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Our File: EB20240129

Attn: Nancy Marconi, Registrar

Dear Ms. Marconi:

Re: EB-2024-0129 – Advancing Performance-Based Rate Regulation – SEC Comments

We are counsel to the School Energy Coalition ("SEC"). Below are SEC's written comments on some of the major questions asked during the stakeholder meeting as part of the OEB's Advancing Performance-Based Rate Regulation consultation.

SEC is strongly supportive of the OEB's stated objective of the initiative "to strengthen the link between what electricity distributors earn and the achievement of outcomes consumers value, such as cost-effectiveness, reliability and customer service."[1]

Performance Incentive Mechanism

The OEB has said that it plans to incorporate Performance Incentive Mechanisms ("PIMs") into the current rate-setting process in the near term. If implemented correctly, the adoption of PIMs can improve the incentive structure for utilities by aligning their financial interests with outcomes that are important to customers in both the short and long term. However, if the metrics, targets, and reward/penalty structures are not properly designed, they may be ineffective, or even counterproductive by creating perverse incentives.

At its core, the OEB's role in rate-setting, from a customer's perspective, is to balance rates (costs) with the service received (primarily reliability, but also customer service). Those outcomes, rates, reliability, and customer service should be the focus of any PIM system. However, identifying the appropriate metrics to measure those outcomes is a more complex challenge.

SEC categorizes PIM metrics into two groups: primary and secondary. Primary metrics are those that directly address core outcomes (costs, reliability, and customer service). These may include broad-based cost-effectiveness measures (e.g. composite unit cost metrics, work achievement measures, total cost benchmarking results), traditional reliability measures (e.g., SAIDI and SAIFI), and metrics

[1] OEB letter, Advancing Performance-Based Regulation, Invitation to Stakeholder Meeting (October 9, 2024), p.1

for overall customer service satisfaction or performance. Secondary metrics address the core outcomes but focus on narrower components. Examples include metrics for the adoption of non-wires solutions (which impact cost-effectiveness), targeted customer-specific reliability measures (e.g. FESI-7, or reliability metrics based on cause code), and customer connection performance (a component of customer service). Secondary metrics allow the OEB to focus on specific areas needing greater attention or address public policy goals. Both primary and secondary metrics play important roles.

The OEB has asked stakeholders several questions, many of which cannot be fully answered at this stage of the consultation. To be most helpful, SEC believes the OEB should consider the following principles when designing any PIM system:

- ***Symmetrical System.*** A properly designed PIM system includes both rewards and penalties for performance. A system that only rewards distributors for superior performance is unfair to customers, while one that only penalizes distributors for not meeting targets may not drive the right incentives. SEC believes the system should be symmetrical and provide equal upside and downside risk for utilities.

- ***Limit the number of metrics and ensure they are transparent, objective, and measure outcome.*** The OEB should avoid creating an overly complex PIM system with too many metrics. Similar to the saying, 'if everything is a priority, nothing is a priority', SEC believes that if you measure everything, you measure nothing. The OEB should prioritize a limited number of critical and relevant metrics, ensuring a company-wide focus on achieving important outcomes. These metrics should be transparent to customers, objectively determined, and focused on outcomes, not activities, which is what customers care about.

- ***Metrics Should Balance Competing Objectives.*** The OEB should ensure that the selected PIM metrics balance competing objectives (costs, reliability, and customer service). A system overly focused on reliability and service metrics, for example, will almost certainly lead to utilities increasing spending. Conversely, focusing solely on cost metrics might encourage distributors to cut costs at the expense of reliability and customer service. A well-balanced system is essential to meet customer expectations.

  Balancing priorities does not necessarily mean equal weighting. The OEB should prioritize metrics that address specific shortcomings in the current rate-setting process and areas of significant importance in a monopoly business, such as affordability and reliability. SEC also believes that secondary metrics should complement primary metrics, by incentivizing specific behaviors while maintaining a broader focus on outcomes that impact all customers.

- ***Design Must Consider Possible Manipulation To Achieve Incentives.*** Any incentive-based compensation system is susceptible to manipulation, in which those it applies to may find ways to achieve the incentive without achieving the intended outcome. For example, in the PIM context, a distributor with a unit cost pole replacement metric might choose to replace poles that are easier for its crews to access, thereby reducing its average replacement cost. While this approach would make the distributor more likely to meet the target, it does so without the hard work of finding more productive ways to undertake the task.

The risk of such manipulation can never be completely eliminated, but the OEB must ensure that, either through the design of individual metrics or more broadly within the PIM system, it incentivizes the correct behavior to achieve the desired outcomes.

SEC suggests the OEB should primarily focus (in terms of weighting the metrics) on primary as opposed to secondary metrics. The benefit of primary metrics is not just that the consider core outcomes, but they harder for distributors to game to achieve the incentive without doing the hard work of delivering real outcome for customers.

- ***Targets Should Be Based on Continuous Improvement.*** A cornerstone of the RRF is the goal of continuous improvement. Similarly, the Ministry of Energy and Electrification's *Ontario's Affordable Energy Future: The Pressing Case for More Power* vision document emphasized the need to "strengthen the governance and accountability of LDCs to improve operational efficiencies, increase reliability, and support investments necessary for the increasing energy demand".[2]

  In the context of a PIM system, SEC believes that metric targets should promote continuous improvement. Maintaining the status quo should not be considered acceptable performance. Targets should require superior performance, ensuring utilities strive for progress beyond current practices.

The creation of a PIM system, including the appropriate reward/penalty mechanisms, selecting the right metrics, and setting performance targets, is a complex task. SEC has been involved in the review of the proposed PIM system in the recent Toronto Hydro Custom IR application[3], the Performance Outcomes Accountability Mechanism established as part of the Hydro Ottawa 2021-2025 Settlement Proposal[4], and the Reliability and Power Quality Review (RPQR) Working Group which is working on reliability benchmarking and performance expectations (i.e. targets). Based on this experience, SEC recommends that the OEB convene a group of utilities, customer groups, and other stakeholders for focused discussions to understand perspectives and potential issues. These discussions would be highly valuable as the OEB prepares its planned discussion paper on PIM proposals.

Longer-Term Approach to Rate Regulation

The OEB is also considering, in the long term, a more fundamental change to utility regulation by developing an approach to rate-setting that is no longer premised on rate base rate of return.

SEC agrees with the underlying premise that a rate-making framework based on a return on utility rate base has well-known structural biases toward traditional capital spending. The more utilities spend on capital, the greater their profit (i.e., their equity return). However, while recognizing the problem is the easy part, determining what replaces it is more challenging.

At the same time, addressing this complex issue is becoming increasingly important. Electrification will require new utility investments to meet demand, yet there is growing emphasis on ensuring affordability. Technological innovation and non-wires solutions are key components of the solution. However, without a fundamental change that eliminates the capital basis of the current rate of return frameworks, these solutions will never reach their full potential.

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[2] Ontario's Affordable Energy Future: The Pressing Case for More Power (October 2024), p.30
[3] EB-2023-0195, Exhibit 1B, Tab 3, Schedule 1
[4] *Decision and Order* (EB-2019-0261), November 19, 2020, Appendix A, Settlement Proposal p.35-37

That said, the OEB must approach this with caution. A fundamental change to how Ontario electricity distributors have been remunerated for more than 25 years, and for gas utilities much longer, requires careful thought and considerable analysis. The impact on both utilities and customers will be significant.

It is also unclear whether alternative approaches taken in other jurisdictions (e.g. the United Kingdom) have led to better outcomes. The UK RIIO totex approach was intended to address the capital bias issue, although the Christensen Associates report did not provide any references to analyses confirming that it achieved this goal.[5] The Christensen Associates report did find, however, that the RIIO approach has its own set of challenges.[6] Ultimately, each jurisdiction reviewed has unique industry structures, business conditions, and policy imperatives. SEC believes that, while much can be learned, a made-in-Ontario approach is likely required.

SEC submits that the first step in any fundamental review should be a study of the current rate-setting approaches, to determine whether they have achieved the stated goals outlined in the initial RRFE Report. The next step is to identify whether, even where these approaches have worked, they are suited to an evolving energy sector.[7]

In assessing how to approach any fundamental change, the OEB must keep in mind the purpose of monopoly utility regulation: to act as a proxy for competition - the market proxy, and to balance the need to protect the interests of customers with the efficiency and financial viability of the electricity industry.[8] Additionally, while the OEB has broad discretion in setting just and reasonable rates, this discretion is not unlimited. Important legal requirements must be met.

SEC commends the OEB for considering the need for fundamental change and looks forward to participating in the discussion about whether and how it should be undertaken.

Yours very truly,
Shepherd Rubenstein P.C.

Mark Rubenstein

cc: Brian McKay, SEC (by email)

[5] Christensen Associates, Jurisdictional Review of Utility Remuneration Models, p.49
[6] Christensen Associates, Jurisdictional Review of Utility Remuneration Models, p.61
[7] We refer the OEB to the presentation, Rethinking Fundamental Concepts of Utility Regulation, that SEC gave at a stakeholder meeting as part of the Utility Remuneration (EB-2018-0287) and Responding to Distributed Energy Resources (EB-2018-0288) consultation that discuss some of these issues.
[8] See *Ontario Energy Board v. Ontario Power Generation Inc*., 2015 SCC 44, para. 11; See *Ontario Energy Board Act*, s.1(1)