Ontario Energy Board

Staff Discussion Paper

Electricity Distributors and Management of Customer Commodity Payment Default Risk

June 4, 2007

A. Introduction

This discussion paper examines the issue of large customer commodity payment default risk management by electricity distributors with a view to identifying whether risk mitigation tools that are currently available to distributors are adequate for the purpose of managing such risk and protecting ratepayers.

This discussion paper focuses on risk mitigation tools that fall within the ambit of the Board's authority, as well as those that are available in the marketplace.

B. Background

Each non-embedded distributor is required to make monthly payments to the Independent Electricity System Operator (IESO) to cover the electricity consumed by all customers in the distributor's service territory other than customers that are wholesale market participants. The invoice from the IESO includes not only charges for electricity delivered but also charges for ancillary services, transmission services, IESO administrative services and other services required to operate the IESO-administered market and direct the operations and maintain the reliability of the IESO-controlled grid. These charges together represent more than half of the total charges on a retail electricity bill issued by a distributor, while charges for the distribution services provided by the distributor are far smaller.

As wholesale market participants, distributors are required to post financial security ("prudential obligations")[1] with the IESO to protect the wholesale market from the financial consequences of a distributor defaulting on its wholesale market financial obligations.[2] In turn, a distributor can collect security deposits from its retail customers and from electricity retailers to protect themselves from the financial consequences of retail market defaults. Rules governing security deposits are set out in the Distribution System Code (DSC) for customers and in the Retail Settlement Code (RSC) for retailers. However, the ability to collect deposits may not always translate into adequate protection from the financial implications of a large customer payment default.

While large credit losses are not common, when they occur they can potentially have a significant financial impact on a distributor, especially one with a narrow customer base (e.g., where the customer's consumption represents a high percentage of total consumption in the distributor's service area). In some cases,

[1] The IESO has undertaken a review of the physical market prudential framework: http://www.ieso.ca/imoweb/consult/consult_se23.asp

The review has led to a Market Rule amendment submission and a draft amendment proposal (**MR-00212)**. The draft amendment proposal was published for stakeholder review and comment on May 24, 2007: http://www.ieso.ca/imoweb/amendments/mr_Amendments.asp

[2] Since market opening in 2002, no distributor has defaulted on an IESO payment.

the cost of power of a single large customer can exceed the distributor's total revenue for distribution services.

The financial consequences of a large customer payment default can potentially be visited on a distributor's remaining ratepayers. The Board has, in the past, received large bad debt recovery requests from distributors (discussed in section D). Rideau St. Lawrence Distribution Inc. lost its largest volumetric customer to insolvency in 2006, a factor contributing to its decision to self-nominate for rate rebasing in 2008.[3]

The remainder of this discussion paper: (1) explores the distinction between customer default risk and commodity volume and price risk; (2) examines existing customer non-payment risk mitigation instruments; and (3) identifies issues for further consideration and stakeholder input.

C. The Nature of Customer Commodity Payment Default Risk

Prior to market restructuring, distributors had the capacity to recover account defaults by property owners through the property tax roll under the *Public Utilities Act.* Market restructuring brought about the commercialization of the distribution sector and removed this tool to recover payment defaults. A move to a commercial orientation entails the assumption and management of normal business risks, including risks related to customer payment default. Distributors are in the best position to manage such risk because they have a direct relationship with the customers in question (i.e., customers that are not wholesale market participants) through the retail billing process. The Distribution System Code (DSC) provides tools for distributors to mitigate customer payment default risk and the terms under which these tools can be used.

Distributors have long expressed the view that bearing customer commodity payment default risk is inconsistent with the role of distributors as pass-through agents.[4] In expressing such concerns, distributors sometimes rely on statements made by the Board in its 1999 Standard Supply Service Code Decision (proceeding RP-1999-0040)[5] published in October 1999.

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[3] The self-nomination letter is available from the Board's website: http://www.oeb.gov.on.ca/documents/cases/EB-2006-0088/self-nomination_applications/RideauStLawrence.pdf

[4] See, for example, Electricity Distributors Association (EDA), "LDC Commodity Risk Analysis and Recommendations," August 8, 2002; Independent Market Operator (now the Independent Electricity System Operator), Technical Panel, "Market Rule Amendment Submission," MR-00212-Q00, October 2002; EDA, "Response to Ontario Energy Board Staff Discussion Paper entitled: Review of Further Efficiencies in the Electricity Distribution Sector," February 19, 2004; EDA, "Response to Ontario Ministry of Energy Discussion Paper entitled: Electricity Transmission and Distribution in Ontario – A Look Ahead," February 28, 2005; and, most recently, EDA, "Commodity Payment Default Risk and Ontario's Electricity Distributors," November 2006.

[5] Decision available from the Board's website: http://www.oeb.gov.on.ca/documents/cases/RP-1999-0040/Decision.pdf

However, commodity risk as discussed in that Decision deals with the price and volume risk associated with procuring supply at a fixed price and customer mobility issues. It does not deal with the risk of customer commodity non-payment.

The issue of customer non-payment risk was addressed in the December 1999 version of the Standard Supply Service Code[6] (SSS Code) and the associated staff Background Paper[7] . The 1999 version of the SSS Code contained provisions governing the ability of distributors to mitigate customer non-payment risk (e.g., security deposits, prepayment, preauthorized payment, etc.).[8] These provisions were not carried forward when the SSS Code was revised in March 2005 (proceeding RP-2004-0205),[9] having been replaced by consumer non-payment risk mitigation provisions in the DSC. The DSC was amended in early 2004 following a broad stakeholder consultation on consumer security deposits (proceeding RP-2002-0146).[10]

D. Customer Payment Default Risk Mitigation Measures

There are a number of tools or measures available for mitigating the risk of customer commodity payment default. Some of these tools fall under the authority of the Board while others are market-based. The discussion below is

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[6] The December 1999 version of the SSS Code is available from the Board's website: http://www.oeb.gov.on.ca/documents/cases/RP-1999-0040/code.pdf

The current SSS Code is available from the Board's website: http://www.oeb.gov.on.ca/html/en/industryrelations/rulesguidesandforms_regulatory.htm#electricity

[7] Report available from the Board's website: http://www.oeb.gov.on.ca/documents/cases/RP-1999-0040/ssspaper.pdf

[8] Section 2.6 (Credit Risk Mitigation Measures) of the December 1999 SSS Code stated that:

> 2.6.1 A distributor may mitigate the risk of non-payment from standard supply service customers by using any means allowed by law including:
> • deposits
> • late payment charges
> • prepayment
> • preauthorized payment
> • load limiters.
>
> 2.6.2 A distributor may disconnect a standard supply service customer for non-payment of standard supply service in accordance with section 31 of the Electricity Act and with the process for disconnection set out in the Distribution System Code.

[9] Background materials available from the Board's website: http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_regulatedpriceplan_development.htm

[10] Background materials available from the Board's website: http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_securitydeposits.htm

not intended to be an exhaustive inventory of all available risk management measures.

1. **Risk mitigation measures under the Board's authority:**

a) Treatment of bad debts in electricity rates:

An ongoing, normal level of bad debt expense is considered part of doing business. Bad debt expense included in rates is designed to recover ongoing bad debt expense on a smoothed basis to assist in maintaining rate stability. The approved distribution rates of distributors include an amount to cover bad debt expense which is based on historical expenses or forecast amounts included in rates approved pursuant to forward test year applications.

As noted earlier, the Board has in the past received large bad debt recovery requests from distributors. Specifically, requests were received from Atikokan Hydro Inc., Halton Hills Hydro Inc., Milton Hydro Distribution Inc. and Oshawa PUC Networks Inc. as part of their respective 2006 electricity distribution rate applications. Recovery in these cases was denied. In the case of Milton, the Board's decision stated that "[a]greeing to the Applicant's request would constitute retroactive ratemaking, a practice not endorsed by the Board."[11]

Distribution rates are currently established using an evolving framework of incentive-based regulation. The opportunity to rebase and establish rates on a cost of service basis will occur for each distributor sometime over the three year period from 2008 to 2010. This means that the distributor will have a chance to calibrate their bad debt expense to actual experience, establish a forward test year amount and then be rewarded under incentive regulation for keeping costs low. This would include effective management of credit risk to keep bad debt expense low.

b) Treatment of bad debt losses in financial accounts:

The Allowance for Doubtful Accounts is an account in the Uniform System of Accounts that is required to be used to accumulate the provision against possible customer defaults (e.g., the accumulation amount included in the cost used to establish rates). Its balance is grouped with accounts receivable to show the net value that the distributor anticipates will be recovered.

[11] Decision available from the Board's website:
http://www.oeb.gov.on.ca/documents/consumers/2006edr/miltonhydro-decision_120406.pdf

The entry to set up the Allowance is based on an estimate of upcoming losses which is:

Dr. Bad debt expense (which is a charge against net income)
Cr. Allowance for doubtful account

Then when a customer does default, the entry is:

Dr. Allowance for doubtful account
Cr. Accounts receivable (to write off the balance)

For example, if a distributor suffers a $1 million credit loss, and a $600,000 allowance has been built up in the Allowance for Doubtful Accounts that can be applied to that customer, then the amount of $400,000 would appear on the distributor's income statement as a bad debt expense. The $400,000 amount would be the actual "hardship" or financial loss incurred by the distributor.

c) *Deferral accounts for large unexpected losses:*

If a large credit loss occurs, a distributor may request that the Board approve the use of a deferral account to capture the cost of unusually high losses for potential recovery in a future period. The distributor would typically need to demonstrate that it had taken prudent steps to protect itself against the risk of payment default from the non-paying customer(s). Demonstrating use of the measures noted here will not necessarily be sufficient for a distributor to potentially recover costs associated with the payment default. In considering whether or not to allow such recovery, the Board would also need to consider the criteria normally applied to deferral accounts. It would also need to be mindful of the fact that distributors have their rates set based on a number of cost factors including compensation for business risks of this kind. Ultimately, decisions on recovery of major credit losses will depend on the merits of each case.

To date no distributor has obtained a deferral account for extraordinary large credit losses. Nor has the Board created a specific account exclusively for such losses. In its March 2006 decision in the generic proceeding regarding 2006 distribution rates (proceeding RP-2005-0020/EB-2005-0529),[12] the Board concluded "that a generic system-wide deferral account for material bad debt is not warranted at this time".

[12] Decision available from the Board's website: http://www.oeb.gov.on.ca/documents/cases/EB-2005-0529/Board/Decision/decision_210306.pdf

d) Payment schedule/frequency:

Distributors can negotiate more frequent (for example, bi-weekly or weekly) payment schedules with customers. This does not require Board approval. However, it is understood that if a customer does not agree to increased payment frequency, a distributor cannot unilaterally impose a more frequent payment schedule on the customer without bringing the matter before the Board.

Specifically, in its December 2004 Summary Report issued as part of the proceeding to amend the DSC in relation to unpaid electricity charges (proceeding RP-2004-0166), [13] the Board concluded that:

> In the event that a distributor becomes concerned regarding the ongoing creditworthiness of a customer, which nevertheless maintains a good payment record, and wishes to institute more frequent billing, the distributor is entitled to bring the matter to the Board if it is not able to reach agreement with the customer. The Board does not believe it is necessary at this time to propose Code amendments to address this issue specifically.

e) Security Deposits:

Distributors are not required by the DSC to collect security deposits from customers, but may do so provided that they act in accordance with the DSC.

The DSC sets out how security deposits are to be calculated and when they must be refunded, and places limits on the ability of distributors to collect security deposits from customers. The rules governing the calculation and refunding of security deposits vary among customer type (residential and non-residential), size of load, billing cycle (e.g., monthly, bi-monthly and quarterly), good payment history, and credit rating (where applicable).

As noted above, amendments to the DSC regarding security deposits were made in early 2004, following broad stakeholder consultation (proceeding RP-2002-0146).[14] In the Companion Policy Document associated with those amendments, the Board indicated that it expected distributors to apply the new security deposit rules only on a prospective basis (i.e., if a deposit had not been required from a customer prior to the amendments, a deposit should not thereafter be required unless the customer fails to meet the requirements of section 2.4.10 of the DSC).

[13] Report available from the Board's website:
http://www.oeb.gov.on.ca/documents/dsc_unpaidelectricity_summaryreport_211204.pdf

[14] Background materials available from the Board's website:
http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_securitydeposits.htm

Therefore, there are large customers from whom distributors may not have had the opportunity to obtain security deposits.

2. Risk mitigation measures available from the marketplace:

The following section describes risk mitigation measures that have been identified by Board staff as available from the marketplace. Staff should not be understood as endorsing any of these measures, nor as considering that their use would be considered prudent in any given case.

a) The sale and assignment of claims to a third party:

After a large customer has defaulted, the distributor may sell the receivable balance to a collection agency at a discount.[15] For example, if the outstanding receivable is $1 million, the distributor may get $750,000 if there is still a chance that the customer will eventually pay the bill and not go bankrupt. The value received will depend on the financial condition of the customer and probability of payment.

b) Credit insurance:

Distributors can purchase insurance that covers all or a particular subset of its receivables. The cost of the product varies depending on the portfolio of receivables and the level of coverage and deductibles.

In a full cost of service rate application, a distributor has the option to request that the Board allow the recovery of credit insurance costs through rates. In considering whether or not to allow such recovery, the Board would need to be mindful of the prudence of purchasing credit insurance compared to the use of other available risk mitigation measures and the reasonableness of the rates charged to customers in relation to their allocated costs.

[15] Hamilton Utilities Corporation was able to recover a portion of the electricity charges owed to it by Stelco Inc., which filed for bankruptcy protection in January 2004, through the sale and assignment of its claim to a third party. It also reached an agreement with Stelco to move to weekly billing.

Hamilton Utilities Corporation, “Hamilton Utilities Corporation Releases 2004 Financial Results,“ News Release, March 9, 2005: “The Corporation’s largest creditor, Stelco Inc. filed for bankruptcy protection on January 29, 2004 and effectively stayed approximately $9.3 [million] of its liability for electricity charges owing to the Corporation as of that date. The Corporation has since recovered $8.8 [million] of this amount through certain set-offs and other recoveries including the sale and assignment of its claim to a third party. The Corporation has entered into an agreement with Stelco Inc. to settle its electricity charges on a weekly basis.”

c) *Credit Default Swaps:*

This product is primarily offered by financial institutions (e.g., banks). The buyer of a default swap pays a premium to the writer or seller in exchange for the right to receive a payment should a credit event occur. In essence, the buyer is purchasing insurance. The spread (or cost) would vary depending on the credit risk involved.

As in the case with credit insurance, a distributor has the option of asking the Board to allow recovery of costs associated with credit default swaps. In considering whether or not to allow such recovery, the Board would need to be mindful of the prudence of purchasing a credit default swap compared to the use of other available risk mitigation measures and the reasonableness of the rates charged to customers in relation to their allocated costs.

3. Other risk mitigation measures:

a) *Termination of Service:*

Section 31 of the *Electricity Act, 1998* gives distributors the ability to terminate service to a customer (i.e., disconnect) in the event of non-payment for the distribution or retail of electricity, subject to conditions (e.g., timing and means of notification). The DSC also permits distributors to disconnect a customer for non-payment of a security deposit.

b) *Legal Remedies:*

Distributors may be in a position to take legal action to recover losses, such as by making a claim as a creditor in a bankruptcy proceeding.

E. Issues for Consideration

There are *ex ante* and *ex post* measures available to distributors for managing customer payment default risk, a number of which have been identified above.

Ex ante actions include the use of security deposits, negotiation of accelerated billing, proper screening and credit evaluation of large volume customers, customer monitoring, pre-emptive action (disconnection, load limiters, use of collection agencies), and the inclusion of bad debt expense amounts in the revenue requirement when applying for a rate adjustment.

Ex post actions include the cashing or realization of security deposits, pursuing legal remedies in bankruptcy proceedings and the ability to apply to the Board for specific relief through the mechanism of a deferral account.

The question remains as to whether the existing measures are generally considered adequate or whether implementation by the Board of additional measures might be warranted. Board staff has identified the following as areas where stakeholder input would be useful in assisting Board staff in furthering its work on this issue:

1. To what extent are distributors, especially those with a narrow customer base, making use of existing *ex ante* and *ex post* risk mitigation management tools?

2. What are the reasons behind a distributor's decision, especially those with a narrow customer base, to not make full use of available risk mitigation management tools (e.g., risk is not of a magnitude warranting extensive use of mitigation tools; lack of awareness of tools available; inability to negotiate alternative billing arrangements; cost of credit insurance)?

3. Do distributors require further guidance from the Board on the issue of prudence within the context of managing customer non-payment risk? If so, in what respect?

4. Do current risk management measures allow distributors to manage customer default risk prudently? If not, why?

5. Do current risk management measures adequately take into account the interests of ratepayers?

6. Are there alternative or additional non-payment risk mitigation measures that should be considered by the Board for potential implementation?

Board staff will consider the input of stakeholders in formulating recommendations for the Board's consideration as to whether further action is necessary or desirable and, if so, what form such action might take.