

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

AND IN THE MATTER OF a 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.

SUBMISSIONS OF THE ELECTRICITY DISTRIBUTORS ASSOCIATION

Background

1. In February, 2006 the Board released a table outlining the projects that comprised the Board's multi-year electricity ratesetting process. In that table, the Board indicated that there would be a generic cost of capital review.
2. In a letter dated April 27, 2006 the Board set out the details of its approach. In that letter, the Board indicated that it would "implement its cost of capital and second-generation IRM determinations through an amendment to electricity distribution licenses." The Board went on to say that Board staff would release proposals for both the cost of capital and second-generation IRM in early June, 2006 based on the research and analysis of external experts and Board staff. That consultation period is currently underway. Based on comments received during a consultation period, the Board indicated it would issue a proposed Cost of Capital Code and a proposed Productivity Code pursuant to the code making provisions in the Ontario Energy Board Act (OEB Act).
3. During the course of the consultation described above, concerns regarding the process have emerged. The Board members present at the consultation process indicated that the process concerns were to be addressed in this license amendment proceeding.

4. On July 7, 2006 the Board, on its own motion, issued the notice of proceeding and notice of hearing which gave rise to this license amendment proceeding. In that notice, the Board proposes to amend the licenses of LDCs "to make provision for methods and techniques to be applied by the Board in determining distribution rates for licensed electricity distributors."
5. On October 6, 2006 the Board issued Procedural Order No. 1 in this proceeding, in which the Board stated that the proceeding:

...would 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.

6. Elsewhere in that procedural order, the Board described the "Code Development Process" as a parallel process where:

...the Board is consulting with interested parties on the development of parameters to be used in determining a distributor's cost of capital and the adjustment mechanism to be used to adjust a distributor's rates. The output of the Code Development Process will be a Code that confirms the cost of capital to be used in adjusting annual revenue requirements for 2007 and beyond and a Code that establishes an incentive rate adjustment mechanism for the period covered by the Board's multi-year incentive rate-setting plan.

7. Therefore, it appears that the subject matter of this license amendment proceeding is restricted to a review of the proposed wording to be inserted into the licenses of LDCs.

The Issue

8. The issue is whether the Board's proposed process for developing codes and amending LDC licenses in relation to ratemaking matters constitutes a proper exercise of the Board's jurisdiction under the OEB Act.
9. It is the EDA's position that the OEB Act requires that the appropriateness of any methodology or technique for establishing rates to be established as a condition of license must be determined within this proceeding and does not fall within the Board's code making authority in the manner proposed by the Board. It is one thing to produce a code that will act as a guideline. It is quite another thing to impose mandatory ratemaking methodologies in license conditions.
10. Under the OEB Act, the Board has jurisdiction to set distribution rates and it has licensing authority over distributors. It is not controversial that both of those functions have to be exercised in proceedings in which interested parties can participate, file evidence and make submissions prior to a decision being made by the Board by way of order, supported by reasons. The Board has authority to carry out proceedings by way of written or oral hearing, and in the case of an oral hearing, interested parties have the opportunity to lead evidence and cross examine witnesses. The Board typically and quite properly holds oral hearings for matters that are controversial and complex or novel. For example, the Board held an oral hearing to determine the appropriate methodology to use for establishing the cost of capital for natural gas distributors.
11. To date, the Board has set distribution rates on the basis of individual applications from LDCs. To streamline the process, the Board has utilized rate handbooks that act as filing guidelines for LDCs. The handbooks have been developed in consultation with interested parties. The handbooks have not been binding on LDCs. However, if an LDC wanted to deviate from the handbook, the Board required additional evidence to support such a deviation.
12. Under its licensing authority, the Board has specific authority under section 70(2)(e) to impose a condition in a license "specifying methods or techniques to be applied in determining the licensee's rates". By commencing this proceeding on its own motion, the

Board has recognized that a proceeding is required in order to impose such a condition in the licenses of LDCs.

13. However, in Procedural Order No. 1, the Board has also indicated that the substantive issue of the appropriateness of a particular method or technique will not be addressed in the license amendment proceeding. Instead the Board proposes to address the substantive issue in a code development process.
14. Under section 70.1 of the OEB Act, the Board has authority to develop codes and to incorporate them by reference as conditions of license. It is clear from section 70.1 that the development of a code is not a hearing process and does not require a proceeding. The code development process involves the production of a draft code and the provision of an opportunity to make submissions on the draft code. After considering the submissions, if the Board determines that the draft code should be amended, it must provide an opportunity for further submissions. The Board then formally issues the code and it is published in the Ontario Gazette.
15. However, this authority is not without limits and in order to determine what those limits are, regard must be had to the rest of the statute. Section 70.1 identifies a number of existing documents that are to be considered codes for the purposes of section 70.1. None of the codes on that list deal with ratemaking matters.
16. When one considers the statute as a whole, it is clear the Legislature did not intend the code making authority to be a substitute for the ratemaking procedures in the OEB Act. Wherever ratemaking matters are addressed in the OEB Act, it is always in the context of subject matter that is dealt with by way of proceeding. Ratemaking can be addressed by way of application under section 78 and the Board must determine that the rates applied for are just and reasonable in a proceeding, culminating in an order with reasons for decision. Ratemaking can also be addressed in a condition of license in which the Board can specify a technique or method and the Board must determine that the technique or method will produce just and reasonable rates. Licenses and amendments to licenses are both dealt with by way of application and therefore by way of proceeding, culminating in an order with reasons for decision.

17. A general code making power cannot be used to get around the very specific direction of the Legislature to address ratemaking matters in proceedings. If the Legislature had intended that codes could be used as an alternative to ratemaking procedures in the Act, then the Legislature would have said that in the statute.
18. There is an important legal context to this issue. Rates have to be just and reasonable. In interpreting the meaning of "just and reasonable", ratemaking tribunals and courts have established long-standing principles. One of those principles is that just and reasonable rates must allow an LDC to recover its cost of capital based on a fair return on invested capital. A fair return is what an investor would receive if investing the same amount in an investment of similar risk. The Supreme Court of Canada in *Northwestern Utilities Ltd. v. Edmonton (City)*, [1929] S.C.R. 186 held:

The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on one hand, and which, on the other hand, would secure to the company a fair return for the capital invested. 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.

19. In *TransCanada Pipelines Ltd. v. Canada (National Energy Board)*, [2004] F.C.J. No. 654, the Federal Courts of Appeal held:

Even though cost of capital may be more difficult to estimate than some other costs, it is a real cost that the utility must be able to recover through its revenues. If the Board does not permit the utility to recover its cost of capital, the utility will be unable to raise new capital or engage in refinancing as it will be unable to offer investors the same rate of return as other investments of similar risk. As well, existing shareholders will insist that retained earnings not be reinvested in the utility. In the long run, unless the regulated enterprise is allowed to earn its cost of capital, both debt and equity, it will be unable to expand its operations or even maintain existing ones. Eventually, it will go out of business. This will harm not only its shareholders, but also the customers it will no longer be able to service.

These are matters that require findings of fact to be made in a properly constituted proceeding, as the Legislature intended.

What is the problem in establishing ratemaking methodologies by way of codes?

20. First, it is clear that the development of a code is purely a consultative process. There is no evidence, there will be no findings of fact, there will be no reasons for an order, there will be no order. There will be a code but there will be no ability to understand the basis on which the Board reached its conclusions that a particular methodology will produce a fair return on invested capital in a manner consistent with the applicable legal principles. This is because there will be no evidentiary record against which to assess the code. Such an approach is entirely inconsistent with a statutory requirement that a person applying for rates must prove, with evidence, that the rates applied for are just and reasonable. That approach is also inconsistent with the Board's obligation to determine whether a methodology to be inserted in a condition of license is in the public interest. In other words, the code approach is inconsistent with the Board's statutory obligation to ensure that rates are just and reasonable and to ensure that an LDC recovers a fair return on invested capital.
21. In contrast to the code approach, if the Board employs a particular ratemaking technique or method in the context of deciding a rates application, that technique or method can be revisited in a subsequent rates application, as the Legislature intended. If the Board prescribes a particular ratemaking technique or method by way of license condition, that also can be revisited because the Legislature made provision for any person to apply for an amendment to a license. These provisions all underpin the legal principle that an LDC must be in a position to recover a fair return on invested capital.
22. There is nothing in the OEB Act to support the proposition that a proceeding to determine whether a condition should be imposed in the licenses of LDCs, specifying the methods or techniques to be applied in determining distribution rates, is to be limited solely to consideration of the wording of the condition. The statutory task of the Board in this proceeding is not a question of whether proposed wording is in the public interest. Rather it is a question of whether it is in the public interest to incorporate a particular ratemaking methodology into the licenses of LDCs. The Board's statutory obligation is to hold a proceeding on the substantive issue of whether a proposed technique or method is an appropriate one to be imposed by way of condition in a license, given the Board's statutory

obligation to ensure that rates are just and reasonable and recover a fair return on invested capital.

23. By stating in the procedural order that the Board will not address the very issue that the statute says must be decided in this proceeding, the Board is improperly fettering its discretion.
24. Furthermore, the question of whether a particular methodology is in the public interest cannot possibly be assessed until there is such a proposal brought forward. At this stage, there is no proposal before the Board in this or any other proceeding. It is therefore premature for the Board to take any further steps in this proceeding.
25. In proposing to develop a cost of capital methodology by way of a code, the Board takes away or constrains the statutory right of an LDC or a ratepayer to apply for the relief necessary to ensure that an LDC recovers a fair return on invested capital.
26. Proceeding by way of a code also improperly fetters the Board's own responsibility to ensure that an LDC recovers a fair return on invested capital in the context of proceedings as envisaged by the Legislature. Under section 74(1)(b), the Board may amend a license if it is in the public interest. If the Board refuses to consider the appropriateness of the methodology as part of this license amendment proceeding, which is what the Board is doing in Procedural Order No. 1, then it is refusing to discharge its statutory obligation to act in the public interest and to ensure that rates will be just and reasonable and will recover a fair return on invested capital. That failure is not and cannot be rectified by the Board's proposed Code Development Process.
27. Worse still, the Board will be creating a whole new level of perceived risk in the equation that governs the relationship between LDCs and the capital markets. Those markets understand the legal principles relating to fair return on invested capital. They won't understand a process that appears to avoid those principles. It would be most unfortunate if as a result of a flawed process, the Board added to the riskiness of the LDC business instead of simply measuring the riskiness and adopting a methodology that reflected that riskiness in a fair return.

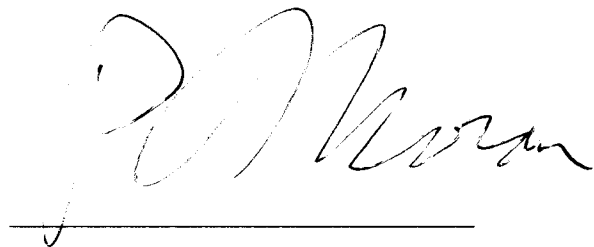
What is the solution?

28. At this stage, the Board has engaged in a consultation exercise on the issue of what constitutes an appropriate methodology for establishing a fair rate of return on invested capital and what constitutes an appropriate mechanism for incentive based ratemaking. The Board has also commenced this proceeding to determine whether that methodology and mechanism ought to be incorporated into a license condition.
29. To avoid the jurisdictional error described above, all the Board has to do is to incorporate into this proceeding the substantive issue of what are the appropriate methodologies for incentive regulation and cost of capital to be imposed by way of condition of license. This will provide Board staff and other parties to file evidence in support of their proposed approaches and to provide the Board with a record upon which the Board can properly discharge its statutory duty.
30. Given the complexity of the issues relating to cost of capital in particular, the most appropriate way to proceed is by way of an oral hearing so that an appropriate and properly tested evidentiary record can be produced in order to assist the Board in determining whether the existing methodology needs to be changed in order to ensure that LDCs recover a fair return on invested capital.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

October 20, 2006

Electricity Distributors Association



Patrick Moran
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Statutory Provisions

OEB Act

1. (1) The Board, in carrying out its responsibilities under this or any other Act in relation to electricity, shall be guided by the following objectives:
 1. To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.
 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.

60. (1) A person may apply to the Board for the issuance or renewal of a licence authorizing one or more of the activities referred to in section 57 as specified in the application.

70. (1) A licence under this Part may prescribe the conditions under which a person may engage in an activity set out in section 57 and a licence may also contain such other conditions as are appropriate having regard to the objectives of the Board and the purposes of the *Electricity Act, 1998*.
 - (2) The conditions of a licence may include provisions,
...
 - (e) specifying methods or techniques to be applied in determining the licensee's rates;
 - (13) A licence under this Part shall not require a person to dispose of assets or to undertake a significant corporate reorganization.

74. (1) The Board may, on the application of any person, amend a licence if it considers the amendment to be,
 - (a) necessary to implement a directive issued under this Act; or
 - (b) in the public interest, having regard to the objectives of the Board and the purposes of the *Electricity Act, 1998*.

70.1 (1) The Board may issue codes that, with such modifications or exemptions as may be specified by the Board under section 70, may be incorporated by reference as conditions of a licence under that section. 2003, c. 3, s. 48.

(2) For the purposes of this section and section 70.2, two members of the Board constitute a quorum. 2003, c. 3, s. 48.

(3) A code issued under this section may provide that an approval, consent or determination of the Board is required, with or without a hearing, for any of the matters provided for in the code. 2003, c. 3, s. 48.

(4) A code issued under this section may incorporate by reference, in whole or in part, any standard, procedure or guideline. 2003, c. 3, s. 48.

(5) A code may be general or particular in its application and may be limited as to time or place or both. 2003, c. 3, s. 48.

(6) The Regulations Act does not apply to a code issued under this section. 2003, c. 3, s. 48.

(7) The following documents issued by the Board, as they read immediately before this section came into force, shall be deemed to be codes issued under this section and the Board may change or amend the codes in accordance with this section and sections 70.2 and 70.3:

1. The Affiliate Relationships Code for Electricity Transmitters and Distributors.
2. The Distribution System Code.
3. The Electricity Retailer Code of Conduct.
4. The Retail Settlement Code.
5. The Transmission System Code.
6. Such other documents as are prescribed by the regulations.

...

(10) In this section, a code includes an amendment to a code and a revocation of a code. 2003, c. 3, s. 48.

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.

19. (1) The Board has in all matters within its jurisdiction authority to hear and determine all questions of law and of fact. 1998, c. 15, Sched. B, s. 19 (1).

(2) The Board shall make any determination in a proceeding by order.

...

(4) The Board of its own motion may, and if so directed by the Minister under section 28 or otherwise shall, determine any matter that under this Act or the regulations it may upon an application determine and in so doing the Board has and may exercise the same powers as upon an application.

20. Subject to any provision to the contrary in this or any other Act, the powers and procedures of the Board set out in this Part apply to all matters before the Board under this or any other Act.

21. (1) The Board may at any time on its own motion and without a hearing give directions or require the preparation of evidence incidental to the exercise of the powers conferred upon the Board by this or any other Act.

(2) 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.

Statutory Powers Procedure Act

17. (1) A tribunal shall give its final decision and order, if any, in any proceeding in writing and shall give reasons in writing therefor if requested by a party.