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VIA E-MAIL AND WEB POSTING

July 23, 2007

To: All Licensed Electricity Distributors
All Participants in Consultation Process EB-2007-0028
All Other Interested Parties

Re: Report of the Board on Rate-making Associated with Distributor Consolidation
Board File No.: EB-2007-0028

The Board has today issued its Report on Rate-making Associated with Distributor Consolidation (the "Board Report"). The Board Report sets out the Board's policy on key rate-making issues that may be associated with consolidation in the electricity distribution sector.

Background

Since the passage of the *Energy Competition Act, 1998*, a combination of distributor mergers and acquisitions, as well as municipal amalgamations, has reduced the number of distributors from over 300 to 85.

In October, 2006, as part of the government's strategy for furthering structural efficiency and productivity in Ontario's electricity distribution sector, the Minister of Energy lifted the moratorium on the purchase and sale of distribution assets by Hydro One. At the same time, the Ministry of Finance announced that publicly-owned utilities will be exempt for two years from paying the electricity transfer tax when they sell electricity assets to other public utilities in Ontario until October 17, 2008. This latter announcement is similar to the two-year transfer tax exemption provided for in each of 1998 and 2003.

Earlier this year, the Board initiated a consultative process focusing on the regulatory treatment of certain rate-related issues associated with consolidation in the electricity distribution sector. The purpose of the consultation was to assist the Board in developing a policy framework for dealing with relevant rate-making issues and to provide greater predictability for distributors and other stakeholders in relation to those issues.

On March 5, 2007, the Board released a staff paper (the “Discussion Paper”) that outlined a number of proposals. The Board received written comments on the Discussion Paper from 13 interested parties. A list of those parties is set out in the Appendix to the Report.

The main rate-making issues that were addressed in the Discussion Paper were:

- the timing for rate rebasing;
- whether rate recovery of transaction costs should be allowed;
- whether efficiency savings resulting from consolidation accrue to the shareholder, ratepayers, or both; and
- whether the Board should require rate harmonization.

Comments from interested parties confirmed these as principal rate-making issues warranting consideration by the Board, and the Board Report sets out the Board’s policy for dealing with each of them.

Comments and Board Approach

The Board Report issued today reflects the Board’s consideration of both the Discussion Paper and the comments received on that document.

The following summarizes some of the key comments received on the Discussion Paper, as well as whether and the manner in which those comments have been reflected in the Board Report. The summary below is not exhaustive of all comments received. Parties’ written comments can be viewed on the Board’s website (www.oeb.gov.on.ca) and at the office of the Board during normal business hours.

Should the scope of the policy be expanded to include distribution system rationalization and/or other transactions that result in a change in control?

The Discussion Paper outlined proposals that would only apply to “distributor consolidation”, described as transactions where two or more distribution companies come together through a transaction (such as an amalgamation) that results in a single, rate-regulated licensed electricity distributor.

More than one distributor commented that the Discussion Paper did not address distribution system rationalization; that is, the purchase of assets and/or customers from one distributor by a neighbouring distributor. These distributors commented that the Board’s policy should not be limited to merger, acquisition, amalgamation or divestiture (“MAAD”) transactions that reduce the number of licensed electricity distributors operating in the Province of Ontario.

The policy set out in the Board Report applies to transactions between distributors where a distributor either sells or otherwise disposes of its distribution system as an entirety or substantially as an entirety, or amalgamates with another distributor. These transactions, referred to in the Board Report and in this letter as “consolidation”, result in a single, rate-regulated licensed electricity distributor (a “consolidated entity”) and are the most closely aligned with the spirit in which the policy was developed. While the scope of the policy does not cover all possible MAAD transactions, distributors that believe that a transaction falls within the spirit of the policy may, at the relevant time, request that the Board extend the application of the policy to them.

Should the Board’s policy offer more incentives to distributors?

The Discussion Paper recognized that clarity on how costs and savings will be treated is important to distributors and ratepayers.

More than one distributor commented that the proposals in the Discussion Paper would not provide sufficient incentives to distributors and shareholders to encourage the level of consolidation that the Government of Ontario may wish to see.

The aim of the Board is to set a clear policy that provides a more predictable regulatory environment for distributors that are considering consolidation, thereby removing potential barriers to consolidation. While different approaches to incentives might be considered in the development of the Board’s overall incentive regulation scheme that would apply to all distributors, the Board does not believe it appropriate to consider this solely in the context of consolidations.

Should the Board provide a “basket of regulatory mechanisms” for distributors to choose from?

Several distributors observed that, given the diversity of distributors in Ontario, it is unlikely that one regulatory mechanism could be developed to meet the diversity of needs. Proposals were put forward for a “basket of regulatory mechanisms”, including options such as distributor choice of: the timing of rebasing; the use of an earnings sharing mechanism; conditional recovery of acquisition premiums; a bonus on the return on equity; or flexibility to put forward its own proposal.

Given the diversity of distributors in Ontario, it is a challenge to design and implement regulatory mechanisms to meet all of their needs. However, from the standpoint of establishing a general approach that is clear and easily understood by all, a policy that enables distributors to design their own ratemaking approaches associated with consolidation would be counter to achieving a more

predictable regulatory environment – for distributors and ratepayers. The Board does not believe that it is practical or appropriate to provide distributors with a "basket of mechanisms" to choose from through this policy. Board policy of a general nature can recognize diversity, and can do so without compromising predictability. The Board believes that allowing a consolidated entity to propose a time for rebasing (within an acceptable range) that best suits its unique circumstances does this.

Should the Board's policy be applied differently depending upon the relative size of parties to a MAAD transaction?

One consumer group commented that policies that are appropriate for two distributors of similar size that consolidate may not be appropriate where a large distributor acquires a small one. This stakeholder suggested that rate-making policy relating to consolidation not apply to MAAD applications in which the rate base of one of the distributors involved is five or more times the rate base of the other.

The Board does not believe it would be fair to potential parties to a consolidation to establish a materiality threshold. Setting such a threshold could have the unintended consequence of discouraging certain consolidations.

Should the proposed time (i.e., up to five years) to rebasing be changed? Should the time when the deferral period begins be changed?

In general, distributors commented that they should have the option to defer rate rebasing for up to seven to ten years after the closing of a MAAD transaction. Distributors that have experience in implementing MAAD transactions also indicated in their comments that the closing date generally is 12 to 18 months after the Board's approval of the transaction.

In general, consumer groups expressed concern over allowing distributors to defer rebasing for as long as five years. One stakeholder commented that the Board should order the distributor in its order approving the MAAD transaction to return with a cost of service rate application within two years. Two stakeholders expressed concern that distributors that anticipate increased costs may elect to rebase earlier rather than later. These stakeholders commented that there should be restrictions on the ability of the distributors to rebase early in such circumstances.

With regard to the five-year limit on deferred rebasing proposed in the Discussion Paper, the Board notes that distributors have generally argued for a longer period and consumer groups have argued for a shorter period. On balance, and for the reasons set out in the Board Report, the Board believes that five years is

reasonable and has not been persuaded to either lengthen or shorten the period. The Board has, however, concluded that the deferral period should begin at the closing date of the transaction, which is generally 12 to 18 months after the Board's approval of the transaction. This is within the 18-month period during which a MAAD approval typically remains in effect before expiring.

Distributors also commented that the policy should allow an opportunity for capital investment needs to be addressed as and when they arise, and that this should not be at the expense of sacrificing any portion of the deferral period. Some distributors proposed full rebasing, some distributors proposed that partial rebasing be provided for, and some distributors suggested that both approaches to rebasing be allowed, depending on the needs of the distributor.

The policy set out in the Board Report provides distributors the flexibility to propose immediate rebasing of the consolidated entity if that is considered necessary or desirable to address capital investment needs. The Board is mindful of distributor concerns over partial rebasing to account for needed capital expenditures, but has concluded that this issue should be examined by the Board separately as part of the development of the 3rd generation incentive regulation mechanism.

Should the Board treat a second, successive consolidation differently from the first in relation to timing of rebasing?

An issue in relation to rebasing is how the Board's policy should apply where a consolidated entity whose rebasing has been deferred subsequently enters into a further consolidation transaction before rebasing has occurred. The Discussion Paper invited interested parties to comment on any incremental issues that might warrant treating the second transaction differently from the first in relation to timing of rebasing.

In general, distributors commented that the Board should allow for flexibility and allow a new, extended deferral period where a consolidated entity subsequently enters into a second, successive consolidation transaction.

One consumer group commented that consecutive consolidations should not delay rebasing and rate harmonization or result in split treatment of ratepayers. This group suggested that an entity that has already undergone one consolidation should be able to do a second more efficiently (faster and cheaper), and should be able to start generating benefits for ratepayers more quickly due to the experience gained from the first consolidation. Another stakeholder commented that it would be unacceptable for distributors involved in consecutive consolidations to escape a cost of service rebasing review for up to another five years.

The Board has concluded that some flexibility should be afforded in such cases. However, in some consecutive consolidations, especially those entered into near the end of a deferral period, extending the deferral by another five years may not be appropriate. The onus will be on the applicant(s) to clearly justify the need for, and benefits of, consecutive deferrals and to demonstrate to the satisfaction of the Board that ratepayers will not be adversely affected by the further deferral.

Should 2nd Generation IRM be established as the plan that consolidated entities will be subject to during the deferral period?

The Discussion Paper proposed that, until a consolidated distributor is rebased, it would have its rates determined based on the Board-approved incentive regulation plan that is in effect at the time the MAADs approval was requested.

More than one distributor commented that the Board should apply 2nd Generation IRM to consolidated entities. A group of distributors proposed this even if one or more of the parties to a consolidation are rebased in 2007, 2008, or 2009. This group expressed concern that uncertainty surrounding the form of and approach to 3rd Generation IRM may be a barrier to consolidation.

The Board understands the desire for greater certainty with regard to the incentive regulation scheme that a distributor will be subject to during the deferral period. The Board has clarified in the Board Report that, until the form of and approach to 3rd Generation IRM are determined by the Board, the incentive regulation plan that a distributor will be subject to for the duration of the consolidated entity's deferral period will be 2nd Generation IRM. Subsequently, the plan that the distributor was subject to at the time of the MAAD application will apply, even if this means that individual (and different) rate plans will be maintained until rebasing.

Should the Board differentiate on the basis of distribution rate levels?

One consumer group proposed that benchmarking of distribution rates should be used by the Board to establish a provincial average and thereby determine what form of rate-making to apply during a deferral period. In instances where the rates of one or more of the distributors to a consolidation are higher than the provincial average, this group suggested that those rates should not be allowed to increase between the time of the transaction and rebasing.

The Board believes that benchmarking should be designed and developed to be applied routinely and consistently under rate regulation. Benchmarking is currently under development as a step in the evolution of the Board's consideration and development of regulation of the sector. Consultation is underway on the application of benchmarking in rate-making. Pending completion of that consultation, it is premature to use benchmarking for the purpose of determining the rate treatment of a consolidated entity.

How should the net impact of a consolidation on ratepayers be dealt with?

The Discussion Paper proposed that the net impact of a consolidation on ratepayers should be dealt with at rebasing, and further proposed that ratepayers should not bear the costs through rates for acquisition premiums or net consolidation costs or losses.

In general, distributors commented that the Board should allow acquisition premiums, in full or in part, into rate base. One distributor proposed that the allowable amount be calculated as a percentage of the fair market value of fixed assets. Another distributor proposed that premiums be treated as a regulatory asset to be recovered over a period of up to ten years. Another distributor proposed conditional allowance for some recovery of premiums based on demonstrated and significant improvements in safety, reliability, system operation, lower debt costs, and/or improved capital structure.

In general, consumer groups commented that acquisition premiums should not be allowed into rate base. One stakeholder commented that the net impact of a consolidation should be factored into the productivity factor for the consolidated entity. Another stakeholder commented that, to the extent that any of these amounts are recoverable, recovery should be limited to the economies of scale and other savings generated by the transaction itself.

The policy set out in the Board Report builds on and complements the work of the Board in relation to incentive regulation, and addresses the issues in a manner that does not unnecessarily increase the regulatory burden on distributors or other interested parties. Specifically, and consistent with multi-year incentive regulation, the policy allows the net savings of a consolidation to accrue to a distributor's shareholder for an extended period. The Board does not believe it appropriate to also allow a distributor to recover an acquisition premium or net consolidation losses in whole or in part through rates while retaining the realized benefits of the transaction over the deferral period.

Is rate harmonization always appropriate? Should a consolidated entity have the flexibility to make its proposal to the Board?

The Discussion Paper proposed that detailed rate harmonization plans be filed at, or before, the time of rebasing, and that implementation of such plans, if appropriate, be expected to begin no later than at the time of rebasing.

More than one distributor commented that the Board should provide flexibility for consolidating entities to propose a rate harmonization plan that reflects their unique characteristics (e.g., different costs to serve due to factors such as customer density and/or kilometres of plant). One distributor noted that forcing premature rate harmonization may in some cases discourage consolidation among distributors with different cost structures and asset bases even though such consolidation would provide significant cost savings.

Consumer groups varied in their comments. One stakeholder commented that the Board should provide generic rules for rate harmonization and that the MAAD application filing requirements should include a requirement to provide the rate harmonization plan. Another stakeholder commented that there is first a threshold issue to be addressed as to whether harmonization is appropriate and that, where special circumstances exist (e.g., rate differentiation reflects different costs to serve due to geography), harmonization should not be forced. Two stakeholders commented that similar customers should pay the same rates, and argued that differentiated rates can only be justified on a continuing basis if there is a "cost-based" rationale.

The Board believes that some flexibility remains appropriate with respect to rate harmonization in each case. To date, distributors have been allowed discretion as to whether, when and how rates might be harmonized after consolidation. Going forward, the Board believes that the issue of rate harmonization should be examined at the time of the consolidated entity's rate rebasing. This is reflected in the Board Report.

Should the MAAD requirements and/or process be amended?

The Discussion Paper included a brief discussion of the principles that guide the Board in its review and approval of applications under section 86 of the *Ontario Energy Board Act, 1998*, and noted that information filed in a MAAD application may inform a subsequent rate review.

Representatives of distributors commented that the Board should more clearly define the status quo in relation to the "no harm" test that applies when the Board considers a MAAD application. One of these suggested that the status quo should be defined as the likely future state or conditions that would evolve absent the transaction. The other proposed that the Board require a customer satisfaction survey before and after a merger to verify that there has been no harm.

One distributor commented that the Board's "no harm" test should be paired with a "net benefit" test to give consideration to the overall benefits of the consolidation as measured by the net difference between the savings achieved and the costs incurred as a result of the consolidation.

Two consumer groups commented that, in addition to the proposed timing for rebasing and rate harmonization, the filing requirements for MAAD applications should include forecasts of revenues and costs each year until the rebasing year so that the Board has a clear picture of how much the incremental profits for the shareholders are likely to be. One stakeholder expressed the view that the applicant should be required to demonstrate an improved outlook for consumers based on a detailed "before consolidation" and "after consolidation" business plan comparison. Further, this stakeholder commented that the Board should set out a specific timeline for the consolidated entity to achieve rate harmonization.

With release of the Board Report, the Board is directing staff to initiate amendments to the MAAD filing requirements to require a distributor to include in its MAAD application a statement of the distributor's proposal for the time of rebasing for the consolidated entity, within the five-year limit. Also, as a procedural matter, the MAAD Notice of Application will include a statement of the applicant's proposal. It is important that interested parties understand that any concerns that they might have regarding the distributor's proposed timing of rebasing must be voiced during the MAAD transaction proceeding.

Beyond that, the Board does not believe that the MAAD filing requirements need to be further amended at this time. The current requirements ask distributors to state their intentions with regards to rate harmonization in their applications. Further, the Board does not believe that this consultation presents an appropriate forum in which to consider the need or merit of further defining the "no harm" test.

The Board thanks all participants in this consultation for their contribution to the development of the Board Report. The Board will address the issue of cost awards for this consultation by separate correspondence to be issued in the near future.

Yours truly,

Original signed by

Kirsten Walli
Board Secretary