Borden Ladner Gervais LLP
Lawyers • Patent & Trade-mark Agents
Scotia Plaza, 40 King Street West
Toronto, Ontario, Canada M5H 3Y4
tel.: (416) 367-6000 fax: (416) 367-6749
www.blgcanada.com

J. MARK RODGER
direct tel.: 416-367-6190
direct fax: 416-361-7088
e-mail:mrodger@blgcanada.com

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October 20, 2006

Ms. E. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2309
27th Floor
2300 Yonge Street
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Generic proceeding to amend the licenses of distributors to determine distribution rates by methods and techniques
OEB File No. EB-2006-0087

Introduction

1. We are counsel to the Coalition of Large Distributors (the "CLD"), comprising Toronto Hydro-Electric System Limited, Enersource Hydro Mississauga Inc., PowerStream Inc., Horizon Utilities Corporation, Veridian Connections Inc. and Hydro Ottawa Limited.

2. The matters currently before the Board all pertain to the approach to be taken by the Board in establishing distribution rates over the 2007 to 2010 period. The Board has commenced proceeding No. EB-2006-0087 on its own motion to amend the licences of electricity distributors ("LDCs") to make provision for methods and techniques to be applied by the Board in determining distribution rates over this period (and potentially beyond 2010).

3. At the same time, and over the course of 2006, the Board has consulted with stakeholders on the development of parameters to be used in determining an LDC's cost of capital and an incentive regulation mechanism ("IRM") to be used to adjust a distributor's rates pending rebasing (the "Code Development Process"). Stakeholders that have participated at the Technical Conference component of the Code Development Process have been asked to file written submissions on the various parameters discussed by Friday October 27, 2006

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("TC Submissions"). On October 6, 2006, the Board issued Procedural Order No. 1 in the licence amendment proceeding referenced above.

4. During the Code Development Process, and given that the determination of distribution rates is the essential outcome of this process, several stakeholders have expressed concerns about the Board's approach. In particular, concerns have been raised regarding whether the Board has jurisdiction to proceed in the manner currently anticipated.

5. Stakeholders were advised that the appropriate forum to raise these concerns is the licence amendment proceeding. The CLD takes this opportunity to provide its submissions on these matters.

General Recommendation on the proposed Licence Amendment Proceeding and the Code Development Process

6. Given the nature and status of the discussions during the Code Development Process to date, the CLD respectfully recommends that the Board discontinue its pursuit of establishing codes to determine cost-of-capital and IRM. While the CLD will fully explain the basis for this recommendation in its TC Submissions to be filed with the Board on October 27, 2006, in essence, the CLD submits that no persuasive basis has been established for introducing the proposed codes at this time and that a revised Distribution Rate Handbook approach would better meet the Board's objective of regulatory efficiency and avoid the various jurisdictional issues that the new codes would create, as described below. If the CLD's recommendation is accepted by the Board, there would be no need to continue with the current proceeding EB-2006-0087.

7. Accordingly, the CLD requests that the Board have regard to its October 27, 2006 TC Submissions in its consideration of the matters arising from Procedural Order No. 1 in proceeding No. EB-2006-0087.

8. Notwithstanding our clients' central recommendation, the CLD does want to address certain jurisdictional and other concerns relating to the Licence Amendment proceeding and Code Development Process as currently contemplated.

While the Board has authority to promulgate codes, the licence amendment process and ultimate utilization of codes for ratemaking purposes as currently contemplated does not comply with the Board's jurisdiction

- **The Board's code-making authority**

9. Pursuant to section 70.1 of the *Ontario Energy Board Act, 1998* ("OEB Act"), the Board has authority to issue codes which "may be incorporated by reference as conditions of a licence". The OEB Act also describes the process by which codes are promulgated – which does not require a hearing. Pursuant to section 70.2, the Board is required to provide notice of a code and provide stakeholders with an opportunity to make written submissions on the proposed code. If the Board

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makes material changes to a proposed code, these changes must also be circulated and an opportunity provided for stakeholders to make further written representations. Thereafter the Board issues the finalized code.

- **To determine LDC rates by codes would be an improper use of codes and licence conditions**

10. The codes issued to date by the Board all focus upon various behavioural and operational standards. These features are captured and reflected in the existing codes including the Affiliate Relationships Code, the Distribution System Code, the Electricity Retailer Code of Conduct, the Retail Settlement Code and the Transmission System Code. These Codes reflect minimum standards on a broad range of operational-related activities for distributors, transmitters and retailers. None of these codes is used to establish rates. The CLD submits that codes are not properly used when they attempt to establish the central financial parameters of distributors and determine "just and reasonable rates".

- **Fairness and natural justice require that just and reasonable rates be established through a hearing**

11. Section 78 of the OEB Act provides, in part:

> **Order re: distribution of electricity**
>
> 78(2) No distributor shall charge for the distribution of electricity or for meeting its obligations under section 29 of the *Electricity Act, 1998* except in accordance with an order of the Board, which is not bound by the terms of any contract. 2000, c. 26, Sched. D, s. 2 (7).
>
> **Rates**
>
> (3) The Board may make orders approving or fixing just and reasonable rates for the transmitting or distributing of electricity and for the retailing of electricity in order to meet a distributor's obligations under section 29 of the *Electricity Act, 1998*. 1998, c. 15, Sched. B, s. 78 (3).

12. Section 21 (2) of the OEB Act states that subject to any provision to the contrary in this or any other Act, the Board shall not make an order under this or any other Act until it has held a hearing after giving notice in such manner and to such persons as the Board may direct.

13. Clearly, distribution rates may only be established on the basis of an order. The Board has explained, in its September 2006 "Report with Respect to Decision-Making Processes at the OEB"[1], that orders are fundamentally different from codes and rules. As the Board has acknowledged, "On the whole, orders may only be issued after a hearing", and "Orders are made by panels on the basis of an evidentiary record."[2] Depending on whether the hearing is written or oral, the parties will "have the right to file evidence, challenge the evidence of other

[1] A Report with respect to Decision-Making Processes at the OEB, published in September 2006 by the Ontario Energy Board
http://www.oeb.gov.on.ca/documents/abouttheoeb/corpinfo_reports/decision_making_processes_report_270906.pdf
[2] *Ibid.*, at p.7.

parties, and make oral submissions" (oral hearing), or "to file written materials and have access to all written materials considered by the Board in making its decision" (written hearing).[3] Orders are based on attested materials filed by parties, and the focus in the processing of information is on creating an evidentiary record, which will be subject to "intense scrutiny through highly formal rules".[4] The Board suggests that the information processing function related to orders is "Labour intensive for Applicants, Intervenors and Board Staff"[5] – while all parties can certainly appreciate the Board's concern in this regard, the applicable legislation requires that just and reasonable rates are determined by **orders** of the Board, and the Board itself confirms that orders are arrived at through hearings, with an evidentiary record that is intensively scrutinized – not through consultative processes in which no evidentiary record is assembled or subjected to intense scrutiny.

- **Distributors have the right to bring their applications of choice before the Board, supported by the appropriate evidence, and to have those applications decided by an unbiased, impartial adjudicator. This right cannot be overridden by a regulatory instrument such as a code.**

14. The Board's role, among others, is to set just and reasonable rates based upon applications from distributors. The Board has promulgated Rate Handbooks that serve as a default mechanism that LDCs may use, but are not required to follow. The 2006 Distribution Rate Handbook was considered by the Board to constitute guidelines from which a distributor could depart. Granted, the departures would have to be justified, but distributors would have an opportunity to do so. The technique of a Rate Handbook has allowed the Board to expedite the preparation and disposition of large numbers of distribution rate applications, while still allowing for the consideration of individual LDCs' circumstances. No reason has been given to date for the abandonment of this approach, except for the need for an expeditious way to process some 90 distribution applications for 2007. The CLD submits that regulatory expediency is not a sufficient reason to either abandon the former approach, which was in itself an expeditious way to process applications, or to adopt the code approach currently proposed.

15. The CLD submits that the Board must take into account the nature of the rights affected in considering this matter. Unlike the issues being addressed by the other codes, a code that determines matters such as cost of capital and rates goes to the heart of the financial integrity of the utility and the fundamental economic interests of its shareholders and subsequently to the LDCs ability to provide service at acceptable levels of quality on an ongoing basis to customers. A well established principle in determining "just and reasonable" rates is that the applicant utility must be permitted to charge rates that will permit it to recover its costs based on a fair return of invested capital. This concept has been discussed during the Technical Conference phase of the Code Development Process. A fair

[3] *Ibid.*
[4] *Ibid.*, at p.10
[5] *Ibid.*

return will only be achieved when LDC investors receive the same return as other investors do on businesses with similar risk.

16. Given the implications for LDCs, a code embodying financial parameters like cost of capital as a mandatory licence condition is not an appropriate vehicle to determine these critical matters. The CLD submits that the OEB Act would have expressly provided for the use of codes to establish distribution rates as licence conditions if the legislature's intent was to use codes for this purpose. However, in establishing "just and reasonable" rates the Act is specific in section 78 that an order from the Board is required. As described above, the Board can and should only make a rate order based on a proceeding where evidence is led and tested, and the finding of facts is rendered by the Board. It would appear that all of these critical features would not occur if the Board established rates through codes as distribution licence conditions.

17. Accordingly, the CLD submits that codes are simply not an appropriate vehicle to determine cost of capital and IRM issues. Such codes may have the effect of restricting the LDC's right to make an application of its own choosing in pursuit of the fair return principle. In effect, the locking in of the cost of capital through the code process represents a denial of fairness and natural justice. An applicant must have an opportunity to lead the evidence it chooses and have an impartial, unbiased decision maker adjudicate that application.

- **Cost of Capital and IRM codes may increase perceived risk associated with electricity distributors within capital markets**

18. The CLD is aware that financial institutions are monitoring the Code Development Process and the Licence Amendment proceeding. Some commentators have expressed similar concerns to the issues raised by the CLD in this submission. For example, on page 9 of the October 13, 2006 report entitled "Wires, Pipes & Btus", BMO Capital Markets offers the following observations on the Code Development Process:

> "We believe that inadequately tested, advocacy positions developed by Board staff are not only potentially incorrect, but highly prejudicial to future regulatory processes and may constrain the Board's ability to objectively hear the evidence of participants."

We attach a complete copy of the October 13 report for your information.

19. The CLD is very concerned that if the imposition of new codes has the effect of increasing the risk profile for Ontario distributors, this will ultimately result in increased costs for distributors and their customers. The CLD believes that such an outcome would be contrary to the Board's guiding objectives contained in section 1 of the OEB Act:

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

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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.

- **In the alternative, if the Board continues to pursue the licence amendment proceeding, this hearing must include a full review of the issues currently excluded by the Board, since these critical code "mechanics" require findings of fact**

20. Through commencing a hearing on its own motion, the Board is acknowledging that a proceeding is required if it intends to impose new codes as mandatory conditions of distribution licences. However, on page 3 of Procedural Order No. 1, the Board identified certain matters that will not be issues in the hearing. Specifically, the licence amendment proceeding will not address the following:

1. Whether incentive regulation, in whatever form it may ultimately take, is an appropriate methodology for setting electricity distribution rates. This is a policy issue that has already been determined by the Board.

2. The details of incentive regulation and cost of capital methodology to be used in setting electricity distribution rates. This is the subject matter of the Code Development Process, and that is the appropriate forum in which those details should be addressed.

3. Whether any particular distributor should be exempt from the application of the incentive regulation or cost of capital methodology that is being developed through the Code Development Process. Consideration of individual exemptions is premature as the Code Development Process has not yet been completed. In addition, determining whether an exemption is appropriate is better addressed on a case-by-case basis further to an application filed for that purpose rather than in a generic proceeding.

21. Accordingly, at this time it would appear that the proceeding is restricted to the language contained in the Proposed Licence Amendment contained in Appendix A of the Procedural Order. It would also appear that the Board intends to arrive at conclusions on the substantive issues currently excluded from the licence amendment proceeding based upon the Code Development Process discussions.

22. The CLD submits that it is not appropriate to have a hearing on whether a licence condition should be imposed that focuses upon the wording only but which extracts the substantive core issues from this review. Furthermore, LDCs cannot determine the appropriateness of the wording without knowing the nature and content of the codes to be introduced. In this sense the CLD submits that the Licence Amendment proceeding is premature, at best, or incomplete, at worst.

23. The dilemma posed by the Code Consultative Process is that it represents a forum for discussion but there is no evidentiary record for the Board to assess whether the financial parameters are appropriate. As Mr. Fogwill of Board staff accurately indicated during the October 17, 2006 Technical Conference, the reports and other materials being reviewed "is not evidence. It's a consultative process that involves the conversation amongst a number of stakeholders" (page 14, lines 17-19).

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24. The CLD submits that if the Board decides to continue to pursue the development of cost of capital and IRM codes, the Board is required to hold a hearing on these substantive issues, permit evidence to be led and tested in order for the Board to make findings of fact on these matters, and thereafter issue a decision on its findings. In short, the Board needs to make a determination on whether the "methods and techniques" are appropriate for purposes of establishing distribution rates.

25. Accordingly, and in the alternative, the CLD recommends that an oral hearing be held in the Licence Amendment proceeding (subject to the qualifications set out in these submissions). The CLD submits that an oral hearing is a superior process for a complete discovery and examination of the substantive issues as compared to what could be achieved in a written hearing.

- **If new codes are issued, distributors still need to retain the flexibility to file applications based upon different parameters from those contained in the codes. Accordingly, exemptions to code licence conditions must be easily obtainable by distributors.**

26. A fulsome review and adjudication of all the issues in the Licence Amendment proceeding and the issuance of new codes thereafter should in no way constrain the ability of distributors to seek, and readily obtain, a licence exemption from these codes. Fairness and natural justice require that distributors continue to have the ability to depart from the codes, at their discretion, in order to submit an application of their choice for the Board's consideration. Accordingly, the CLD submits that the Board should articulate a policy in this regard with respect to licence condition exemptions.

27. In other words, an oral hearing and Board decision on the substantive issues surrounding cost-of-capital and IRM should not constrain the ability of LDCs to pursue applications based upon different parameters and the Board should acknowledge that the licence exemption process must accommodate this outcome.

Summary & Conclusion

28. The CLD respectfully submits:

(a) That the Board should not proceed to promulgate codes for cost-of-capital and IRM.

(b) That the Board should instead issue non-binding guidelines for cost-of-capital and IRM pursuant to a revised Distribution Rate Handbook.

(c) In the alternative, if the Board intends to promulgate new codes, the Licence Amendment proceeding should be comprised of a valid, duly constituted oral hearing that includes an examination of the issues currently excluded by the Board in its Procedural Order No. 1.

(d) In the further alternative, that if cost-of-capital and IRM codes are promulgated pursuant to item (c) above, the Board should articulate the clear expectation that the threshold for distributors to obtain an licence

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exemption from these codes will be minimal to ensure that distributors will be treated fairly by not being denied the right to bring forward a rate application of their choice based upon evidence that the LDC deems appropriate.

All of which is respectfully submitted.

Yours very truly
Borden Ladner Gervais LLP

Original signed by J. Mark Rodger

J. Mark Rodger

Encl.
copy to:

Pankaj Sardana, Toronto Hydro-Electric System Limited
Colin McLorg, Toronto Hydro-Electric System Limited
Kathi Litt, Enersource Hydro Mississauga Inc.
Colin Macdonald, Powerstream Inc.
Paula Conboy, Powerstream Inc.
Cameron Mckenzie, Horizon Utilities Corporation
Lynne Anderson, Hydro Ottawa Limited
George Armstrong, Veridian Connections Inc.
All parties of record

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