ONTARIO ENERGY BOARD
DRAFT POLICY
ON PERFORMANCE BASED REGULATION

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INTRODUCTION AND PURPOSE

The Ontario Government released its White Paper on the restructuring of the electricity industry, Direction for Change on November 6, 1997 in which it proposes retail competition for electricity. It also indicates that it would direct the Ontario Energy Board (the "Board") "to examine, advise on, and subsequently implement a performance-based approach to regulation (PBR) that ensures efficiencies are achieved in the monopoly parts of the industry and result in benefits to the customers". The monopoly parts of the industry are the delivery components (transmission and distribution).

Bill 35, *Energy Competition Act, 1998* (the "Act") was introduced in the Legislature on June 9, 1998. The proposed Act creates a competitive electricity market and expands the Board's regulatory responsibility to the monopoly delivery components of the electricity industry in addition to the natural gas industry.

The purpose of this draft policy paper is to introduce the Board's PBR principles which will be considered in setting rates for natural gas and electricity transmission and distribution utilities.

WHAT IS PBR

PBR is the term used to describe the application of a set of incentive-based tools which can be applied to the determination of just and reasonable rates. These flexible rate setting tools can reduce regulatory burden while at the same time protecting the interest of ratepayers. While there are many variations, the basic types of PBR schemes are: indexing/benchmarking applied to traditional cost of service regulation; price/rate caps; and revenue caps which may or may not include mechanisms to share efficiency gains.

PBR has the potential to provide greater flexibility to the utility and the regulator, while providing direct incentives for improving efficiency. Technological changes, policy and legislation are affording customers more choice. Because PBR plans incorporate flexibility to deal with changed circumstances, they are being adopted as the preferred regulatory approach for monopoly functions.

STATUS OF PBR IN ONTARIO

The opportunities for implementing PBR approaches by the Board have been limited and constrained by the rate setting requirements prescribed by the current *Ontario Energy Board Act.* Guidelines exist for the determination of rate of return on equity and natural gas system expansion, and some revenue sharing schemes have been approved for the sale of some natural gas services. Current applications before the Board include the proposal for a formulaic adjustment of operating and maintenance expenses for The Consumers' Gas Company Ltd., and a proposal from Union Gas Limited for a more extensive PBR scheme to be implemented in fiscal 2000. Bill 35, would provide authority to the Board to apply incentive rate making approaches such as PBR in all regulated energy sectors.

RATIONALE FOR DEVELOPING PBR TOOLS FOR APPLICATION IN ONTARIO

Historically, the Board has applied cost of service/rate of return regulation to meet rate making objectives. These tools have been generally effective in establishing just and reasonable rates and encouraging efficient operation of the utility by its management.

The reasons for proceeding to develop PBR include:

1. With the passage of Bill 35, the Board will have the task of regulating a large number of diverse utilities within the province. Since PBR has the potential to provide an expedient mechanism for adjusting rates over time as circumstance change, it is expected to result in fewer rate reviews before the Board and, hence, a lesser regulatory burden.

2. PBR would allow the Board to establish minimum service quality and reliability standards and maintain compliance with these standards.

3. PBR can provide greater incentives for cost reduction and productivity gains compared to those available under traditional cost of service regulation while protecting the interests of customers.

PRINCIPLES FOR THE DEVELOPMENT OF PBR

In addressing the general objectives as stated in Bill 35 and sound regulatory practices, the following principles will guide the Board in developing and implementing PBR:

1. The PBR framework should address all specific requirements of the legislation and regulations.

2. The PBR framework should protect customers and result in prices for regulated services that are just and reasonable.

3. The PBR framework should discourage cross-subsidization between regulated and competitive services.

4. The PBR framework should encourage greater economic efficiency by providing the appropriate pricing signals and a system of incentives to maintain an appropriate level of reliability and quality of service.

5. The PBR framework should permit the utility an opportunity to earn a reasonable return on shareholder capital and to maintain its financial viability.

6. The PBR framework should be transparent and as simple as possible. The cost of administering PBR, including costs imposed on all participants, including the regulated entity and the regulator, should not exceed the benefits available from PBR.

7. PBR should allocate the benefits from greater efficiency fairly between the utility/shareholder and the customers.

8. A PBR framework should be flexible and able to handle changing and varied circumstances.

9. The PBR framework should facilitate the use of efficient processes.

These principles will apply to each sector of the energy industry to which a PBR approach is applied. The utilities' cost of service will provide the foundation upon which the PBR plans will be constructed and the basis upon which its results will be assessed.

BOARD APPROACH

The Board will proceed using a sectoral approach to PBR development and implementation. In the case of the gas utilities and electricity transmission utilities, the Board will review specific applications brought forward by these entities. In the case of the electricity distribution utilities, the Board will develop a generic PBR scheme appropriate to those utilities, and in consultation with stakeholders.