LDC DISTRIBUTION RATES

ISSUE:

The Ontario Energy Board (OEB) has issued the majority of rate orders for 2017 distribution rates for Ontario electricity distributors (LDCs).

Hydro One Networks has submitted a five year Custom IR distribution rate application for the years 2018-2022 inclusive.

1. SUGGESTED RESPONSE ON 2017 ELECTRICITY DISTRIBUTION RATES:

- **The OEB has approved the majority of distribution rates for 2017.**
- **Some LDCs have their rates set effective January 1. Others have their rates set effective May 1.**
- **Based on OEB decisions to date, the average monthly delivery charge in 2017 for a typical residential customer using 750 kWh per month is decreasing by about $1.74 for a total bill impact of roughly -1.6%[1].**
- **The OEB is an independent regulator with a mandate to protect Ontario consumers with respect to electricity prices and ensure the financial viability of electricity distributors.**
- **Under Ontario's Fair Hydro Plan, we broadened distribution rate protection to provide distribution cost relief to residential customers of local distribution companies with some of the highest costs.**

2. SUGGESTED RESPONSE ON HYDRO ONE NETWORK'S 2018-2022 RATE APPLICATION:

- **Hydro One's application is currently before the OEB for review. The OEB must approve any distribution rate increases and has a transparent and thorough process to review rate applications such as Hydro One's application.**
- **The OEB is an independent regulator with a mandate to protect Ontario consumers with respect to electricity prices and ensure the financial viability of electricity distributors.**

If pressed

- **Hydro One Networks is owned by Hydro One Limited, an independent, publicly listed corporation. Any questions about Hydro One's distribution rate application should be directed to Hydro One.**

[1] All of the rate impacts in this note are exclusive of taxes and the 8% rebate.

BACKGROUND

The residential electricity bill includes several charges, such as the commodity cost (Regulated Price Plan, or RPP), the delivery cost (which includes distribution, transmission and distribution line losses) , and regulatory charges to operate the electricity marketplace. The debt reduction charge (DRC) to pay down the debt and liabilities of the former Ontario Hydro was also part of the residential bill; however, the DRC was removed from residential customers' bills effective December 31, 2015. As part of the Fair Hydro Plan, OESP costs were removed from the regulatory charge as were the majority of costs associated with RRRP. As a result, on May 1, 2017, the OESP charge was reduced from $0.0011 per kWh to $0.00 and the RRRP charge was reduced from $0.0021 per kWh to $0.0003. Combined, these reductions save a typical residential customer $2.17 per month (750 kWh per month).

When the OEB sets distribution rates for an LDC, it sets the amount that LDCs can charge consumers for the distribution services it provides. The distribution charge includes the costs to build and maintain power lines, towers and poles, stations and local transformers, and operate systems locally. It also includes costs associated with billing, metering and collection. LDCs pass the transmission costs on to consumers (with no profit or loss). On average, distribution charges account for about 25-30% of the monthly electricity bill, and transmission charges about 5-10% of the bill.

OEB Rate-setting Process

Electricity distributors apply to the OEB to determine which costs they can pass on to their customers through rates. The OEB reviews each rate application independently in a public process and approves the rates each distributor can charge.

The OEB's rate-setting process allows electricity distributors 3 ways to file for rates:

- A simpler method aimed at smaller LDCs with limited incremental capital requirements. (Annual Incentive Rate-setting Index or "AIRI")
- 4th Generation Incentive Regulation approach which provides for a detailed cost of service application once every five years and a simplified formulaic adjustment in the intervening years (now called Price Cap Incentive Rate-Setting – formerly referred to as Incentive Regulation Mechanism or IRM.)
- A method aimed at LDCs with large or highly variable capital spending plans that allows for a 5 year rate plan. (Custom IR).

Cost-of-service rate reviews take a comprehensive look at utility costs, including: costs to design, build and maintain overhead and underground distribution lines, poles, stations and local transformers, operate local systems, read meters, customer service, emergency response as well as the costs to deliver electricity from generating stations to local utilities along the high-voltage transmission system and include a regulated profit.

The Price Cap Incentive Rate-Setting (Price Cap IR or IRM)

The Price Cap (IR) uses a formula that provides a standard rate adjustment for inflation minus productivity improvements.

- The adjustment for inflation is based on a combination of GDP-IPI (Gross Domestic Product Implicit Price Index) (70%) and the average weekly earnings for workers in Ontario (30%). This is a more Ontario-specific approach to setting the inflation factor.

- The productivity factor is set at zero to reflect an average declining productivity growth in Ontario's distribution sector. Actual average productivity growth is negative; however, the Board set it at zero in order to promote continuous improvement. A zero productivity factor means that distribution rate increases during the IRM period will not exceed the inflation rate.

- Distributors are assigned to one of five groups with stretch factors based on their benchmarked total cost performance. Stretch factors range from 0% for distributors who achieve 25% or more below their predicted costs and up to 0.6% for distributors whose costs are 25% or more above predicted costs.

Changes to the Distribution Application Process

Typically, when LDCs file their distribution rate application the OEB requires the utility to issue a Notice of Application (NoA), which informs ratepayers and interested parties of the pending application, type of hearing process, and estimated rate impacts. Prior to 2016, the OEB required the NoA to be published in a local newspaper. Since 2016, the OEB no longer requires publication in a newspaper; however, the OEB puts the NoA on its website, requires the LDC to put the NoA on its website, in its office, and make available through social media channels, if available.

Currently, all initial Custom IR and Cost of Service and a few Price Cap IR applications continue to be reviewed under this well-established regulatory process. However, a large number of IRM applications and subsequent year CIR applications are now dealt with by delegated authority, in which an OEB staff member is delegated the authority to make the decision, rather than an OEB Panel of Board members, and no Notice of Application is issued.

Status of 2017 Distribution Rate Applications

The Ontario Energy Board (OEB) has issued final rate orders for 2017 distribution rates for the majority of Ontario electricity distributors (LDCs). A small number of LDCs have not gotten final rate orders for 2017.

Custom IR (CIR) Applications

For 2017, only one LDC filed a custom IR application. Innpower (serving Innisfil) filed an application with the OEB in June 2016 under the Custom Incentive Rate-setting (Custom IR) option for rates effective 2017-2021.

- Upon a preliminary review, the OEB determined that Innpower did not provide sufficient evidence to satisfy OEB requirements for a CIR application. The OEB directed Innpower to re-file its Custom IR, or alternatively, choose another rate filing option available to it, such as a single-year cost-of-service.
- Innpower subsequently filed a cost-of-service application and it is currently under consideration at the OEB. Due to the delay, the OEB has declared Innpower's 2016 rates to be interim 2017 rates.

Rate Impacts

The Board has issued the majority of Rate Orders for 2017 rates. Some LDCs, such as Hydro One, Alectra, etc., have multiple rate zones. Based on decisions to date, the average delivery charge for a typical residential customer using 750 kilowatt hours per month has decreased by about $1.74 monthly, a total bill impact of about -1.6%.

As of January 1, 2017, due to the enhancement of RRRP available to Hydro One R2 customers, the monthly RRRP subsidy for Hydro One R2 customers increased from $31.50 per month to $60.50 per month. As a result, monthly delivery for an R2 customer consuming 750 kWh per month decreased by $28.82 per month, or about 22% of the total monthly bill, based on July 1, 2017 RPP costs (i.e., taking into account Ontario Fair Hydro Reductions in commodity cost). Additionally, Hydro One's residential customers classified as low-density (R2) and medium-density (R1) will receive enhanced distribution rate protection which will hold their monthly base distribution rates to a maximum charge determined by the OEB.[2]

[2] The maximum charge set for 2017 is $36.43 per month. This applies only to base distribution rates (monthly service charge and variable distribution rate, excluding all fixed and variable rate riders). In addition to Hydro One R1 and R2 customers, the maximum monthly base distribution charge also applies to residential customers of Northern Ontario Wires, Lakeland Power (Parry Sound rate zone), Chapleau PUC, Sioux Lookout Hydro, InnPower, Atikokan Power and Algoma Power. Rate impacts in this note do not take into account this additional reduction as it does not reflect rates approved by the OEB.

Excluding the Hydro One R2 rate class, on average, monthly delivery charges for a typical residential consumer using 750 kWh per month declined by about $1.35 per month, or 2.9% (1.3% total bill decrease).[3]

The largest increase monthly delivery charge for a typical residential customer consuming 750 kWh per month is $5.18 or 13.9% (4.8% total bill increase) for Renfrew Hydro.

There are various factors influencing the rate impacts for all decisions including the need to replace ageing infrastructure, recovering lost revenue associated with various conservation initiatives, revenue-to-cost ratio adjustments, income tax adjustments, and clearing of deferral and variance accounts balances related to transmission costs, wholesale market service charges and smart meter costs. In addition, rate impacts for Price Cap IR decisions are impacted by the formulaic adjustment for inflation less productivity.

On-Reserve First Nations Delivery Credit

Acting on recommendation from the Ontario Energy Board, Ontario's Fair Hydro Plan provides a credit for all delivery charges for First Nations on-reserve residential customers of licenced distributors. This initiative will provide residential customers an average monthly benefit of $85 for approximately 21,500 on-reserve First Nations residential customers. The First Nations On-Reserve Delivery Credit is funded by provincial revenues.

Hydro One Remote Communities

On March 30, 2017, the Board approved Hydro One Remote Communities' (Remoteco) distribution rates for 2017 using a price cap adjustment. Effective May 1, 2017, the overall bill for the average Remoteco year-round residential customer using 750 kWh monthly will increase by $0.81[4] per month or 0.9%. Remoteco generates and distributes electricity to 21 geographically remote off-grid communities in northern Ontario.

OEB Rate Redesign Initiative

In April, 2015, the Ontario Energy Board (OEB) announced that it would be eliminating volumetric distribution charges for residential customers and allow Local Distribution Companies (LDCs) to recover all their distribution costs through a fixed monthly charge. Standard rate design methodology in most jurisdictions and in Ontario up to now, had electricity distributors recover their costs through a combination of a fixed monthly charge and a volumetric charge based on kilowatt hours used (often called split fixed-variable rate design). The change to fully-fixed distribution rates is being phased in over a four year period for most LDCs and began with 2016 rates, and in most cases will be fully implemented by 2019.

For customers of Hydro One Networks, the OEB approved a five-year transition to fixed distribution rates for its high density urban residential rate class (UR), and an eight-year transition for medium- and low-density residential (R1 and R2) and seasonal residential rate class customers. This is to allow the impact of the change to be held at less than 10% for low volume customers at the 10^{th} percentile of consumption.

The OEB is currently working on an initiative to implement a new rate design for Commercial and Industrial Customers, including small commercial customers (i.e., GS<50 kW) as well as larger commercial, industrial and institutional customers (GS>50 kW). The OEB has consulted with stakeholders and it is anticipated that a proposal will be issued later this year.

Hydro One Seasonal Customers

In its 2015 decision on Hydro One's 2015-2019 Distribution Rate Application, the OEB determined that the seasonal customer class is no longer justified and directed Hydro One to prepare a plan by August 4, 2015 for the elimination of this rate class commencing January 1, 2016. Subsequently on September 30, 2015, after reviewing the plan prepared by Hydro One, the OEB issued an order to Hydro One that it expects the Board's policy on moving

[3] All of the rate impacts in this note are exclusive of taxes and the 8% rebate.
[4] Bill Impact is before taxes and also takes into account the removal of the OESP charge.

residential customers to fully fixed rates over time would apply to Hydro One's seasonal customers, starting in January 1, 2016.

The Order stated that in the OEB's view, such a change constitutes the initial steps in the execution of the OEB's direction to eliminate the seasonal class by aligning rates for these customers' premises with a density-based rate structure applicable to other residential customers. At the time, the OEB indicated it would initiate a further proceeding in the future to consider the remaining steps for the elimination of the seasonal class.

In November 2016, the OEB initiated a proceeding to implement the OEB Decision to eliminate the Hydro One Networks Inc seasonal distribution rate class. In its Procedural Order, the OEB required Hydro One to file an updated report on the elimination of the seasonal class no later than December 1, 2016. It also required Hydro One to file a draft notice to inform seasonal customers of the upcoming proceeding and an estimate of how the elimination of the seasonal class would affect customers.

On December 1 2016, Hydro One filed an updated report on eliminating the seasonal rate with the OEB. This updates the original report, filed in August of 2015. The report indicates that the move to all-fixed rates alone addresses the key concern of some seasonal customers that low consumption customers are not paying their fair share of costs. The analysis also shows that from a customer's perspective, very little incremental benefit is gained by the elimination of the seasonal class and that the elimination of the seasonal class combined with the move to all-fixed residential distribution rates results in only a small benefit to the 70,000 seasonal customers moving to the R1 class and a very large negative impact on the 84,000 seasonal customers that would move to the R2 class.

The report also detailed options for mitigating bill impacts associated with the elimination of the seasonal class, discusses and assesses options for billing and meter reading frequencies, identifies areas of Hydro One's Conditions of Service that require revision as a result of the elimination of the seasonal class, and identifies a number of significant implementation and ongoing administrative issues associated with eliminating the seasonal class, including the need for extensive customer information system (CIS) changes, annual monitoring of formerly seasonal customers' consumption and customer communication challenges, among others.

The updated report suggested that the elimination of the seasonal class represents a significant change to Hydro One's distribution rates structure that will impact the rates for all customer classes. As such, Hydro One is proposing that any changes related to eliminating the seasonal class should be coordinated to coincide with the next planned rebasing of distribution rates on January 1, 2018.

No further advance on the elimination of the seasonal class has occurred to date. Hydro One has subsequently filed a new Custom Incentive Rate (CIR) Application for 2018-2022 (see next section). The new application does not propose to eliminate the seasonal class; however, Hydro One suggests the application as structured provides flexibility to reset customer rates should the OEB proceed with the elimination of the seasonal rate class.

Hydro One Networks 2018-2002 Custom Incentive Rate Application

On March 31, 2017 Hydro One filed a five year Custom IR distribution rate application with the Ontario Energy Board (OEB). This application is to set rates for the years 2018-2022 inclusive. The application, as filed, requests an increase in revenue requirement for 2018 of 1.9% over OEB approved 2017 levels.

The application is based on a Custom Incentive Rate-Setting approach for a five-year period. The revenue requirement for the first year (2018) is determined using a cost of service, forward test year approach. In subsequent years, annual revenue requirements are established through a proposed Revenue Cap IR. This is a fundamentally different approach to IR ratemaking than has been approved by the OEB up until now (the OEB generally uses price-cap IR, where rates are set via the IRM (incentive–regulation mechanism), rather than revenue requirements.

Hydro One suggests the revenue cap approach provides flexibility to incorporate transition to fully-fixed rates for residential customers, to eliminate the seasonal rate class if the OEB proceeds with that initiative, to reset customer rates as the OEB advances its initiative relative to rate design for commercial and industrial electricity customers, and provides flexibility to integrate acquired utilities' rates, among other things.

See **F1 – Hydro One** for more details.

Cost of Capital

Electricity and gas distributors regulated by the OEB are allowed to earn a return on their capital, which includes debt and equity. The OEB uses its own regulatory accounting framework for setting rates. Under this approach, a utility's return on capital, including Return on Equity (ROE), is set through a standard formula, regardless of the LDC's actual capital structure. The Board deems 60% of a utility's rate base (its assets) as debt and the remaining 40% as equity. The Board then sets the maximum return on debt and equity a utility is allowed to earn. The utility applies this formula to calculate the return it can include in rates.

Updated cost of capital parameters are calculated based on the formula documented in a 2009 OEB report, *The Cost of Capital for Ontario's Regulated Utilities*. The report sets out the Board's approach to determine the cost of capital. It also establishes a periodic review process. The first review will take place in 2014 and any policy changes identified as a result of this review would be applied in 2015. On January 14, 2016, the OEB released a letter and OEB Staff Report on a review of the current cost of capital policy. The OEB concluded that it will make no changes to its cost of capital policy at this time. The OEB's 2015 - 2018 Business Plan has a number of initiatives underway, planned for 2016 and beyond. The cost of capital will be considered in the broader context of these initiatives.

ROE Calculation

The ROE formulaic adjustments are based on forecasts of the Long Canada Bond Forecast (LCBF) and the difference between 30-year A-rated Canadian distributor bonds and 30-year Government of Canada bond yields.

The formula has been refined to reduce the sensitivity of the approach to changes in government bond yields due to monetary and fiscal conditions that do not reflect changes in distributor cost of equity.

On October 27, 2016, the OEB updated its cost of capital parameters which will be used to set 2017 rates for electricity (distribution and transmission) and gas applications. The allowed return on equity has been reduced from 9.19% to 8.78%, the deemed long-term debt rate reduced from 4.54% to 3.72%, and the deemed short term debt rate will increase from 1.65% to 1.76%. The OEB updates the cost of capital once per year.

The return-on-equity as well as the long and short-term debt rates are:

	2017 Jan 1	2016 Jan 1	2015 Jan 1	2014 Jan 1	2013 May 1	2013 Jan 1	2012 May 1	2012 Jan 1
Cost of Capital Parameters								
Return on Equity	8.78%	9.19%	9.30%	9.36%	8.98%	8.93%	9.12%	9.42%
Deemed LT Debt rate	3.72%	4.54%	4.77%	4.88%	4.12%	4.03%	4.41%	5.01%
Deemed ST Debt rate	1.76%	1.65%	2.16%	2.11%	2.07%	2.08%	2.08%	2.08%