CJI0011132

The Ontario Energy Board: Mandate, Powers and Processes

Report Prepared for the Collingwood Judicial Inquiry

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Purpose of the Report

The Town of Collingwood called for a judicial inquiry into the 2012 share sale of Collingwood Utility Services Corporation (COLLUS) to PowerStream Inc. The Collingwood Judicial Inquiry is looking into a number of issues, including the sale transaction, the process leading up to the sale, and the impact on ratepayers. The share sale required the approval of the Ontario Energy Board (OEB), and therefore as part of its work, the Inquiry has requested a report which outlines the roles and responsibilities of the OEB. In particular, the Inquiry would like to understand the OEB's oversight of mergers and acquisitions, including the sale of all or part of a local distribution company (LDC), and the role of the Affiliate Relationships Code. The Inquiry would also like to understand the OEB's sources of information, its jurisdiction, and the limits on its oversight related to mergers and acquisitions of an LDC.

This Report begins with a discussion of the mandate of the OEB, why it exists, and what it does. The second section focuses on the role of the OEB with respect to mergers, acquisitions, amalgamations and divestitures (known as MAADs).The third section focuses on the setting of rates for electricity distribution, including the impact of shared services with affiliated companies.

1. The Mandate of the OEB

Why Does the OEB exist?

The OEB is a typical economic regulator. Economic regulators are created by governments to regulate natural monopolies. A natural monopoly has two key characteristics: it has high fixed start-up costs (for example, building an electricity distribution system) and it has economies of scale (in other words, the more customers added to the system, the cheaper it is to serve each customer). Natural monopolies exist for a number of essential services, such as water, natural gas distribution, and electricity distribution. If there is a natural monopoly, customers have little choice in who provides service, and therefore there is no pressure on the utility to maintain the pricing and service levels which would be expected in a competitive sector. Creating a regulator like the OEB is a way to protect the public interest, by regulating the prices monopolies can charge and ensuring they provide appropriate service.[1]

Governments sometimes play the role of economic regulator directly through a government department or cabinet decisions. However, many governments establish independent economic regulators in order to separate these decisions from political influence. The Ontario government created the legislation governing the OEB, the *Ontario Energy Board Act*, and retains some decision-making for itself (through Directives, Regulations, and other means). The *OEB Act* reflects the policy decisions of the government

[1] Over time, the factors that give rise to a natural monopoly may change. This is often the result of technology change. Telephone service was once a natural monopoly, but it no longer is one.

and sets out how the OEB will implement that policy. The specific decision-making is done by the OEB in open, fair, evidence-based processes, using the expertise of the regulator and the principles of administrative law.

The OEB has a set of objectives and powers which are set out in legislation. The *OEB Act* identifies six objectives in the area of electricity regulation:[2]

1. *To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.*

1.1 *To promote the education of consumers.*

2. *To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.*
3. *To promote electricity conservation and demand management in a manner consistent with the policies of the Government of Ontario, including having regard to the consumer's economic circumstances.*
4. *To facilitate the implementation of a smart grid in Ontario.*
5. *To promote the use and generation of electricity from renewable energy sources in a manner consistent with the policies of the Government of Ontario, including the timely expansion or reinforcement of transmission systems and distribution systems to accommodate the connection of renewable energy generation facilities.*

This set of objectives includes traditional regulatory objectives (consumer protection, economic efficiency, financial viability) and Ontario policy-specific objectives (consumer education, conservation and demand management, smart grid, and renewable electricity generation).

Economic regulators like the OEB are sometimes described as a "substitute for competition". The OEB tries to simulate the effects of competition in terms of economic efficiency (how well the companies invest and operate their systems) and consumer protection (service quality and cost-based pricing). However, the OEB also has a role in implementing government policy. The government will often decide the overall market structure (for example, whether competition will be introduced), or how broader policies will be implemented (for example, how climate change policy will be implemented through carbon pricing or other means).

The Ontario government recently released a report by an expert panel which reviewed the structure of the OEB. That report recommends a number of changes in the organization and governance of the OEB, but does not recommend any fundamental changes in its mandate.[3]

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[2] The OEB has extensive powers related to electricity and natural gas. For purposes of this report, the focus is on electricity distribution.

[3] *Ontario Energy Board Modernization Review Panel, Final Report*, October 2018.

Whose Interests Does the OEB Protect?

Overall, the OEB must protect the *public interest*. The public interest is a broad concept which involves the consideration of the interests of particular individuals and groups, as well as the overall interests of the province and the people of the province.[4] As part of its public interest mandate, the OEB has specific objectives related to consumer protection as well as to the economic viability of the sector.

One of the main objectives of every economic regulator is to protect the interests of consumers. This involves short-term and long-term considerations. The OEB could set prices below cost in order to provide low prices for today's customers, but that would discourage further investment, and leave future customers vulnerable to inadequate service. The OEB works to ensure that the utilities it regulates undertake an efficient level of investment and charge for that service fairly. The OEB also ensures that utilities provide adequate service for customers. That will include areas such as billing practices, connection and disconnection, and planning for the future system.

The OEB protects the interests of electricity distributors and their investors (debt holders and shareholders) by having a fair process to set rates which in turn gives the company the *opportunity* to recover its costs and earn a fair return. The OEB does this to fulfill, in part, its objective to maintain a financially viable sector. Electricity distributors have an "obligation to serve".[5] In other words, if a customer wants service, the company is obliged to connect the customer and provide service. In exchange, the company is entitled to recover its (efficient) costs and earn a return on its investment.[6] This is known as the "regulatory compact". It is important to note that the OEB does not *guarantee* that costs will be recovered or *guarantee* that a certain return will be earned. The company will have to operate the system efficiently in order to earn the allowed return.

Regulation is sometimes characterized as a balancing of consumer and investor interests, but other interests are considered as well. Sometimes the various interests are aligned, and sometimes not. The OEB works to establish policies and processes which align the interests as much as possible. For

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[4] A full analysis of the public interest, what it is and how it is best achieved, is beyond the scope of this report.
[5] There are limitations on the obligation to serve. For example, if the customer is far from the existing system, he/she may be have to pay money up front to get connected.
[6] The opportunity to earn a fair return is a fundamental concept established by the Supreme Court of Canada in 1929:

> *By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise...*
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> *The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested. Northwestern Utilities v. City of Edmonton [1929] S.C.R. 186 at 193; [1929] 2 D.L.R. 4 (NUL 1929), per Lamont J. at p. 8*

example, incentive regulation tries to align the interests of consumers and utility shareholders. When the interests are not aligned, or cannot be aligned, the OEB must consider the evidence and determine the best outcome which balances the various competing short-term and long-term interests, including all relevant public interest factors.

Economic regulation is built on a long history of economic theory and legal precedent. Many of the principles involved today were developed by scholars such as James Bonbright[7] and Alfred Kahn[8] decades ago. Similarly, key court cases in the early 20th century established the foundations of economic regulation and administrative law. The principles established for economic regulation have found wide application around the world. The OEB is typical of many economic regulators in Canada, North America, and worldwide. Although each regulator differs in terms of the scope of its powers and the precise nature of some of its objectives, they are very similar in overall mandate and approach.

What is an LDC?

Ontario's electricity system has three main components:

- Generation: Electricity is produced using nuclear power, hydro, wind, solar, and fossil fuels.
- Transmission: Electricity is moved long distances at high voltages using lines that connect generation sites to areas with customers, and also connect Ontario to its neighbours. Very few customers are directly connected to the transmission system.
- Distribution: Local networks of lines and poles deliver electricity to individual customers from the transmission system.[9]

A Local Distribution Company (or LDC) is a company which installs and maintains poles and wires to deliver electricity to residential, commercial and industrial customers in a specific geographic area. LDCs in Ontario are predominantly municipally-owned. Historically, these organizations were commissions within the municipal government. Ontario LDCs are now business corporations under the Ontario *Business Corporations Act*.[10]

What Does the OEB Do?

The OEB has specific powers in relation to electricity distribution.[11] There are three broad categories:

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[7] *Principles of Public Utility Rates*, James C. Bonbright, Columbia University Press, 1961. This is a seminal work in the field of public utility regulation.

[8] *The Economics of Regulation: Principles and Institution*, Alfred E. Kahn, 1970. Kahn was a leading thinker in the area of deregulation, beginning with studies about the airline industry.

[9] Some large industrial customers are connected directly to the transmission system. Also, increasingly, small scale generation facilities are connected to individual customers (e.g. rooftop solar installations) or to distribution systems. These are known as *distributed energy resources* (or DERs).

[10] See section 142 of the *Electricity Act, 1998*.

[11] The OEB has a variety of other powers related to the electricity and natural gas sectors, but those aspects are beyond the scope of this report.

- **Licensing**: every LDC must have a licence from the OEB to operate. A licence identifies the distributor's specific service territory and includes a set of standard licence conditions which set out the distributor's operational and financial obligations. More recently, licences have been amended to include obligations related to conservation and demand management and restrictions on winter service disconnections. If a distributor has received any exemptions to the licence conditions, those are included as well.
- **Rates**: An LDC may only charge rates which have been approved by the OEB. The LDC makes an application to the OEB justifying the rates it wants to charge, and the OEB has a public hearing to decide what the rates will be. The OEB considers system planning, costs, and various incentive factors to determine the appropriate rates. (The rate setting process is discussed in the third section of this Report.)
- **Oversight**: The OEB has developed a number of Codes which impose binding rules on LDCs for how they conduct many aspects of their business, including customer service and operations. Two of the key codes are the *Distribution System Code* and the *Affiliate Relationships Code for Electricity Distributors and Transmitters* (the latter is discussed in the third section of this Report). Electricity distributors are also required to report on their performance each year across a set of key indicators. These *Performance Scorecards* are posted on the OEB's website, and consumers can compare the performance of their LDC with others. The OEB also has various enforcement powers (including audit and inspections), and if an LDC is found to have broken the rules, then the OEB can force the company to change its practices and can fine the LDC and/or the directors and officers of the LDC.

What Does the OEB NOT Do?

Although the OEB has a broad mandate and wide powers in relation to electricity distribution, it does not regulate all aspects of an LDC's business. LDCs may pursue other lines of business which are not rate regulated. Some of these businesses may be done within the LDC directly, but it is more common for the LDC, or its parent company, to set up affiliate companies to undertake these businesses.[12] Often there are business relationships between the LDC and the affiliates whereby the companies purchase services from each other. The OEB does not have power over the affiliates, but it does have the power to put limits on the business relationships between the LDC and all of its affiliates. (The *Affiliate Relationships Code* is discussed further in the third section of this Report.)

Municipalities often establish a holding company to in turn own the LDC as well as any unregulated businesses (the affiliates). While the OEB has no power over the holding company, the OEB is concerned with how decisions taken by the holding company will impact the LDC and its customers. For

[12] The *OEB Act* prohibits distributors from carrying on business activities other than distributing electricity, but there are a number of exceptions related to government policy. There is no restriction on the business activities of an affiliate (see section 71). Examples of unregulated affiliates include businesses involved in telecommunications, streetlighting, electricity generation, and services (such as billing). EPCOR Electricity Distribution (the new name for COLLUS PowerStream) has two affiliates, but both are identified as *inactive*.

this reason, the OEB has taken a growing interest in corporate governance for LDCs.[13] The board of directors of an LDC must act in the best interests of the corporation, but if key decisions (related to system investments or dividends, for example) are taken in a way which puts the interests of the holding company ahead of the LDC and its customers, then there may be adverse consequences for the LDC and/or its customers. For example, if dividends paid to the holding company are increased, and funds for investment in the LDC system are reduced, there may be a reduction in service quality or reliability over time. The OEB has recently issued guidance on corporate governance.[14] The guidance describes best practices in the several areas of corporate governance, including director independence, director skills, board and committee structures and functions, and documentation and practices. The guidance is not mandatory, but the OEB expects to improve corporate governance practices in the sector.

2. The OEB and Mergers, Acquisitions, Amalgamations and Divestitures (MAADs)

What is a MAADs Application and Why is it Necessary?

Oversight of changes in control of LDCs is one way in which the OEB protects the public interest. The *OEB Act* requires that an LDC receive OEB approval before it can sell its system or amalgamate, and the *OEB Act* requires that a company get OEB approval before it can purchase more than 10% of the voting securities in a distributor.[15] These provisions are designed to ensure that a company acquiring a distribution system has the financial resources and operational qualifications to fulfills its obligations, including licence conditions, rate orders, and all the codes and rules of the OEB. These powers are typical of most economic regulators.[16] For the OEB, these provisions relate to when a company is looking to merge, acquire, amalgamate, or divest a distribution system, hence the term “MAADs”.

How Does the OEB Decide Whether to Approve a MAADs Application?

If an LDC has negotiated a transaction with a purchaser, the two companies file an application (known as a “MAADs application”) with the OEB, and the OEB holds a hearing. (The various process steps for a hearing are described in the third section of this Report.)

[13] The OEB has always had some involvement in corporate governance. For example, the *Affiliate Relationships Code* (discussed later in this report) requires that one-third of the corporate directors be independent. The focus on governance increased after the OEB introduced a new framework for rate regulation, the Renewed Regulatory Framework, in 2012.

[14] *Report of the OEB: Best Practices regarding Governance of OEB Rate Regulated Utilities*, EB-2014-0255, December 20, 2018.

[15] The two key provisions are sections 86(1) and 82(2) of the *OEB Act*.

[16] Some transactions may be explicitly excluded from a regulator’s review. For example, the Ontario government’s decision to sell over 50% of the Hydro One Inc. through an initial public offering was excluded from the OEB’s approval process.

The *OEB Act* does not set out a specific test which the OEB must apply in deciding a MAADs application. Over time, though, the OEB has developed a consistent approach to assessing MAADs application, known as the "no harm test".[17] The OEB assesses whether the proposed transaction will have an adverse impact on the achievement of the OEB's statutory objectives. If the OEB determines that the cumulative impact of the transaction will be neutral or positive, then the "no harm" test is met and the OEB will approve the application.

Most of the transactions involving LDCs have involved consolidation, or the gradual reduction in the total number of Ontario LDCs through mergers, acquisitions and amalgamations amongst LDCs. The OEB has explicitly stated that it is committed to reducing regulatory barriers to the consolidation of LDCs. The *Handbook to Electricity Distributor and Transmitter Consolidations*[18] sets out the principles the OEB will apply when considering consolidation applications, as well as the rate-making policies associated with consolidation. The *Handbook* is designed to provide the sector with consistency and predictability, thereby facilitating more consolidation.

The OEB has confirmed the "no harm" test in the *Handbook*, and explained that the OEB's focus will be on its first two statutory objectives: the impact of the proposed transaction on price, reliability and quality of service; and on the cost effectiveness, economic efficiency and financial viability of the electricity distribution sector. The OEB will generally not conduct a review of the impact of the transaction on the statutory objectives related to smart grid, conservation and demand management, and renewable generation, because it has a number of codes and rules through which it can ensure that distributors continue to meet their obligations in those areas.

In considering the impact on price, the OEB is more concerned with the underlying cost structures than with temporary rate decreases, because these temporary measures may not be sustainable or beneficial in the long term. The *Handbook* states:

> *To demonstrate "no harm", applicants must show that there is a reasonable expectation based on underlying cost structures that the costs to serve acquired customers following a consolidation will be no higher than they otherwise would have been.*[19]

In considering impact on reliability and quality of service, the OEB focuses on the relevant performance metrics. In considering the impact on cost effectiveness, economic efficiency and financial viability, the OEB focuses on the effect of the purchase price, including any premium above the book value of the assets, and the financing of any transaction and integration costs to implement the transaction.

The *Handbook* also confirms a number of issues that the OEB will NOT consider. These issues were originally considered in a combined proceeding in 2005 which examined three distribution MAADs

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[17] The "no harm test" was established through a proceeding in 2005.
[18] *Handbook to Electricity Distributor and Transmitter Consolidations*, Ontario Energy Board, January 19, 2016.
[19] *Ibid., p. 7.*

applications. In that decision, having confirmed the "no harm" test as the appropriate test, the OEB concluded that three specific concerns that had been raised would be of limited relevance to the "no harm" test analysis.

First, the OEB determined that no consideration should be given to whether an alternative transaction would be more beneficial:

> *The Board is of the view that its mandate in these matters is to consider whether the transaction that has been placed before it will have an adverse effect relative to the status quo in terms of the Board's statutory objectives. It is not to determine whether another transaction, whether real or potential, can have a more positive effect than the one that has been negotiated to completion by the parties.*[20]

Second, the OEB concluded that the purchase price in the transaction would be of limited relevance to the "no harm" test assessment:

> *The Board is of the view that the selling price of a utility is relevant only if the price paid is so high as to create a financial burden on the acquiring company which adversely affects economic viability as any premium paid in excess of the book value of assets is not normally recoverable through rates. This position is in keeping with the "no harm" test.*
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> *By contrast, the fact that the selling entity may have received "too low" a purchase price for the utility would not be relevant to the outcome of the proceeding on the basis of the "no harm" test. The fact that the seller could have received a higher price for the utility, even if true, would not lead to an adverse impact in the context of the objectives set out in section 1 of the Act.*[21]

And third, the OEB also concluded that the process used by the sellers would be of limited relevance to the "no harm" test review:

> *A number of other Intervenors have raised concerns regarding the adequacy or integrity of the process by which the sellers in these Applications decided to sell their utilities. In most of these cases, the position has been that perceived deficiencies in the process (such as inadequate public consultation or "improper" motives) in and of themselves are relevant to the Board's determination of the Applications. The Board disagrees.*
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> *As a general matter, the conduct of the seller generally, including the extent of its due diligence or the degree of public consultation in relation to the transaction, would not be issues for the Board on share acquisition or amalgamation applications under section 86 of the Act. Based on the "no harm" test, the question for the Board is neither the why nor the how of the proposed*

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[20] *Decision*, Ontario Energy Board RP-2005-0018/EB-2005-0234/EB-2005-0254/EB-2005-0257, August 31, 2005, p. 6.

[21] *Ibid.*, p. 7.

transaction. Rather, the Board's concern is limited to the effect of the transaction when considered in light of the Board's objectives as identified in section 1 of the Act.[22]

These findings confirm that the OEB does not give any particular consideration to the shareholders and their interests in deciding a MAADs application. The OEB will want to ensure that the financial impacts of the transaction will not put the company in financial jeopardy or increase its risk in a way that might result in harm. Here the concern is with the LDC itself, and not the shareholders. The shareholders of the purchaser and the shareholders of the seller are presumed to have assessed and protected their own interests in doing their due diligence and negotiating the transaction.

If the shareholders of the acquired LDC receive a premium, the OEB protects consumers by ensuring that the premium is not included in rates. The acquiring shareholders can finance the premium and recoup those costs through efficiency savings over time. The OEB does allow the LDC to delay its rate rebasing in order to extend the time over which it can implement the integration and recoup its transaction and integration costs through efficiency savings.

Most LDC MAADs applications have been approved by the OEB. A recent exception has been the application by Hydro One Inc. to acquire Orillia Power. In that case, the OEB was concerned about the underlying cost structures, and expressed doubt that Hydro One's overall cost structure to serve Orillia's customers would be no higher than Orillia's underlying cost structure (absent the transaction). The OEB pointed to the rate proposals Hydro One had filed for a group of other distributors it had acquired previously and noted that the customers of those LDCs were now facing significant rate increases. Hydro One was given the opportunity to file additional evidence to address this issue, but did not do so. The OEB concluded that the "no harm" test had not been met.

The OEB's Decision on the Application by Collingwood and PowerStream

The Town of Collingwood and Collingwood Utility Services Corporation (the holding company for the LDC) applied to the OEB for approval to sell 50% of the holding company to PowerStream Inc., and the OEB issued its decision on July 12, 2012.[23] This section describes the OEB's decision.

The Background section of the decision summarizes the various corporate relationships amongst the parties and identifies the relevant sections of the *OEB Act* under which the application is made. Collingwood needed the OEB's approval to sell 50% of its LDC and PowerStream similarly needed the OEB's approval to purchase that 50%. Because PowerStream also owned generation assets, an additional application was required under another section of the *OEB Act* which we will not discuss further here.

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[22] *Ibid.*, pp. 8-9.

[23] *Decision and Order*, Ontario Energy Board, EB-2012-0056, July 12, 2012.

The Background section also summarizes the transaction and summarizes the applicants' main reasons for why the OEB should approve the transaction. These are factors which are designed to show potential benefits for customers, and little potential for harm to those customers.

The Proceeding section summarizes the steps the OEB took for this particular hearing. Because there were no intervenors, only OEB staff asked questions and made a submission. OEB staff had no concerns with the transaction.

The Board Findings section sets out the panel's conclusion and the reasons for that conclusion. The findings are quite brief because there was no opposition to the application. However, the OEB must still satisfy itself that the transaction should be approved, so the decision summarizes the no harm test and explains how the evidence has been assessed. The OEB concludes that the application has met the no harm test.

The Order section formalizes the OEB's approval and sets out a time period in which the transaction must be completed.

3. Rate Setting and Affiliate Relationships

Statutory Provisions

An LDC may only charge rates for distribution that have been approved by the OEB. The OEB has broad discretion in how it sets rates. The only requirement in the legislation is that rates be "just and reasonable".[24] If an LDC wants to change its rates, it must make an application to the OEB. The application must contain the LDC's proposals for new rates as well as the data, analysis, and reports which the company is relying on to support its proposals. Under the *OEB Act*, the burden of proof is on the applicant. In other words, the LDC has to prove why its proposals are just and reasonable and meet the OEB's various statutory objectives and policy goals. In order to decide on an application, the OEB usually holds a public hearing.

The Hearing Process

A public hearing, where the decision-maker considers an applicant's evidence in an open and accessible process, is one of the foundations of administrative law. One of the key concepts is *natural justice*. Simply put, natural justice means that if you are affected by a decision, then you should have the right to know the decision is going to be made, have the right to participate in the process and make your views known, have the right to know the decision and the reasons for the decision, and have some rights to appeal the decision. In Ontario the hearing process is governed by the *Statutory Powers Procedures Act*.

[24] See *OEB Act*, section 78(2) and 78(3).

The OEB has a *Rules of Practice and Procedure*, as well as various practice directions and filing requirements which explain how the OEB will conduct its hearings.

One of the key strengths of the hearing process is that decisions are made using open, accessible processes, and decisions are made based on the evidence and by the people hearing the evidence. Running public hearings in an efficient and effective way can be challenging. There can be multiple participants with widely varying interests, which may result in large amounts of evidence and various reasons for extended time lines. The OEB has developed a number of different processes and standards to ensure that its hearings follow the principles of administrative law and natural justice and also are efficient and effective.

An OEB hearing generally includes the following steps:

- **Notice**: The OEB issues a Notice of the hearing. The Notice is usually published in local newspapers, and increasingly is being put on social media. Many utilities also inform their customers of the Notice through email.
- **Public Participation**: People, companies, and organizations that believe they will be affected by the application can apply to be participants in the hearing. Participants in the hearing are called "intervenors".
- **Getting More Information**: Intervenors are given time to ask questions to the LDC about the application. They might seek more data or any reports that the company has produced or received from consultants. The answers are generally given in writing and are part of the evidence that the OEB uses to decide on the application.[25]
- **Negotiation**: The OEB often holds a settlement conference, which provides the LDC and intervenors an opportunity to negotiate a resolution of the application without the need for further process steps.
- **Oral Hearing**: If there is no settlement, the OEB will often hold an oral hearing.[26] This is a formal process conducted in front of a panel of OEB Board Members, during which intervenors may cross-examine witnesses from the LDC in order to challenge the strength of the company's evidence. At the end of the hearing, the LDC and the intervenors make submissions to the hearing panel, setting out their views for how the application should be decided.
- **Decision**: The OEB Hearing Panel makes its decision and issues a document that identifies the issues, sets out the OEB's decision, and explains how the panel reached its decision. The approved rates are then put in a Rate Order, which gives the LDC the authority to charge the new rates.

[25] Intervenors may also submit their own evidence, which is also subject to written questions and cross-examination.
[26] If there are no intervenors, or no evidence in dispute, the OEB may forgo an oral hearing and take written submissions from the parties.

How the OEB Sets "Just and Reasonable" Rates for LDCs

The OEB panel assigned to an application reads and hears the evidence, considers the submissions of the LDC and intervenors, and reaches a decision on the issues in the case. In reaching its decision, the panel will also consider any relevant legislation, the OEB's statutory objectives, and prior OEB decisions. The panel will also consider any applicable OEB regulatory policies.

The OEB develops regulatory policies as a way to provide consistency and predictability in regulatory decisions. For example, many years ago the OEB developed a regulatory policy to set the cost of capital included in rates by using a formula.[27] The policy replaced a case-by-case analysis with a transparent, consistent, and fast method for setting the return on equity an LDC would be allowed to earn. The OEB's regulatory policies are not strictly binding, but they set the default approach. If an LDC or an intervenor wants the OEB to take a different approach, they must convince the OEB why a different approach is justified.

One of the key regulatory policies for ratemaking is the OEB's Renewed Regulatory Framework.[28] Under this policy, LDCs have their rates set for multiple years. Rates for the first year are set using a thorough review of the LDC's forecasts and proposals (called "rebasing"). The rates for subsequent years are set with a formula which uses inflation and productivity improvement expectations. Rebasing applications generally involve an extensive application and hearing process. The OEB has set out its expectations for these applications, and explained how they will be assessed, in its *Handbook for Utility Rate Applications*.[29]

In considering an LDC's proposals, the OEB will assess whether the evidence demonstrates that the proposals meet the OEB's expectations around performance in four key areas: customer focus, operational effectiveness, financial performance, and public policy responsiveness. The *Handbook* identifies the key components of a rate application and identifies what the OEB will consider when assessing each component. For example, customer engagement is a key component, and the OEB states:

> *In reviewing customer engagement, the OEB will consider:*
> - *The forms of customer engagement used, their quality and effectiveness*
> - *The quality of the utility's analysis of customer input*
> - *Whether and how customer input has informed the utility's planning*

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[27] Prior to the policy being established a significant amount of time was used in each hearing to hear the evidence of various experts hired by the applicant or by intervenors. This evidence was often highly technical and often as much a matter of opinion as of fact and was often very similar from case to case.

[28] *Report of the Board, Renewed Regulatory Framework for Electricity Distributors: A Performance-Based Approach*, October 12, 2012. This policy sets out how the OEB is moving to Performance Based Ratemaking, which is a form of regulation which focusses more on measuring the outcomes an LDC achieves (in terms of cost efficiency, customer service, etc.) than on a detailed review of all the individual cost inputs.

[29] *Handbook for Utility Rate Applications*, Ontario Energy Board, October 13, 2016.

- *Whether and how the utility's plan deliver benefits which address customer needs and preferences*[30]

Rate applications include data and analysis in many areas, including load forecasts, system planning, operations and maintenance costs, executive compensation, rate structures, etc. Rate applications must also identify any transactions between the LDC and its affiliates. The OEB considers the rate impact of affiliate transactions (or shared services agreements) in the rate application process. The OEB also places restrictions and requirements on LDCs through the *Affiliate Relationships Code*.

Shared Services Agreements and the Affiliate Relationships Code

The relationships between an LDC and its affiliates are regulated by the OEB through the *Affiliate Relationships Code for Electricity Distributors and Transmitters* (also known as the "ARC").[31] The ARC is a set of rules about what an LDC can, and cannot, do in its dealings with an affiliate. Although the affiliates may be involved in unregulated businesses, the OEB is still concerned about the LDC's relationship with an affiliate for two key reasons:

1. The OEB wants to ensure there is no *cross-subsidy* between the businesses. A cross-subsidy happens when the utility provides a service to its affiliate at less than the cost of the service, or when the LDC acquires a service from an affiliate at a price that is higher than the cost of the service or higher than the LDC would have to pay on the competitive market for the service. In either situation the affiliate benefits at the expense of the LDC and its customers.
2. The other concern is if the LDC *discriminates* in a way that benefits its affiliate. For example, if the LDC requires its customers to use the services of its affiliate rather than allowing customers to choose a competitor. This damages competition and is detrimental to the interests of customers. Affiliates can also receive an unfair competitive advantage if they have access to utility information or customer information to which competitors do not have access.

The purpose of the ARC is to prevent the types of inappropriate behaviour that would lead to cross-subsidies or discrimination. The ARC deals with a variety of areas, including accounting separation, information protection and information sharing, transfers and sales of assets, loans and investments, and access and treatment of competitors. The pricing of services between the LDC and its affiliates has a comprehensive set of requirements:

- A Services Agreement (or Affiliate Contract) must be in place if the utility provides, or receives, a service from an affiliate, and the maximum term is five years.
- If there is a competitive market for the particular service, the LDC may pay the affiliate *no more than* the market price for the service, which generally must be determined through a competitive bidding process. Similarly, the LDC may charge *no less than* the market price for providing a service to an affiliate.

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[30] *Ibid.*, p. 12.

[31] *Affiliate Relationships Code for Electricity Distributors and Transmitters*, Ontario Energy Board, March 15, 2010.

- If there is no competitive market for the particular service, the LDC may pay the affiliate *no more than* the affiliate's fully-allocated cost[32] for the service, and the LDC may charge *no less than* its fully allocated costs for providing the service to an affiliate.
- For any shared corporate services, fully allocated cost-based pricing must be used.

The OEB requires the CEO of the LDC to self-certify each year that the LDC is in compliance with the ARC.

As indicated above, shared services are often reviewed through the rate application process. For example, if the LDC acquires services from an affiliate, the intervenors and the OEB staff may challenge the LDC to demonstrate that it is paying no more than would be paid in the competitive market (or no more than fully allocated costs if there is no competitive market). The OEB *Handbook for Utility Rate Applications* sets out the OEB's expectations in this area:

> *The OEB will consider non-regulated activities and transactions with affiliates in the context of their effect on the regulated rates to customers to ensure there are no cross subsidies that negatively affect these regulated customers.*
>
> *Depending on the corporate structure of the utility, this could include an assessment of:*
> - *The reasonableness of the costs allocated to non-regulated activities within the regulated utility*
> - *The costs to be charged to the regulated utility from an affiliate*
> - *The revenues forecast to be received from an affiliate for services provided by the regulated utility*
> - *Whether these activities affect the quality of services to be delivered to the customers of the regulated utility*
> - *Whether non-regulated activities will affect the financial viability of the regulated utility, or introduce a significant enough risk that it affects debt financing costs*[33]

If the OEB determines that the LDC is overpaying for services, or undercharging for services, it will adjust the LDC's rates accordingly.

The OEB can also review compliance with the ARC through an investigation outside of a rate application. An investigation could be triggered by a complaint, by evidence which comes out in a hearing, or through the OEB's audit activities. Generally, the OEB seeks to bring companies into compliance, and there have been no formal compliance actions against an LDC in relation to the ARC.

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[32] Fully allocated costs means all the direct costs of a service (direct labour, materials and supplies, etc.) as well as a share of the indirect, or overhead costs, including fixed costs and administrative costs.
[33] *Handbook for Utility Rate Applications,* pp. 21-22.