EB-2006-0088

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule B;

IN THE MATTER OF a generic proceeding initiated by the Ontario Energy Board pursuant to section 74 of the *Ontario Energy Board Act, 1998* to amend the licenses of electricity distributors to make provisions for methods and techniques to be applied by the Board in determining distribution rates for licensed electricity distributors.

Preliminary Submissions of Bluewater Power Distribution Corporation, Chatham-Kent Hydro Inc., Middlesex Power Distribution Corp., Newmarket Hydro Ltd., and Welland Hydro-Electric Systems Corporation (the "Distributors")

OVERVIEW AND POSITION OF THE DISTRIBUTORS

1. The Distributors thank the Board for this opportunity to make preliminary submissions in response to the Board's Procedural Order No. 1 herein, issued on October 6, 2006. That Procedural Order appears to invite preliminary submissions on three issues:

(a) whether the Board should hold a written or an oral hearing in this matter;

(b) the language of the proposed license amendment; and

(c) what the issues to be addressed herein ought to be.

2. In addition, the Distributors are mindful of the direction given by the Board through the sponsors at the technical conference held on September 21, 2006 in the related proceedings under Board Files EB-2006-0088 and 0089 (the "Incentive Regulation and Cost of Capital Consultation"), which indicate at p. 110-111 of the transcript that, with respect to the issue of whether the Board has jurisdiction to set the cost of capital by way of a Code, as opposed to a hearing:

> "… that issue, is being dealt with in a separate proceeding. The Board has established a proceeding, EB-2006-0087, to deal with that. A Public Notice was issued on July 7. A panel has been established. Submissions will be heard, and a decision will be made."

3. The Distributors' Preliminary Submissions will address each of these issues.

4. With respect to the form of hearing that is appropriate herein, it is assumed that the Board's decision in the Procedural Order to proceed at this stage "initially by asking for written submissions" is not a final disposition of this issue.

5. The Distributors' position on this issue is that, unless and until a full oral hearing is held, the Board has no jurisdiction to make amendments to the licenses of electricity distributors in Ontario ("LDCs"), by Code or otherwise. That is particularly so where, as appears here, the proposed amendments may make fundamental changes to the basis on which the cost of capital is set for the purposes of determining distribution rates for LDCs and to the principle of allowing a "fair rate of return" to the shareholders of LDCs. Depending upon the form they take, changes to the incentive rate adjustment mechanisms may well support the same requirement for a full oral hearing.

6. Similarly, until such a hearing is held, the Distributors believe it would be an exercise in futility to debate the detailed language of the proposed license amendment here. As the real substance and effect of that amendment is currently being determined elsewhere, in the Incentive Regulation and Cost of Capital Consultation, or subsequent Code-making proceedings, in which currently no such full hearing opportunity is being proposed, this language is simply not meaningful at the present time.

7. With respect to the issues for determination herein, the Board has already indicated a desire to exclude several of the most important substantive issues from consideration, by suggesting that those issues will be addressed in the parallel Cost of Capital Consultation, or subsequent Code-making proceedings. Thus, the Procedural Order specifically states:

> "The Board also considers it expedient to identify matters that will not be issues in this proceeding. Specifically, this proceeding will not address the following:

- 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.
- The details of the 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.
- Whether any particular individual 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."

8. The Distributors' position, generally, is that this fragmentation and pre-emption of the issues across multiple proceedings is not appropriate. Any of these issues might well be found to be interrelated if a proper oral hearing, covering all material issues, were to be held as we submit is required. With respect to the specific points addressed in the above excerpt, we submit as follows:

- While incentive regulation may well be a "policy issue that has already been determined by the Board", the form in which that policy decision is applied to LDCs, and the use of a licence amendment mechanism (as opposed, for example, to pure economic incentives) are still very much live debates affecting how that policy decision ought to be implemented.
- Further, while it may be entirely appropriate for Board Staff to consider the details of incentive regulation and cost of capital methodologies in a consultation process, in the absence of any procedural rights protecting LDCs, such a process cannot substitute for or displace the essential functions of the Board, as a judicial tribunal, in setting "just and reasonable rates" and allowing a "fair return" to LDCs. Those functions require a proceeding in which all the protections of a full oral hearing are ensured.
- Finally, while there is superficial appeal in the proposition that exemptions for individual LDCs should not be addressed in a generic proceeding such as the present, this also highlights a further weakness in the Board's approach. It implicitly acknowledges there will be some element of "rough justice" in the final package, eventually requiring individual exemptions, when the substance and effects of the proposed amendments are eventually known. Yet this ruling apparently excludes from early consideration the important question of whether the amendments may ultimately require more, and more frequent, exemption applications, and hence defeat any hoped-for benefits of this generic proceeding

in terms of “regulatory efficiency”.

9. The Distributors believe that these are significant concerns, which highlight the novelty of the Board’s current approach, and the serious questions it raises about statutory interpretation, jurisdiction and the requirements of natural justice. In fairness to the Board, we propose to address those issues head on, at this early stage.

10. In summary, the Distributors’ position is that the Board does not have jurisdiction to specify methods or techniques to be applied in determining rates for LDCs by Codes developed and issued in accordance with s. 70.1(1) of the *O.E.B. Act*. We submit that position is supported by an examination and analysis of all relevant provisions of the statutory scheme under which the Board acts, as outlined below and elaborated in the following sections of this Submission:

(a) this panel of the Board cannot meet its obligations and make the determinations required by s. 74(1)(b) of the *O.E.B. Act* if essential elements of the required analysis are assigned to a parallel Code-making process of which it is not seized;

(b) similarly, the Board cannot discharge its legal obligation to include an allowance for a fair return to LDCs on their invested capital in setting “just and reasonable rates” under ss. 70(2)(e) and 78 of the *O.E.B. Act* within the processes that are currently underway;

(c) the statutory requirement to make these determinations “in a proceeding by order” is consistently expressed or referred to in each of ss. 19(2), 20, 21(2), 70(2)(e), 74(1)(a) and 78 of the *O.E.B. Act*, including the requirement of an oral hearing where required by the *Statutory Powers Procedure Act* or the principles of natural justice, and these explicit and mandatory procedural requirements cannot be circumvented by anything found in s. 70.1;

(d) on its proper interpretation, the Code-making process in s. 70.1 of the *O.E.B. Act* is limited to operational issues (standards of conduct relating to “how” the regulated business is carried on), and it does not include fundamental legal terms or conditions of entry into the regulated field, that are covered separately, by ss. 70, 74, 78 and other express provisions;

(e) finally, whatever importance may attach to any other objectives of the Board, such as “regulatory efficiency”, these cannot override the Board’s legal obligation to hold a full, oral hearing in this matter, nor indeed are they likely to be achieved by the process that is currently underway.

A. The Jurisdictional Basis of this Proceeding Under s. 74 of the *O.E.B. Act*

11. In the absence of any Ministerial directive affecting the commencement or disposition of this proceeding under ss. 28.1 and 74(1)(a) of the *O.E.B. Act*, this panel of the Board is proceeding under s. 74(1)(b), which provides:

> "*74(1) The Board may, on the application of any person, amend a licence if it considers the amendment to be,*
> …
> *(b) in the public interest, having regard to the objectives of the Board and the purposes of the Electricity Act, 1998.*"

12. Thus, in order to grant any amendments proposed, the Board must be satisfied, in this proceeding, that it is "in the public interest" to do so, and it must make that determination "having regard to the objectives of the Board and the purposes of the *Electricity Act*".

13. It is instructive to consider how those "objectives" and "purposes" relate to the Board's rate-making jurisdiction which is at issue, and particularly the matters of cost of capital and incentive rates. The Distributors note that at least two issues, expressly raised by those objectives and purposes, should give the Board reason to proceed carefully in this area:

(a) both s. 1(1).2 of the *O.E.B. Act* and s. 1(i) of the *Electricity Act* require this Board to be guided by the objective of facilitating the maintenance of a financially viable electricity industry; and

(b) s. 1(1) of the *O.E.B. Act* read as a whole, and the detailed provisions of s. 1(a)-(g) of the *Electricity Act*, each highlight a range of specific areas in which, it is generally recognized, significant new capital investment will be required by Ontario LDCs in the coming months and years.

14. The Distributors respectfully submit that this panel of the Board cannot possibly satisfy itself that either aspect of this test or any of these objectives and purposes can be met, if it is not prepared to address the "details of the incentive regulation and capital cost methodology". Further, of course, it can never do the latter as long as those details are still at an uncertain stage of development, in another process, of which this panel is not seized.

15. Nor can this panel simply delay this proceeding until the Code development process is complete, and then make the amendment proposed, incorporating their outcomes. To do so would effectively be to delegate responsibilities that properly belong to this panel, and to passively accept a pre-determined outcome to this proceeding. It would also obviously deny any adversely affected parties (whether they be LDCs or other interested intervenors) their fundamental rights to test the evidence, and challenge the analysis, that may be used in the parallel process to pre-determine the "public interests" at stake. Such an approach to the determination of the public interest is not just bad policy, and a bad regulatory process: it is contrary to the *O.E.B. Act* and the normal practice and procedure of this Board.

B. The Board's Obligation to Fix Just and Reasonable Rates

16. Similarly, this Board has an obligation to approve or fix just and reasonable rates for LDCs. That obligation can only be discharged in a proceeding governed and conducted in accordance with ss. 70(2)(e) or 78 of the *O.E.B. Act*, and not by means of the Code development process in s. 70.1.

17. With respect to the first of these provisions, it is noted that s. 70(1) expressly refers to the same "objectives" and "purposes" as s. 74(1)(b), such that all of the arguments in Section A of this Submission are directly applicable.

18. With respect to rate-making under s. 78, the Distributors fully adopt the submissions of the EDA with respect to the proper interpretation of this aspect of the Board's jurisdiction. On the issue of a fair return to LDCs on their capital invested in the regulated enterprise, whether it be debt or equity capital, we agree this is governed by such established authorities as *Northwestern Utilities Ltd. v. City of Edmonton*, [1929] S.C.R. 186, as more recently applied in *TransCanada Pipelines Ltd. v. National Energy Board*, [2004] F.C.J. No. 654 (Fed. C.A.). This is a legally recognized cost faced by LDCs, and a fundamental component of the Board's obligation to set rates that are "just and reasonable".

19. We also agree with the EDA, and submit it is obvious, that these matters require factual determinations, based upon an appropriate evidentiary record, tested under cross-examination.

Such determinations are simply not possible to make in an abbreviated, Code-making process under s. 70.1, that allows only for the making of "written representations".

20. The Distributors also agree with the EDA as to the significance of the fact that the Board has, in the past, always set rates by order in the context of individual applications made by LDCs, and has utilized the Rate Handbooks only as a non-binding filing guide for LDCs in such proceedings. This highlights the fact that the current cost of capital methodology, as reflected in the Rate Handbook and incorporated by this Board in individual rate approvals, is grounded in factual and legal determinations made by this Board, based in each case upon an appropriate evidentiary hearing under ss. 70 and 78 of the *O.E.B. Act*. They have been tested repeatedly against the Board's objectives and statutory purposes, and found appropriate for rate-setting purposes.

21. The Distributors submit that those determinations supporting the current methodology cannot reasonably or fairly be swept aside by a mere Code-making process under s. 70.1.

22. In these circumstances, the onus of proof and persuasion ought not to be on LDCs to demonstrate why these existing Board determinations remain appropriate, as Board Staff appears to assume. Rather, the onus should be on Board Staff who are proposing a different methodology, to satisfy this panel of the Board that their proposals are "just and reasonable". Certainly, this panel cannot possibly be satisfied that there is any basis to depart from those prior determinations and methodology by making the license amendments sought, without addressing the details of these proposed new incentive regulation and cost of capital methodologies.

C. The Requirement to Hold an Oral Hearing

23. Given that the Board's determinations under each of ss. 70, 74(1)(b) and 78 all involve both factual and legal elements, ss. 19(2), 20 and 21(2) together expressly provide that these determinations are to be made only "in a proceeding by order", and specifically that they must not be made "until" the Board "has held a hearing after giving notice".

24. Moreover, the Distributors adopt the position of the EDA in noting that this Board has, quite properly, established the practice of holding an oral, as opposed to a written hearing,

whenever the matters under consideration are novel, complex or controversial. That practice accords with the requirements of natural justice and of the *S.P.P.A.*, and is clearly applicable here.

25. The Distributors submit it is already clear from the record of proceedings in the Cost of Capital Consultation, that the issues and proposals under consideration are both controversial both from a policy perspective, and the subject of widely differing and disputed facts and expert opinions. In particular, the Distributors have given notice in that Consultation that they, and the experts they have retained, fundamentally reject any move towards a "one-size-fits all" capital structure as proposed by Board Staff. They claim an opportunity to present testimony, including that of experts, to support the continued recognition of a "size premium" for smaller LDCs in terms of their cost of capital, and to test by cross-examination any testimony to the contrary.

26. It is also clear from that record that the range of options under consideration in that process, including some that are actively promoted by Board Staff, include changes to existing methods and techniques that would, if implemented and applied to all LDCs, be a marked departure from both the principles and rates of return under this Board's current methodology. They thus involve a fundamental change in what constitutes a "just and reasonable return".

27. In those circumstances, we agree with the EDA that an oral hearing, with findings and reasons by this Board, are necessary before any such findings may be made.

D. The Proper Interpretation of s. 70.1

28. The case against any claim that the Board has jurisdiction to set rates using the Code-making procedures in s. 70.1 of the *O.E.B. Act*, rather than a hearing process, is further reinforced by a proper interpretation of that section, itself.

29. Under s. 70.1, it is not contemplated that every Code developed will necessarily be incorporated into LDCs' license conditions. This is something the Board "may" do. However, this recognizes that some Codes will not be so incorporated, because for example they may be intended to be voluntary or advisory, rather than immediately binding. It is the Distributors' position that the abbreviated process prescribed by s. 70.1, involving only the right to make

“written submissions”, is designed and intended only for the latter, non-binding Codes, and not for those that are incorporated as conditions of license.

30. Those Codes that are intended by the Board to become binding must follow an additional procedure. If the legislature had intended that there be a simple "rubber stamp" to incorporate the Code into a license amendment, then it would have stated that all Codes, once developed, are immediately and automatically incorporated as a condition to a license. Section 70.1 does not say that. We submit that something more than a "rubber stamp" process was clearly intended, and that is a hearing process under s.70.

31. This position is supported by the wording of s. 70.1(1), itself, which states clearly that a Code can only be incorporated by reference as a condition of license “with such modifications or exemptions as may be specified by the Board under s. 70”. This statutory language confirms that the proper procedure for incorporating a code as a condition of license is “under s. 70”: that is, a hearing process, and not the abbreviated Code-making process under s. 70.1. It also recognizes that the Board has an obligation, under s. 70, to consider the need for “modification or exemptions” in making the Code enforceable as a condition of license. Obviously, the Board can only make modifications or grant exemptions if it engages in a proceeding, including a substantive hearing on the merits of such a license amendment. Finally, this language raises serious questions about the Board’s decision to effectively turn its back on any consideration of "modifications and exemption" under the terms of the Procedural Order.

32. The Distributors submit that the proper nature of a license amendment proceeding as required by s. 70 is to be guided by a thoughtful consideration of the subject matter of the Code, and of the Board’s obligations with respect to matters within that subject matter, as reflected in the remainder of the *O.E.B. Act* and at common-law. In simpler terms, in order to incorporate a Code as a condition to a license, the Board must follow the procedure that would normally be afforded to a direct license amendment dealing with the same subject matter. In this case, a Code dealing with matters fundamental to rate setting can only be incorporated into an LDC's license through a proceeding that contains all of the procedural protections the Board would require in a rate-setting procedure.

33. The Distributors submit that the differences between the legal status of voluntary Codes, as distinct from license conditions, and potential remedies applicable to each, also mandate and support the different procedures applied under ss. 70 and 70.1. Board Staff's approach, as reflected in the current Procedural Order, overlooks or seeks to override this important distinction in the statutes.

E. The Current Process will not Achieve the Board's Objectives

34. While "regulatory efficiency" is an important goal, the Distributors note that it is not one of the objectives or purposes set out in s. 1(1) of the *O.E.B. Act* or in s. 1 of the *Electricity Act*. As such, it cannot by itself justify the adoption of the process currently contemplated by the Procedural Order and the Incentive Rate and Cost of Capital Consultation.

35. Moreover, the current process simply cannot hope to achieve this objective, for at least two reasons.

36. First, as noted above, the language of s. 70(1) makes it very clear that in incorporating a Code by reference in LDCs' conditions of license, the Board simply cannot avoid dealing with the issue of "modification and exemptions", as the Procedural Order seeks to do. Indeed, if the Board were to adopt a "one-size-fits-all" approach to capital structure as proposed by Board Staff, it must surely expect to immediately receive numerous applications for such modification and/or exemptions from the many affected smaller LDCs.

37. Moreover, if the Board proceeds in the face of a serious risk of jurisdictional challenge, it faces not only the possibility of court challenge, and if that is successful the potential need to re-mount this entire proceeding from scratch, but also the much greater risk that markets will again see evidence of yet more regulatory uncertainty in the electricity industry, and once again raise LDCs' cost of capital at a crucial time.

Summary and Conclusion

38. Board Staff have confidently asserted during the technical conferences held in EB-2006-0088/0089 that the Board has jurisdiction to follow the procedures set out in those conferences and the Procedural Order herein. However, they have declined the request by several parties to outline their reasons for that position at this time.

39. For the reasons outlined above, the Distributors believe Board Staff are wrong in taking that position.

40. One may infer that Board Staff's reasoning is based upon a simplistic reading of s. 70(2)(e) and 70.1 of the *O.E.B. Act* together, roughly as follows: *s. 70(2)(e) permits methods and techniques to be applied in determining rates to be specified in license conditions, and s. 70.1(1) contemplates conditions of a license taking the form of Codes developed in accordance with that section, therefore it must follow that the two provisions together permit rate making by using Code-making procedures in s. 70.1 rather that by a full hearing process and order.* Unfortunately, there are serious problems with this form of argument.

41. First, it ignores all of the contrary provisions in ss. 19, 20, 21, 70, 74, 78 and even 70.1, itself, that have been reviewed above.

42. More fundamentally, if accepted, it would effectively vitiate the traditional requirement for an oral hearing and related protections for the determination of any and all of the important issues that are listed as "examples of conditions", in s. 70(2)(a)-(m) of the *O.E.B. Act*.

43. In particular, it would mean that in future, no proceeding under ss. 70, 74, or 78 would again be required, even for the most fundamental changes to the methods and techniques to be applied in setting rates: rather, the Board could simply amend the Code using the abbreviated process under s. 70.1, and those amendments would automatically be incorporated by reference by the language of the condition now being inserted in LDCs' licenses.

44. The Distributors submit that the Board has no such jurisdiction, and that the Board will not be able to discharge its established statutory obligations if it continues with the process it has set out.

45. The Distributors substantially agree with the alternative procedures proposed by both the EDA and Coalition of Large Distributors, and propose as follows:

(a) that the Board either terminate or conclude the present Incentive Rate and Cost of Capital Consultation and subsequent Code-making procedures, before going further in this proceeding;

(b) that in either event, the Board then address ,in this proceeding, by way of oral hearing, the substantive issues of what the appropriate methods and techniques for incentive rate regulation and cost of capital should be, including the question of "modification" of any proposed Code as required under ss. 70, 70.1(1), 74 and 78; and

(c) that the Board also consider in that hearing the substance of any generic exceptions from cost of capital provisions of the proposed Code, including that proposed by the Distributors with respect to an appropriate recognition of a "size premium" for smaller LDCs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

October 20, 2006

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