RP-2004-0140

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

AND IN THE MATTER OF a proceeding pursuant to
section 44(1) (a) of the *Ontario Energy Board Act, 1998*
to amend the Affiliate Relationships Code for Gas Distributors

SUBMISSION OF HYDRO ONE INC. UTILITIES REGARDING THE BOARD'S PROPOSED CHANGES TO THE AFFILIATE RELATIONSHIPS CODE FOR GAS DISTRIBUTORS

HYDRO ONE'S SUBMISSION ON THE BOARD'S PROPOSED CHANGES TO THE AFFILIATE RELATIONSHIPS CODE FOR GAS DISTRIBUTORS

The Board proposes changes to the transfer pricing and reporting sections of the Affiliate Relationships Code (the Code) for Ontario gas distributors and is requesting comments. The Board's proposal includes more rigorous standards -- mandated competitive bidding processes, independent evaluation of bids for larger contracts, more stringent conditions for information disclosure, restrictions on the duration of contracts and similar rules for the pricing of asset transfers between a utility and its affiliates. Moreover, the Board notes that it "will pay close attention" if a utility out-sources services to a third party which is not technically an affiliate, but economically related to the same corporate group.

The Code for gas utilities today is nearly identical to that for electricity utilities; we understand that similar changes for the latter may be contemplated. The following accordingly is the submission of the utilities of Hydro One Inc. – Hydro One Networks Inc. ("Networks"), Hydro One Remote Communities Inc. ("Remote Communities") and Hydro One Brampton Networks Inc. ("Brampton Networks") on this issue.

Hydro One's Response in Summary

Although Hydro One acknowledges the Board's and intervenors' concerns with transactions between a utility and its unregulated affiliates, we believe that the proposed amendments are more onerous than required in some respects:

1. The sharing of administrative functions allows corporate groups to be more efficient and can result in savings for customers and the corporate entities. The sharing of those services in this manner is not an indication that services could reasonably be out-sourced to unaffiliated third parties. Transactions to share corporate functions between a utility and its affiliates should be priced at fully allocated cost and should not be subject to competitive bidding requirements.

2. Similarly, utilities should be encouraged to share services between them so that fixed costs can be spread among them more efficiently. Accordingly, the proposed requirement for utilities to seek competitive bids for all of the services it procures should not apply in instances where an OEB regulated utility receives services from another OEB regulated utility, provided those services are obtained at a price not greater than fully allocated cost.

3. Where services are provided by an unregulated affiliate, the contract length and other significant terms and conditions should be comparable to what could be obtained in the same circumstances in the competitive marketplace.

Hydro One acknowledge that utilities must be prepared to provide evidence that supports their compliance with these provisions at future rate proceedings.

These suggestions are made taking into account concerns respecting the cost and time which will be required to justify and evaluate such transactions prior to their being awarded, in addition to that already needed to defend them during rate proceedings.

With respect to the Board's proposed Code changes respecting transactions between utilities and unregulated affiliates, Hydro One offers the following comments.

Comments on Specific Aspects of the Board's Proposal

Justification of Out-sourcing – Use of Internal Costs

The Board proposes new sections 2.3.2 and 2.3.3, which state that a utility which is out-sourcing services for the first time, must, after applying either the market-based or cost-based transfer pricing rule, pay no more than the utility's fully-allocated cost to provide the same service itself at that time.

We believe that the intent here should be to prevent a utility from purchasing from a third party, a service which it could provide more economically and efficiently, itself, *all other things being equal.* Hydro One agrees with the March 25, 2004 submissions of both Union Gas and Enbridge, which note that the prior internal cost for the service may not be the most appropriate measure of reasonableness. Utilities may decide to out-source due to the need to replace an underlying asset or to obtain a more cost-effective "re-packaging" of services than it had previously been capable of providing itself. This may mean that the cost of the new total could be higher than the limits which the Board's proposed rule would allow, but the overall decision may nonetheless be more cost-effective and efficient in the end.

The Board recognizes Enbridge's and Union's position above and in response, requests comments on Enbridge's suggestion to replace the proposed rules 2.3.2 and 2.3.3 with those posed by the Alberta regulator. Those rules are quoted below from AEUB Decision 2003-040, page 77:

1) *"If a Utility intends to out-source to an Affiliate a service it presently provides for itself, the Utility shall...undertake a net present value analysis appropriate to the life cycle or operating cycle of the services involved."*
2) *"Each Utility shall periodically review the prudence of continuing" for-profit outsourcing.*

The Board also notes the AEUB's stress on the importance of a full business case and what that business case should include.

Hydro One submits that the development of a business case which includes an NPV analysis of the services and the utility's periodic reviews of the prudence of such out-

sourcing as suggested above, would be the more appropriate approach and should replace the highly prescriptive rules 2.3.2. and 2.3.3.

Shared Corporate Services

The proposal explicitly includes "corporate" services in the definition of services and invites comment on whether this inclusion is needed as well as on the scope of the services defined as "corporate." It also invites exploration of "new options which would lead to a 'win-win' outcome in respect of the pricing of shared corporate services." Options proposed include:

a) addressing the pricing of shared corporate services with a separate new rule,
b) codifying the Board's three-part test regarding shared corporate services (EBRO 493/4) and
c) replacing the requirement of market–based pricing with a requirement of demonstrated up-front benefit to ratepayers.

Hydro One supports the need for further clarification here. Corporate services generally are those which together, comprise the administrative (and often physical) infrastructure supporting the parent and subsidiary companies. They can include planning, human resources, general counsel, treasury, insurance, risk management and communications functions and possibly, facilities and information management.

For efficiency purposes, such services are usually provided from central units. Hydro One agrees with Union Gas that the nature of many of these activities does not lend itself to provision by an external party retained via competitive bidding. Accordingly, we support Union's proposed amendments to Section 2.3 of the Code, as follows:

"Corporate Services and Shared Services

Section 2.3.Xi

Despite sections 2.3.4, 2.3.5 and 2.3.6 ..., a utility may enter into agreements with affiliates for a corporate service or shared service if:

(a) the details of the cost allocation methodology are documented and filed with the Board; and
(b) the details of the cost allocations for the agreements between the utility and affiliate are fully disclosed.

Section 2.3 Xii

In the case of a corporate service or shared service, the utility shall pay no more than the affiliate's fully-allocated cost to provide that service. The fully-allocated cost may include a return on the affiliate's invested capital. The return on invested capital shall be no higher than the utility's approved weighted average cost of capital."

This position is supported by the AEUB Decision 2003-040, which approves the sharing of corporate services, provided that such sharing aligns with the Code, is prudent and

documented in an appropriate services agreement and subject to a periodic prudence review by the utility. The services agreement must adhere to the Code's provision for transfer pricing and in doing so, references an acceptable cost allocation methodology. In short, the AEUB does not require the utility to undertake competitive bidding for corporate and shared services, but considers the scrutiny of both the costs and cost allocation methodology to be sufficient in this regard. (AEUB Decision 2003-040, p. 63).

The Definition of an Affiliate

The Board questions whether the definition of "affiliate" is sufficiently broad, noting that it is defined in the Act for rule-making purposes, but not for rate-making. It states its intent to attend closely to utility contracts with economically related parties which technically are not affiliates, during rate proceedings.

Hydro One believes that the definition of "affiliate" should continue to be taken directly from the OBCA, as this is the legal and therefore, most commonly understood term. A less precise definition will lead to uncertainty for utilities and for parties with whom they wish to contract. We make some suggestions in response to the Board's question 5, below, regarding the need for guidance on the issue of maintaining confidentiality in the contracting process. Such guidance would be helpful to utilities when informing service providers (affiliated or not) of the Board's requirements, to help avoid misunderstanding.

Hydro One's Responses to the Board's Specific Questions

1. *Should the three-month transition period (to the new Code) be lengthened? If so, to what period?*

   Hydro One supports Enbridge's response that at least a six-month transition period would be more realistic, enabling utilities to align their practices with the new rules.

2. *Should a new provision be added to address application of the amendments to existing contracts and if so, what period of time should be specified before they become subject to the new rules?*

   Hydro One recommends the addition of a provision enabling existing contracts to run to the end of their terms. Utilities with existing contracts are legally bound by their terms and conditions and cannot break them. They, therefore, would be faced with the need to request exemptions to the Code for situations which could not be readily rectified should those exemptions not be granted. This would inject considerable uncertainty and potential cost to the completion of work already underway. Furthermore, there is likely not a large number of contracts in effect today which run beyond five years, so this should not be a major issue. The Board should be able to satisfy its need to identify and monitor these contracts through a provision under utility reporting requirements as well as through regular rate proceedings.

3. *Should longer-term contracts be encouraged or discouraged? What further provisions should be added to ensure that the amount charged is fair over the length of any contract extending beyond five years?*

   Utilities need the flexibility to negotiate the best overall contract terms they can, depending on the specific circumstances and the risks and benefits related to those. In cases where risks could be mitigated through a longer-term contract, the Board's proposed imposition of an arbitrary contract length could damage the distributor's capability to obtain the best price or other benefits for the ratepayer. Hydro One believes that where contracts are negotiated with affiliates, the terms of those agreements (including contract duration) should be typical of what would be negotiated for like services, in the competitive marketplace.

4. *Should the Policy Paper address the question of bundling vs. unbundling of services in the context of the enforcement of the new transfer pricing rules and if so what should be the Board's position?*

   Hydro One acknowledges the Board's need to ensure compliance with its rules. The Board, however, must equally recognize the practicalities of undertaking competitive bidding processes. Electric utilities routinely carry out forestry, lines and stations maintenance work, which, for operational efficiency, may be combined in organizational units, with budgets structured accordingly. Should these be subject to a bidding process, there may be private operators who are capable of bidding on one or two of the components, such as forestry work, but not necessarily on the total "package." Utilities need the freedom to structure bidding processes around work packages which can be accommodated by the market.

5. *Should the Policy Paper add interpretative guidance enabling competitive bidding to be undertaken on a confidential basis (so that other bidders would not be aware of bid terms)? Would this improve the quality of the bidding?*

   Yes, utilities must be able to assure confidentiality to bidders of key aspects of their agreements. We also acknowledge the potential for public disclosure of signed contracts (through a summary or expurgated agreement). Guidance, either in the Code or the Policy Paper which could assure bidders that an unsuccessful bid and also that key details of the signed contract could be retained in confidence, would help to improve the quality of the process by encouraging bidders to submit greater detail.

6. *Should the Policy Paper acknowledge potential special circumstances (e.g., spot markets) where the Board may grant an exemption from mandatory independent evaluation of the tendering process for significant contracts, proposed in new rule 2.3.7? What interpretative guidelines could be offered – as to the appropriate circumstances and as to the alternative measures to be considered?*

   There are likely some special circumstances, particularly where time is of the essence, which should be explicitly exempted from this requirement of the Code. Spot market

transactions are a particularly relevant example. In this case, the Board could review the utility's bidding procedures as part of the rate proceeding.

Another area which requires consideration as these changes are reviewed, is the provision of emergency services to other utilities, which both the current gas and electricity Codes allow without the need of a services agreement. Hydro One believes that this exemption in its entirety should be continued.

Other Areas Requiring Clarification

- Use of the total contract value as proposed in Section 2.3.6 to determine the threshold for competitive bidding, creates a discrepancy in treatment of multi-year vs. annual contracts. We agree with Union Gas that an average annual value should be used for the assessment of multi-year contracts.

- Section 2.3.10 indicates that evidence that a market does not exist will be required prior to application of the cost-based rule. It would be helpful to understand the kind of evidence that would be expected by the Board in this regard.