1 **RP-2004-0140**

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NOTICE OF PROPOSAL TO AMEND A CODE

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PROPOSED AMENDMENTS TO AFFILIATE RELATIONSHIPS CODE FOR GAS UTILITIES

4 To: **All Interested Parties**

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Background

6 On July 31, 1999, the Ontario Energy Board (the "Board") issued the Affiliate Relationships Code For Gas Utilities ("ARC"). The Board has had the opportunity to review various aspects of affiliate relationships in several recent natural gas rate cases and intends to exercise its authority under section 44(1)(a) of the Ontario Energy Board Act, 1998 (the "Act") to propose amendments to the ARC rules. The proposed amendments will focus on updated transfer pricing rules and enhanced affiliate information disclosure.

7 Subsection 45(10) of the Act requires the Board to consult with the gas utilities before the Notice is issued. On March 15, 2004, the Board forwarded the proposed amendments (the "initial proposed ARC") and a draft Background Policy Paper to five gas utilities for comment. Comments were received from Union Gas and Enbridge Gas. The Board has posted this material on its web site (see "What's New" entry for May 14th, 2004).

8 After considering the utilities' comments, the Board has decided not to make any changes at this time to the initial proposed ARC or the draft Policy Paper.

9 This public Notice is issued under section 45(1) of the Act. All interested parties are invited to provide their written submissions on the proposed ARC. Comments are also welcome on the draft Policy Paper, and on the utilities' comments.

10 The Board will not be granting cost awards in this consultation.

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Summary of Proposed Amendments

12 The Board's correspondence of March 15, 2004 (now posted on the Board's web site) includes a copy of the proposed amendments in full. They can be summarized as follows:

13 Purpose of Code

14 • Section 1.1 will be amended to provide that keeping ratepayers unharmed, at a minimum, is one of objectives of the ARC.

15 Definitions

16 • Section 1.2 will be amended by adding definitions of direct costs, fully-allocated cost, indirect costs, market price, service, and utility asset, and removing the current definitions of Director and fair market value.

17 Interpretations

18 • Section 1.3 will be amended by adding a sentence that nothing in the ARC precludes the Board's powers to subsequently review the prudency of actions taken by a utility.

19 To Whom this Code Applies

20 • Section 1.4.2 will be added, exempting a utility that is not rate regulated by the Board from being subject to the transfer pricing rules.

21 Coming into Force

22 • Section 1.5 will be amended to propose that the new rules come into effect three months after issue.

23 Transfer Pricing

24 • Current section 2.3 will be revoked and replaced by a new set of rules addressing:

25 • term of contracts with affiliates (section 2.3.1);

26 • utility's internal cost (sections 2.3.2 - 2.3.3);

27 • transfer pricing where a market exists (sections 2.3.4 - 2.3.9);

28 • transfer pricing where no market exists (sections 2.3.10 - 2.3.11); and

29 • pricing of transfer of assets (sections 2.3.12 - 2.3.16).

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Equal access to services

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- Section 2.5.4 will be amended by replacing “Director” with “Board”.

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Confidentiality of Information

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- Section 2.6.1.1 will be added requiring utilities to include specific information disclosure terms in their agreements with affiliates.

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Record Keeping and Reporting Requirements

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- Section 2.8.2 will be amended to correct a typographical error.

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Purposes of the Proposed Changes

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The March 15, 2004 draft Background Policy Paper (now posted on Board’s web site) sets out policy issues and considerations. The purposes of the changes can be summarized as follows:

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- The changes to the market-based pricing rule are intended to reinforce reliance upon the market as the preferred means of establishing fair prices for affiliate transactions.

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- The new requirement for independent evaluation before significant contracts are tendered to affiliates is designed to promote transparency and confidence in the bidding process.

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- The changes to the non-market based pricing rule and associated definitions are intended to generally codify existing practices.

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- The new definition of “service” is intended to confirm the Board’s view that the current (and proposed) transfer pricing rules apply to shared corporate services.

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- The proposed five year limited on affiliate contracts will ensure that the prices paid are periodically re-evaluated, and that any efficiency gains are shared with ratepayers through eventually lower prices.

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- The proposed utility’s internal cost test is intended to ensure that a utility proceeds with affiliate outsourcing only when the market or affiliate price is not higher than the internal cost.

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- The new transfer of assets rules are designed to be more comprehensive and fairer than the current rules.

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- The new information disclosure rule is designed to ensure any utility contract with an affiliate discloses the financial data considered for enforcing all the transfer pricing rules.

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- The new interpretations section provision is intended to remind stakeholders that the prudency of the transfer price paid will be reviewed in future rate cases (the draft Policy Paper proposes some guidance on how the Board will approach this task).

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Anticipated Costs and Benefits of the Amendments

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Cost-based pricing rules

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The bulk of the proposed changes (e.g. specifying that the affiliate's costs are to be the basis of non-market based pricing) codify prior decisions and practices. Stakeholders will benefit as the ARC is kept up-to-date, and no incremental costs are anticipated.

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Market-based pricing rules

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The amendments will reinforce the Board's view that tendering in a competitive marketplace is the most desirable means by which to confirm that regulated utilities are paying a fair price for outsourced services and goods. It is anticipated that rigorous competition will lead to lower prices over time, thus benefiting ratepayers.

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The Board recognizes utilities will incur some costs in tendering. Accordingly, proposed section 2.2.6 provides that, even where a market exists, competitive bidding will not be required in the case of minor contracts.

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As noted in the draft Policy Paper, other North American regulators have found it reasonable to require use of third party evaluators. The Board anticipates that proposed section 2.3.7 will promote more rigorous bidding, thus providing ratepayers with enhanced benefits where market-based pricing is followed. The Board recognizes utilities will incur some expense to retaining third party evaluators. To ensure the costs are proportional to benefits, proposed section 2.3.7 includes a threshold test. The proposed limited mandate of the independent evaluator (reporting on how the bids meet the criteria established by the utility itself) will further assist in limiting the incremental compliance costs.

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The threshold tests in sections 2.3.6 and 2.2.7 both take the form of the lower of a fixed dollar amount or a percentage of the utility's revenue net of the cost of gas. The percentage tests have the effect that the thresholds are considerably higher in the case of the two larger gas distributors in the Province, thus lowering their cost of compliance significantly.

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Transfer of asset rules

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The new rules are more thorough (e.g. new section 2.3.16 deals with pricing of utility purchases of affiliate assets), and the Board anticipates all stakeholders will benefit from the greater regulatory certainty.

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Ratepayers will further benefit since new section 2.3.12 provides that on the sale of utility assets to affiliates, the price must be the higher of market price or net book value (current section 2.3.4 refers to net book value only).

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The Board recognizes that determining a market price can be prohibitively costly in some cases and therefore proposed section 2.3.13 allows for exemptions.

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The Board believes the regulatory review process will be enhanced by the new requirements in sections 2.3.14 and 2.3.16 that the utility obtain independent assessments of the market price of the asset(s) transferred. There may be some incremental cost (although utilities could already be obtaining such evaluations), and to limit this cost thresholds are proposed in sections 2.3.14 and 2.3.16. The percentage component in the threshold tests will have the effect of significantly increasing the threshold for the two larger gas distributors.

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Shared Corporate Services

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Shared corporate services are currently subject to the section 2.3 transfer pricing rules. The proposed new definition of "services" is intended to benefit stakeholders by making this explicit.

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The new market-based pricing rules are more onerous (for example, competitive bidding will be the only way of establishing market prices for sizeable affiliate contracts where a market exists), and utilities will face higher compliance costs if they are now obliged to tender for services which were formerly bundled into cost-based shared corporate services arrangements (while ratepayers may realize a gain if the prices are lowered through competitive bidding).

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Utilities, however, retain the option of requesting an exemption under section 1.6, and one utility already has indicated it plans to do so.

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Length of term of contracts

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The effect of proposed sections 2.3.5 and 2.3.1 is that, where a market exists, if a utility tenders a contract for a year, it would have to retender the contract upon renewal. The effect is that utilities will face higher compliance costs if they use a series of annual contracts. This result can be avoided, however, if the utility chooses to exercise the proposed right to enter into affiliate contracts of up to five years in length.

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The intention of the cost-based pricing rules is that a complete fully-allocated cost study be undertaken whenever a contract is renewed. But this expense can be deferred by choosing to enter into the affiliate cost-based contract for a five-year term.

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Enhanced information disclosure

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The proposed requirement that a utility add a term dealing with information disclosure in its affiliate agreements will have minimal ongoing cost implications once suitable language is drafted. All stakeholders will benefit if the information necessary for the Board to review just and reasonable rates is expeditiously provided. Ratepayers may further benefit through enhanced enforcement of the transfer pricing rules.

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Utility's internal cost

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Ratepayers will benefit from the proposed rule as it requires utilities to confirm that affiliate outsourcing was reasonable to undertake in the first place. A utility may face some increased compliance costs since it must explicitly calculate its internal cost of the service, but similar measures may well have been taken in any event to meet the utility's burden of proof in a rate case that outsourcing was prudent.

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Results of Consultation with Gas Utilities

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Board staff's review of the utilities' comments indicated some support for two specific utility proposals. First, Board staff saw some merit in the utilities' suggestion to replace proposed sections 2.3.2 and 2.3.3, dealing with a utility's internal cost, with a similar but less prescriptive provision found in an Alberta code (cited at page 13 of draft Policy Paper). However the Alberta regulator has also stressed the importance of a full business case to overall code compliance ("A business case should contain a statement of needs, benefits, a comparison of options considered, criteria for selection, and an economic basis of comparisons to alternatives" - see AEUB Decision 2003-061 at page 60; also see AEUB Decision 2003-019 at page 59). The Board therefore invites further comments on the merits of the Alberta wording, possibly revised, for adoption in Ontario.

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Board staff also noted the utilities' concern expressed about the proposal to add the following definition to section 1.2: "service" includes a corporate service. The Board staff questioned whether this proposed amendment helped to clarify matters, and suggested that it may be appropriate not to introduce the definition. The Board would like to hear stakeholder views on this issue.

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The Board notes a variety of concerns expressed by the utilities regarding the treatment of shared corporate services. This is an area in which there does not appear to be a consensus among public utility tribunals. Some regulators have held that the "corporate philosophy" of the regulated utility's parent should not be determinative when establishing affiliate relationship codes (see page 23, AEUB Decision 2003-040 re ATCO Group Code of Conduct). However, several other North American regulators have decided not to apply their regular tendering rules to shared corporate services (see, for example, part III C "Competitive Bidding - Conclusions" of Telecom Decision CRTC 90-17 regarding Bell Canada).

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The Board therefore invites all stakeholders to explore any new options that could be developed which would lead to a 'win-win' outcome in respect of the pricing of shared corporate services. Specifically, comments may be offered on:

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a) the merits of dealing with the pricing of shared corporate services by some type of separate new rule in section 2.2;

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b) the merits of codifying the Board's three-part test regarding shared corporate services set out in the *Westcoast* decision, E.B.R.O. 493/4; or

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c) the merits of dropping any requirement that shared corporate services be subject to market-based pricing, but adding a requirement that ratepayers must be shown to positively benefit "up front" from such outsourcing.

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If stakeholders wish to advance a proposal requiring that the scope of shared corporate services be defined, the Board would ask that a proposed definition also be forwarded. Stakeholders are also asked to consider to what extent solutions in other jurisdictions (such as the requirement that BC Gas should contract for shared corporate services on an individual basis, after a full business case has been established - see pages 51-52, BC Gas Utility Ltd. 2003 Revenue Requirements Application, BCUC, February 4, 2003) can usefully be followed in Ontario.

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In addition to these areas, the Board also invites comments from stakeholders on the following specific matters:

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i) Should the three-month transitional period set out in the proposed amendment to section 1.5 be lengthened? If so, to what period of time?

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ii) Should a new provision be added dealing with application of the ARC amendments to existing affiliate outsourcing contracts (see section 2.4 of the February 2004 EPCOR Code of Conduct, AEUB Decision 2004-010)? What, if any, period of time should be specified before the existing agreements become subject to the new rules?

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iii) While proposed section 2.3.1 limits the term of a contract between a utility and its affiliate to five years (unless an exemption is granted under section 1.6), the Board is aware that affiliate contracts for terms of 10 years have been entered into elsewhere in Canada. Should such longer-term contracts be encouraged, or discouraged (as in AEUB Decision 2003-061, re AltaLink and TransAlta, at page 74)? What further provision should be added to the ARC to ensure the amount charged is fair over the length of any contract extending beyond five years?

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iv) Should the Policy Paper address the question of bundling versus unbundling of services in the context of the enforcement of the new transfer pricing rules? If so, what should be the Board's position on this matter?

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v) Should the Policy Paper add interpretative guidance providing that competitive bidding can be undertaken on a confidential basis (that is, other bidders will not be aware of bid terms)? Will this improve the quality of the bidding?

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vi) Should the Policy Paper acknowledge that there may be special circumstances (e.g. spot gas 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 guidance could be offered as to the appropriate circumstances, and as to alternative measures to be considered (for example, could a third party still be retained to review the overall fairness of a spot gas bidding procedure)?

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Invitation to Comment

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All interested stakeholders are invited to comment on the proposed ARC amendments, and interpretative guidance set out in the accompanying draft Policy Paper. References to specific sections of the proposed rules or Paper are encouraged. Documentary material in connection with this proposal is available on the Board's website at www.oeb.gov.on.ca under 'What's New'.

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Any person who wishes to make a written representation with respect to the Rule must file two (2) paper copies of the representation, and an electronic copy in Adobe Acrobat (PDF), or WordPerfect or Word, if possible, with the Acting Board Secretary by **4:30 pm** on **June 30, 2004**. Your submission must quote file number **RP-2004-0140** and include your name, address, e-mail address and fax number.

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The ARC amendments and accompanying Policy Paper, and all written representations received by the Board with respect to same, will be available for public inspection on the Board's website at www.oeb.gov.on.ca and at the office of the Board during normal business hours.

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If you have any questions regarding the above proposed ARC amendments, please contact John Vrantsidis at (416) 440-8122 or toll free at 1-888-632-6273.

DATED at Toronto,June 3, 2004.

ONTARIO ENERGY BOARD

Peter H. O'Dell
Acting Board Secretary