

**Ontario Energy Board**  
P.O. Box 2319  
2300 Yonge Street  
27th. Floor  
Toronto ON M4P 1E4  
Telephone: (416) 481-1967  
Facsimile: (416) 440-7656  
Toll Free : 1-888-632-6273

**Commission de l'Énergie de l'Ontario**  
C.P. 2319  
2300, rue Yonge  
27e étage  
Toronto ON M4P 1E4  
Téléphone; (416) 481-1967  
Télécopieur: (416) 440-7656  
Numéro sans frais : 1-888-632-6273



**Compliance Office**

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Compliance Bulletin 200604

To: All Licensed Electricity Distributors

Re: Compliance with the Affiliate Relationships Code for Electricity Distributors and Transmitters.

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**This Bulletin is intended to provide guidance to licensed electricity distributors in relation to compliance with the Affiliate Relationships Code for Electricity Distributors and Transmitters.**

A key priority of the Annual Compliance Plan for 2005/06 was a review of compliance with the Affiliate Relationships Code for Electricity Distributors and Transmitters (the "ARC" or the "Code") by distributors.

In the spring of 2005, the Compliance Office initiated a review of the relationship between selected distributors and their affiliates. Through these reviews, a number of compliance concerns were identified, and it became apparent that distributors hold different views regarding the nature of their obligations under the ARC.

This Bulletin provides an overview of my views and expectations in relation to certain key provisions of the ARC, as communicated to the distributors that were subject to the ARC review process. This will ensure that all distributors have a common understanding of my expectations regarding compliance with the ARC.

My views and expectations have been informed by my exchange with distributors whose affiliate relationships have been the subject of review, by other Board regulatory instruments – including the Affiliate Relationships Code for Natural Gas Utilities – and by decisions of the Board in relation to affiliate matters.

The following issues are discussed in this Bulletin:

1. Sharing of employees

2. Transfer pricing
3. Equal access to services
4. Physical separation
5. Definition of energy service provider

While there are other important provisions of the ARC, this Bulletin focuses on recurring issues that have arisen in the context of the Compliance Office's ARC reviews.

### Introduction

In considering all compliance issues regarding the ARC, I am guided by the purpose statement set out in section 1.1 of the Code. In particular, I have emphasized the need to protect confidential information, as that term is defined in the Code, and to minimize cross-subsidization between monopoly and competitive activities. Attainment of these two objectives will, in my view, promote the achievement of the overriding purpose of the Code, which is to enhance the development of a competitive market while saving ratepayers harmless from the actions of distributors with respect to dealing with their affiliates.

While it may be that the ARC was developed at a time when retail activities were broadly expected to be a significant activity for affiliates of distributors, the ARC was not created for the sole purpose of addressing affiliate relationships in that context. Neither the fact that such affiliate retail activities have failed to materialize in a sustained way, nor the fact that the electricity market today is different from what was envisioned at market opening, affects the continued importance of the Code. Nor should it result in an interpretation or application of the Code that differs from what it would have been had the marketplace evolved as originally intended. My approach regarding compliance with the ARC reflects these views.

### Sharing of Employees

Section 2.2.3 of the Code states that:

*A utility may share employees with an affiliate provided that the employees to be shared are not directly involved in collecting, or have access to, confidential information.*

Section 2.2.4 of the Code states that:

*A utility shall not share with an affiliate that is an energy service provider employees that carry out the day-to-day operation of the utility's transmission or distribution network.*

Confidential information is defined in the Code as follows:

*Information the utility has obtained relating to a specific consumer, retailer or generator in the process of providing current or prospective utility service.*

It is my opinion that sections 2.2.3 and 2.2.4 of the Code are intended to ensure that confidential information will not be accessible to an affiliate in a manner that might result in the use of that information in unregulated activities.

Distributors are both required and entitled to collect confidential information about current and prospective customers. That information may be of considerable value to any entity that wishes to provide unregulated products or services to the distributor's customers. As monopoly service providers, distributors are in a privileged position in this regard, and it is in my view inappropriate for an affiliate of a distributor to gain a competitive advantage by means of access to customer information. This is not to diminish the importance of maintaining the confidentiality of confidential information as a goal unto itself, which is addressed in other Code and licence provisions as a separate matter.

#### *Employees Covered by Code Sections*

In practice, there is little difference in terms of the identity of the employees covered by the two sections of the Code noted above. Most individuals that carry out the day-to-day operation of a distribution system will by definition have access to confidential information. For example, this could be said of both customer service personnel and system control operators, who in performing their duties would have access to customer consumption and demand information. Thus, in most cases the employees referred to in section 2.2.4 of the Code represent a sub-set of the employees referred to in section 2.2.3 of the Code.

I do not consider that a person must have an employment relationship with both the distributor and the affiliate in order to be shared within the meaning of the Code. It is also my view that the ARC provisions relating to the sharing of employees are not limited in their application to persons that are employed by the distributor. The provisions refer simply to the sharing of employees, and do not specify whether the employee to be shared is the employee of the utility or of the affiliate. Therefore, for purposes of assessing compliance with the Code I consider that an employee of an affiliate that provides distribution services to the distributor is shared with the distributor. To do otherwise would allow the Code to be circumvented - and confidential information to be accessible to the affiliate for non-utility purposes - by the simple means of having distribution functions outsourced to affiliate employees.

#### *Scope of Sharing*

A narrow interpretation of the employee sharing provisions of the ARC would result in an absolute prohibition on sharing of many employees. This, in my view, was not the

intention as it is not necessary to achieving the underlying purpose of ensuring that confidential information is not accessible for purposes of unregulated activities. In my view, in order to comply with the employee sharing provisions, a distributor must ensure that employees (whether of the distributor or the affiliate) who have access to confidential information or carry out the day-to-day operation of the distribution network are not involved in the provision of the affiliate's unregulated activities in the distributor's licensed service area. This interpretation allows affiliate staff to provide distribution services for the distributor provided that the same staff is not also involved in the provision of any unregulated activities.

For example, an affiliate employee who completes the connection of a customer to the distribution system may not be involved in the provision of sub-station maintenance on equipment owned by customers who are located within the distributor's licensed service area. Similarly, an affiliate employee who provides metering and billing services for the distributor may not be involved in the provision of energy management services within the distributor's licensed service area. The restriction on involvement in both of these examples extends to all unregulated activities. The specific unregulated services are referred to for illustrative purposes only, and are examples of services where there could be a clear advantage to the affiliate from access to confidential information obtained through the provision of distribution services on behalf of the distributor.

The distributor must also ensure that employees (whether of the distributor or the affiliate) who have access to confidential information or carry out the day-to-day operation of the distribution network are physically separated (in the manner described in a later section of this Bulletin) from employees who provide unregulated services within the distributor's licensed service area. This physical separation is necessary in order to minimize any opportunity for inappropriate access to confidential information.

### Transfer Pricing

Section 2.3.1 of the Code states that:

*Where a utility provides a service, resource or product to an affiliate, the utility shall ensure that the sale price is no less than the fair market value of the service, resource or product.*

Section 2.3.2 of the Code states that:

*In purchasing a service, resource or product from an affiliate, a utility shall pay no more than the fair market value. For the purpose of purchasing a service, resource or product a valid tendering process shall be evidence of fair market value.*

Section 2.3.3 of the Code states that:

*Where a fair market value is not available for any product, resource or service, utilities shall charge no less than a cost based price, and shall pay no more than a cost based price. A cost based price shall reflect the costs of producing the service or product, including a return on invested capital. The return component shall be the higher of the utility's approved rate of return or the bank prime rate.*

These provisions of the Code are intended principally to ensure that a distributor's rates are not adversely affected by the affiliate relationship. They are also aimed at ensuring that an affiliate does not have a competitive advantage by virtue of its unregulated services being subsidized by the distributor.

The following discussion focuses on sections 2.3.2 and 2.3.3 of the Code, but the principles expressed apply equally to section 2.3.1.

The key threshold requirement of the transfer pricing provisions of the Code is that a distributor must not pay more than fair market value for any service, resource or product that the distributor purchases from an affiliate. In my view, the only way for a distributor to determine whether or not it is paying more than fair market value for a service, resource or product is to conduct a review of the marketplace to determine if there are other suppliers available and, if so, what the market value of the service, resource or product is having regard to the fees or prices charged in the marketplace.

Therefore, in my view, in order to comply with the transfer pricing provisions of the ARC, where a distributor is considering purchasing a service (or product or resource) from an affiliate the distributor must take the following steps:

1. The distributor must determine whether or not a market for the service exists (i.e., do other companies offer the services?). In order to adequately determine if a market for the service exists, I would expect a distributor to complete a review of the applicable industry to determine if there are any companies that would be willing to provide the service. Bundling a number of distribution services together so that they form a unique service requirement that cannot be provided by any entity other than the affiliate cannot, in my view, be used as a means of eliminating the possibility of a market existing for specific services.
2. If a market exists for the service, then a fair market value can be determined. The recommended evidence of fair market value is a valid tendering process. If a valid tendering process is not used, the distributor must be able to demonstrate that it is paying no more than fair market value through other means.
3. If a market for the service does not exist and cost based pricing is used, then the distributor must ensure that the price payable is no more than the affiliate's actual fully allocated costs of providing the service, including a return on invested capital that is no higher than the distributor's approved rate of return. In order to ensure

that a cost based pricing approach is being appropriately implemented, the affiliate's actual costs must be verified and a proper cost allocation methodology must be used.

I expect that a distributor will be able to demonstrate that legitimate attempts have been made to follow the above process. I also expect that the distributor will have services agreements with all of its affiliates that meet the requirements of section 2.2.1 of the ARC.

### Equal Access to Services

Section 2.5.1 of the Code states that:

*A utility shall not endorse or support the marketing activities of an affiliate which is an energy service provider. A utility may include an affiliate as part of a listing of alternative service providers, but the affiliate's name shall not in any way be highlighted.*

Section 2.5.3 of the ARC states that:

*A utility shall take all reasonable steps to ensure that an affiliate does not use the utility's name, logo or other distinguishing characteristics in a manner which would mislead consumers as to the distinction between the utility and affiliate.*

The ARC review conducted by the Compliance Office revealed instances where customers were directed to a website that was shared by the distributor and an affiliate and that described both distribution and affiliate services. In a number of cases, it was unclear as to whether the entity being referred to on the website was the distributor or an affiliate.

The review also revealed instances where identification on customer bills, letterhead, vehicles, business cards and the like used by the distributor and/or an affiliate did not distinguish between the distributor and the affiliate. In some cases, the affiliate was referred to as the "regulated distribution company" or the company which "supplies all the electric power" to the community.

It is my view that a distributor who directs distribution customers to a website, or other point of contact, that fails to clearly distinguish the distributor (and its services) from any affiliate that is an energy services provider (and its services), is supporting or endorsing that affiliate's marketing activities contrary to section 2.5.1 of the ARC.

It is also my view that a consumer would be misled as to the distinction between the distributor and an affiliate if a website or other type of customer communication fails to clearly distinguish the distributor (and its services) from an affiliate (and its services).

This would be contrary to section 2.5.3 of the ARC. For example, the use of the name “Acme Hydro” interchangeably in relation to both the distributor and an affiliate would not be compliant with the ARC.

Therefore, in order to be compliant with the equal access provisions of the ARC, it is my expectation that a distributor will:

- ensure that all communications with consumers (for example: bills, letterhead, phone numbers) that relate to distribution activities clearly identify the distributor as the service provider, and do not direct consumers to an affiliate (or to a shared website where the distributor is indistinguishable from the affiliate), except as part of the listing referred to in section 2.5.1 of the Code;
- if it wishes to maintain a website as a source of information for current or potential distribution customers, ensure that a customer may visit the website without visiting the sites of any affiliates, and that customers are not directed to a website or other point of contact, of any affiliate that is an energy services provider.

The above discussion has focused on specific non-compliant activities that were revealed during the ARC reviews. The activities cited are by no means the only ones that may raise concerns in relation to compliance with the equal access provisions of the Code.

### Physical Separation

Section 2.1.2 of the ARC states that:

*A utility shall be physically separated from any affiliate who is an energy service provider.*

In my view, the ARC does not necessarily require that physical separation be achieved through separate physical locations or buildings. What is required, however, is an adequate degree of separation between the operations of the distributor and the operations of an affiliate which is an energy service provider. For example, the required degree of separation could be achieved through restricted access mechanisms that apply to both information and the physical areas of operation.

### Definition of Energy Service Provider

Section 1.2 of the ARC defines an energy service provider (“ESP”) as:

*A person, other than a utility, involved in the supply of electricity or gas or related activities, including retailing of electricity, marketing of natural gas, generation of electricity, energy management*

*services, demand-side management programs, and appliance sales, service and rentals.*

In reviewing the affiliate relationships of some distributors, it became apparent that there is not a common understanding of the meaning of the term ESP.

A key element of the ARC definition of the term “ESP” is the reference to involvement “*in the supply of electricity ... or related activities*”. The definition is not limited to retailing or appliance rental activities, which are cited as examples only. I consider the provision of services related to the production or use of electricity to be activities related to the supply of electricity. Such services include, but are not limited to, generation, street lighting, sentinel lighting, water heater rentals and sales, metering, wholesale settlement, and billing. I would consider an affiliate providing any of these services, or any other services related to the production or use of electricity, to be an ESP.

### **Achieving Compliance**

The information in this Bulletin should provide distributors with greater clarity and certainty regarding compliance with their obligations under the ARC. Distributors should take steps as required to ensure that their affiliate relationships are compliant in the manner described in this Bulletin. The compliance management process seeks to resolve most issues of non-compliance on an informal basis. It is central to that approach that distributors organize their affairs such that they can substantiate compliance with their legal and regulatory obligations as and when required.

A distributor that is uncertain about whether its operations are compliant with the requirements set out in this Bulletin should contact the Compliance Office to seek additional guidance.

Please direct any questions you may have on this matter to the Market Participant hotline at 416-440-7604 or by e-mail at [market.operations@oeb.gov.on.ca](mailto:market.operations@oeb.gov.on.ca).



Brian Hewson  
Chief Compliance Officer  
Compliance Office

No statutory power of decision has been delegated to the Chief Compliance Officer, and the views expressed in this Compliance Bulletin are not binding on the Board. The Chief Compliance Officer may seek enforcement action by the Board under Part VII.1 of the *Ontario Energy Board Act, 1998* in relation to non-compliance.