Incentive Regulation
- Business Considerations

Coalition of Large Distributors (CLD)

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Overall Considerations

- 2nd Generation IRM has been defined as "transitional" by Board staff
- For a transitional period, the use of a rate cap mechanism is not unreasonable – but the short duration is not likely to create incentives
- The somewhat arbitrary nature of the proposed adjustment mechanisms is concerning, but the CLD recognizes the short timeline to implement a rate adjustment for 2007 rates
- The use of a "K" factor is unusual and essentially rebases one element of costs without rebasing others – the "K" factor should be dropped
- The CLD submits that adjustments for capital programs are essential for those LDCs with pressing requirements for infrastructure renewal or expansion.

Inflation Factor

- Ideally, this component should be closely tied to the inflationary pressures specific to the Ontario electricity industry
- Present and future cost pressures include:
    - collective agreement settlements typically in the 3% range (which represent a substantive portion of costs),
    - costs of changing and more onerous regulatory environment (eg. billing and call centre cost for Time-of-Use RPP, changes to EBT, Standard Offer program administration etc.)
    - hiring and training of new trades staff to address aging workforce
    - rising fuel costs
    - benefit, pension and insurance costs
    - increased bad debts due to rising costs
- For rate adjustments in May 2007 either GDP-IPI or CPI could be used – the selection of the index should take into account the industry-specific cost pressures noted above
- The CLD would be concerned about enshrining GDP-IPI in code since it is not clear how well it tracks to the cost pressures of LDCs.
- LDCs that do not rebase in 2008 should have the opportunity of proposing a different inflationary measure

Productivity Factor

- Ideally, productivity adjustments should be based on experience of Ontario LDCs. However, for May 2007 a generic productivity factor, not including a stretch factor, would be reasonable.
- Considerations should include:
  - the long period of LDC rate freezes (most did not have rate increases for local operating costs between 1993 and 2006) therefore efficiency and productivity improvements most easily implemented have already been done – future improvements will be more difficult and costly
  - LDCs are facing aging plant and workforce – eg. increased maintenance costs and incremental costs of required apprenticeship programs
  - There is no clear consensus on how to calculate productivity for LDCs
- A 1% productivity factor seems excessive given all of these considerations
- LDCs that do not rebase in 2008 should have the opportunity of proposing a different productivity measure.

K Factor

- Cost of capital issues should be reviewed thoroughly by way of a hearing.
- LDCs have been under significant constraints in recent year with frozen rates, while having to incur additional regulatory and settlement costs.
- The K factor proposed by Board staff will be barrier to the kinds of capital investments LDC need to make in upcoming years.
- Introduction of a K factor essentially results in rebasing one element of the costs of service without the others.
- No K factor is required for 2007

Z Factor

- LDCs should be able to file an application to the Board to make their case for any Z factor reflecting costs that are material, prudently incurred, outside the control of management and beyond the costs included in the current revenue requirement.

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Capital Program Adjustment Factor

- The CLD is concerned with the lack of any adjustment for capital programs. Rebasing in 2008 therefore becomes essential for many LDCs. The OEB could be faced with far more than 1/3 of LDCs filing rate applications for 2008 unless consideration is given to capital expenditures.
- Hydro One, Toronto Hydro and Hydro Ottawa, the only three LDCs who filed on a forward test year for the 2006 EDR, all presented evidence on the issue of aging infrastructure and the significant increases that would be required in capital spending in the next decade.
- The Board must address this situation or the ability of LDCs to maintain reliable and cost effective distribution systems will be impaired.
- If the Board provided assurance that it would consider multi-year capital plans at the next cost of service application, it would alleviate but not eliminate the concern.

Service Quality

- Members of the CLD have participated in a working group to review service quality indicators, and are interested in participating when the OEB reconvenes these discussions.
- The OEB needs to be aware that changes in service quality indicators (assuming the measures become more stringent) can result in significant increases in costs to LDCs. Therefore, changes need to be aligned with appropriate rate adjustments.

2008 Cost of Service Application

- The CLD reminds the OEB that as part of the 2006 EDR, the Board issued a Report advising LDCs that they would be allowed to rebase in 2008. The decisions of many LDCs to file on a historic test year were based on this assurance. It would therefore seem only reasonable that the OEB allow any LDC that wants to rebase in 2008 to be part of the 1st group.