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Memorandum
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To: Clients & Friends

From: Mark Rubenstein

Re: <u>Bending the Delivery Rates Cost Curve</u>

A. Summary

Last week the Government of Ontario released its *2018 Ontario Economic Outlook and Fiscal Review* re-affirming its previous commitment to further reducing electricity bills by 12%. One area which has received much less public attention is the delivery line on customers' bill which are made up of distribution and transmission rates that are regulated by the Ontario Energy Board ("OEB").

Based on our experience, here are five simple ways the OEB could reduce electricity bills right now, creating long-term savings and not simply shifting costs from ratepayers to taxpayers:

1. ***Reduce Profit Levels for Regulated Utilities By Reviewing Capital Structure.*** Electricity transmission and distribution utilities have their capital structure set by the OEB so that they finance 40% of their capital with equity and the other 60% by debt. The higher the level of equity, the higher the profit. The OEB should review the capital structure of electricity distributors which has not been reviewed in almost a decade and is now at a level much higher than in other provinces, as well as the level set for Ontario gas distributors.

2. ***Set A Rate-Setting Productivity Factor for Distributors At Target Levels, Not Levels Based on Poor Historical Performance*.** Most utilities have their rates set through the use of a formula, either entirely, or as part of an approved multi-year plan. The OEB's current formula includes no expectation of productivity in the future. If the formula included a productivity expectation annually, rates would decrease annually.

3. ***Share the Benefits of Consolidation with Customers.*** The OEB encourages consolidation of electricity distributors by allowing them to keep the savings from the consolidation for ten years. If the shareholder benefits from consolidation were limited to a reasonable return above their costs to achieve it, rates would, over time, be lower. Alternatively, splitting the benefits equally between customers and shareholders for the first ten years would provide some of the benefit to customers, but sooner.

4. ***Capital Spending Fairness Between Customers of Large and Small Distributors*.** Unfairness exists for customers from the inclusion in rates of capitals depending on the rate-setting plan their distributor chooses. Customers of large utilities, who have their rates set based on Custom IR, pay for all capital as extra rate increases. Customers of other utilities only pay for some additional capital, and only above a certain threshold. The OEB should ensure that the threshold is applied to all rate-setting approaches.

5. ***Balance the Voice of the Utilities and the Voice of the Customers More Evenly.*** Currently, the utilities continue to press both the OEB and the Government to reduce the regulatory burden,

particularly the scrutiny of their applications by customer groups. This is pitched as a reduction of red tape, but it is really code for reducing oversight of their requests for more money. While ensuring the correct balance is important, the Government and the OEB should see through this transparent attempt to increase rates even more. The OEB should instead ensure that the customers' voice is given a more – not less - prominent place in their decision-making. The voices of the customers in rate cases, and in regulatory policy development, are central to bending the delivery cost curve.

B. Bending the Cost Curve

The Government of Ontario released its 2018 Ontario Economic Outlook and Fiscal Review on November 15th, and re-affirmed its commitment to further reducing electricity bills by 12%.[1] Much of the public discussion is about reducing commodity costs, but one element of any plan should be reducing the delivery line of customers' bills, which is made up of distribution and transmission costs regulated by the OEB.

The independence of the OEB is important, but there are ways in which it can both help this important Government objective, and further its own statutory mandate to protect consumers with respect to the price of electricity.[2]

In reducing customers' bills, the Government should prioritize efforts that achieve long-term cost savings to bend the cost curve, as compared to those that simply shift costs between ratepayers to taxpayers. Regulated utilities are pushing the government to change the regulatory rules for their benefit. While they argue that the changes they propose will benefit customers by reducing rates, none of their proposals are about utilities having lower revenues. In fact, the opposite is likely to occur.

1. Reduce Profit Levels for Regulated Utilities By Reviewing Capital Structure

In the rate-setting process, regardless of a utility's actual capital structure (debt vs. equity), the OEB determines an appropriate capital structure based on the prevailing business and financial risk. This is the foundation for determining the appropriate cost of capital. The higher the level of equity, the higher the profit level of utilities, and the higher the amount included in customers' bills. Cost of capital is the largest cost element for wires companies.

The OEB has not undertaken a comprehensive review of its cost of capital policy since 2009, and has not carried out *any* review of the appropriate equity level for electricity distributors and transmitters, which continues to be set at 40%.[3]

Since 2009, the financial and business risks of utilities have significantly changed, not only because of industry and regulatory changes, but also due to changes in the broader business climate. In 2009, Ontario was still feeling the impact of the 2008 global recession, which had a significant impact on all sectors of the economy, including regulated utilities. While there may be a greater risk today due to increasing use of behind-the-meter generation, this has been more than offset by the OEB's implementation of full fixed residential distribution rates, which has had a significant impact on the risk profile of distributors. They are now insulated from weather and usage risk for 90% of their customers.

In Alberta, which also had deemed equity levels of 40-41% in 2009, subsequent cost of capital reviews in the last decade have gradually lowered them to now a uniform 37%.[4] In Ontario, gas distributors have had their deemed equity level set at 36%.

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[1] *A Plan For the People: Ontario Economic Outlook and Fiscal Review 2018,* p.48 <https://www.fin.gov.on.ca/fallstatement/2018/fes2018-en.pdf>

[2] *Ontario Energy Board Act, 1998*, section 1(1)1

[3] *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities* (EB-2009-0084), December 11 2009

The OEB should initiate a review of its cost of capital policy, so that the appropriate equity thickness can be analyzed and explained. The likely outcome is a lower deemed equity level which would provide savings to customers.

A reduction of just 1% in the equity thickness would result in about $22M in savings to electricity consumers. [5] Setting the deemed equity level at the same level as Ontario's gas distributors would result in $88M a year in savings.

2. **Set A Rate-Setting Productivity Factor for Distributors At Target Levels , Not Levels Based on Poor Historical Performance**

Central to all three of the OEB's rate-setting methods (Custom IR, Price Cap IR, and Annual IR) for electricity distributors has been the use of an index approach, which reduces inflationary or other annual rate adjustments by an X-Factor. The OEB's X-Factor is made up of the sum of a productivity and stretch factor. Since 2013, the Board has determined that the productivity factor would be set at 0%, based on the empirical evidence that the Ontario electricity distributors had in the previous 10 years had *negative* productivity growth.[6] Distributors were becoming increasingly inefficient.

In contrast, using similar empirical methods, the evidence was that the United States' electricity distributors were seeing positive productivity. [7] A more recent study looking at US electricity distributors shows that the trend of positive productivity growth remains.[8] There is no reason why Ontario electricity ratepayers should expect Ontario distributors to perform worse than US distributors.

The Board sets the productivity factor based on Ontario distributors' historic productivity levels. By doing so, future productivity for rate-setting purposes is determined by past poor performance. This has created a circular problem where poor performance justifies low expectations and higher rates.

The original report indicated that the Board's intention was to update the productivity factor again in 2019.[9] Its most recent business plan (2018-2021) makes no reference to undertaking such an update.[10]

The OEB should undertake an update to its incentive regulation productivity factor which uses not just Ontario distributors' historical productivity levels, but also reasonable productivity levels that should be expected in the future.

A positive productivity factor would have the effect of reducing the amount paid by ratepayers. For example, if the OEB adopted a productivity factor based on US distribution productivity trends (0.22%) then it could reduce the amounts included in distribution rates by over $7M a year.[11]

3. **Share the Benefits of Consolidation with Customers**

Under the OEB's current framework for electricity distributor consolidation, the consolidating distributor is allowed to determine a period of up to 10 years before they are required to have their

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[4] *Decision 22570-D01-2018,* 2018 Generic Cost of Capital (Alberta Utilities Commission), August 2 2018
[5] Based on data from the 2017 OEB Yearbook and the 2017-18 Hydro One Transmission rate case (EB-2016-0160).
[6] *Report of the Board Rate Setting Parameters and Benchmarking under the Renewed Regulatory Framework for Ontario's Electricity Distributors* (EB-2010-0379), December 4 2013
[7] *See* chart undertaken by Pacific Economic Research on various productivities studies it undertook for sample periods between 2002 and 2011. <http://www.pacificeconomicsgroup.com/whats-new.html>
[8] Lowry et al, *State Performance-Based Regulation Using Multiyear Rate Plans for U.S. Electric Utilities*, July 2017
[9] *Report of the Board Rate Setting Parameters and Benchmarking under the Renewed Regulatory Framework for Ontario's Electricity Distributors* (EB-2010-0379), December 4 2013, p.13
<https://eta.lbl.gov/sites/default/files/publications/multiyear_rate_plan_gmlc_1.4.29_final_report071217.pdf>
[10] Ontario Energy Board 2018 to 2021 Business Plan
[11] Based on 0.22% of the 2017 distribution revenue from the 2017 OEB Yearbook.

rates re-set.[12] During this rate-setting deferral period, while the distributors cannot pass on the costs of the transaction or integration, they get to keep the savings generated, with a limited exception[13], for the entire period. The deferral period is meant to act as an incentive for distributors' shareholders.

The problem with this approach is that distributors will not pass on any savings generated from the consolidation for 10 years to customers. This is a significant period of time in which customers are not sharing in the benefits that consolidation is supposed to bring.

The OEB's decision in 2012 to double this deferral period from 5 to 10 years was not based on any empirical evidence, and it was not in any way linked to the specific cross-over point in which the savings exceed any transaction and integration costs for any given consolidation.

Assuming that a financial incentive is required, and that it is to be determined by deferring the rebasing period, the OEB should set the deferral period as a function of the forecast cross-over period of the consolidated distributor. For example, a consolidated distributor whose cross-over point is in year 3 does not receive the same deferral period as a consolidated distributor whose cross-over period is in year 7. This would ensure that the incentive is set at an appropriate level for each transaction, and there is alignment between the incentive and the timing of sharing savings with customers.

At the very least, the OEB should ensure that customers share equally in the benefits, by requiring that all savings are shared 50-50 with customers during the deferral period.

The Government has recently affirmed its commitment to consolidation by extending certain time-limited transfer tax incentives, and an exemption for capital gains under the deemed disposition rules.[14] But if the goal is to lower electricity rates through consolidation, it must ensure ratepayers, not distributor's shareholders, are the primary beneficiaries of electricity sector consolidation.

4. Capital Spending Fairness Between Customers of Large and Small Distributors

Under the OEB's most common rate-setting method, Price Cap IR, rates are initially set on a cost of service basis, and then adjusted annually by a formula of inflation minus an X-Factor for the next four years (known as the IRM period). The OEB allows for certain additional capital above that to be funded through the formulaic adjustment. Those costs are passed on to ratepayers through what is known as the Incremental/Advanced Capital Module (ICM/ACM).

The OEB requires that the incremental amount that is eligible for additional funding be reduced by 10% (known as the "dead band") to reflect two things. First, there is a natural imprecision in the rate-setting model and the data it uses. Second, a distributor's management is expected to control or influence what is needed from a cost and operations' perspective. A materiality threshold ensures that a certain amount above what is funded in rates is the responsibility of the utility during that IRM period.[15]

Most large distributors, such as Hydro One and Toronto Hydro, have their rates set by way of a Custom IR, not Price Cap IR. Under this method, the capital portion of rates is set for the entire 5 year period on a cost of service basis, with a small adjustment to account for productivity.

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[12] For full details, Ontario Energy Board, *Handbook to Electricity Distributor and Transmitter Consolidations*, January 19, 2016

[13] The limited exception is that between years 6 and 10, the consolidated distributor or transformer is required to share equally all earnings over 300 basis points on its approved return on equity.

[14] *Plan For the People: Ontario Economic Outlook and Fiscal Review 2018,* p.50 <https://www.fin.gov.on.ca/fallstatement/2018/fes2018-en.pdf>

[15] *Report of the OEB: New Policy Options for the Funding of Capital Investments: Supplemental Report* (EB-2014-0219), January 22 2016, p.16-18

The Custom IR rate-setting method is intended for distributors and transmitters who have significant capital needs that could not be funded under Price Cap IR. The problem is that, under this method, utilities are able to recover during the term of their plan all capital spending. There is no similar dead band of 10%, as is required for those who utilize an ACM/ICM under Price Cap IR. This is unfair to customers. Because it generally applies to the larger, less efficient utilities, ironically it increases the rates for customers served by already high cost utilities.

The same rationale that the OEB used in setting the current dead band for ACM/ICM applies for distributors who have rates set by way of Custom IR. OEB Staff's own independent expert in the recent Hydro One distribution rate proceeding recognized this unfairness.[16] The OEB should set a dead band of 10% of approved capital in Custom IR applications, similar to its approach for those who seek ACM/ICM under the Price Cap IR.

5. Balance the Voice of the Utilities and the Voice of the Customers More Evenly

Unnecessary regulations can hamper economic growth. However, the electricity distribution sector is very different from most other sectors of the economy. It is made up of natural monopolies that do not face the pressure of the competitive market. Without proper and stringent rate regulation, they are able to pass on unreasonable costs to customers. Utilities come before the OEB because they are spending money that is recovered from ratepayers in rates. Someone needs to oversee their increases in rates.

Utilities continue to press both the OEB, and the Government, to reduce the regulatory burden. This is pitched as a reduction of red tape and regulatory burdens. The Government has taken a keen interest in reducing red tape, and has even launched a province wide consultation on the issue.

While all stakeholders, including customers, have an interest in cutting unnecessary red tape, the Government and the OEB must be careful since in most cases less regulation of these monopoly distributors and transmitters will lead to higher customers' bills, not lower.

The OEB and the Government should be vigilant about imposing new regulatory requirements that serve limited value. By the same token, they should be very skeptical of the claims of red tape and regulatory burdens by monopoly utilities. In most cases, utility advocacy is really not about reducing costs for customers. It is about ensuring that there is less oversight of their requests for more money from customers. Utilities don't want less regulatory burden so that their revenues will be lower. That is not their goal. Their goal is less thorough review of their budget increases.

The utilities would like their voice to dominate ratemaking and policy development, while at the same time they limit the voice of the customer. This is the wrong balance. The Government and the OEB must ensure that the experienced customers' voices are given more – not less - prominent place in decision-making. The voices of the customers in rate cases, and in regulatory policy development, are central to bending the delivery cost.

For more information or if Shepherd Rubenstein can provide you or your organization with assistance, please contact Mark at mark@shepherdrubenstein.com or at 647-483-0113.

[16] EB-2017-0049, Exhibit M1, Mark Lowry (Pacific Economics Group Research LLC), IRM Design for Hydro One Networks, April 13 2018,p.34-35

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Mark Rubenstein is a lawyer who focuses on regulated sectors, representing consumer and stakeholder interests before courts, agencies, and tribunals. Mark has a significant energy regulatory practice and regularly appears before the Ontario Energy Board representing clients in utility distribution and transmission rate applications, leave to construct proceedings, policy consultations, IESO market rules reviews, and a wide variety of other matters. He has sat on numerous Ontario Energy Board working groups and is currently a member of its Regulatory Affairs Standing Committee.