Brave New World at the OEB

POLICY DEVELOPMENT AND THE NATURAL GAS EXPANSION CASE

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An ongoing Ontario Energy Board (OEB) proceeding offers timely insight into the role the Board sees itself playing in the implementation of government policy through its rate-making activities.

At issue in the case is the extension of natural gas infrastructure to numerous communities who currently would not qualify for natural gas service under the current regulatory structures. These communities represent territory currently not served by the two principal gas distributors because they are sufficiently remote, and their populations sufficiently small, that extension of infrastructure to them could not be rationalized on what has up to now been considered an economic basis. These communities are currently served by other, competing energy sources.

This paper will highlight some of the concerns associated with having the economic regulator of the energy sector engaged in the development of broader social policy, acting on cues from the government of the day.

This commentary is in no way intended to comment on the relative merits of any of the proposals or positions taken by the parties in the case, nor is it intended to canvass all of the areas under consideration in it. The parties have made their final submissions, and the case now rests with the OEB panel for decision. The case has produced voluminous evidence on a wide range of important regulatory issues, and all interested students of regulatory economics and policy will be amply rewarded by a thorough review of the evidence and submissions filed in it.

We want to emphasize that virtually all of the proposals filed in this case appear to be highly respectful of the various interests engaged, and have expertly attempted to find a balance within what is a somewhat confusing policy environment.

While it could be said that the proceeding underway is deficient in a number of respects, it may be the case that the proposed expansions of gas infrastructure are, at the end of the day, in the broad public interest. And if that is the direction the Board chooses, it should allow the gas distributors to get on with it. As the Board knows, construction activities of this magnitude require significant advance work and can only be conducted between frosts.

But the suggestion is that the Board's application process is a poor crucible for the development and evolution of social and economic development policy.

This commentary addresses the role apparent government policy has played in a fundamental reconsideration of the economic basis upon which natural gas infrastructure should be extended to remote communities.

The current regulatory regime had the effect of blunting the natural, but pernicious, tendency of utilities to expand capital base within a cost-of-service environment.

Up until now the regulatory regime governing expansion of natural gas infrastructure has required that proposed expansions meet certain specific economic criteria which rigorously balance the interests of existing natural gas ratepayers with the interests of new customers proposed to be served by the extension. This regime was established in a seminal Board Report in 1998, EBO-188.[1] Under this regime all proposals for the extension of natural gas infrastructure have been required to demonstrate that the revenues generated by the new customers over a set period of time divided by the capital costs associated with providing the new infrastructure result in an overall portfolio ratio of no worse than

1 Ontario Energy Board, Report of the Board EBO-188, January 30, 1998. At http://www.ontarioenergyboard.ca/documents/cases/Xo188/decision.pdf.

1.0, and that no individual project within the expansion portfolio exceeds a ratio of 0.8. Generally speaking this means that the revenue from the new customers in a given new serviced territory should be equal to at least 80% of the costs of connecting them.

This regime was adopted by the Board to ensure that gas distributors did not unduly burden existing ratepayers with the subsidization of expansion plans that are fundamentally uneconomic. The regime had the effect of blunting the natural, but pernicious, tendency of utilities to expand capital base within a cost of service environment, and to protect existing ratepayers from undue rate impacts associated with the expansions.

Revenue shortfalls can be offset by cash contributions from the new customers to get the overall portfolio ratio up to 1.0.

It also preserved the important regulatory principle that utilities ought not to be put in the position of "risk takers" when considering system expansion.

It was, and is, definitional of an economic, rational approach to natural gas infrastructure expansion. It is precisely the kind of guidance that one would expect from an economic regulator, and few would argue that it has not served the province, ratepayers and utilities alike, very well. It pursues no outcomes other than the rigorous application of economic regulatory principle.

This new case at the OEB effectively began with the issuance of a mandate letter by the Premier's Office on September 25, 2014 to the Minister of Economic Development, Employment and Infrastructure (MEDEI). That mandate letter directed the Minister to establish two funding instruments – the Natural Gas Access Loan Fund and a Natural Gas Economic Development Grant Program. These funding instruments were intended to "help communities partner with utilities to extend natural gas infrastructure", and "to accelerate projects with clear economic development potential" respectively.[2] It is worth highlighting the fact that the Premier's letter specifically references assistance to *communities* to enable extension of the natural gas infrastructure.

2 Government of Ontario, 2014 *Mandate letter: Economic Development, Employment and Infrastructure*, September 25, 2014. At https://www.ontario.ca/page/2014-mandate-letter-economic-development-employment-and-infrastructure.

The Minister of Economic Development, Employment, and Infrastructure responded that his ministry would develop funding instruments to facilitate the extensions of natural gas infrastructure to such communities.

The two financing instruments still under development by the provincial government would presumably be brought into play to make the economics of proposed expansions viable, by way of capital contributions.

Some five months after the mandate letter, on February 17, 2015, the Minister of Energy, the minister responsible for the OEB, sent a letter to the Chair of the OEB explicitly encouraging the Board "...to move forward on a timely basis on its plans to examine opportunities to facilitate access to natural gas services to more communities... to ensure the rational expansion of the natural gas transmission and distribution system for all Ontarians."[3] He also specifically referenced the fact that the provincial government was developing the two financing instruments referenced above.

On the very next day the OEB sent a five-page letter with an appendix, entitled "To All Applicants and Potential Applicants for Expansion of Natural Gas Distribution."

In this letter the OEB expressly invited applications seeking "regulatory flexibility" and "exemptions" from the current regulatory structure governing infrastructure expansions. The letter expressly referenced government policy and the two funding instruments being developed by the government. The Board's letter also made specific reference to EB0-188, and its goal of holding existing customers harmless from the rate impacts of expansion projects and highlighted that it was this very standard that was at issue. In other words, holding existing customers harmless from the effects of expansions was no longer the guiding principle, and that the Board, "as part of its adjudicative process" would address these "regulatory issues" and seek flexibility respecting them.[4]

3 Letter from Bob Chiarelli, Minister of Energy, to Rosemarie Leclair, Chair of the OEB, February 17, 2015. At http://www.ontarioenergyboard.ca/oeb/_Documents/Documents/Letter_Minister_to_OEB_Chair_20150217.pdf.
4 Ontario Energy Board, Letter: All Applicants and Potential Applicants for Expansion of Natural Gas Distribution, February 18, 2015. At http://www.ontarioenergyboard.ca/oeb/_Documents/Documents/OEB_Letter_Gas_Expansion_20150218.pdf.

The natural gas distributors understandably responded with applications, the common thread of which was to substantially amend the existing EBO-188 regulatory regime in order to allow what would have otherwise been uneconomic expansions to these communities.

It should also be noted that all the applications for service to new communities in this case include, and are dependent upon, additional cash contributions from the public. Those cash contributions may come from the municipalities themselves or from provincial government, or both. However, the specific role that the funding instruments were to play was not clearly delineated in the applications, beyond non-specific references to cash contributions in aid of construction intended to somewhat soften the new burdens placed on existing customers.

If approved, the result of the applications to expand natural gas service and the proposed relaxation of the current regulatory standard would be to increase costs on existing ratepayers and taxpayers. As the taxpayer and ratepayer are often the same person, or household, the extra costs for connecting the new community would be added to their gas bill and paid for through municipal or provincial taxes.

At this point it is important to note that the Minister of Energy, who has a statutory facility available to him to direct the Board to undertake any activity within its jurisdiction, has not chosen to *direct* the Board in this subject matter.

Directions from the Minister of Energy are mandatory directions to the Board to execute the contents of the direction without amendment or alteration. Since the section providing for Directions from the Minister of Energy was added to the Ontario Energy Board Act, the Minister of Energy has issued many such Directions on a variety of subjects. Such Directives expressly originate with the Lieutenant Governor in Council, i.e., the Cabinet.[5]

5 See Section 27 of the OEB Act, and the full list of the directives issues by the Minister can be found at Ontario Energy Board, "Directives Issued to the OEB by the Minister of Energy." At http://www.ontarioenergyboard.ca/OEB/Industry/Regulatory+Proceedings/Directives+Issued+to+the+OEB.

One may question the fundamental appropriateness of the Minister's power under Section 27. As an independent quasi-judicial adjudicative body, the Board should arguably be insulated from any such direction from the government. The government has many tools at its disposal to change the statutory environment that the Board operates in. Short-circuiting such change through Section 27 Directives seems inconsistent with the Board's independence. But at least the issuance of a Section 27 Directive carries with it the authority of Cabinet, and places accountability where it belongs, with the government.

The point is that government policy appears to have evolved to a point where expansion of natural gas infrastructure would not appear to have the same priority.

In any event, in this case the Board acted to incite gas infrastructure expansions on the basis of the government's stated policy objectives, and in the absence of a statutory direction from the Minister of Energy pursuant to the Ontario Energy Board Act.

An important component of any regulatory regime is the independence of the regulator from influence. This is particularly so within an adjudicative model, such as we have in Ontario. And particularly so with respect to influence from the government of the day. Of course this concern would have a different tone if the Board was executing a mandatory direction from the Minister of Energy pursuant to the statute. In such a case, accountability for the directive would lie squarely with the Cabinet. The Board would therefore not be seen to be a volunteer with respect to a matter it would be obliged to adjudicate.

It should be noted that some of the parties in the case have asserted that elements of the proposals actually fall outside of the Board's jurisdiction – a subject beyond the scope of this commentary.

But it is concerning that the Board would put itself in a position to have to litigate a series of proposals for gas expansion when it had already signaled, in the most explicit way, its appetite for "regulatory flexibility" with respect to the very standard at issue, acting on cues from the government.

There may well be legal impediments to having the Board engaged in this manner. But it is suggested that it is at least inappropriate, given the Board's role as an economic regulator. It is an economic regulator insofar as it is obliged to decide cases on the basis of economic regulatory principle. It is not an instrument of social or economic development policy, and that role is incompatible with its statutory charge, and the legal environment in which it operates.

But another concern arises with respect to this current proceeding. A degree of ambiguity has arisen in recent months respecting government policy.

Like many jurisdictions around the world, Ontario has adopted a series of measures and policy directions that are designed to reduce the production of greenhouse gases in pursuit of climate change goals. The Ontario government has established as a key component of its Climate Change Action Plan (CCAP) a cap-and-trade system, and a variety of other measures intended to reduce the use of fossil fuels. This recent policy direction would seem to be at least tangentially in opposition to the government's objective of expanding natural gas infrastructure to remote small communities, and the Board's invitation for applications eroding the regulatory standard. While the CCAP does not explicitly mandate the reduction of natural gas use within the province, it is clear that, as a general principle, the province is moving to a position that eschews or discourages growth in all fossil fuel consumption.

Whether that direction is advisable or not is not the point, and certainly not within the scope of this commentary. The point is that government policy appears to have evolved to a point where expansion of natural gas infrastructure would not appear to have the same priority, particularly if that expansion was to be accomplished with subsidies from existing natural gas customers as well as taxpayers.

It is worth highlighting the fact that as part of their proposals in this case, and as part of evidence filings in other proceedings before the Board, one gas distributor, quite sensibly, is seeking changes to depreciation rates and other financial parameters to blunt the effects of having assets "stranded" in the event that natural gas usage is curtailed as a result of, *inter alia*, emerging government climate change measures.[6]

One of the pitfalls that presents itself to an adjudicative economic regulator such as the Board, where it appears to be responding to government policy, is that government policy can and regularly does change. And change may come not merely with changes of government, but also with changes in overall policy direction within an existing government.

The erosion of an economic test that would require proposals for gas expansion to meet the revenue/capital cost ratio provided for in EBO-188 would seem to be inconsistent with the government's stated goal of reducing the use of fossil fuels throughout the province. Imposing new costs on existing ratepayers, and it would appear from the submissions of the parties, taxpayers, to fund what have been up until now considered to be uneconomic expansions would seem to be counterintuitive.

In such a context it would seem that developing economic development policy within the regulatory processes of the Board carries considerable risk of unintended outcomes.

These are the structural issues raised by this case, but there are other contextual issues that we think are noteworthy.

First, this proceeding giving rise to the proposed erosion of the economic standard does not include empirical evidence comparing a variety of clean energy technologies that may be able to meet the needs of the communities seeking gas infrastructure expansion. It would appear that before embarking on the erosion of a durable economic standard that provides protection to existing customers and the utilities, that a thorough evidence-based review of the relative cost/benefits of competing and alternative technologies should be undertaken. The

6 See, for example, the issues in the Board's case EB-2016-0186.

evidence suggests that where natural gas replaces propane, diesel, and oil, there may well be a GHG benefit. The relative strengths and drawbacks associated with alternate technologies is surely crucial to this determination, in this context.

This would appear to be key information in light of the emergence of a programmatic approach embodied by the CCAP. The CCAP in its current form gives reason to believe that the costs associated with certain energy technologies may be sharply subsidized in the province's effort to reduce GHG emissions. We would also expect the CCAP to evolve to intensify this effect. How sensible is it, all other considerations aside, to undermine a long-established economic standard to subsidize natural gas infrastructure in the absence of evidence respecting other clean technologies? It may well be that natural gas is the right "solution" for these communities, but the Board really has no credible basis upon which to make that determination.

Finally, we think that it is noteworthy that the OEB's penchant for customer outreach seems to have fallen quiet with respect to this case. One would have thought that customer outreach would be particularly germane in a case where the Board was considering the imposition of an additional rate burden for existing customers by way of a subsidy for new customers. And yet it appears that the Board has not taken any steps to gauge the acceptance of customers for this fundamentally altered regulatory landscape.

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