Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

Presentation on 2nd Generation Incentive Regulation

to Participants of September 18 22, 2006 Technical Conference

Outline

- 2nd Generation IRM in staff's July 25, 2006 discussion paper
- Responses to Guide for Presentations at this Conference
- Q&A

Cost of Capital and 2nd Generation IRM

Guiding Objectives

- Protect customers in relation to prices.
- Predictability and stability.
- Promote economic efficiency by providing appropriate pricing signals and system of incentives for distributors to maintain appropriate level of reliability and quality of service.
- Ability to raise the financing necessary to invest in distribution infrastructure to enhance service quality and reliability.
- Minimize the time and cost of administering framework.
- Establishing a common capital structure and incentive framework for all distributors.

2nd Generation IRM Staff s July 25th Discussion Paper

Mechanism Element	2nd Generation
Adjustment for cost of capital (K-factor)	% based on change in ROE (2007) and cost of capital (2008)
Base	2006 Rates
Form	Price Cap
Term	*Up to* 3 years (per Rate Plan)
Price Escalator	Canada GDP-IPI (Final Domestic Demand)
Input price and productivity differential, and stretch factor (X-factor)	1%
Contingencies (off ramps, Z-factors)	Z-factors limited
Earnings Sharing	None
Service Quality Requirements	To be enforceable as a condition of licence
Smart Meter Funding	Adder to the fixed rate
Conservation & Demand Management	On application

Responses to Guide for Presentations

There are different views on what elements are important to a successful IR mechanism, even if it is transitional

- What elements, if any, do you believe are of particular importance to 2nd Generation IRM (i.e., price escalator, X-factor, Z-factors, off-ramps, earnings sharing, service quality, other)?

- The price escalator, X-factor, service quality and Z-factor elements are of particular importance to 2nd Generation IRM to provide a reasonable and formulaic adjustment to rates for up to 3 years.

Responses to Guide for Presentations

Other empirical approaches that might be considered to determine an appropriate X-factor

- What empirical approaches might be considered to determine an appropriate X-factor, either in common for distribution companies or segmented into groups?

- There are no empirical approaches that appear to have support amongst stakeholders.

Responses to Guide for Presentations

Stretch factors

- What reasons can be provided to include a stretch factor?

- To provide a benefit to consumers for the added flexibility afforded to the company under incentive regulation.

Responses to Guide for Presentations

Making interim adjustments to rates due to changes to the cost of capital

- If the cost of capital is adjusted prior to the rebasing of distribution rates, should a mechanism be created to make interim adjustments to rates? If so, what mechanism might be appropriate? Are there any implications to not making interim adjustments?

- Assuming that the cost of capital methodology will be adjusted prior to re-basing, staff suggest the K-factor as an accelerated adjustment to rates:
  - to smooth the impact of the changes for distributors (if rate decrease) and ratepayers (if rate increase); and
  - to make distributors indifferent to when they are re-based.

Responses to Guide for Presentations

Z-factors, off-ramps, and earnings sharing mechanisms

- What possible consequences should the Board be aware of when determining the use and role of these mechanisms in 2nd Generation IRM?

- The larger the number of off-ramps, the greater the uncertainty.
- The greater the uncertainty, the smaller the incentive to improve productivity.