general. Significant effort is required to provide the level of detail required by the current template, and current practice among OEB staff and intervenors indicates that they focus on only a small portion of the entire application. There is an opportunity to reduce the amount of administrative work by 30-50 per cent while still retaining all relevant information simply by revising the templates.

To further facilitate the review of a COS application, the OEB should develop metrics including permissible ranges to be used to evaluate an LDC's application. If the information contained in the LDC's application falls within the established permissible range, the application could be efficiently evaluated through a more limited review. This permissible range should be LDC-specific and be based on defined variables/cost drivers which take into account the specific situation of the LDC such as urban/rural mix, the extent of underground plant and local geography, and other factors which influence costs. Once established, using metrics will reduce the administrative cost and the regulatory burden on both the OEB and LDCs resulting in significant cost and time savings.

Notwithstanding the above recommendations, any updates or revisions to application filing requirements should be provided well before the application deadline (i.e., a minimum of eight months prior to filing deadlines) to enable LDCs sufficient time to compile their applications well before the due date for filing.

Key Benefits:

A revised template that focuses solely on relevant information, coupled with pre-established evaluation metrics will reduce administrative activity and costs for all parties and facilitate timely approvals.

Challenge:

Requests for information from intervenors and OEB staff are essentially duplicative in nature, however are worded such that they appear subtly different, necessitating a tailored response. This results in additional administrative burden with limited added value.

The situation is further aggravated by the fact that many intervenors serve common interests, with some representing a subset of a broader interest group. Since intervenors are allowed to recover their costs, the amount of work undertaken by intervenors, along with their growing numbers, has led to a sharp increase in cost awards payable which ultimately is borne by the customer.

Intervenors are expert consultants or counsels who participate in the review of applications on behalf of customer groups they represent. Intervenors are eligible for cost awards from the applicant for their time spent in reviewing the application, preparing questions on the application and participating in the process.

Some intervenors appear genuinely interested in addressing the concerns of their constituents as effectively as possible. However, due to lack of proper safeguards, the current process has become cumbersome and more costly than strictly necessary. For example, questions appear to be designed to elicit more material than necessary to effectively review the applications.

The OEB has established rules to prevent abuse of the cost award process. For example, intervenors must demonstrate that they do not unduly repeat questions asked by other parties, that they make effort to co-operate with other parties to reduce duplication, or that they don't act to unnecessarily lengthen the duration of the process. Nevertheless, the current process does often result in duplication as intervenors do not always follow a coordinated approach in filing questions.

Compounding the issue is that both intervenors and OEB staff have the same deadline for filing their questions on the application. As a result questions are often essentially duplicative, but only just different enough to require a tailored response.

Intervenors are eligible for cost awards if they primarily represent the direct interests of customers or primarily represent a public interest relevant to the OEB's mandate, such as an environmental group. However, some intervenors do not appear to represent a unique interest as they represent a subset of a larger group of customers already represented by another intervenor, often leading to duplication of questions in the regulatory process.

In all cases, intervenor costs are ultimately reflected in rates, so it is in the customer's interest to ensure these costs are reasonable and controlled.

Recommendation: Revise the Intervenor Process

Reduce the duplication of effort between OEB staff and intervenors in raising interrogatories.

- **OEB staff to take leadership role and issue the first round of interrogatories**
- **Intervenors to review OEB staff interrogatories and only then raise their own interrogatories without duplicating staff effort**
- **OEB staff should screen interrogatories from intervenors for duplication, relevance and materiality**

Intervenors should represent a clearly definable/distinct interest that is relevant to the issue being reviewed and OEB should be more strict in providing intervenor eligibility

Establish a cap on cost awards provided to intervenors so that costs and benefits of their review are balanced

Revise cost award eligibility rules so that parties with access to financial resources are not eligible for total cost recovery e.g. only 80 per cent of recovered through cost awards

Intervenors could act jointly in order to qualify for joint funding

There is opportunity to reduce duplication of requests for information by having OEB staff take on a greater leadership role in the entire application review process. OEB staff could develop the preliminary list of questions (i.e. interrogatories) on LDC applications. Intervenors would then be required to review the OEB staff interrogatories prior to submitting their own interrogatories with the requirement that these questions not be duplicative. OEB staff would screen the interrogatories for duplication, relevance and materiality before issuing them to the LDC applicant.

In order to encourage intervenors to make best use of resources, the EDA proposes that the OEB establish a cap on cost awards for each proceeding. The cap would be based on the anticipated effort required, as presently done for some OEB consultations. This would encourage intervenors to focus on issues that are material and help ensure the cost awards are better balanced with the benefits they provide.

To keep overall costs of the proceedings reasonable, the EDA proposes that cost award eligibility rules be revised so that parties with access to financial resources are not eligible for total cost recovery e.g. only 80% of expenses are recoverable through cost awards. This would encourage groups being represented by intervenors to undertake more active oversight of the work undertaken by the consultant/counsel working on their behalf. Presently, there is no cost driver to encourage groups to adequately oversee the intervenors working on their behalf and ensure their interests are being represented efficiently and effectively.

Intervenors should represent a clearly definable and distinct interest that is relevant to the issue being reviewed. There is an opportunity for the OEB to tighten rules around intervenor eligibility. This approach

would reduce the overlap among intervenors and reduce the costs associated with funding two groups essentially representing the same interest.

Key benefits:

The proposed changes to the intervenor process will ultimately reduce costs associated with regulation and lead to more timely assessment of LDC applications. In addition, intervenors would be more focused on issues material and important to the groups they represent.

Ultimately, the customer would benefit from regulatory cost reductions in the form of more stable, affordable rates.

Additional Recommendations:

The OEB should conduct periodic review (every two to three years) of the reporting requirements to examine relevance and to avoid duplication.

The Social Agency Role for LDCs should be removed.

New requirements that involve significant implementation efforts should be coordinated between agencies and government to reduce overlapping implementation timelines that impact on LDC workload.

LDCs should not be compelled to take on the role of acting as a social agency. Recent examples include the requirement of LDCs to assist low income customers by adopting special customer service rules. The role of assisting low income customers should remain with social agencies that have the expertise and infrastructure to provide this assistance. LDCs should not be burdened with the administrative costs of implementing such social programs.

Conclusion

LDCs are experiencing increasing resource pressures associated with the steadily increasing regulatory burden year-over-year. The current regulatory process needs to be streamlined and simplified to reduce regulatory and administrative burdens in the interest of customers, LDCs and shareholders.

Implementation of the proposed recommendations will:

- Avoid sharp rate increases caused by the current regulatory approach and move to gradual rate changes.
- Reduce administrative/regulatory burden on both the regulator and LDCs.
- Reduce the undue financial burden on LDCs.