

Ontario Energy Board

Staff Discussion Paper

**on Rate-making Policies Associated with
Distributor Consolidation**

March 5, 2007

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1 Introduction

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 87.

As part of the government's strategy for furthering structural efficiency and productivity in Ontario's electrical distribution sector, the Minister of Energy lifted the moratorium on the purchase and sale of distribution assets by Hydro One¹. 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 Ontario². This latter announcement is similar to the two-year transfer tax exemption provided for in each of 1998 and 2003.

Government policy to drive further structural efficiency and productivity

Purpose and Scope

Staff of the Ontario Energy Board has prepared this paper to facilitate consultation with stakeholders on rate-making issues that may be associated with certain distributor mergers, acquisitions, amalgamations and divestitures ("MAADs" transactions).

How should the Board deal with consolidation in rate-making?

Consolidation may take a number of forms. The proposals set out in this paper apply only to 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. References in this paper to "distributor consolidation" should be interpreted accordingly.

¹ Minister of Energy. Letter to Hydro One. (<http://www.energy.gov.on.ca/english/pdf/electricity/MC-2006-4635.pdf>)

² Ministry of Finance. News Release. Municipalities Will Benefit from Two-Year Transfer Tax Exemption Changes Promote Greater Efficiency and Investment in Electricity Distribution. October 17, 2006. (<http://www.fin.gov.on.ca/english/media/2006/nr10-transfertax.html>)

With the recent transfer tax exemption announcement, some distributors have expressed concern with regard to the following rate-making issues associated with consolidation:

Four areas of concern

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

Specifically, certain electricity distributors have voiced the view that insufficient regulatory predictability in relation to these rate-making issues may have an inhibiting effect on consolidation.

This paper sets forth staff's views on these four issues. Staff would be aided by comment from interested parties on whether there are additional areas of concern.

Are there additional areas?

This paper proposes a framework that would provide a greater measure of regulatory predictability to distributors that are considering consolidation, to facilitate planning and decision-making and assist distributors in determining the value of consolidation transactions. The proposals build on and complement the work of the Board in relation to incentive regulation, and attempt to address the concerns of distributors in a manner that does not unnecessarily increase the regulatory burden on distributors or other interested parties.

Scope of this Review

There are currently 87 electricity distribution companies regulated in Ontario, some with multiple service territories and rates. What is the most appropriate approach to ensure that, in its rate-making, the Board creates a more predictable regulatory environment, thereby minimizing any existing barriers to further consolidation in the distribution sector?

Focus on rate-making

This review will focus on the regulatory treatment of the financial impacts of consolidation in electricity distribution rate-making. While this review may discuss various potential costs and benefits that may be associated with consolidation for illustrative purposes, it does not discuss the economics of consolidation.

2 Proposed Regulatory Treatment of Financial Impacts

Board staff understands that the parties' perceptions of regulatory risk can be affected by the manner in which the Board might treat costs and savings associated with consolidation. The costs could include out-of-pocket costs, acquisition premiums, and restructuring costs. The treatment of net impacts (net savings or net losses) and rate harmonization are important to distributors and ratepayers.

Clarity on how costs and savings will be treated important to distributors and ratepayers

In addressing these matters, it is important to understand the principles that guide the Board in its review and approval of applications under section 86 of the *Ontario Energy Board Act, 1998* (the "Act").

2.1 Principles Guiding Review and Approval of Applications under s.86 of the *Ontario Energy Board Act, 1998*

The Board's filing requirements for consolidation transactions are embodied in its "Preliminary Filing Requirements for Applications under Section 86 of the Act"³ (the "Preliminary Filing Requirements").

A recent Board Order⁴ in relation to the review of an application for approval of an amalgamation under section 86 of the Act refers to the following as the principles that guide the review and approval of such applications:

³ Ontario Energy Board. Preliminary Filing Requirements for Applications under Section 86 of the *Ontario Energy Board Act, 1998*. (http://www.oeb.gov.on.ca/documents/industryrelations/rules/MAAD_forms/MAAD_sec_86_filing_requirements_011206.pdf)

⁴ Ontario Energy Board. Board File Number EB-2006-0186. Procedural Order No. 1, dated January 30, 2007.

- The factors to be considered in approving an application for approval of an amalgamation under section 86 of the Act are the factors outlined in section 1 of the Act;

Factors to be considered outlined in section 1 of the Act

- The test to be applied to amalgamations is the "no harm" test (i.e., whether the proposed transaction will have an adverse effect relative to the status quo in relation to the Board's statutory objectives)⁵; and

The "no harm" test

- The Board will not approve or set rates as part of an application for leave to amalgamate. Should they wish to do so, interested parties will have the opportunity to intervene in future rates proceedings where rates will be generally at issue. Parties may comment on the issue of rates as it relates to a MAADs proceeding if it can be shown that the proposed transaction (i.e., the amalgamation itself) would have a negative impact on the interests of consumers with respect to prices.

Separation of MAAD and rate reviews

In developing the proposals in this paper, staff has assumed that these principles will continue to guide the review and approval of any application under section 86 of the Act that involves a consolidation transaction.

Through the Preliminary Filing Requirements, applicants provide some indication of their plans for rate harmonization, amongst other matters. These are viewed as preliminary plans and are not seen as being exhaustive or binding.

While plans filed in a MAADs application may not be binding on parties, staff believes that those plans can contain useful information for giving a realistic picture of what the Board and ratepayers might expect in a subsequent rate application. That is, the information filed as part of a MAADs application may well inform

Information filed in a MAAD application may inform a subsequent rate review

⁵ This "no harm" test was first articulated in a decision of the Board in a combined proceeding relating to three applications under section 86 of the Act. See the August 31, 2005 Decision of the Board in proceeding RP-2005-0018/EB-2005-0234/EB-2005-0254/EB-2005-0257. (http://www.oeb.gov.on.ca/documents/cases/RP-2005-0018/decision_310805.pdf)

a subsequent rate application. However, staff cautions that changes to regulated rates that may be requested in relation to a MAADs transaction must be dealt with in the context of a proceeding under section 78 of the Act, and not necessarily at the same time that the MAADs application is reviewed.

2.2 Rate-Making Issues Associated with Distributor Consolidation

This section addresses the four areas of concern that have been expressed by some distributors.

2.2.1 Timing of Rebasing

Rates in the first year of a multi-year incentive regulation plan are generally founded on a cost of service review. At the end of that plan, a cost of service review is generally carried out. This review is referred to as “rate rebasing”. Since rebasing sets rates charged to customers relative to the cost of serving them, the timing of rebasing is an important consideration for parties considering a consolidation. Parties may use this information to calculate the value to shareholders of a transaction (i.e., determine time horizons for costs, benefits, and revenue retention assumptions).

*Incentive
regulation and rate
rebasings*

There are different circumstances among distributors and different motivations for MAADs transactions. Each transaction may be based on a different rationale and each offers the potential for different kinds of benefits that vary in nature, timing, and certainty. For example, consolidation of adjacent distributors and acquisitions between non-adjacent distributors to extend market coverage could produce some short-term, and generally one-time, savings associated with cost reductions from combining systems and corporate functions and from some business integration activities. In contrast, strategic consolidations for business-related purposes

*All transactions
have costs.
Benefits may vary
in nature, timing
and certainty*

rely on other factors to create value. These may include better strategic management, service improvements, diversification of risk, and so on. Such benefits are less well defined, appear over time and may occur more than once.⁶

Regardless of the nature, timing, or certainty of hoped for benefits of a consolidation, the distributor's ability to retain any achieved savings for a sufficient amount of time to at least offset the costs of a transaction is the subject of this section.

Time to offset costs is important

Given the diversity of Ontario's electricity distributors and the differing motivations underlying MAAD transactions, staff is concerned that a prescriptive approach, without flexibility as to when rebasing must occur, might act as a barrier to distributor consolidation. For example, if it is believed that significant expenditures will be needed to improve or maintain adequate service quality and reliability and that this spending is appropriate; a consolidated entity may be motivated to seek early rate rebasing. In this case, the consolidation may not be reasonably economic without a revenue requirement increase to cover these expenditures. On the other hand, if net savings from a consolidation are likely and it is forecasted that rates will ultimately decline from what they might have been had the consolidation not taken place; the consolidated distributor may prefer to seek later rate rebasing in order to capture, for a time, the savings to offset the costs and efforts underlying the consolidation. In this case, the consolidation may not appear economic unless sufficient time is allowed for the consolidated entity to realize and retain net savings. These two examples illustrate a need for flexibility.

Urgency to rebase will differ depending on "going-in" needs and assumptions

At the same time, however, distributors considering consolidation require some measure of regulatory predictability in order to properly assess the costs and benefits of a proposed consolidation.

⁶ Peterson, Carl F. and Karl A. McDermott. Mergers and Acquisitions in the U.S. Electric Industry: State Regulatory Policies for Reviewing Today's Deals. The Electricity Journal. Jan./Feb. 2007, Volume 20, Issue 1.

Staff proposes that the Board provide a distributor some flexibility on the timing of rate rebasing for the consolidated entity and that the Board rely on the licensing regime and incentive regulation framework as adequate to protect the consumer interest and distributor financial viability pending post-consolidation rebasing. However, staff proposes a limit of five years, from the time of the MAADs approval, on the allowed timing for rebasing. This is an alternative to the Board's three-tranche rebasing schedule. Staff believes that affording the consolidated entity some flexibility to defer rate rebasing for up to five years from the time of the MAADs approval provides a greater opportunity to offset the costs of consolidation. Where a distributor anticipates that significant expenditures are necessary in the short term, the distributor may propose an earlier rebasing. A policy that would allow the consolidated entity to elect its rebasing schedule, within the permitted timing band (i.e., up to 5 years), would enhance predictability of regulatory treatment and thus assist consolidation assessment and planning.

Staff proposes flexibility – up to 5 years from the time of MAADs approval

Staff's proposed five-year limit on a distributor's choice is based on a review of other jurisdictions which suggests that it is a reasonable limit. The proposed five-year period is referenced in several US commission rate review findings⁷. However, in one instance, the National Grid – Niagara Mohawk merger, the applicants had negotiated a 10-year rate regulation scheme with stakeholders. The commission's findings in that case were an overall endorsement of the settlement agreement⁸. In the UK, Ofgem has issued a policy statement in relation to mergers in the electricity

⁷ Examples include: Oklahoma Corporation Commission - American Electric Power Company, Inc. and Central and South West Corporation (May, 1999); The Kentucky and Indiana Public Service Commissions - Cinergy and Duke Energy (November, 2005); Public Utilities Commission of the State of California - Pacific Enterprises/Enova Corporation (June, 2001); State of New York Public Service Commission - New York State Electric & Gas Corporation with Rochester Gas and Electric Company (April, 2006).

⁸ State Of New York Public Service Commission. Opinion No. 01-6: Opinion And Order Authorizing Merger And Adopting Rate Plan. Case 01-M-0075 - Joint Petition of Niagara Mohawk Holdings, Inc., Niagara Mohawk Power Corporation, National Grid Group plc and National Grid USA for Approval of Merger and Stock Acquisition. December 3, 2001.

distribution sector⁹. In that statement, Ofgem relies on its existing price control mechanism to set rate review periods (currently five years). Ofgem does not provide longer plan periods following a merger.

Staff believes that more than five years may be problematic for two reasons. First, Ontario's experience with multi-year rate regulation plans is limited. To date, the maximum duration of a rate plan implemented by the Board for a gas or electricity distributor has been three years. Staff believes that it is premature to propose a plan length of more than five years until greater experience with multi-year rate plans is gained by distributors, other stakeholders and the Board. Second, a study carried out in the UK on the process and impact of mergers of National Health Service trusts concluded that the longer the timeframe used, the more difficult it is to attribute effects – for example, the impact on service developments – to the merger process, given the context of a turbulent environment of change in that sector¹⁰. Staff thinks this study's conclusion may be applicable regardless of the sector, and that it could reasonably apply in Ontario's electricity distribution sector. The Board may want to assess efficiencies that result from consolidation at the time of rebasing, particularly if distributors are allowed to retain efficiency gains for an extended period of time. Allowing for rebasing deferral beyond five years would make this assessment difficult.

Is 5 year maximum appropriate?

How flexibility in relation to rebasing is actually implemented at the time of a MAADs application could be as follows. Staff proposes that the Board require a distributor to specify, as part of the MAADs application, the distributor's proposal for the time of rebasing for the consolidated entity, within the proposed five-year limit.

Distributor specifies timing

⁹ Ofgem. Policy statement. Mergers in the electricity distribution sector. May, 2002. (http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/207_1may02.pdf?wtfrom=/ofgem/work/index.jsp§ion=/areasofwork/mergersandaquisitions)

¹⁰ Fulop, Naome, et al. Process and impact of mergers of NHS trusts: multicentre case study and management cost analysis. *BMJ* Volume 325. August 3, 2002.

In the normal course, the expectation would be that the distributor's proposal for rebasing would be accepted by the Board. While a Board panel assigned to hear a MAADs application always retains the discretion to reject the distributor's proposal, the expectation would be that the panel would only do so where participants in the proceeding provided cogent evidence that the proposal would not result in just and reasonable rates.

*Impact on MAADs
application and
proceeding*

The Board retains discretion to review the rates of a distributor at any time. Also, the consolidated entity retains the right to file an application to the Board earlier. However, where a distributor's proposal for timing of rebasing has been accepted by a panel of the Board in the context of the MAADs proceeding, the expectation would be that the consolidated entity's rates would not be subject to rebasing at a different time, whether at the instance of the Board or on application by the consolidated entity, without evidence that current rates are not just and reasonable.

A final issue in relation to rebasing is whether the above proposed approach should apply where a consolidated entity whose rebasing proposal has been accepted by the Board subsequently enters into a further consolidation transaction before rebasing has occurred. Board staff invites 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.

Implementation Considerations

In order to ensure procedural fairness, a MAADs Notice of Application should include a statement of the applicant's proposal for timing of rebasing. It is important that interested parties understand that any concerns that they might have regarding the proposed timing of rebasing must be voiced during the MAADs transaction proceeding, as no subsequent opportunity will be provided.

MAADs Notice

The Preliminary Filing Requirements include, amongst other matters, information to describe the transaction. This includes financial statements and pro-formas, and impact statements related to consumer protection, economic efficiency and financial viability. These requirements may need to be reviewed to confirm that appropriate information is being collected to allow for consideration of the distributor's proposal on timing of rebasing.

*Are the MAADs
filing requirements
sufficient?*

2.2.2 Treatment of Costs and Savings

A distinguishing feature of incentive regulation over annual cost of service regulation is the potential to retain savings achieved during the term of a multi-year rate plan. There is also an expectation that benefits are shared with ratepayers intrinsically through the X-factor of a price cap formula and more explicitly at the end of the plan through rate rebasing. As a result, incentive regulation is well suited to allowing retention of net consolidation savings while protecting the interests of ratepayers.

*Incentive
regulation well
suited to allowing
retention of
savings to offset
costs*

To provide a more predictable regulatory environment and to optimize the benefits of incentive regulation, staff proposes 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 is requested. This would maintain rate predictability while assuring ratepayers that rates do not escalate unexpectedly as a consequence of the consolidation. This approach, combined with the option to specify the rebasing deferral period (up to five years), would give distributors a greater measure of predictability on the potential net benefits attached to the efficiency gains that they expect to achieve. It is assumed that all consolidation costs would be managed by the distributor under the rates indexed by the incentive regulation formula.

*Staff proposes
incentive
regulation plan at
time of MAAD
application
until rebasing*

2.2.3 Treatment of Net Impact (Costs/Savings)

Up to this point, this paper has focussed on rate-making issues related to consolidation and the impact on the distributor. This section addresses the net impact on ratepayers.

Rebasing at the end of an incentive regulation term ensures that ratepayers benefit from savings achieved – regardless of the source of the efficiency. The net impact of a consolidation on ratepayers will be dealt with at rebasing. In two recent significant Board consultations that examined incentive regulation, the Board described what might be expected at rebasing.

In its March 30, 2005 Natural Gas Forum Report¹¹, the Board stated, amongst other things, that at rebasing it would need to receive a thorough analysis from the distributor in order to determine whether efficiency improvements achieved by a distributor are temporary or sustainable. For example, of interest will be the relationship between operation, maintenance and administration costs and capital expenditures, the timing of capital expenditures and the associated impacts on shareholders and consumers. Further, during the incentive regulation term, the Board would expect to see measures that are designed to improve the distributor's productivity on a sustained basis – not temporary, unsustainable budget cuts. The Board reinforced this view in its December 20, 2006 Cost of Capital and 2nd Generation Incentive Regulation Report¹².

*Natural Gas Forum
Report*

and

*Report of the
Board on Cost of
Capital and 2nd
Generation
Incentive
Regulation*

With regard to distributor consolidation, the rate-making treatment of acquisition premiums should be clarified. Staff believes it is generally inappropriate to expect ratepayers to bear these costs through rates. Staff is of the view that the value of the assets to

*Acquisition
premiums should
not be allowed in
rate base*

¹¹ Ontario Energy Board. Natural Gas Regulation in Ontario: A Renewed Policy Framework Report on the Ontario Energy Board Natural Gas Forum. March 30, 2005.

(http://www.oeb.gov.on.ca/documents/consultation_ontariogasmarket_report_300305.pdf)

¹² Ontario Energy Board. Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors. December 20, 2006.

(http://www.oeb.gov.on.ca/documents/cases/EB-2006-0088/report_of_the_board_201206.pdf)

ratepayers does not change with a change in ownership, as the distributor invested in those assets to provide service to ratepayers. Also, previous Board decisions have generally involved the use of net book values in determining rates after ownership changes.

At the same time, staff would expect that any resulting net consolidation costs or losses would be to the account of the shareholder.

2.2.4 Rate Harmonization

To date, distributors have been allowed discretion as to when and how they harmonize distribution rates after a consolidation. As a result, there are still a number of merged or amalgamated entities that require multiple rate orders each time rates are set.

Currently, distributors file some information on rate harmonization plans with their MAADs application. It may be helpful to distributors and their customers for the Board to establish its expectations for rate harmonization as this issue is of concern to consumers.

Staff proposes 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.

*Staff proposes
Board examine
harmonization at
rebasings*

Implementation Considerations

To facilitate distributor filing of a detailed rate harmonization plan at rebasing, appropriate filing requirements may need to be developed and included in the Board's "Filing Requirements for Transmission and Distribution Applications".

*Filing
requirements may
need to be
developed*