

On October 15, 2008, the IESO posted a discussion paper written by Dr. Townley. “A Microeconomic Policy Perspective of the IESO’s Pre-dispatch Forecasting Proposal.” In this report, Dr. Townley set out a general framework for microeconomic policy decision making when the general objective is to enhance the aggregate well-being of a population such as the province of Ontario. In this framework he offered a method for addressing potential efficiency/equity trade-offs that can arise in most policy matters. Dr. Townley also applied his general framework to the specific policy proposal – the use of average demand instead of peak demand in pre-dispatch in non-ramping hours.

On October 30, 2008, the IESO presented the general framework outlined in the paper to the Stakeholder Advisory Committee (SAC). Stakeholders were requested to send in written comments on Dr. Townley’s findings by November 13, 2008.

The IESO received six written comments. There were several common themes in the comments. Below is a summary of key comments received along with the IESO response.

For complete text of stakeholder comments, please refer to:

[http://www.ieso.ca/imoweb/consult/consult\\_se77.asp](http://www.ieso.ca/imoweb/consult/consult_se77.asp)

### **Comments on Dr. Townley’s Proposed Approach**

1. *Dr. Townley’s approach is one of a number of tools to be used by the IESO to make a decision on the merit of a proposed change to the market.*

Several SAC members stated that Cost-Benefit Analysis (CBA) and Dr. Townley’s framework are useful parts of the IESO’s decision making process. However it should be considered one of many tools used in the IESO’s decision making processes.

Some suggested that factors that may not fit well within the framework such as strategic issues of long term market evolution, or politics should or will also come into play.

A stakeholder stated the view that the IESO should focus market evolution to make loads and generators more price responsive and to develop programs that are consistent with the generation assets and demand response components of the IPSP.

Another stated that there is a need to continue discussion of the factors beyond the capability of Dr. Townley’s framework and associated weighting allocations to allow full appreciation and consultation of the issues.

## **IESO Response**

The IESO agrees that the outcome of a CBA, although a key factor, is only one of several factors that may affect the decision making process. CBA is important, but the role that it serves is not to resolve stakeholder debates; rather its role is to inform those debates—to challenge advocates and decision-makers to take account of the values and preferences of all of the affected parties—what the province as a whole, for better or worse, would choose.

CBA, in its simplest form, ignores the income dependence of preferences and it is silent on the income distributional effects of the alternatives being assessed. Dr. Townley's approach, the "Balancing Weights Approach," is simply one way (of many potential ways) to focus on the relevant efficiency versus equity trade-off. Its key strength is that it brings transparency and structure to how this trade-off is made. It puts an onus on the affected parties to bring forth evidence (and definition) of "egregious" distributional effects. It also brings accountability to the decision maker to articulate what factors were used to make this trade-off.

Finally, within the CBA framework, not all of the consequences need to be quantified or summarized in dollar terms. Trade-offs can be identified and critical values—what an impact would have to be worth for a particular alternative to be favoured—can be calculated. The goal is to inform in a clear and consistent way the different implications to the different affected parties. In this regard, factors difficult to quantify or put a dollar values on, can still be incorporated into the CBA framework. This can include factors related to the strategic long-term vision of the market or broader governmental objectives.

- 2. There is a need to develop a clear decision rule however it should not be onerous on the IESO or participants?*

One member stated that there was a need to develop a clear decision rule as it would focus the work of the IESO and provided transparency to IESO decision making. However, the member cautioned that the decision rule and decision making process should not require onerous amounts of analysis and investigation as this would lengthen the decision making process to the point where decisions may never get made.

The member stated the view that the Townley approach may be too onerous – it is difficult to measure the marginal utility of wealth amongst the divergent Ontario market participants.

Similarly, another member stated that the "Balancing Weights Approach" to address benefit inequities but how this weighting would be applied will be very difficult to determine.

## **IESO Response**

The IESO agrees that having a clearly stated decision rule in advance of stakeholder debates on an issue would focus the debates and provide transparency.

The merits of the “Balancing Weights Approach as a decision rule is its flexibility in addressing the distributional issues on a case-by case basis. And in this sense, unlike other decision rules, it is not arbitrary in its approach to the trade-off. This approach was established for the review of mergers. Dr. Townley would argue that every merger case is different with respect to efficiencies and distributional impacts, and thus a rigid weighting system is not likely appropriate for merger policy; there is value in flexibility for the decision maker.

However, many of the policies the IESO may wish to consider may be somewhat similar. Therefore, rather than calculating the weight necessary to reject a market change that would create gainers and losers (Townley’s approach), the IESO may wish to incorporate a fixed set of weights into its analyses that accounts for the distributional impacts on a more general basis. While this approach may introduce a level of arbitrariness, it would reduce the evidence and analysis burden. This approach could favour consumers (but justified on the basis of accounting for the distributional effects), and this may be seen as the deference they merit vis-a-vis the stated objectives of the *Electricity Act 2004*. Although some flexibility would be lost, consistency of application would be gained.

A document “Towards the Choice of an IESO Decision Criterion” that discusses four possible decision criteria for the IESO, has been posted on the IESO web site at [http://www.ieso.ca/imoweb/pubs/consult/se77/se77-20081127-IESO\\_Decision\\_Criterion.pdf](http://www.ieso.ca/imoweb/pubs/consult/se77/se77-20081127-IESO_Decision_Criterion.pdf) . One criterion that is discussed is the “Ross – Winter” criterion. This criterion applies fixed weights and may represent an alternative to the more general approach put forth by Dr. Townley.

### *3. The Kaldor-Hicks Criterion is the appropriate Criterion*

Two members stated their support for the Kaldor-Hicks criterion.

One member stated that the primary goal of the market should be to enhance efficiency –striving for efficiency will allow the IESO to satisfy its regulatory obligations to protect the interests of Ontario consumers. Applying a weight greater to consumers that is greater than the weight applied to producers would inflate consumer welfare relative to other participants. This would ignore a fundamental problem of the Ontario’s electricity sector – the lack of sufficient revenue to rationalize private investment.

Another member stated that while it appreciated the balance that must be struck between objectives or purposes contained within the Electricity Act (the “Act”) that may, at times, seem to compete, it still does not agree with the integration of a Balancing Weights Approach within the IESO’s CBA methodology.

### **IESO Response**

The IESO acknowledges the stakeholder support for the K-H criterion and will consider this view in its final recommendations.

#### *4. Distributional issues are not the purview of the IESO.*

Accounting for the distributional aspects of a market change is outside the purview, and expertise of the IESO. This is a matter of public policy and should be left to the government and its direct agencies.

Within the Electricity Act, there are at least four “purposes” that speak directly to the issue at hand:

- to ensure the adequacy, safety, sustainability and reliability of electricity supply in Ontario through responsible planning and management of electricity resources, supply and demand;
- to protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service;
- to promote economic efficiency and sustainability in the generation, transmission, distribution and sale of electricity; and
- to facilitate the maintenance of a financially viable electricity industry.

Promotion of these purposes does not bestow upon the IESO an obligation to formulaically quantify and rank-order those Purposes. Were that the intent, then the legislation would prescribe such an ordering.

#### **IESO Response**

The IESO acknowledges the stakeholder view. In general, the IESO agrees that distributional aspects are not within its area of expertise and is a matter of public policy more broadly. However, the IESO is charged with making decisions on market rule changes and each time it makes a decision, it is in effect, balancing the potential trade-offs of efficiency and consumer distributional effects. The IESO would like to provide transparency and structure to its decision making process and how to how trade-offs are made. As future matters involving this trade-off are brought before the Ontario Energy Board, and as further judicial guidance is provided, the IESO will revise its decision making criterion as required.

#### *5. Specific shortcomings of the Townley approach*

The IESO proposal is to use average demand in non-ramp periods (largely off-peak periods) but peak demand in ramp periods. The result of this process is that the change could impact consumers/generators that consume/produce more in off-peak periods more than those that consumer/produce in on-peak hours. The Townley analysis should capture potential wealth transfer of the different classes of participants.

The proposed cost-benefit analysis is not well set up to address regional or sectoral “losers” on the consumer side. Projected downstream loses such as job loses within a region or sector are hard to quantify but are sure to be used politically, if losers feel that they are disadvantaged by the initiative. For this reason there are many possible pitfalls to be addressed if the criteria is used as a major decision making tool where there are major winners and major losers as a result.

## **IESO Response**

The IESO believes that where or when these effects are relevant they can be factored into the CBA framework. As stated in 1 above, not all of the consequences need to be quantified or summarized in dollar terms. Trade-offs can be identified and critical values—what an impact would have to be worth for a particular alternative to be favoured—can be calculated. The goal is to inform in a clear and consistent way the different implications to the different affected parties.