

Section 5, page 40: 5 Effectiveness of current electricity pricing model

Question: *At a high level, how effective is the current electricity pricing model, and should any changes to it be considered? Is it appropriate to continue to set rates for consumers of electricity on a cost of service basis or is there another more appropriate basis to set rates?*

Electricity pricing in Newfoundland and Labrador is based on a cost-of-service approach in determining revenue requirement to be recovered through customer rates. Under this approach, Hydro submits evidence to the Board regarding the costs expected to be incurred to provide safe and reliable service to its customers. The Board reviews these costs, determines their prudence, and sets rates to permit Hydro the opportunity to recover its costs plus a reasonable rate of return.

London Economics International (“LEI”) provided a report to the Commission of Inquiry (the “Commission”) indicating that Newfoundland and Labrador should move beyond cost of service ratemaking and that performance-based ratemaking (“PBR”) should be considered as a more effective alternative. The objective of rate regulation in Newfoundland and Labrador is to provide electricity service that is least cost and reliable in accordance with the requirements of provincial legislation. The main difference between cost of service based regulation and PBR is the role of the Board in meeting these objectives.

Under the cost of service regulation, the role of the Board is to determine through the general rate application (the “GRA”) process a level of expenditures that is prudent for establishing customer rates which are deemed to be reasonable and in compliance with Government direction/legislative requirements. The approved level of expenditures is considered the Test Year revenue requirement which is allocated by customer class in determining fair rates for each customer class. In determining the Test Year revenue requirement, the Board approves an operating cost level which provides an incentive for the utility to operate efficiently between

Test Years while continuing to provide reliable service.¹ In the GRA process, the Board also gives consideration to the quality of service being provided by the utility. The capital expenditures to maintain reliable service and address system expansion are approved on an annual basis through a separate regulatory process. The Board has also established regulatory mechanisms to limit regulatory processes between GRA proceedings to enable the flow-through changes in costs that are beyond the utility's control to be recovered through customer rates (e.g., changes in fuel costs). It has been the practice of the Board to set the filing date for the next GRA filing in the Board Order concluding the current GRA process. Generally the GRA filings are required within a 3-year period. Any excess earnings under cost of service regulation are set aside for future disposition by the Board.

Under PBR, the Board must initially establish a regulatory framework to reduce the level of detailed regulatory review required in establishing customer rates while ensuring: (i) the service to customers meets acceptable reliability targets; (ii) the costs permitted to be recovered through customer rates are reasonable; (iii) the utility is provided an opportunity to recover prudently incurred capital and operating costs; and (iv) the utility is provided a financial incentive for continual efficiency improvements. The starting point in establishing a PBR process is, generally, cost of service based rates. Once a PBR approach and term is established (for example, PBR has a 5 year term in Alberta), revisions to customer rates occur through PBR adjustments rather than a GRA process and these rate revisions do not require the review the reasonableness of customer rates by rate class. The PBR process also often provides a sharing of any excess revenues between the utility and customers. At the conclusion of the PBR term, the rates in effect for each customer class would normally be tested through the cost of service process (with adjustments made, if required) before starting another PBR term.

Hydro has not conducted a comprehensive review of the effectiveness of PBR vs. cost of service based regulation. The information provided by LEI indicates that PBR is in effect in Ontario,

¹ For example, it has been the practice of the Board to apply a productivity allowance in establishing revenue requirement if the Board is not satisfied with the utility's operating cost management.

Alberta and British Columbia. However, Hydro notes that PBR does not appear to be in effect for the Crown utilities in Canada which are primarily responsible for the generation supply in each province (including British Columbia).

In February 2019, BC Hydro submitted a PBR review report in its “Fiscal 2020 to Fiscal 2021 Revenue Requirements Application”. This report was provided in response to a directive from the British Columbia Utilities Commission (BCUC); the purpose of the report was to determine if PBR could help BC Hydro to achieve its cost control objectives and improve productivity while maintaining service quality. Hydro believes this report prepared by BC Hydro provides valuable guidance when considering the merits of cost of service regulation vs. PBR and has attached the report as Attachment 1 to this response (the “BC Hydro PBR Report”).

The BC Hydro PBR Report cited a survey by Professor Graeme Guthrie, which concluded that:

The two most important lessons to be drawn from the literature surveyed here are that there is no single combination of regulatory settings that is best in all situations and that the various components of a regulatory scheme are interrelated. The most appropriate regulatory scheme for a given situation will depend on the characteristics of the firm and industry being regulated, as well as the institutional environment.²

The BC Hydro PBR Report indicated that if the BCUC decided to adopt PBR, then the most appropriate regulatory approach would be a hybrid approach in which certain costs are subject to a PBR formula while other costs are dealt with through cost of service regulation.

The BC Hydro PBR Report indicated that implementation of PBR required a great deal of regulatory process very similar to a general rate application involving many intervenors.³ The

² Graeme Guthrie, “Regulating Infrastructure: The Impact on Risk and Investment,” *Journal of Economic Literature*, Volume 44(4), December 2006, page 966.

³ See page 11-59 of BC Hydro PBR Report, lines 9-16.

consultant supporting the BC Hydro PBR Report also indicated concern with adoption of PBR for Crown corporations stating:

Policymakers should recognize that the expected gains from adopting PBR may be subject to greater uncertainty in the case of crown corporations. In many respects, these public enterprises are de facto subject to two different regulatory authorities—the regulatory commission of jurisdiction and its government owners.

BC Hydro did not recommend proceeding with PBR at this time. The BCUC decision on this matter is expected in 2021.

Hydro believes that a material portion of its supply costs are beyond its control given the legislative requirements for recovery of the costs of the Muskrat Falls Project and the requirement to recover the rural deficit from customers. Therefore, Hydro believes a PBR approach in this jurisdiction would require Hydro to separate certain cost items from PBR rate determination.

As a crown corporation, Hydro believes its mandate is not to maximize profits; the maximization of profits is used as the incentive mechanism to drive efficiencies under the PBR approach. Hydro is currently incited by its obligation to provide reliable service on a least cost basis. Hydro supports regulation that provides for efficient processes to effectively provide for: (i) the recovery of the reasonable cost to serve, (ii) the approval of the capital investments required to provide safe and adequate service to its customers, and (iii) the establishment of rates consistent with generally accepted ratemaking principles.

Fairness of customer rates in Newfoundland and Labrador is an important component under the cost of service approach. Hydro believes the current electricity pricing model is effective in achieving this result. Hydro would be concerned with a material deviation in regulatory process that would not maintain cost-based rates. Hydro does believe that refinements to the existing cost of service regulatory approach to reduce the duration of regulatory proceedings may

provide for increased regulatory efficiency. Hydro also supports the continued use of deferral account mechanisms such as the Rate Stabilization Plan to (i) provide the utility the opportunity to recover supply cost variations that are beyond the control of the utility, and (ii) reduce the cost of regulatory oversight in establishing customer rates.

Newfoundland and Labrador's electrical system is in a period of transformative change with the integration of the Maritime Link and Muskrat Falls projects and future retirement of generating sources on the Island. Interconnection with the North American grid and the move away from reliance on Holyrood is the biggest transition with the system since the 1960s. The contemplation of additional transformative change introduces the potential for added cost and risk. The timing and impact of such suggested change needs to be carefully considered against the materiality of the opportunity identified, as well as balanced against the opportunity to gain efficiencies through changing regulatory practices.

Hydro believes a complex regulatory process would be required for the evaluation and implementation of PBR in Newfoundland and Labrador involving the participation of many intervenors. The regulatory calendar in this jurisdiction is very crowded for the next several years. Hydro does not believe a review of the effectiveness of the currently electricity pricing model should be a priority at this time.