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Ontario Energy Board

SPEECH

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Check Against Delivery

Good morning everyone!

It's good to be with you again. This is the third time I have had the pleasure of speaking at one of your annual meetings.

Let me begin by expressing my appreciation for all of the hard work you've done over the past year. Most of you are rolling out conservation programs; you've worked with us on implementing the new Regulated Price Plan; contributed to the 2006 distribution rate consultation process, the Conservation and Demand management Handbook and the Cost Allocation Project.

A busy year, to be sure! And without your involvement, we would not be getting it all done. So thanks to all of you.

A few years ago, I was in Thailand and visited a monastery that was built at the very top of a huge cliff. The only way to get to the monastery was to be suspended in a basket, which was hauled up to the top by several monks, pulling with all their strength. I can tell you, that was one harrowing ride! But just as we were about half way up, I noticed that the rope was old and frayed. I called down to the monks and asked them how often they changed the rope.

There was a long silence and then one yelled up, "whenever it breaks."

Well, when it comes to energy regulation, we cannot wait until the rope breaks! We have to anticipate challenges and get ahead of them. We need to get ahead of the curve.

When I spoke with you last year, I indicated that the OEB was working on a plan to do just that. This morning, I'd like to speak to that plan and begin by laying out a very specific schedule for the OEB's priority that affects you most directly - setting electricity distribution rates over the next few years.

We believe this plan offers real benefits to you – not only in terms of providing opportunities for greater efficiencies, but also in terms of greater predictability.

Almost all of you have applied to the Board for changes to your distribution rates for 2006. This is the first year that your applications have been part of a full regulatory rate-setting process and I know it has meant a tremendous amount of work for all of you.

We expect to start rendering our decisions on your applications by late March, to take effect, as you know, on May 1st.

Well, if we're right in the middle of the current rate setting process, why do I want to talk about rate setting in the future? Two reasons. First, because you have told us that you need more predictability, more certainty in the process. And second, you have told us that timeliness is a big concern for you. We share your view, these things are important to us as well.

And so today I want to tell you how we are moving on both of these issues and my hope to see that implemented in the rate-making process over the next few years. With a clear idea of what's ahead - and what to expect – we will all be in a better position to plan our work and execute our plans into the future.

Let me talk to you about the basic plan.

First, to the year at hand. In 2006, we will focus on three things:

- Number one, review the cost of capital and rates of return for utilities;
- Number two, we will develop a simple rate adjustment mechanism that provides incentives and reduces regulatory burden. And finally,
- We will review the results of our cost allocation work and implement that which is material and prudent to do.

Next year, 2007, we will be focusing on three key issues in preparation for 2008 rates:

- We will continue to work on the comparators and cohorts project that was begun in the 2006 EDR;
- We'll look at standards for depreciation, working capital and other elements of distribution utilities' revenue requirements that had been deferred from the 2006 EDR;
- And finally, we will adjust rates using a simple incentive rate adjustment mechanism. A plan that I'll call "second generation" performance-based rates.

Next year, 2007, is the last year we expect that all of the distribution utilities will be before the Board at the same time. That's because we'll be taking a more selective approach to rate reviews in the future.

In 2008, we expect only about a third of LDCs to have new, re-based revenue requirements on which rates need to be set, while the remainder will stay on the second generation incentive rate mechanism.

We also expect that the utilities which have their rates re-based in 2008 - and thereafter - will operate under what I will refer to as "third generation incentive rates." The other two-thirds of the companies will be coming forward in 2009 and 2010 so that we have a staggering of when utilities come to the Board for a full review.

This has implications for the cost allocation project that many of you are involved in. This Fall, we expect to see cost allocation filings from most utilities. This could amount to more than 87 information filings, to be analyzed by staff and the results considered by the Board. That's a lot of work between the Fall and Spring of next year if all 87 utilities are involved!

That's why we're proposing a selective approach, dealing with only the most pressing cost allocation issues - if any are found to be material – for implementation in 2007. Our rate plan anticipates that we would continue to implement cost allocation "reform" in 2008 and onward, again on a prioritized basis.

What's more, this staggered approach will allow us to consider what changes to rate design and rate classifications might result from the introduction of smart meters and the development of a culture of conservation in Ontario.

At the Board, we're working on two key projects to address all of these issues. First, we'll continue our work on comparators and cohorts, with the goal of using this as a major tool in screening and prioritizing utilities for rate review.

And second, our policy group, headed by Marika Hare, will be focusing on distributed generation, smart meters and conservation policy and how these might affect charges for distribution services.

So that's the plan for the next couple of years. But why are we going in this direction? Why those priorities? Well, first of all because as the regulator, we have certain responsibilities - to you and to your customers.

To consumers, we are responsible for ensuring that the rates they pay are just and reasonable, regardless of the number of utilities in this province or the differing cost structures that those utilities might have. This can only occur through a regulatory framework designed to optimize utilities' efficiency.

And to you, the distributors, we have the responsibility to ensure a fair rate of return for your investors. In fact, rates can only be considered just and reasonable if they have taken into account prudently incurred costs and reasonable rates of return.

We also have a responsibility to regulate you as fairly and efficiently as possible. I think you would agree that the current situation - in which the OEB requires more than 87 utilities to apply to change rates at the same time - is not optimal.

The Board has heard your concerns and has seen how the current process taxes our own resources as well as yours. That is the reason that we have worked to evolve to a better process that allows us to customize our approach to reflect your particular circumstances.

Our staggered approach - to review in detail only about a third of the distribution utilities in any given year - just makes sense. It allows us to focus on the greatest needs in light of an evolving energy policy environment, while improving efficiency under a multi-year rate scheme.

As you know, incentive rates will be the cornerstone of how we regulate the natural gas sector. Yes there are differences between the two industries, but it might be instructive to look at how they will work for gas.

In the gas sector, we are moving to multi-year incentive rate regulation for several reasons. First, setting rates for one year at a time does not facilitate long-term investment planning - and we wanted to send a clear message that Ontario has a stable plan in place that can sustain long-term investment in infrastructure and services.

We also wanted to provide customers with a longer term pricing horizon so that they can operate in a more predictable environment.

Second, cost of service has not provided sufficient incentives for efficiency - and to the extent that it does provide incentives, it does so in a somewhat contentious environment - as some of you know all too well!

Incentive rate plans, by contrast, provide much better inducements to efficiencies - and that benefits everyone.

Of course, there's no greater incentive to efficiency than higher earnings and we're asking ourselves whether distributors shouldn't be able to keep more of the revenues realized through improved operations. At the moment, and so long as service quality is not compromised, we don't see any reason why utilities should not share in some of the benefits of improving efficiency. Indeed, that is likely to be the greatest incentive for achieving such efficiencies.

I have said before there is a basic principal of economics, that all people respond to incentives.

There's another advantage to this approach as well: we'll see less of each other. And I mean that in the kindest way! You won't have to go through the process every year and we won't have to handle as many as 87 applications at one time. That will reduce the regulatory burden on you and should improve the timeliness of the response we can provide.

Of course, we will not do it all in the first year. But gradually, as we learn more and as stumbling blocks are removed, we'll make steady progress toward a more "ideal" regulatory regime.

I've spoken this morning of second and third generation incentive rates. You might remember that first generation performance-based rates were introduced when the Board unbundled rates and allowed a fair market rate of return to be earned, together with an incentive rate adjustment. However, the rate freeze came and this first generation of incentive rates never got off the ground.

But we learned something. And this time around - in the second generation - rates are going to be simpler and faster. Faster in the sense of having an incentive mechanism in place to adjust rates in 2007. And simpler in the sense of being straightforward - easy to develop and to implement.   In other words we're developing a good incentive rate plan now while working on better plans for the future.

Why this two step approach? Why not just go directly to the better scheme? Well the fact is that utilities face different challenges and this makes it difficult to measure the cost-effectiveness of their service delivery. A one size fits all approach unduly rewards those who need to do better, while under rewarding those which are already running efficiently.

That's why we are working hard on developing a useful comparators and cohorts tool. As this tool matures, we will be able to rely on it with increasing confidence to hopefully flag potential areas that warrant a closer look. I would expect that the development and use of this tool is of equal importance to you in the operation of your businesses.

After all, benchmarking is not a new concept that emerged as a result of the new regulatory environment or the commercialization of the sector. The use of benchmarking tools to self-assess utility efficiencies has been a practice of yours for quite some time. We are aware of that. We hope to develop incentive rate making systems that recognize the difference between prudently incurred costs and inefficiencies of LDCs.

To that end, it is important that we continue to work together in developing an effective comparison tool. One of our priorities in 2006, as I mentioned, is to work with you on the regulatory accounts to ensure that we have consistent data from all LDCs.

To be sure, Ontario's large number of LDCs presents us with some regulatory challenges. But it also offers some real opportunities. And with such a large number of utilities in one regulatory jurisdiction, we can tackle many of the issues that normally hamper bench marking.

For example, we don't have to sort through differences in tax treatment, accounting practices or regulatory policy that so many bench marking studies struggle with.

The third generation performance-based rates we're working to build will use the knowledge we gather from our work on comparators and cohorts. We want to develop a rate-making mechanism that recognizes that there should be greater rewards for those LDCs who do better than the average. On the other hand, those LDCs that cannot attain the industry norm should be encouraged to improve their performance.

We see comparators and cohorts as a critical tool - and an important part of moving to incentive rates. Our challenge - together - is to develop a comprehensive and understandable approach.

And that's the key word - comprehensive. The fact is, we as an industry need to ask - and answer - some big questions.

For example, how should rates be designed when every consumer in Ontario has a smart meter?

Some have argued before our Board that distribution rates should be 100% fixed to match the fixed nature of distribution costs. Others, looking at it from a conservation perspective, have argued that rates should be 100% variable to provide the maximum incentive to customers to reduce consumption.

Which is right? Fixed or variable? Or should we stick with a mix of both, as we have now? If so, should we have consistency in the fixed rate, as was suggested in the Badali Report?

We also need to ask what the implications of smart meters will be on rate classes.

When the time comes when everyone is measured by the hour or the minute, does an over 50kw or under 50 kw class make any sense? Is there really a cost difference to service a small business versus a large home? What, if anything, is significant about a "residential" class if all customers' demands can be measured?

Twenty years ago the telephone industry struggled with the implications of digital technology. Does smart meter technology mean we should consider similar fundamental change? Should we forget about trying to figure out who uses a service and design rates based on how people use the service?

These are the kinds of questions that we're wrestling with - and that all of us must answer. And these are the types of issues our policy staff will be studying over the coming months.
And because we don't yet have all the answers, we need to take a cautious approach to such things as today's cost allocation project. What parts of that project does it make sense to implement today in light of potential changes to rate classification in the future?

So we have to be prudent. We have to take our time and do this right. Look before we leap. And candidly acknowledge that there is simply too much that is unknown at the moment to jump to some kind of end point. That way, we won't waste your time, our time, or ratepayers' money.

It's also about having a plan that anticipates changes. This is a difficult environment for the Board to be altering the traditional methods of regulation. But that's our plan. We want to reduce the regulatory workload on you although at the moment, I know that's probably not your impression! Our current combined efforts are a necessary and sound investment that is establishing the basis of the more sustainable and rewarding rate setting mechanisms that I have described here today.

I want to just briefly mention some of the other initiatives before the Board this year.

Work is proceeding on the Natural Gas Electricity Interface Review (NGEIR). There are annual delivery rates cases for Union Gas and Enbridge Gas Distribution Inc. This year we will be reviewing the regulatory framework for the recovery of conservation and demand management expenditures by natural gas distributors. In the midst of all of this we will be reviewing the Integrated Power System Plan for the province that is being developed by the Ontario Power Authority.

So as you can see, we have a very full agenda for the next few years. Implementing change, step by step and phase by phase. Learning as we go, but also preparing ahead of time for the issues that we'll face. Doing our homework. Developing our policies.

And using the overhaul of rate making to address such key issues as cost allocation, cost of capital, smart meters, conservation and rate design. A comprehensive approach to comprehensive change.

Throughout this process, we're committed to working with you. Our respective roles are intertwined but we have very distinct responsibilities. Yours is to utilize the expertise you have developed in over a century of proud service to this province while seeking out and employing new innovations in running your businesses.

Ours, as an economic regulator, is to set fair and reasonable rates that provide you with your required revenues and also to establish the environment that will drive your pursuit of innovations. The plans that I have spoken about today are presented with these distinct responsibilities in mind.

You have demonstrated time and time again your willingness to participate and assist in the evolution of this sector. We look forward to continuing this constructive relationship with all of you.