

3.4 Incentives to Improve Efficiency Under CoS Regulation

One of the principal reasons that IRM is an attractive option is the conviction that it will lead to greater and enduring efficiency benefits as compared to CoS regulation. A proper comparison to CoS regulation must reflect the fact that CoS regulation incorporates its own set of incentives. The relative strength of incentives to operate efficiently depends on the specific implementation details for both approaches but some general conclusions can be drawn.

For example, it is possible under CoS regulation for distribution utilities to retain all of the benefits of efficiencies (as well as profitable sales growth) between rate cases as long as the utility is able to avoid rate filings. There have certainly been historical periods where this has been possible due to growing sales, moderate inflation, CAPEX programs that contributed primarily to increased revenues, and the absence of regulatory requirements that dictated the timing of rate filings. More recently, the slowing of sales growth and extent of non-revenue producing CAPEX have led to more frequent rate filings at least for distributors, making it harder for them to retain efficiency benefits for extended periods under a CoS regime.

The perspective of some parties is that "regulatory lag" – that period between the time plant is placed in service and when its costs begin to be recovered through rates – creates an incentive under CoS to operate efficiently in order to offset the adverse earnings impacts of regulatory lag. Regulatory lag is a function of many factors but the three most important contributors are the definition of the test period, the rules that apply to post-test period adjustments, and the length of the regulatory review process. An historical test period based on average plant balances (as opposed to end-of-period) with minimal opportunity to incorporate pro forma adjustments that update plant balances results in a longer regulatory lag, all other things being equal. At the other end of the spectrum, a forward-looking test year with an opportunity to adjust rate base in response to CAPEX in subsequent years provides for a much closer matching between the time that plant is placed in service and when its costs are recovered from customers. However, in both cases, a dollar of efficiency benefit will be retained by the utility until its next rate filing, weakening the argument that regulatory lag contributes to more efficient operations.

One of the primary incentives reflected in CoS regulation is the threat of a prudence disallowance. Prudence reviews are after-the-fact reviews of either a major investment or a purchasing practice that provides a one-way penalty mechanism which creates an incentive to operate efficiently. The standards applied to prudence reviews are based on the exercise of reasonable judgment by the utility based on facts that existed at the time the decision was made. Thus, the threat of a prudence review promotes reasonable decision-making (and retention of documentation); its primary focus is not to drive improvements in efficiency. Prudence reviews are also not restricted to CoS regulation; they remain an element of regulation when IRM is applied.

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The ability to retain efficiency gains under CoS regulation is also a function of specific ratemaking policies. In some instances, the regulator may also decide that a change to a ratemaking practice is appropriate in order to encourage certain behavior. For example, the adoption of CAPEX trackers for a significant portion of non-revenue producing investments would allow the utility to “stay out” of a rate filing for a longer period of time. The reliance on variance and deferral accounts can also impact incentives in a CoS model. For example, many vertically integrated utilities recover the fuel, variable O&M, and purchased power costs attributable to electricity production through a separate variance account with balances that are passed through to customers. Absent a target and/or sharing mechanism the passthrough feature can reduce the incentive to minimize these costs although the threat of an after-the-fact performance review does act as a restraint at least with respect to imprudent behavior. This is particularly relevant with respect to OPG given the number of variance and deferral accounts that are currently in place (see Chapter 2.1.4).

A more frequent outcome over the last decade, particularly in United States jurisdictions, is resolution of rate filings through multi-year settlement agreements. These agreements are based on CoS principles but often include elements that are common to IRM such as second and third-year step increases, ESM, and specified timing for the next rate filing. In that sense, they are akin to multi-year IRM plans that have cast-off rates based on CoS. The utility may share confidential forecast information on their investments and expenses in order to facilitate a multi-year agreement.

With respect to rate design, the recovery of fixed costs through rates that are tied to sales (or production in a generation context) also influences utility incentives. For example, within Ontario, the existing prices for the prescribed hydroelectric and nuclear facilities are calculated as one-part commodity prices. The one-part rate provides an incentive to OPG to maximize production as recovery of fixed costs through a commodity rate flows through to earnings.

In summary, when designing an IRM for OPG, it is important to recognize that the existing CoS framework has its own set of incentives and that these incentives will change with an IRM. Thus, IRM does not represent a change from a system without incentives to one with incentives. Furthermore, both CoS and IRM approaches reflect an allocation of risk between the utility shareholders and customers. Evaluation of the merits of a specific IRM approach relative to the existing CoS approach should reflect these considerations.