Ontario Energy Board

Commission de l'énergie de l'Ontario

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Ontario

# Staff Research Paper: Affiliate Relationships Code for Electricity Distributors and Transmitters

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## Executive Summary

This Staff Research Paper provides information and analysis regarding the Ontario Affiliate Relationships Code for Electricity Distributors and Transmitters (the “Electricity ARC”).

The *Ontario Energy Board Act, 1998* gave the Board new powers and responsibilities for regulating the electricity and gas industries. The Board issued the Electricity ARC on April 1, 1999 and the Affiliate Relationships Code for Gas Distributors (the “Gas ARC”) on July 31, 1999. These ARCs govern the business relationships between distributors and transmitters and their affiliates. The Board amended the Gas ARC effective in 2005 mainly to clarify transfer pricing requirements such as market pricing and tendering for goods and services. However, the Electricity ARC has only undergone limited amendments since 1999.

The electricity sector has changed since 1999. Early expectations that Ontario distribution affiliates would enter the competitive electricity retail sector did not materialize. Some Ontario electricity affiliates have entered into other types of competitive businesses, such as infrastructure construction, metering and telecommunications. There is also a renewed interest in the utility sector on conservation, demand management and generation initiatives. The Board’s statutory objectives were changed in 2005 by the Government of Ontario, removing the reference to facilitating competition in the sale of electricity but retaining the objective of promoting distributor economic efficiency and cost effectiveness.

The majority of the approximately 85 electricity distributors and four of the five transmitters in the province have affiliates in some form. Many distributors have one or more affiliates that provide services to the distributor, and are involved in other business activities. These service affiliates are active in the provision of energy and distribution services, telecommunication services, and generation.

This paper addresses the following issues:

- Does utility efficiency belong in the Electricity ARC as a code objective?
- Does competition belong in the Electricity ARC as a code objective?
- Should the current Electricity ARC definition of energy service provider be narrowed or eliminated entirely?
- Should the current Electricity ARC treatment of “confidential information” be narrowed or otherwise changed?
- Should the Electricity ARC rules on the sharing of employees between utilities and their affiliates be made more flexible?
- Do the Electricity ARC provisions regarding the percentage of independent utility directors remain appropriate?
- Should the current Electricity ARC rules for market or cost-based pricing of goods and services be changed?
- Should the Gas ARC outsourcing provisions be included in the Electricity ARC?

- Should the cost-based pricing rules for shared corporate services used in the Gas ARC be extended to the Electricity ARC?
- Should the asset transfer-pricing provisions of the Electricity ARC mirror the requirements of the Gas ARC rules?
- Should the Electricity ARC rules or exemption process treat small distributors differently?

In staff's view, the analysis has shown that the Electricity ARC is robust and remains relevant to the needs of the Ontario electricity sector. Staff's research has indicated several issues that merit consideration by the Board and potentially changes to some provisions of the Electricity ARC. Issues that have been identified for consideration by the Board include:

i) the relative roles of efficiency and competition considerations as reflected in the purpose section of the Electricity ARC;

ii) the potential for further clarification of the employee sharing rules; and

iii) the applicability of more detailed transfer pricing rules for products and services, outsourced utility activities, shared corporate services and asset transfers.

On balance, staff's working conclusion is that the current definitions of energy service provider and confidential customer information are suitable. Staff's analysis also raises questions regarding the percentage of utility independent directors mandated in the Electricity ARC and the need for more detail on the criteria and process for an Electricity ARC exemption request. Staff would benefit from stakeholder comment on all of these issues.

# Section 1: Background

## 1.1 Purpose of the Paper

This Staff Research Paper provides information and analysis to facilitate discussion of the issues pertaining to the Ontario Affiliate Relationships Code for Electricity Distributors and Transmitters (the "Electricity ARC"). It addresses developments in the Ontario electricity sector since the Ontario Energy Board (the "Board" or "OEB") issued the Electricity ARC in 1999, issues that arise from experience in other jurisdictions, issues raised by some Ontario distributors, and staff's views on factors relevant to those issues.[1] Staff anticipates that this document will help to frame the issues and promote the participation of other stakeholders in discussion of them.

The paper addresses the following issues:

1) Does utility efficiency belong in the Electricity ARC as a code objective?
2) Does competition belong in the Electricity ARC as a code objective?
3) Should the current Electricity ARC definition of energy service provider be narrowed or eliminated entirely?
4) Should the current Electricity ARC treatment of "confidential information" be narrowed or otherwise changed?
5) Should the Electricity ARC rules on the sharing of employees between utilities and their affiliates be made more flexible?
6) Do the Electricity ARC provisions regarding the percentage of independent utility directors remain appropriate?
7) Should the current Electricity ARC rules for market or cost-based pricing of goods and services be changed?
8) Should the Gas ARC outsourcing provisions be included in the Electricity ARC?
9) Should the cost-based pricing rules for shared corporate services used in the Gas ARC be extended to the Electricity ARC?
10) Should the asset transfer-pricing provisions of the Electricity ARC mirror the requirements of the Gas ARC rules?
11) Should the Electricity ARC rules or exemption process treat small distributors differently?

In analyzing these issues, staff has specifically considered:

- the history of affiliate relationship codes in Ontario
- the current electricity distributor and affiliate structures in Ontario

[1] In completing its research and analysis, Staff has utilized the services of Liberty Consulting to verify certain regulatory precedents and to provide additional insights on North American affiliate codes of conduct.

- the Board's amended 2005 objectives in the electricity sector, as set out in section 1 of the *OEB Act,* and the current wording of the purpose section in the *Electricity Act*
- the 2004/05 amendments to the Gas ARC, the policy analysis set out in the Staff Discussion Paper released at the commencement of the Gas ARC review, and the Board's interpretive guidance released at the conclusion of that review
- the Chief Compliance Officer's (CCO) Electricity ARC Compliance Bulletins
- references to affiliate transactions in the 2006 Electricity Distribution Rates (EDR) decisions
- issues raised by some Ontario electricity distributors
- Canadian and U.S. affiliate codes of conduct in the gas, electricity and pipeline sectors, and related regulatory and judicial decisions
- a November 2000 report by the Finance and Technology, Gas, and Electricity Committees of NARUC [2] entitled "Codes of Conduct Governing Competitive Developments in the Energy Industry: An Analysis of Regulatory Actions"
- a January 1999 study prepared for EEI [3] entitled "Developing Codes of Conduct: An Analysis of Parties and Positions".

The codes in other jurisdictions are the result of a variety of procedural approaches, consensus building and regulatory review processes, some of which differ greatly from Ontario's. Certain regulators, for example, in Canada the British Columbia and Alberta regulators, and in the U.S. the Federal Energy Regulatory Commission (FERC), have issued general guidance, pursuant to which utilities then prepare and file specific codes for approval. Utilities in other jurisdictions, such as pipeline companies under the National Energy Board (NEB) jurisdiction, have used negotiations with stakeholders to guide code preparation. New Brunswick used a stakeholder-working group to develop principles to be submitted for regulator approval. The Nova Scotia Utility and Review Board (NSUARB) retained an expert to review an interim Nova Scotia Power code and reviewed its recommendations in a subsequent proceeding, adopting a number of them. Because of this difference in procedural approaches and the different energy markets in various jurisdictions, drawing policy implications for Ontario from other North American codes requires caution and judgement.

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[2] The National Association of Regulatory Utility Commissioners (NARUC) is a non-profit organization of governmental agencies that are engaged in the regulation of utilities and carriers in the United States.

[3] The Edison Electric Institute (EEI) is an association of U.S. shareholder-owned electric companies.The study examined the codes of conduct that were the subject of proceedings before the regulators in the states of California, Delaware, Maryland, Massachusetts and Illinois.

## 1.2 Background to Affiliate Codes of Conduct

Affiliate codes of conduct govern relationships between a regulated entity and its affiliates. North American electricity and gas sector regulators typically design these rules to:

- prevent cross-subsidization of affiliates
- protect and regulate the sharing of customers' confidential information
- prevent affiliates from gaining improper advantages in their competitive markets through affiliation with the regulated entity.

Setting just and reasonable distribution rates require the Board to ensure, as one of its regulatory priorities, that no cross-subsidization takes place between a monopoly distributor and any of its affiliates. There is unanimous agreement on the importance of this objective amongst utility regulators when designing and applying affiliate codes of conduct.

Regarding the protection and regulation of customer confidential information, harms commonly referred in connection with this objective are:

a) cross-subsidization of the affiliate as a result of the provision at little or no cost of assembled customer information
b) the anti-competitive impact of providing an affiliate with detailed account level information or aggregated utility network status information
c) protecting consumers from unwanted solicitations, and
d) general principles about protecting the privacy of consumers with regard to personal information.

The most relevant for ARC protection purposes are concerns pertaining to a) and b) while concerns for c) and d) are addressed through federal and provincial legislation regarding customer privacy.

Regarding market advantages accruing to affiliates as a result of association with the regulated utility, harms commonly referred to are:

a) confusion of customers regarding the identity of the affiliate and the utility
b) implicit endorsement or control of the affiliate by the utility or the regulator
c) preferential access to information regarding the status of the utility network, and
d) in part related to the preceding points, the affliate taking undue advantage of the "inherent" market power of the utility resulting from its utility status.

Staff's review of affiliate codes of conduct found that the issues typically covered in the codes of other jurisdictions are generally the same as those covered by the Electricity ARC, as follows:

- Intent and purpose – the articulation of overall code objectives.
- Code applicability – the definition of “affiliate” for the purpose of application of codes of conduct, and provisions for exemptions.
- Corporate governance, structural/functional separation – the corporate relationship of the regulated entity to its affiliates.
- Transactional relationships – information sharing and goods and service transactions among affiliates.
- Resource sharing restrictions – the sharing of human, physical and information resources between a regulated entity and its affiliate.
- Preferential/discriminatory treatment, subsidization and cost allocation – the financial relationship between the regulated entity and its affiliates, the commercial relationships between the utility and its affiliates on the one hand and the utility to competitors on the other, and the economies of scale, scope and integration of specific functions.
- Joint sales, promotions and marketing – the relationship of the regulated entity and its affiliates to customers and the use of the regulated entity’s name and/or logo.
- Regulatory oversight - auditing, monitoring, reporting, and compliance requirements.

## 1.3 Ontario’s Early Codes

Starting in the 1980s, as ownership of the large Ontario gas utilities changed, “Undertakings” were required by the Lieutenant Government in Council from the new utility owners. These Undertakings generally addressed corporate governance matters and certain aspects of affiliate relationships.

On May 15, 1997, the Board approved an interim code of conduct for gas utilities at the inception of gas marketing activities by utility affiliates. The *Ontario Energy Board Act*, *1998* gave the Board new electricity-sector powers and new gas-sector rule making powers. The Board issued the Electricity ARC on April 1, 1999[4] and the Gas ARC on July 31, 1999, each of them similar in specifying the terms and conditions applicable to dealings between distributors and transmitters and their affiliates.

[4] The Board made limited amendments effective November 24, 2003 to address concerns regarding the independent board of directors’ requirements (ARC sections 2.1.3 and 2.1.4).

### 1.4 Gas Code Development

Rate hearings between 2000 and 2003, as gas utility affiliates grew, gave voice to debates about the interpretation and application of the ARC transfer pricing rules.[5] The Board commenced a review in 2004 of the Gas ARC, assessing it against the backdrop of prior Board decisions and North American best practices.

The staff's March 15, 2004 policy paper entitled "Understanding the Proposed Amendments to the Affiliate Relationships Code for Gas Utilities: An OEB Background Policy Paper" commenced the review. In December 2004, the Board issued the final Gas ARC amendments, with an effective date of June 9, 2005. The changes focused mainly on the transfer pricing sections of the Gas ARC, such as clarifying the requirements for market pricing and tendering.

### 1.5 Ontario Electricity Sector Developments

A number of changes have occurred in the electricity sector since the Board first issued the Electricity ARC in 1999, for example:

- early expectations that distribution affiliates would enter the competitive electricity retail sector did not materialize
- entry of some Ontario electricity affiliates into other types of competitive businesses, such as infrastructure construction, metering and telecommunications
- the 2005 removal of the reference to promoting competition in supply from the Board's electricity-sector statutory objectives, while retaining the objective of promoting utility economic efficiency and cost effectiveness [6]
- renewed utility sector interest on conservation, demand management and generation initiatives [7]
- a regulation allowing distributors to provide municipal water and sewage services.

The 2006 EDR filings indicated outsourcing of core utility functions by some distributors to affiliates such as customer service, line maintenance and billing. The Board has

[5] See, for example, the 2002 (RP-2001-0032) and 2003 (RP-2002-0133) Enbridge test year decisions.
[6] Section 73(1)6 allows affiliates to undertake business activities the principal purpose of which is to use more efficiently the assets of the distributor.
[7] Amended section 71(2) of the *OEB Act* allows distributors to directly provide services related to the promotion of CDM and cleaner energy sources. Section 73(1)9 contemplates affiliates directly providing CDM related services.

questioned in some electricity distribution cases the adequacy of the cost information provided in respect of the affiliate.[8]

In 2006, some Ontario electricity distributors expressed concerns about the design and application of specific Electricity ARC rules such as the employee sharing restrictions and the definitions of energy service provider and confidential customer information.

### 1.6 Current Status of Ontario's Electricity Distributors and Affiliates

According to 2006 EDR filings and information from other sources, the great majority of Ontario's approximately 85 electricity distributors and five transmitters have affiliates. Approximately 19 distributors have only one affiliate - the municipal shareholder or a holding company.[9] The remaining distributors have one or more affiliates that provide services to the distributor, and engage in other business activities, including energy and distribution services, telecommunication services, and generation. Distributor affiliates provide a wide variety of energy related services, including customer billing, meter maintenance, hot water heater rentals, street light maintenance, energy management, and electrical facility construction and maintenance. Eight affiliates hold a retailer licence;[10] however, none appear to be active in today's electricity commodity market as retailers. The affiliates generally operate in the distributor's regulated service area. However, some[11] actively promote their services more broadly within the province and even into other countries. Also some distributors have merged their telecomm affiliates into one larger service provider.

Distributors and affiliates use a variety of resource-sharing approaches. Eighteen distributors have little or no internal staff; they have outsourced to affiliates the conduct of all of the activities necessary to operate the distribution system. Some distributors have partnered with affiliates which provide limited distribution related functions, for example, contracting the provision of electrical facility construction or metering services.

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[8] In one 2006 EDR decision, the Board commented: "[T]he Board is concerned that the Applicant has not met the burden of proof in demonstrating the reasonableness of its costs. … The Board reminds the Applicant that the burden of demonstrating the reasonableness of costs rests with an applicant, including costs associated with transactions with affiliates" (page 4, RP-2005-0020, EB-2005-036).

[9] Based on the most current information, these consist of Barrie Hydro, Centre Wellington Hydro, Hearst Power, London Hydro, Midland Power Utility, Newbury Power, Terrance Bay Superior Wires, Tillsonburg Hydro, Waterloo North Hydro, Wellington North Hydro, West Coast Huron Energy, West Perth Power, Clinton Power, Cooperative Hydro Embrun, Dutton Hydro, Hydro 2000, Hydro Hawkesbury, Newmarket Hydro and Thunder Bay Hydro.

[10] The utilities with inactive electricity retailer licenses are: Bluewater Power, Guelph Hydro Electric, Halton Hills Hydro, Horizion Utilities, Hydro Ottawa, Oakville Hydro, Toronto Hydro-Electric and Whitby Hydro Electric.

[11] Examples include affiliates associated with Whitby Hydro Electric, Erie Thames Powerlines and Peterborough Distribution.

Some holding companies provide corporate services, such as accounting or human resources functions, to a distributor that they own.

A number of distributors have worked actively with the CCO to bring their operations into compliance with the current Electricity ARC.

### 1.7 Application of the Electricity ARC

Common objectives of North American affiliate codes of conduct include preventing cross-subsidization of affiliates, protecting and regulating the sharing of customers' confidential information, and preventing affiliates from gaining improper advantages in their competitive markets through affiliation with the regulated entity.

When considering the current Ontario context, it has been noted that no distributor affiliates are active in today's electricity commodity market as retailers. The failure of that market to develop as expected has led some to question the current role of the Electricity ARC.

As explained in section 1.6 above, Ontario electricity distributors continue to operate a significant number of affiliates that provide energy services such as conservation and demand management, customer billing, meter maintenance, etc., along with non-energy related goods and services such as telecommunication services.

Cross-subsidization of an affiliate by a utility can cause customers to bear added costs whatever the market in which the affiliate operates. In addition, inappropriate sharing of confidential customer information creates a risk for an affiliate to have an unfair advantage over its competitors, possibly at the expense of the customers, regardless of the nature of the business of the affiliate that receives that information.

Thus an affiliate relationships code continues to be essential in protecting ratepayers in the current Ontario marketplace.

## Section 2: Discussion of Issues

### 2.1 The Role of Utility Efficiency in the Electricity ARC

**Does utility efficiency belong in the Electricity ARC as a code objective?**

The promotion of efficient utility operations is universally recognized as an important regulatory goal. Rules limiting the nature and extent of utility/affiliate interaction can constrain efforts to gain efficiency through common resource usage. If so, the effect could be an increase in the rates that customers pay for distribution services. The issue raised is the degree to which promotion of the goal of efficient operations should be considered when developing and applying the Electricity ARC provisions and restrictions.

## Current ARC Provisions

At present, there is no reference to utility efficiency in the purpose section of the Electricity ARC.

The 2005 *OEB Act* sets out the following two objectives for the Board in relation to electricity:

> 1. To protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service.
>
> 2. To promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry.

Section 1 of the *1998 Electricity Act* lists a variety of purposes, including:

> to promote economic efficiency and sustainability in the generation, transmission, distribution and sale of electricity.

## Other Jurisdictions

Staff found that the introductory sections of several recent Canadian codes include references to utility efficiency.

The AEUB's 2003 ATCO decision established the following code of conduct objectives:

> …to protect customer confidential information, prevent undue preference or advantages, prevent cross-subsidization, and to level the playing field among comparable alternatives while *enabling inter-affiliate economies and efficiencies to occur*.[12]

Alberta affiliate codes of conduct approved from 2003 onwards specifically address efficiency. For instance, the objectives section of the EPCOR code provides as follows:

> providing an environment in which inter-affiliate economies and efficiencies can legitimately occur for the mutual advantage of both a Utility's customers and its shareholders.[13]

A recent AEUB exemption decision makes clear that efficiency is not paramount, but only one of several regulatory objectives of an affiliate code of conduct.[14]

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[12] Page 37, EUB Decision 2003-040. Italics added.

[13] Objective b) in section 1.1 of the EPCOR Code. The TCPL code approved by the NEB in 2006 contains a similar clause.

The two U.S. surveys of affiliate codes of conduct did not list any examples of codes that specifically listed efficiency as an objective; however, the EEI Report observed that "state regulators have demonstrated a clear concern for both protecting competition and for allowing ratepayers to benefit from the increased economies of scope".[15] Affiliate auditing work for many U.S. regulators recognizes the importance of promoting cost efficiency, but not at the expense of inappropriate sharing of customer information with, subsidizing the costs of, or providing affiliates preferential treatment.[16]

## Analysis

It should be recognized that current regulatory practices give some weight to efficiency considerations. The *OEB Act* sets out as an objective for the Board in carrying out its legislative and regulatory activities that it shall consider the objectives of protecting consumer interests and promote economic efficiency. The Board must consider how the requirements of the Electricity ARC are to be applied in a manner that is consistent with the Act's objectives. Specific examples of the efficiency objective being considered in relation to the design of the ARC and its application include:

- in designing the details of various Electricity ARC rules, the physical separation requirement was limited to an affiliate providing energy services

- in applying the Electricity ARC, Compliance Bulletin 200604 has allowed employee sharing for affiliates providing services outside of the distributor's service territory

- in considering exemptions to the code, efficiency considerations have been taken into account.[17]

A suitably worded reference to efficiency in ARC section 1.1 could reflect current regulatory practices and it would confirm that the efficient use of distributor resources has been taken into account when developing the Electricity ARC rules. While other jurisdictions have included some reference to utility efficiency in the introductions to their codes, what may be distinctive about the Ontario situation is the express emphasis on efficiency in the legislation governing the regulator. Therefore adding a reference to efficiency in the purpose statement of the Electricity ARC would make it consistent with Ontario legislation as set out in *OEB Act* sections 1 and 73, and *Electricity Act* section 1.

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[14] ATCO Pipelines Muskeg River Pipeline, Decision 2006-136, December 29, 2006 at page 10.
[15] Page 76 of that Report.
[16] As advised by Liberty Consulting.

[17] As in the development of criteria set out in the successful 2002 Orillia Hydro exemption request.

One problem with adding a reference to efficiency in the purpose section of the Electricity ARC is the potential for unjustifiably viewing efficiency as the core objective of the code. Any new wording would have to take care not to create confusion that the core code objectives of the ARC, such as preventing cross-subsidization, regulating the sharing of confidential information and preventing unfair preferential treatment of affiliates, remain unchanged. As a result, it may be appropriate to describe efficiency as one of the factors that should be taken into account in the development and application of the Electricity ARC rules.

As it appears that efficiency considerations have been taken into account in the design and administration of the Electricity ARC, adding in the purpose section of the ARC that efficiency is one of the factors that should be taken into account in the development and application of the Electricity ARC rules could be useful. Staff welcomes comments from interested parties on the role of efficiency in the Electricity ARC.

## 2.2 The Role of Competition in the Electricity ARC

### Does competition belong in the Electricity ARC as a code objective?

The 2005 *OEB Act* no longer references facilitating competition in the sale of electricity. The Electricity ARC, however, still refers to enhancing the development of a competitive market as a principal objective. As a result, it appears that there is an inconsistency between the current objectives of the Electricity ARC and the current *OEB Act* with respect to competition and what may be the Board's role in this area.

### <u>Current ARC Provisions</u>

Section 1.1 of the Electricity ARC provides that (emphasis added):

> The principal objectives of the Code are to *enhance the development of a competitive market* while saving ratepayers harmless from the actions of electricity transmitters and distributors with respect to dealings with their affiliates. The standards established in the Code are intended to:
>
> > (a) minimize the potential for a utility to cross-subsidize competitive or non-competitive monopoly activities;
> > (b) protect the confidentiality of consumer information collected by a transmitter or distributor in the course of provision of utility services; and
> > (c) ensure there is no preferential access to regulated utility services.

This ARC section was consistent with 1999's *OEB Act* section 1(1) objective to "… facilitate competition in the generation and sale of electricity and to facilitate a smooth transition to competition". The Board's statutory objectives were changed in 2005 by the Government of Ontario, removing the reference to facilitating competition in the sale of electricity.[18] This appears to have created an inconsistency between the current objectives of the Electricity ARC and the current *OEB Act* with respect to competition.

**<u>Gas ARC Provisions</u>**

In a decision in 2000, the Board examined the extent of its jurisdiction and found that, while the Board must consider its statutory objectives, the *OEB Act* objectives are not an exhaustive list of all the Board's goals. The Board reiterated that it "has a broad public policy mandate to regulate the conduct of monopoly utilities in the public interest". The Board went on to state:

> A role of the Board in enhancing the competitive energy service marketplace is to ensure that the utility does not use its dominant position in the storage, transmission, and distribution of gas to frustrate the development of a competitive market in other non-regulated energy services.[19]

**<u>Other Jurisdictions</u>**

Staff found that the introductory sections of several recent Canadian codes make reference to competition. While there is no consensus on the best language to be used, the dominant approach appears to focus on the avoidance of anti-competitive practices as a result of dealings between monopoly utilities and their affiliates.

The Alberta codes approved by the AEUB contain a specific clause dealing with competition. The EPCOR code uses the following wording: The parameters of the code are intended to, among other things, "avoid uncompetitive practices between Utilities and their Affiliates, *which may be detrimental to the interests of Utility customers.*"[20] This somewhat circumscribed language follows the regulator's rejection of broader language (i.e., "enhance the competitive marketplace", similar to section 1.1 of the Ontario ARC) in the 2003 ATCO code decision.[21]

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[18] There are some references to protecting wholesale electricity markets and competition remaining in sections 82(2) (a) and 87(1) of the *OEB Act.*

[19] See RP-1999-0058, issued October 23, 2000. All quotes are from section 3.1 of that decision.

[20] See clause d) of section 1.1 of that Code. Italics added. The introductions of the Alberta codes separately address code "purposes", "objectives" and "parameters".

[21] The 2003 ATCO decision (EUB Decision 2003-040, at page 37) explained: "The insertion of a provision into the Code that would require ATCO to actively enhance the competitive marketplace does not appear appropriate. Rather, the Board considers Government policy and the passage of legislation as the appropriate and more effective sphere in which to champion objectives of fostering competition and the creation of a level playing field between affiliates of regulated utilities and alternative suppliers of unregulated services and products. Notwithstanding the foregoing, the Board considers that the Code should require ATCO utilities to refrain from unfair competitive practices …".

The Alberta Government has also issued its own regulation specifying that efficiency-promoting arrangements by an owner must not create an unfair competitive advantage for its affiliated retailer. [22]

The 1997 British Columbia gas code of conduct decision also circumscribed its view of markets within its zone of interest. The decision considered impacts only on "utility ratepayers" because the Commission found that "it has no jurisdiction to consider the impacts of the use of utility assets and services, either directly or through NRBs [Non-regulated Businesses], on the retail market downstream of the meter."[23]

In contrast, the 2005 Nova Scotia Power code more broadly defines the affected markets, providing that "competition in markets where NSPI's affiliates are active will not be impaired by non-market behaviour by NSPI".

The NARUC review of U.S. codes revealed some references to competition-related principles in affiliate code of conduct decisions. The precise language used differed from jurisdiction to jurisdiction.[24] The NARUC Report authors used the term "fair competition" to sum up the underlying code competition-related policy objective.

## **Analysis**

The effect of the 2005 changes to the general electricity sector objectives of the Board under the *OEB Act* can be interpreted as signaling that the Board no longer has a positive duty with respect to competition. However, the Board still has a role around issues related to competition because the Board does have a positive duty to protect consumers from the utility abusing its monopoly position or its affiliates engaging in anti-competitive behaviour by taking advantage of their association with the utility.

One way to address the issue of the appropriate scope of the Board's objective regarding competition is to distinguish between the various categories of markets that affiliates of utilities may be involved in. This approach could allow the Board to have different competition-related interests depending on the particular market. This could include separately considering affiliates that are involved in energy retailing, energy services beyond energy retailing, and non-energy related goods and services.

a) <u>Energy retailing market</u>: This line of business clearly falls within the core mandate of the Board as it licenses all energy retailers including retail affiliates and deals with compliance issues surrounding retailing activities. A potential policy question is whether

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[22] Section 19(1), Alberta Regulation 160/2003, Code of Conduct Regulation: "An owner and its affiliated retailer (a) may make arrangements to create cost efficiencies in their operations, but (b) must not create an unfair competitive advantage for the affiliated retailer by the arrangements."
[23] Page 22, Retail Markets Downstream of the Utility Meter Guidelines, April 1997.
[24] The Report provides examples at page 5.

the Electricity ARC should be used simply to protect against any retailing affiliates gaining improper advantage in such competitive markets through affiliation with the regulated entity, or whether the Board should go further and promote retail competition as an Electricity ARC objective. At the practical level, given the absence of distributor retailing affiliates in Ontario, this distinction has minimal direct impact on the electric utilities and their affiliates.

b) Energy services beyond energy retailing market: This category includes energy-related businesses such as conservation and demand management (CDM), appliance sales, rentals and service, etc., which are relatively closely connected with the utility's businesses. Therefore the utility regulator should be concerned with cross-subsidization and use of confidential customer information in these markets. The issue is whether the utility regulator has a further interest in protecting competition in such markets.

Given the large number of Ontario distributors with energy service affiliates operating in their home service territories, there is a substantial risk of ratepayer confusion and potential harm to competition for all types of energy services. This supports a more active role for the Board in using the Electricity ARC to address competition-related concerns with respect to energy services.

Staff found varying views amongst utility regulators in precisely how they describe their interest in competition for affiliate code of conduct purposes. Although concerns with "unfair competition" are found in the objectives of many North America codes, there is no consensus on the precise dividing line between "fair and unfair" competition.

As the *OEB Act* no longer directs the Board to facilitate competition in the electricity sector, one could argue that the appropriate current focus for the OEB in respect of energy services beyond energy retailing is to apply the Electricity ARC to limit anti-competitive practices. Other government agencies could deal with promoting competition in such markets. This division of responsibilities is consistent with what other utility regulators have considered with respect to their responsibility in regulating utility business dealings with their affiliates.

c) Non-energy related goods and services markets: Utility affiliates could be engaged in businesses with little or no apparent connection with the core utility functions or with energy-related goods or services. Telecommunication service is an example. In these cases, the utility regulator is still concerned with the potential for cross-subsidization or inappropriate use of confidential utility customer information by the utility affiliate insofar as such use could harm distribution ratepayers. The question for these types of markets is whether policy objectives related to competition in such markets should fall within the scope of an affiliate code, or be left to other government agencies, including specifically competition authorities.

There is a less serious risk of ratepayer confusion and harm in non-energy related markets such as telecommunication services. Therefore one could argue dealing with competition-related concerns in such markets should be primarily left to other government agencies.

The Board has an interest in addressing concerns related to utilities abusing their monopoly position or their affiliates engaging in anti-competitive behaviour. As a result, consideration could be given to amending section 1.1 of the Electricity ARC to reflect the Board's inherent role in guarding against anti-competitive behaviour. Interested parties are invited to comment on the competition-related interest of the Board in various markets.

## 2.3 Energy-Service Provider Rules

**Should the current Electricity ARC definition of energy service provider be narrowed or eliminated entirely?**

The major objective of the current definition of "energy service provider" is to mitigate the potential for an affiliate to draw undue advantage from the utility's monopoly position in the energy retailing and energy related goods and services markets.

The definition of energy service provider is very much linked to the different competition-related interests the Board could have in various categories of markets, as discussed above.

The first issue in this area is whether there is a need for the additional and more stringent rules which are currently applied to energy service providers. The Electricity ARC applies to all affiliates the following rules: transfer pricing, confidentiality of information, equal access to service, and the rules related to marketing material and the use of names. Affiliates that are energy service providers face the following additional rules:

- physical separation requirement (section 2.1.2)
- prohibition against sharing employees who carry out day-to-day operation of utility business (section 2.2.4)
- prohibition on utility support for the marketing activities of an energy service provider (section 2.5.1)
- requirement that the utility shall not state a preference for an affiliate that is an energy service provider (section 2.5.2).

The second issue in this area is what should the rules be and whether the current ESP definition should be narrowed to reduce the applicability of the additional rules to a small range of affiliates. For example, should the additional rules apply only to the retailing of electricity and marketing of natural gas but exclude generation of electricity, energy management services, demand-side management programs, appliance sales, services and rentals, and other electricity related activities?

**Current ARC Provisions**

Section 1.2 of both the Gas and Electricity ARCs define the term “energy service provider” as follows:

> a person, other than an exempt 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.

Compliance Bulletin 200604 explains the scope of activities related to the supply of electricity as services including, but not limited to, generation, street lighting, sentinel lighting, water heater rentals and sales, metering, wholesale settlement and billing.

**Other Jurisdictions**

Canadian codes generally apply the same rules to all affiliates without Ontario’s energy service provider distinction.[25] Canadian codes were also found that applied to all affiliates the physical separation, employee sharing and undue influence rules which are applied to ESPs alone in the Ontario Electricity ARC. Although the language is different, the end result as far as consumer protection appears to be similar. For example, the 2003 EPCOR code applies to all affiliates a physical separation rule and a no sharing of operating employees rule; it has also adopted undue influence rules that have the same general objective as those in the Electricity ARC. [26]

Review of U.S codes also found that most applied one set of rules to all affiliates. However, several U.S. codes were found that effectively make distinctions similar to Ontario’s energy service provider. The observed wording of the corresponding definitions tended to differ somewhat from the Ontario ESP definition, but it could not be confirmed if this leads to material differences in practice without further knowledge of the local context.

The Maryland Commission, for example, accepted rules that apply stricter requirements to core utility functions than to non-core ones. Core functions were defined as those that “duplicate or replace the essential services formerly provided only by a utility”.[27] After

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[25] The draft ATCO code of conduct submitted to the AEUB had a definition of energy service provider, but the concept was dropped in the final approved version.

[26] See sections 3.2.2 (physical separation), 3.3.1 (restrictions on sharing operating employees), and 5.3 (no undue influence) of the 2003 EPCOR code.

[27] Re Affiliated Activities, Promotional Practices and Codes of Conduct of Regulated Gas and Electric Companies, Case No. 8820, Order No. 76292, 202 PUR4th 177 (Maryland Public Service Commission,

the state Court of Appeal overturned the decision on procedural grounds,[28]new Commission draft rules changed the definition of core services to encompass "a gas or electric supply service that was provided to the public in Maryland by a utility as a monopoly service, *within the utility's distribution territory*, prior to the introduction of customer choice programs." [29]

The Massachusetts code also applies distinct sets of rules to two different types of affiliates and provides one of the most detailed economic rationales for making such a distinction. The Massachusetts regulator decided to apply core rules, such as transfer pricing to control cross-subsidization, to all affiliates, while adding another set of rules only for affiliates "engaged in the sale or marketing of natural gas, electricity or energy-related services". Energy-related services were further defined as "those services the costs of which have been recovered by Distribution Companies through rates approved by the Department".[30] It is understood that such services include the delivery of demand-side management programs. The following rationale was provided for not extending these rules to non-energy related affiliates:

> Wholesale extension of the [Code] to non-energy related affiliates, beyond that necessary to prevent cross-subsidization or discriminatory transfers of tariffed public utility services or other products, services, or information in which the distribution company has market power, would result primarily in competitive handicapping of those affiliates. Such a wholesale extension would benefit incumbents in those non-energy-related markets, but not the public at large or even, necessarily, distribution company ratepayers.[31]

The Massachusetts regulator further stated that:

> [G]as and electric distribution company affiliates have no such inherent market power in non-energy related markets, except in limited circumstances that are adequately addressed by other statutes … or by antitrust principles … [32]

## Analysis

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July 1, 2000). The Ontario ESP definition wording is broader as, for example, appliance sales, services and rentals are not businesses solely performed by Ontario utilities prior to unbundling.

[28] Delmara Power v. PSC, 370 Md 1(2002).

[29] Cited at page B-3, [Maryland] Commission Staff Analysis of Ring-Fencing Measures For Investor-Owned Electric and Gas Utilities, February 18, 2005.

[30] Section 220 CMR 12 Standards of Conduct for Distribution Companies and Their Affiliates.

[31] Quoted at page 19, NARUC Report.

[32] Quoted at page 19, NARUC Report.

Excluding holding companies and municipal owners, most of the current distributor affiliates, such as generators and service companies for example, fall within the definition of an energy service provider. Although currently eight affiliates hold an electricity retailer licence, none of them provides the commodity. Telecoms are the principal current type of affiliates that do not fall under the definition of energy service provider. As a result, any changes to the definition of ESP could affect many electricity distributors and their affiliates.

The current Electricity ARC definition of “energy service provider” is based on the principle that the close relationship with distribution services warrants mitigation of the potential for an affiliate to draw undue advantage of the utility’s monopoly position. This is because the Ontario electricity distributors and their ESP affiliates operate almost exclusively in the same territory, which has the tendency to magnify the risk of customer confusion and inherent competitive advantage in a number of areas, including:

- who is offering the energy service
- whether the affiliate’s activities carry the utility’s endorsement
- whether the utility will grant advantage in regulated services to those who buy related services from an affiliate
- whether affiliate services are provided under Board regulation or approval.

The changes that have occurred in the Ontario marketplace since the Board approved the ESP definition in 1999 have not reduced the weight of the above considerations. The current definition of ESP balances efficiency concerns and monopoly abuse concerns. It does not apply all rules to all affiliates, but does apply extra rules to those affiliates with the highest risk of anti-competitive behaviour.

An alternative approach would be to keep the extra provisions and narrow the current ESP definition. This could take the form of revising the ESP definition to only cover retailing of electricity and marketing of natural gas and exclude generation of electricity, energy management services, CDM services, appliance sales, services and rentals, and other electricity related activities.

Narrowing the definition of ESP could provide more flexibility to the distributors to achieve greater efficiencies through sharing of resources with their affiliates.[33] However, as discussed in the role of competition section above, depending on the market of the affiliate, narrowing the ESP definition could provide an unfair competitive advantage to the utility affiliate relative to its competitors. There is also the potential that

[33] ARC section 2.2.4 now precludes sharing operating employees where the affiliate falls within the definition of an energy service provider.

any resulting anticompetitive behaviour could lead to higher costs for customers in the long run. In addition, there is the risk for customer confusion regarding who is offering specific services, the regulated utility or its affiliate. Thus, narrowing the definition will not adequately protect for the risks of anti-competitive behaviour in those areas currently covered in the definition and for which there are continuing concerns as discussed in the competition section above.

A third option is to apply one uniform set of code rules to all affiliates. Most of the current Electricity ARC rules, including the transfer pricing and cross-subsidization rules, already apply to all affiliates. The practical impact of this approach would be to eliminate the ESP definition and to extend some version of the operating employee sharing, physical separation and undue influence rules to all affiliates. Such a step was taken in Alberta, but the rules were modified before applied to all utilities.[34]

One set of rules for all affiliates could simplify the Electricity ARC but it will not necessarily provide more flexibility to the affiliates included under the current ESP definition. In some cases, it could increase costs for affiliates that are not included in the existing ESP definition, such as the telecommunication affiliates, if they are required to have physical separation or stricter employee sharing rules than under the current Electricity ARC rules. Therefore, removing the ESP definition and applying all rules to all affiliates would not be consistent with efficiency concerns and the extent of the anti-competitive concerns across all affiliates that operate in different markets.

The current definition of ESP can be viewed as suitable since it attempts to minimize both the risk of affiliate anti-competitive behaviour and customer confusion. Interested parties are invited to comment on the ESP definition options discussed above.

## 2.4 Confidential Customer Information and Employee Sharing Rules

### 2.4.1 Confidential Customer Information

**Should the current Electricity ARC treatment of "confidential information" be narrowed or otherwise changed?**

The main issue in this area is whether the current definition of confidential customer information should be narrowed to exclude customer information that is otherwise available to the public, and/or information that does not provide a "competitive advantage" to an energy retailing affiliate.

**<u>Current ARC Provisions</u>**

[34] The Alberta regulator, in the 2003 ATCO decision, required wording changes before versions of Ontario's undue influence rules 2.5.1 and 2.5.2 were applied to all affiliates (see pages 87-89, AEUB Decision 2003-040).

Section 1.2 of the Electricity ARC (and Gas ARC) contains the following definition:

> "confidential information" means information the utility has obtained relating to a specific consumer, retailer or generator in the process of providing current or prospective utility service.

Electricity ARC section 2.6.2 requires written consent for the release of such information, except where required for purposes of billing or market operation, law enforcement, complying with a legal requirement, and processing past due customer accounts passed to a debt collection agency.

The ARC uses the confidential information definition in several places, including the sharing of employees rule discussed below. An underlying objective of the prohibition of sharing employees with access to confidential information is to prevent unfair competitive advantages to affiliates by virtue of access to customer information in the possession of the utility.

**Other Jurisdictions**

The Electricity ARC definition of confidential information falls within the mainstream of experience in other jurisdictions. Many jurisdictions, such as Connecticut for example, also follow a broad approach but provide greater detail in the definition.[35]

A number of North American codes added qualifications to their definition of confidential information.[36] One approach, followed in the recent Alberta codes, adopts a narrower definition by adding the qualification "the information is not otherwise available to the public". This qualification is also included in the TCPL code. A second approach, found in several U.S. codes, requires that the customer information in question must lead to a competitive advantage before employee sharing restrictions become applicable.

Some codes make specific employee information exceptions for certain types of common or shared utility/affiliate functions. One such exception allows disclosure to senior management for corporate governance, which several recent Canadian codes have recognized.[37]

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[35] "Customer information" means customer-specific information which the electric distribution company or its predecessor electric company acquired or developed in the course of providing electric distribution services and includes, but is not limited to, information that relates to the quantity, time of use, type and destination of electric service, information contained in electric service bills and other data specific to an electric distribution company customer.

[36] Specific Canadian and U.S. reference are provided in the next section of the paper. To fully understand the practical effect of a narrower or wider definition of confidential information, the employee sharing restriction in section 2.2.3 (applicable where the employees have access to "confidential information") should also be considered.

[37] Section 6.2 of the 2003 Altalink code exemplifies this exception, in providing that "Officers of a Utility who are also officers of an Affiliate … may disclose … Utility planning, operational, financial and strategic

North American codes often allow the disclosure of confidential customer information to persons (often a potential supplier seeking usage information) possessing a waiver of disclosure from the individual customer. The effect is similar to the Electricity ARC rule 2.6.1, which provides that confidential information can be released with the consent of the customer.

Some jurisdictions provide special treatment for information about individual customers that is not deemed confidential or aggregated information that does not identify particular customers. An example of such information that has commercial value is geographic or other usage patterns that present targeted marketing opportunities. New Jersey provides that the utility must make available on equal terms and conditions to others any such information that it provides to its affiliate. This approach avoids the need to address the sometimes knotty questions of commercial value and availability through public sources. A similar result is obtained in Ontario under section 2.6.3 of the Electricity ARC, which requires the aggregated information provided to an affiliate to also be shared on a non-discriminatory basis with parties requesting the same.

Some U.S. codes require non-customer information such as information about utility network conditions or operations that are shared with an affiliate to be provided on similar terms and conditions to third-party requestors. This information is particularly useful to distributed generators as it allows them to identify sites where distributed generation would be mostly valuable. Access to this type of information is already permitted as a result of recent amendments to the OEB's Distribution System Code.

## Analysis

The current Electricity ARC definition of confidential customer information is similar to that in other jurisdictions.The Electricity ARC currently requires information confidentiality in standard service agreements between distributors and affiliates. Distributors must establish system and process controls, such as passwords and separate databases, to ensure customer information remains secure. Their Reporting and Record keeping filings must also address training sessions and employee reminders about keeping information confidential.

An advantage of the present unqualified definition is that it is simple to understand and implement, thus minimizing regulatory and compliance burden. It also gives maximum protection to utility customers. However, a number of North American regulators have approved more "qualified" definitions allowing sharing of information that is available to the public or information that does not provide a competitive advantage to the affiliate relative to its competitors.

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information to the Affiliate to fulfill their responsibilities with respect to corporate governance … but only to the extent necessary and not for any other purpose".

One alternative approach is to add a qualifier that for code purposes the confidential information must not be otherwise available to the public. This qualifier may initially appear modest since in theory there could be little risk of competitive harm in sharing information that is already public. Significant compliance issues could arise, however, such as what “available to the public” means in practice. Consider the example of customer information filed with the city planning office. Although it may be deemed to be publicly available, a competitor must undertake significant search efforts at a cost while an affiliate could get the information from a distributor at little or no cost.

A second approach is to require that the information in question provide a competitive advantage before it is considered confidential for code purposes. The rationale for this approach is that competitive harm cannot logically exist if the information does not provide a competitive advantage. The advantage of such an approach is that it would better focus on the major harm sought to be addressed by the code rules in this area. The underlining premise of the example, however, may be questioned: Why would the affiliate who received the information from the utility have sought it if it had no value in the first place? The issue really goes to the scope of permitted sharing of employees with access to customer information, rather than the character of the information itself. Attempting to address the issue through the definition of confidential information would raise practical concerns about the vagueness of the proposed qualification.

On balance, staff’s working view is that the current definition of confidential customer information is suitable, as it is simpler to apply relative to the other options and provides maximum protection to utility customers. Interested parties are welcome to comment on the merits of the alternative confidential information definitions discussed above.

### 2.4.2 Employee Sharing

**Should the Electricity ARC rules on the sharing of employees between utilities and their affiliates be made more flexible?**

The primary purposes of the employee sharing provisions are to preclude:

- customer confusion
- sharing customer information where such could provide the affiliate with an unfair competitive advantage
- sharing customer information where such could result in the affiliate soliciting utility customers in the sale of the affiliate’s own services
- leveraging by the affiliate of the utility’s “inherent” market power by creating the impression that the utility or the regulator endorses or controls the affiliate’s business.

The employee sharing rules could become more flexible by permitting more extensive sharing of staff resources, which could also allow, for example, more extensive joint provision by utilities and affiliates for CDM services. These potential changes, however, should be balanced with the concern of affiliates gaining a competitive advantage over their competitors and customer confusion when having the same employees provide both distribution and competitive services, or through other implicit connotations of association between the affiliate and the regulated operations of the utility.

**Current ARC Provisions**

Section 2.2 of the Electricity ARC states:

> 2.2.3 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.
>
> 2.2.4 A utility shall not share with an affiliate that is an energy service provider employee that carries out the day-to-day operation of the utility's transmission or distribution network.

Compliance Bulletin 200604 provides interpretation from the CCO on the application of the code employee sharing provisions:

> In my view, in order to comply with 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.

Compliance Bulletin 200604 clarified that affiliate employees who provide distribution services may also provide unregulated services outside of the distributor's service territory.

**Gas ARC**

Section 2.2.3 of the Gas ARC is the same as the Electricity ARC Section 2.2.3 above. However, Gas ARC section 2.2.4 provides more specific employee-sharing limits:

> A utility shall not share with an affiliate that is an energy service provider any employee who controls the access to utility services, or directs the manner in which utility services are provided to customers, or who has direct contact with a customer of the utility service.[38]

[38] The definitions of "energy service provider" and "confidential information" are the same in the Gas and Electricity ARCs.

The general policy objective is the same in the two Ontario ARCs. The Gas and Electricity ARC versions of section 2.2.4 were drafted at different times resulting in different wording. The Gas ARC language, which is more common in other Canadian codes, seems to provide a more detailed description of the types of work done by employees who cannot be shared. Greater specificity may reduce uncertainty around the interpretation of the provision and thus provide some incremental operational flexibility to distributors and their affiliates.

**Other Jurisdictions**

A number of U.S. codes provide utilities with more detailed guidance on employee sharing by defining more explicitly “operating” and “non-operating” employees. Other regulators also allow the use of confidentiality agreements to facilitate employee sharing in certain occupations. In addition, most codes tend to apply one set of employee sharing rules to all affiliates. This, however, should be seen in the context of the definition of “confidential information” used in these jurisdictions.

The 2003 EPCOR code provides a good Canadian illustration. It states:

> A utility may share employees on a Cost Recovery Basis with an Affiliate provided that the employees to be shared: … (b) do not routinely participate in making decisions with respect to the provision of Utility Services or how Utility Services are delivered; (c) do not routinely deal with or have direct contact with customers of the Utility; and (d) are not, subject to the provisions of section 3.1.4 hereof, routinely involved in operating, planning or managing the business of the Utility.[39]

Utility Service as used in Clause (b) is defined as a service “the terms of which are regulated by the EUB.” Clauses (b), (c) and (d) differ from the Ontario Electricity ARC in that they are more detailed along the lines of the Gas ARC section 2.2.4. The EPCOR employee sharing restrictions apply to all affiliates, whether or not energy service providers.[40] The definition of confidential information, however, is narrower than Ontario’s definition.

The FERC, which regulates transmission providers and gas pipelines in the U.S., has among the most detailed guidance on this issue, explaining and illustrating what it considers to be operating and non-operating employees.[41] The FERC defined “operating employees” as, in part, those “engaged in the day-to-day duties and

[39] See section 3.3.1 of the 2003 EPCOR Code. Clause 3.3.1 (a) precludes sharing of employee who have access to confidential information (similar to ARC rule 2.2.3). It must be read along with the information sharing exceptions under section 6 of that Code (which differ from the Ontario rule).

[40] The 2006 TCPL code followed the same approach (see section 3.3.4.2).

[41] The FERC (and Alberta) explanations of operating versus non-operating employees did not relate to electricity distributors, making elaboration required to apply these principles to the Electricity ARC.

responsibilities for planning, directing, organizing or carrying out utility-related operation".[42] The FERC also elaborated what it considers to be non-operating employees. Transmission providers may share support employees and field and maintenance employees with their marketing and energy affiliates. The FERC deems these employees to be as "supportive in nature and would not have direct operational responsibilities". The FERC has a code compliance audit program and FERC staff has issued replies to Frequently Asked Questions (FAQ) that provide written guidance about the support and maintenance staff that can be shared.[43]

An Alberta decision takes an approach similar to that of FERC, in accepting sharing of employees engaged in "non-commercial" functions such as "pipeline maintenance and operation".[44]

It should be noted that the FERC and Alberta definitions of operating versus non-operating employees do not directly relate to the operations of electricity distributors. As a result, it is difficult to judge the application of these definitions to the electricity distributors in Ontario. The general approach, however, could be considered.

Some North American regulators have narrowed the confidential information definition for purposes of the employee sharing restrictions. One qualification in both Canadian and U.S. codes is to exclude from the definition of confidential customer information any information that is already public.[45] A few U.S. codes have added an additional qualification to the meaning of confidential information for employee sharing purposes:

- Massachusetts has relaxed employee-sharing restrictions where affiliate access to customer information would not have any significant anticompetitive effect. Access restrictions only apply to information "that could provide a Competitive Energy Affiliate with an *undue advantage"* (italics added).

[42] See FERC Order No. 2004 (issued November 25, 2003), which sets out, and explains, standards of conduct for transmission providers. The regulator subsequently issued a clarification to Order No. 2004 (FERC Order No. 2004-A dated April 16, 2004). These FERC standards of conduct were recently subject to a successful jurisdictional challenge on the grounds of the broad definition of affiliate used. In January 2007, the FERC indicated it would make interim adjustments (see Order No. 690) on its own initiative to conform to the court decision and consult further on permanent changes.
[43] FAQ reply number 16 clarified that the actual function rather than formal job title is relevant. FAQ reply number 17 clarified that the field and maintenance staff who can be shared for code purposes are limited to staff who do not have access to customer and market information.
[44] Page 13, the ATCO Pipelines Muskeg River Pipeline Affiliate code of conduct exemption decision No. 2006-136.
[45] This position is accepted by the AEUB (see EPCOR code) and the NEB (see TCPL code). For a similar U.S. example, see the Maine code of conduct decision (Docket No. 98-457 at page 7).

- Virginia uses the same qualifier, defining "undue advantage" as "reasonably likely to adversely affect the development of effective competition within the Commonwealth". [46]

The FERC, in the areas where there are strong physical separation requirements between utility and affiliate, allows shared non-operating employees to receive confidential information "as long as the shared employee did not act as a conduit for actively sharing the information with the marketing affiliate or wholesale merchant function".[47]

The FERC approach also authorizes confidentiality agreements to support the "no-conduit" requirement. Utility compliance plans rely on such agreements to prevent shared employees from providing sensitive information to affiliate personnel. For example, a Canadian pipeline company with FERC-regulated operations requires its shared corporate services employees to "*certify* that they will not be a conduit for sharing sensitive information," and its shared senior officers and directors to "*declare in writing* that they will observe the 'no-conduit' requirement".[48]

Examples of confidentiality agreements in Canada include the EPCOR compliance plan [49] and the AEUB requirement that confidentially agreements be entered into as part of granting the affiliate code of conduct exemption requested by ATCO Pipelines and Muskeg River Pipeline.[50]

Some jurisdictions allow the use of code exemptions where specific utility circumstances warrant it. For instance, the AEUB granted EPCOR a code exemption to allow sharing of "operational and administrative employees, but not management team members" between the distribution and transmission corporations, with the proviso that a particular employee "shall not be shared if it could reasonably be considered to be detrimental to the interests of customers" of either entity.[51]

## Analysis

[46] Page 19, Staff Report On Proposed Rules Governing Retail Access to Competitive Energy Services, issued March 13, 2001. Stakeholders in various U.S. states have expressed concerns about the vagueness of such a qualifier. Some regulators have declined to adopt such a qualifier when suggested by utilities (as in the 2000 Maryland code of conduct decision case No. 8820).

[47] Page 55, FERC Order No. 2004.

[48] Page 8-9, Vector Pipeline Compliance Manual dated September 22, 2004. The pipeline is a jointly owned asset, with Enbridge Inc. being one of the owners.

[49] Their 2006 code of conduct compliance plan specifically requires employees using shared corporate services to sign and agree that customer information must not be shared with the sales and marketing colleagues, unless the customer agrees.

[50] AEUB Decision 2006-136 at page 12. Woodstock Hydro had also requested use of a confidentiality agreement in its unsuccessful Electricity ARC exemption application (see EB-2005-0352 at page 3).

[51] Page 3, EUB Decision 2004-010.

A number of employee sharing arrangements currently occur between Ontario distributors and affiliates. In the most typical case, an affiliate provides staff to a distributor, or vice versa, where each also has significant staff of their own. Less typical are "virtual distributors," who have few or no employees of their own and outsource essentially all functions to an affiliate. There are also some "virtual affiliates," who have few or no employees and contract essentially all functions to the distributor. In these cases, the employees provide both regulated distribution services and unregulated affiliate services.[52]

The current employee-sharing restrictions may limit or prevent the sharing of an employee with an affiliate depending on the type of work that the employee does. This restriction can require a distributor to incur the added costs for hiring additional staff. It has been suggested that the current employee sharing rules could adversely affect in particular:

- smaller distributors with fewer employees, in providing efficient distribution services
- larger distributors with more employees in enhancing efficiency, by providing services to affiliates in activities within the scope of a distributor's operations
- affiliate services to distributors in ways that would enhance the overall efficient use of utility assets
- joint distributor/affiliate CDM activities in the distributor's service area.

Some electricity distributors, however, have arranged their affairs to comply fully with the ARC. They have also indicated that compliance can be undertaken in a manner consistent with efficiently run operations. Although some parties have suggested that the Electricity ARC rules could limit CDM activities, at this stage, staff has not been made aware of any specific instances in which Electricity ARC provisions have constrained a distributor's ability to conduct CDM activities. Staff notes that a license-amendment application provides a method for a distributor to seek an Electricity ARC exemption should its particular circumstances warrant.

Deciding whether to change the employee sharing provisions depends on whether there are likely to be categories of employees who can be shared without allowing commercially advantageous customer information to flow to affiliates. Narrowing the scope of the code restrictions on employee sharing could facilitate utility cost efficiencies by expanding employee-sharing opportunities between distributors and affiliates. This should be balanced, however, with the interests of competitive service providers. They can be expected to have concerns about any increase in the potential for sharing of commercially sensitive customer information or strategic business knowledge, or leaving impressions of integration or endorsement of affiliate activities by the utility that could provide a competitive advantage to the utility's affiliate. One must also consider the increased risk of customer confusion from having the same

[52] The concerns surrounding "virtual affiliates" also include compliance with section 71(1) of the *OEB Act.*

employees provide both distribution and competitive services to utility customers. The potential increase in regulatory burden must also be considered. The lessening of a clear and simple (i.e. "bright line") approach towards more complex employee sharing rules may lead to more compliance issues as parties and the Board question the types of activities which can be shared.

Given the concerns above, the following options could be considered for modifying the employee-sharing rules of the Electricity ARC:

a) Clarify the current wording of Electricity ARC section 2.2.4 regarding the types of employees that may be shared [53] by defining "employees that carry out the day-to-day operation of the utility's transmission and distribution network" and therefore cannot be shared, or by providing examples of "non-operating" employees that can be shared. Such clarifications would confirm that any efficiency issues have been fully considered when applying the Electricity ARC. The more detailed Gas ARC description of what is prohibited could be considered. However this definition would only affect those affiliates that are ESPs, and any clarification would have to take into consideration the unique issues discussed above in relation to customer confusion and market power.

b) Amend Electricity ARC section 2.2.3 to allow non-operating employees with access to customer information to be shared, provided they enter into confidentiality agreements. The large number of distributors in Ontario, many of whom have a limited number of employees performing multiple functions, may make this approach less practical in the Ontario context. In any event this approach would not address all of the concerns discussed above.

c) Amend Electricity ARC section 2.2.3 to expand the range of employee sharing by narrowing the type of information considered confidential. This option will require changing the definition of confidential information that will raise other compliance issues.

d) Refocus employee sharing prohibitions on the nature of the affiliate's activities in order to clearly define those affiliate activities that might, with sharing of utility employees, cause the harms that are generally of concern. To a certain extent, this has been the approach that the Board and the CCO have already taken when considering Electricity ARC compliance and exemptions.[54]

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[53] Note Compliance Bulletin 200604 has already relaxed the impact of the prohibition by indicating that employees (whether of the affiliate or the utility) with access to commercially-sensitive utility customer information may be used by the affiliate, as long as they are not involved in the *unregulated* business of the affiliate *in the service territory*.

[54] For example, see the reference above as to how Compliance Bulletin 200604 has interpreted the employee sharing rules to focus on potential harms in utility-affiliate business dealings within the distributor's home service territory.

When considering the above options, the context of the Ontario industry and rest of the Electricity ARC rules should be considered. Option a) represents incremental modifications that could provide further clarity to the employee sharing rules and potentially some increased flexibility in the utility operations.

The need for greater employee sharing under options b) and c) involving confidentiality agreements for sharing non-operating employees or narrowing the definition of confidential information could potentially be addressed in specific cases through the current exemption application route.[55] Option d) is promising as it focuses more on the affiliate's specific activities with the premise to allow the sharing of selective employees if there is no potential to cause the harms discussed above. In this case the issue becomes which employees should not be shared and the definition of the subject class of employees becomes important.

Staff is of the view that it could be useful for the Board to clarify, for purposes of Electricity ARC section 2.2.4, the types of non-operating employees that can be shared and the types of operating employees that cannot be shared. Comments from interested parties, especially with respect to any practical problems that might exist with the current employee sharing rules, would be particularly helpful in finalizing staff's position on this issue. Practical illustrations are also sought as to what specific type of customer information could be shared to facilitate increased utility-affiliate employee sharing and associated operating efficiencies, but not adversely impact fair competition in the Ontario marketplace.

## 2.5 Independent Directors

**Do provisions regarding the percentage of independent utility directors remain appropriate?**

The primary purpose of the provision requiring a minimum number of independent directors for a utility is to ensure that utility-related decisions are taken independently of affiliate interests and in the interests of ratepayers. The issue to be addressed is whether the current rule is appropriate for assuring adequate focus on utility interests at the corporate governance level.

**<u>Current ARC Provisions</u>**

Section 2.1.3 of the Electricity ARC and the Gas ARC provides:

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[55] The final section of this paper discusses the need for more detail on the criteria and process for Electricity ARC exemption requests.

A utility shall ensure that at least one-third of its Board of Directors is independent from any affiliate.

**Other Jurisdictions**

U.S. jurisdictions do not frequently address director requirements. Some states, such as New Jersey, prohibit utility officers from simultaneously holding affiliate positions. The NARUC Report[56] listed only a few examples of U.S. codes that do put firm limits on the sharing of directors; however, prevailing practice is not to establish a requirement in this area.

Alberta faced this issue in the 2003 ATCO code proceeding, where the AEUB declined to adopt Ontario's one-third independent utility directors' requirement. The AEUB cited the potential for marginalizing independent directors where they comprise less than a majority. The AEUB did, however, address the independence issue by:

- prohibiting an individual from simultaneously holding utility and affiliate positions as a director, officer or member of the management team if "it could reasonably be considered to be detrimental to the interests of customers of the utility"

- requiring a director to abstain, if acting in a dual capacity, from any activity reasonably considered detrimental to utility customers' interests. [57]

The various Alberta codes (e.g. the 2003 EPCOR code) and the 2006 TCPL code follow the same approach.

**Analysis**

There is widespread Canadian regulator agreement on maintaining some degree of separation between utility and affiliate directors. Canadian regulators take two different general approaches: a mandatory independent director requirement or a prohibition on a director acting in a dual capacity if detrimental to customer interests. The former approach is easier to apply as it involves clear cut rules although the latter may lower the overall costs by allowing increased use of shared directors.

Requiring less than 50% independent utility directors may produce marginalization to some degree. Increasing the number will tend to mitigate this concern. Requiring additional independent utility directors would, on the other hand, increase costs for retaining them.

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[56] See Page 29 of NARUC report.
[57] Page 59, 2003 ATCO Decision.

There is a potential argument that an increased number of independent utility directors may allow less stringent affiliate rules (e.g. transfer pricing), because it will encourage more rigorous self-policing. Such an approach, however, is not common in practice.

Staff welcomes comments on whether there is a need to change the current percentage of independent utility directors mandated in the Electricity ARC.

## 2.6 Transfer Pricing Rules

### 2.6.1 Transfer Pricing Rules for Products and Services

**Should the current Electricity ARC rules for market or cost-based pricing of goods and services be changed?**

The major objective of the transfer pricing rules for products and services is to protect ratepayers by ensuring a utility does not pay an unreasonably high amount to an affiliate for a service or product, or provide a service or product to an affiliate for an unreasonably low amount. Although the primary objective is to protect utility ratepayers against cross-subsidization, a by-product of such rules is to protect third-party service providers against anti-competitive pricing behaviour resulting from ratepayer subsidy of competitive operations. The issues for analysis are whether the current Electricity ARC rules for market or cost-based pricing of goods and services should remain as is, be amended to adapt the Gas ARC transfer pricing rules or be modified to reflect the directions provided in Compliance Bulletin 200604.

**<u>Current ARC Provisions</u>**

Electricity ARC Section 2.3 sets out the current transfer pricing rules:

2.3.1 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.

2.3.2 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.

2.3.3 Where a fair market value is not available for any product, resource or service, a utility 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.

Compliance Bulletin 200604 provides the following views by the CCO on compliance with the transfer pricing provisions:

> 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.
>
> If a market for a 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 used, the affiliate's actual costs must be verified and a proper cost allocation methodology must be used.

The CCO also explained what steps should be taken before using the cost-based transfer pricing rules:

> 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 wiling 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 the specific service.

**Gas ARC**

Gas ARC Section 2.3.4 requires[58] a competitive bidding process where a market exists for the product or service, to establish the market price before a utility enters into or renews a contract with an affiliate. The Gas ARC also requires a distributor to retain an independent evaluator to determine whether contracts valued at more than the greater of $300,000 or 0.3 percent of utility non-commodity revenues meet the competitive bidding process requirements. By contrast, Compliance Bulletin 200604 only recommends the use of tendering where a market exists and does not address the need for an independent evaluator.

The Gas ARC limits pricing to no more than the affiliate's "fully-allocated cost" to provide the product or service for which markets do not exist. In contrast, section 2.3.3 of the Electricity ARC merely refers to a "cost-based price". The Gas ARC provides specific details regarding the calculation of "direct costs," "indirect costs," and "fully-allocated cost". The Gas ARC also provides specific directions regarding the calculation of the

[58] For fixed dollar amounts less of at least $100,000 or 0.1 percent of distributor's non-commodity revenue

appropriate rate of return for the affiliate. Section 2.3.1.2 of the Gas ARC requires utility/affiliate contracts to include an express provision requiring compliance with Board requests for, among other things, affiliate cost data, which can be used to assist with the application and review of the cost-based transfer pricing rules.

**Other Jurisdictions**

Transfer pricing rules for goods and services are a common part of affiliate codes of conduct. The NARUC transfer pricing guidelines[59] influenced the changes made in the 2004 Gas ARC, along with the language used in other codes found as part of the literature review at that time.

In a CRTC ruling, the Commission concluded "… as a general rule, the company should undertake a competitive bidding process when an affiliate is an actual or potential supplier of goods or services".[60] The CRTC also adopted a minimum threshold value for competitive tendering requirements ($500,000 for Bell Canada).

Other regulators such as the Texas PUC have implemented mandatory use of an independent evaluator.[61]

The Gas ARC section 2.3.8 anti-avoidance rule was modeled after a similar provision in the Minnesota rules.[62]

An issue that has arisen from time to time in U.S. regulatory audits of transfer pricing compliance is the treatment of capital costs. Fully allocated costs include both a return of (e.g. depreciation) and a return on capital assets.[63] Some U.S. audits[64] have failed to include one or the other of these cost components.

Joint purchasing may raise separate cost allocation issues concerning what is the proper method for assigning the costs of goods or services purchased jointly. Some U.S. jurisdictions[65] have addressed this issue by requiring a benefits sharing where each participant pays the same unit cost for each item. Some U.S. codes also require a

[59] See the 1999 NARUC Guidelines for Cost Allocations and Affiliate Transactions.
[60] Telecom decision 90 -17.
[61] The utility shall use an independent evaluator when a competitive affiliate's bid is included among the bids to be evaluated. If an independent evaluator is required, the utility shall maintain a record of communications with the independent evaluator. The independent evaluator shall identify in writing the bids that are most advantageous and warrant negotiation and contract execution, in accordance with the criteria set forth in the request for proposals. The utility retains responsibility for final selection of products or services. Chapter 25.273(d)(2) of the Texas code rules.
[62] Minn. Stat. s. 216B.48, subd. 4.
[63] In Ontario, the Accounting Procedure Handbook has a section (Article 340) dedicated to accounting rules dealing with the application of the Electricity ARC.
[64] As advised by Liberty Consulting.
[65] As advised by Liberty Consulting.

number of measures designed to make pricing and recordkeeping for affiliate transactions transparent and auditable. Some of the common measures include:

- annual reporting of the utility's transactions with affiliates
- the rendering of bills between entities to make the value of services and payment terms and conditions visible and auditable
- retention of records showing that assigned and allocated costs in affiliate transactions can be traceable on the books and records of the affiliates involved.

**Analysis**

The update of the Gas ARC in 2004 added more detailed transfer-pricing requirements. Compliance Bulletin 200604 has extended many of these provisions to the electricity sector as factors when assessing Electricity ARC compliance. To formally extend all Gas ARC transfer-pricing rules to the Electricity ARC would require a number of amendments, including:

- Adding a mandatory requirement for market tendering for large contracts.
- Requiring an independent evaluation for tenders involving significant products and services, in order to promote transparency and robustness.
- The Gas ARC sets the affiliate's maximum rate of return at the utility's approved weighted average cost of capital, and uses the same rate as the minimum where the utility serves the affiliate. The Electricity ARC refers to the approved rate of return or bank prime rate, although Compliance Bulletin 200604 has interpreted the two codes in a similar manner on this point.
- The Gas ARC requires evidence that a market does not exist before considering the application of the cost-based transfer pricing rule.[66] Similarly, Compliance Bulletin 200604 discussed undertaking a market review to determine whether a market exists for the good or service in question.

Extending all the Gas ARC rules to the electricity sector would expand ratepayer protection[67] and restore consistency between the electricity and gas sectors. Such changes could create some additional compliance costs, which may be of concern to many medium and small electricity distributors.

Rejection by the Board of the Compliance Bulletin 200604 requirement for market assessment prior to taking cost-based pricing from an affiliate would reduce compliance costs for the industry. On the other hand, eliminating that requirement may increase the opportunity for awarding contracts to affiliates on a cost basis where a competitive

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[66] As explained in the Gas ARC Policy Paper, the same view was taken by the Board in the Enbridge 2003 test year decision, RP-2002-0133 at line 524.
[67] Third-party service providers may also benefit from stricter transfer pricing rules.

market may offer better terms. The gas sector rules apply the market tendering requirement to large and small distributors, but provide a threshold test (Gas ARC section 2.3.6). Adding a threshold before requiring a market review in the electricity sector, which is not part of the current Gas ARC rules[68], could address potential cost versus benefit concerns of many electricity distributors.

Compliance Bulletin 200604 has extended many of the Gas ARC market-based and cost-based transfer pricing rules to the electricity sector. The Board could consider amending the Electricity ARC to codify the transfer pricing rules for products and services. Interested parties are welcome to comment on whether the transfer pricing rules for products and service should remain as is, be amended to adapt the Gas ARC transfer pricing rules or be modified to reflect the directions provided in Compliance Bulletin 200604.

### 2.6.2 Outsourcing Utility Activities to an Affiliate

**Should the Gas ARC outsourcing provisions be included in the Electricity ARC?**

The Gas ARC requires development of a business case prior to outsourcing. The major objective of a business case requirement rule is first, to protect ratepayers by providing evidence that the decision to outsource to an affiliate is sound from a business viewpoint and second, to provide assurances that the decision to outsource: (a) came from a desire to minimize utility costs, (b) considered both third party and utility self-provisioning options, and (c) promotes arm's-length bargaining between utility and affiliate. The Gas ARC does not require benefit to utility customers from outsourcing, it does limit the length of an affiliate contract, and it does require a competitive tendering process where a market exists for the good or service being procured by the utility. The main issues to be addressed are:

- The merit of extending the Gas ARC business case requirement to the electricity sector or developing new one, and if so, how to structure it.
- Whether outsourcing should be permitted where it produces no harm to the utility, or whether it must be preceded by a demonstration of positive net benefits.
- Whether there should be a limit on the length of a contract with an affiliate, which is intended to oblige a utility to periodically undertake a new business case analysis.

[68] There is no threshold for a market review under the Gas ARC. The thresholds in that code focus on the tendering and independent evaluation requirements. As the Gas ARC requires use of market prices when there is a market in existence, a market review is therefore generally required (approved corporate services are an exception).

- Whether there should be a requirement that, where market exists, the utility undertake market tendering prior to entering into an affiliate transaction.

**<u>Current ARC Provisions</u>**

The Electricity ARC, unlike the Gas ARC, has no rule requiring that a utility conduct a sound business case and undertake a structured examination of options before outsourcing to an affiliate a function currently provided internally. In addition, the Electricity ARC, unlike the Gas ARC, has no rule regulating the maximum length of a utility's contract with its affiliate.

**<u>Gas ARC</u>**

Section 2.3.2 of the Gas ARC mandates a business case analysis before an affiliate may displace a utility's internally provided service:

> If a utility intends to enter into an affiliate contract for the receipt of a service, product, resource, or use of an asset that it currently provides to itself, the utility shall first undertake a business case analysis.

Gas ARC section 2.3.3.2 requires the utility to redo or review the business case analysis at least every five years if the affiliate wishes to continue to provide the service. The original and repeat analyses must include:

- description of relevant utility needs on a per-service basis
- identification of options available internally, and from an affiliate or third party
- economic evaluation of all available options including the utility's current fully-allocated cost (which may include a return on the utility's invested capital equal to the approved weighted cost of capital)
- explanation of the selection criteria (including any non-price factors)
- estimate of any benefits to the utility's ratepayers from outsourcing [69]
- justification for bundling separate items together for outsourcing.

When the 1999 Gas ARC replaced the transfer pricing rules in the earlier gas utility "Undertakings," the prior reference to benefits was dropped.[70] The same approach was carried forward in the 1999 Electricity ARC.

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[69] This rule is consistent with the no-harm approach since there is no requirement for any savings to exist before outsourcing proceeds; but the business case may document expected savings.
[70] For example, the December 1992 Union Gas Undertakings had defined "affiliated transaction" to encompass any dealings between the utility and any affiliated or associated corporation, required pre-

The 2004 review of the Gas ARC examined the issue and the Board added the phrase to the purpose section of that code "*at a minimum*, keeping ratepayers unharmed by actions of gas distributors". The accompanying policy document explained that ratepayers could benefit over the long run from lower costs when affiliates must vigorously compete with other providers for a utility's business.[71]

New Gas ARC section 2.3.1 added a further rule limiting the term of any contract between a utility and an affiliate to a five-year maximum, in order to require periodic validation that the utility is paying a reasonable price in light of current business conditions. Unlike the Gas ARC, the Electricity ARC does not impose a maximum contract length.

**<u>Other Jurisdictions</u>**

Alberta decisions have addressed the need for periodic verification of outsourcing prudence. The standard language adopted is in section 4.1 of the Altalink Management Ltd code: "If a Utility intends to outsource to an Affiliate a service it presently provides for itself, the Utility shall … undertake a net present value analysis appropriate for the life cycle or operating cycle of the services involved. Each utility shall periodically review the prudence of continuing For Profit Affiliate Services arrangements."[72]

The need for positive benefits to customers from an activity transfer to an affiliate has been affirmatively established by the Nova Scotia Board. The 2005 Nova Scotia Power Inc. code of conduct provides that:

> before an activity is transferred from NSPI to an affiliate or from an affiliate to NSPI, NSPI *must ensure there is a demonstrated benefit to its customer.*[73]

**<u>Analysis</u>**

Ontario electricity distributors sometimes do not undertake a business case analysis or use a tendering process to confirm that outsourcing to an affiliate is the most cost-effective decision for the utility. Arguments against requiring such analysis (or tenders)

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approval of affiliate transaction aggregating $100,000 or more annually, and adopted transfer pricing rules requiring evidence that affiliate transactions benefit the utility and do not harm customers.

[71] Paragraphs 2(b) and 2(c) of the Gas ARC Review Background Policy Paper issued March 15, 2004.

[72] The same requirements are adopted in section 4.1 of the 2006 TCPL code.

[73] 2005 NSPI code, section 6.10. Italics added. See Order NSUARB –NSPI - P-167. The Nova Scotia regulator, over objections of the utility, made positive benefits to ratepayers the underlying goal of the entire code - not just the activity transfer provisions - by requiring that the purpose section of the Nova Scotia Power Code provide (italics added): "The primary purpose of this Code of Conduct is to ensure that transactions between Nova Scotia Power Inc. (NSPI) and its affiliates demonstrate a benefit to the customers of NSPI."

tend to focus on a number of factors claimed to confirm that payments to affiliates do not exceed fair market value. Some of the arguments include:

- the business judgement of the Board of Directors is sufficient to justify cost effective purchasing decisions
- the affiliate uses the same pricing for the distributor and third party customers
- the affiliate prices mirror a utility's internal costs before transfer of work to the affiliate.

As discussed in a preceding section of this paper, the requirement that only one-third of utility directors be independent of the affiliate may leave questions as to whether utility governance focus exclusively on the well being of utility customers. The fact that the utility could pay the same price third parties are paying when they buy the same services from the affiliate or pay the same price as previously expended on the service does not provide assurances that this is the best deal for the utility customers. The utility might have been able to negotiate a lower price from competing suppliers if it had gone through a tendering process.

The sections below will address the major issues pertaining to outsourcing of utility activities to an affiliate.

*a) Mandatory business case requirement*

The lack of a well-supported business case increases uncertainty as to whether the outsourcing to an affiliate represents the lowest cost alternative for a utility. An "upfront" utility business case analysis before a new service is outsourced to an affiliate provides verification of the best-cost option from the utility's perspective on a go-forward basis, documents a sound analysis of alternatives, demonstrates arm's length bargaining with the affiliate, and lays a foundation for verifying that the affiliate is delivering the results that led to a decision to transfer an activity to it.

The incremental costs of business case requirement should not be overstated as some documentation will be required in any event to support management consideration of the transaction and regulatory scrutiny of the outsourcing in future rate reviews. A mandatory business case, however, may cause some increase in costs for decisions involving small expenditures. This could be addressed by allowing for a threshold under which no business case will be required. Options include: (a) codifying a requirement that is less detailed than the current Gas ARC rule, (b) applying the requirement only to distributors exceeding a threshold size, or (c) exempting lower value transactions.

An argument against a new Electricity ARC business case requirement is that the Board can use its ratemaking powers to require evidence that an outsourcing decision was prudent. A code rule, however, will ensure that all utilities gather the needed information and undertake the required detailed analysis at the relevant time. The expected impact of specific code rules in this area includes enhancement of the operation and enforcement of the other transfer pricing rules.

*b) No-Harm versus Positive Benefits Approach*

Proponents of the no-harm approach argue that utility management should generally be able to organize the business as it sees fit and reap the benefits, provided that in so doing ratepayers are not harmed.[74] A corollary of this principle is that if a utility can outsource functions to an affiliate and lower costs, the savings should be to the benefit of shareholders until the next rate re-basing. This approach has the advantage of simplifying code compliance and administration, but offers less by way of immediate benefits to the ratepayers of the utility. A majority of the codes surveyed were consistent with this approach.

The opposing view argues that it would not be prudent for a utility to outsource a function unless it realizes some benefits. This view is supported by the notion that reductions in utility activities and functions can have subtle negative effects (e.g. loss of cross-training, job promotion, and availability of a larger pool of workers to accommodate unplanned or emergency work) that are hard to measure. A few regulators have made decisions supporting transfer-pricing rules requiring a utility receive tangible net benefits, in the form of lower costs or better service or a combination thereof, at the time of and as a result of outsourcing to an affiliate. As mentioned earlier, this is the approach that the Nova Scotia regulator adopted in respect of NSPI.

In Ontario, following the 2004 Gas ARC review, the Board declined to mandate a sharing of benefits requirement within the code. However, the question of ratepayer benefits has been raised in past gas distribution rate cases.[75]

If any supporting business analysis voluntarily undertaken at the time of outsourcing failed to document any expected cost savings or service improvements, one may expect that further questions would be asked at a future rates hearing. As a result, rate hearings could provide electricity ratepayers with some additional protection in this area. The use of ratemaking rather than the Electricity ARC to address outsourcing benefits has the advantage of permitting ARC compliance to remain focused on the issue of how the relationships operate and not on the issue of why the transaction was undertaken.

*c) Length of Affiliate Contract*

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[74] This view is particularly relevant if the outsourcing was at the same price to the utility, but produced additional benefits for the affiliate.

[75] An earlier gas distribution rate case, involving a large distributor, requested a study to confirm, among other things, whether net savings would arise from shared corporate services. Note the wording of the third part of the often cited *Westcoast* test is technically consistent with a no-harm outcome; see lines 630 and 573 of the Enbridge 2003 test year decision (RP-2002-0133) issued November 7, 2003.

The appropriate length of time for contracts between electricity distributors and their affiliates will depend on the type of goods or service provided. Any limit established should allow for a sufficient period for the affiliate to amortize investment and start-up costs. The Gas ARC rule of up to five years can provide a starting point for a standard new Electricity ARC rule. A more flexible alternative approach could be to require a utility to justify as part of its business case an appropriate affiliate contract term based on the type of goods or service provided under the contract.

*d) Market Tendering*

Where a competitive market for the services in question exists, new Gas ARC section 2.3.5 requires any outsourcing agreement or renewal to be preceded by establishment of a market price through fair and open competitive bidding. Changes over time in market conditions and service options are reasons for considering a requirement for periodic testing of the continuing advantages of an affiliate contract. Among the available potential competitors, there may be less incentive to compete for utility business in the absence of a clear understanding that the selection will be truly competitive. Allowing potential third-party service providers regular opportunities to bid for utility work, along with requiring the utility to continue objective examination of self-provisioning, can promote a more robust marketplace and benefit electricity ratepayers over the long term.

Although the Board could use its ratemaking powers to require evidence to determine whether an outsourcing decision was prudent, staff considers that it could be useful for the Board to add outsourcing provisions to the Electricity ARC. Interested parties are welcome to comment on whether to include specific outsourcing provisions in the Electricity ARC.

### 2.6.3 Transfer Pricing for Shared Corporate Services

**Should the cost-based pricing rules for shared corporate services used in the Gas ARC be extended to the Electricity ARC?**

Distributors often arrange with their services affiliate or holding company for the sharing of corporate finance, legal and human resource services. These arrangements can also include the provision of services like procurement, information technology and building maintenance. There are currently no Gas or Electricity ARC compliance issues of which staff is aware. However, rates cases have given occasion for debates about the costs of shared corporate services.[76]

[76] For instance, intervenors expressed concerns over the cost allocation of the distributor's shared services arrangements in the Toronto Hydro 2006 distribution rates proceeding. After the hearing, the Toronto Hydro restructured the operations of the affiliate and revised the allocation of the shared corporate services costs

The issue that the current situation raises is whether the present Gas ARC transfer pricing rules for shared corporate products and services should be extended to the electricity sector.

**<u>Current ARC Provisions</u>**

The Electricity ARC does not contain rules dealing with the treatment of shared corporate services such as human resources, finance or taxation. The Compliance Office has communicated to a number of individual distributors that shared corporate services can be priced on a cost-plus basis.

**<u>Gas ARC</u>**

The Gas ARC review produced several new shared corporate services rules, including a definition of “shared core corporate services”:

> “shared core corporate services” are business functions that provide shared strategic management and policy support to the corporate group of which the utility is a member, relating to legal, finance, tax, treasury, pensions, risk management, audit services, corporate planning, human resources, health and safety, communications, investor relations, trustee, or public affairs.

The Gas ARC transfer pricing rule 2.3.11.2 addresses this topic and provides:

> … for shared core corporate services, fully-allocated cost based pricing may be applied between a utility and an affiliate.

These provisions allow the utility to source the service from its corporate group and pay a cost-based transfer price, even where a market may exist for the service. The Gas ARC Background Policy Paper assumed that the Board remains free to explore questions about positive ratepayer benefits from shared corporate services in rate cases, which is currently the practice in both sectors.

**<u>Other Jurisdictions</u>**

In New Brunswick, the broadly-based Working Group that developed the 2000 Code of Conduct for Gas Distributors and Marketers agreed:

> … the LDC should be allowed to use shared services with an affiliate if the sharing results in savings in the LDC’s operating budget. [77]

The New Brunswick regulator accepted the above recommendations and added that the “the cost consequences of any sharing would be dealt with in a rates application.” [78]

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[77] NB Board of Commissioners of Public Utilities, Decision, March 28, 2000.

During the Gas ARC review, staff found that U.S. jurisdictions with dedicated shared services rules (e.g. Texas) typically required cost-based pricing but did not require in their codes that there should be ratepayer benefit from such arrangements. In U.S. jurisdictions, in general utilities are required to show, if questioned in rate proceedings or as a result of an affiliate transaction or code audit, that taking service from the affiliate is more beneficial than self-provisioning.[79]

The creation of service companies to provide shared services is a relatively common approach among larger U.S. utility holding companies. In some cases, they are required under U.S. securities laws. In others, regulators have required them as conditions on their approval of mergers. The creation of service companies generally allows for more structure, formality, service-agreement creation, budgeting and performance management, and other control elements.

The Massachusetts code permits the sharing of "information relating to the provision of general and administrative support".[80] Similar provisions are included in other codes to expressly authorize the sharing of customer information necessary to facilitate the provision of shared corporate services.

## Analysis

The Electricity ARC does not contain rules dealing with the treatment of shared corporate services. However, the CCO has communicated to individual distributors, which have raised the issue that shared corporate services should be priced on a cost-plus basis.

Amending the Electricity ARC to allow the use of cost-based pricing as an acceptable methodology for pricing shared corporate services could promote stakeholder and regulatory certainty.

Adding shared corporate service rules to the Electricity ARC will raise implementation issues. The first is whether to use the Gas ARC definition of shared corporate services. That definition of "shared core corporate services" is specific rather than open-ended and may not include all items pertaining to potential shared services in the electricity distribution sector.[81] The policy underlying the definition adopted is to avoid including

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[78] See page 20, Decision In The Matter Of The Board Hearing to Consider Rules and Regulations Regarding the Conduct of gas Distributors and Marketers, March 28, 2000.

[79] As advised by Liberty Consulting. Some codes, for example the one applicable to Duke Power in North Carolina, arguably require an examination of market alternatives before taking shared services from an affiliate.

[80] Section 12.03(8) of the Massachusetts Standards of Conduct for Distribution Companies And Their Affiliates. For a similar exemption, see section 6.3 (e) of the 2003 Altalink code of conduct.

[81] In certain cases, utilities have suggested there is no alternative supplier for the shared service. This does not apply to all cases (e.g. legal services can often be provide by outside venders), and therefore

too many items in order for the utilities to be required to tender externally for services not included in the definition (e.g. computer services).

A second implementation question is whether to apply the “no-ratepayer harm” versus net benefit approach for administering code rules on shared corporate services. The general merits of each position were discussed earlier in the business case section. ARC compliance would be simpler, however, if the code operated on a no-ratepayer harm basis. This would permit continuation of rate proceedings as the sole forum in which to consider the nature and treatment of any benefits to ratepayers, while extending the new cost-based Gas ARC rules to the Electricity ARC would clarify day-to-day code treatment of shared corporate services.

Given the prevalence of shared corporate services in the electricity sector, amendments to the Electricity ARC in this area could promote regulatory certainty and establish consistency with the Gas ARC. Comments from interested parties on the need to incorporate specific shared corporate services rules in the Electricity ARC are welcome.

### 2.6.4 Transfer Pricing Rules for Assets

**Should the asset transfer-pricing provisions of the Electricity ARC mirror the requirements of the Gas ARC rules?**

Staff is unaware of any data on the extent to which asset transfers have occurred or will occur between Ontario electricity distributors and their affiliates. Experience in the U.S. jurisdictions that periodically audit affiliate transactions is that such transfers are not frequent. Those that have taken place generally, but not always, have occurred in the context of transferring lines of business or intellectual property. The latter has on occasion raised concerns,[82] because utilities have not always properly recognized that intellectual property is an asset or measured its value objectively.

A specific issue that arises is whether the Electricity ARC rules should be changed to mirror the Gas ARC rules that require asset transfers to be valued at the higher of market price or net book value.

**<u>Current ARC Provisions</u>**

Section 2.3.4 of the Electricity ARC currently provides: “A utility shall sell assets to an affiliate at a price no less than the net book value of the asset”. This provision ensures that ratepayers are not harmed by asset transfers between a utility and its affiliate.

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there are policy issues surrounding the appropriate scope of the shared services definition for code purposes.

[82] As advised by Liberty Consulting.

**Gas ARC**

The Board amended Gas ARC section 2.3.12 to require that asset transfers from a utility to an affiliate generally be at the higher of market price or net book value (NBV). Gas ARC section 2.3.13 addresses cost benefit concerns by allowing a utility to sell depreciable assets with an NBV of less than $10,000 at NBV.

To deal with a perceived gap in the Gas ARC rules (which also exists for the Electricity ARC), the Board added a complementary provision (section 2.3.15) limiting the maximum utility purchase price for an asset transferred by an affiliate to the market price. Gas ARC sections 2.3.14 and 2.3.16 also require an independent assessment of market price for the sale or purchase of more valuable assets; that is, those valued at the higher of $100,000 and 0.1 percent of utility revenues, net of commodity costs.

**Other Jurisdictions**

Gas ARC asset transfer pricing rule 2.3.12 is similar to the NARUC transfer pricing guidelines, which state: "Generally, transfer of a capital asset from the utility to its non-regulated affiliate should be at the greater of prevailing market price or net book value." Such a rule offers ratepayers greater protection.[83] It also prevents providing an unfair advantage to an affiliate by ensuring it pays prices comparable to what its competitors can obtain.

The Gas ARC review of North American best practices underscored the importance of obtaining an independent assessment of the market price of significant assets. For example, the West Kootenay Power code requires an independent appraisal for asset transfers to a non-regulated business exceeding $100,000.

When reviewing the ATCO code, the Alberta regulator added a rule allowing asset transfers, on a cost recovery basis, where they are intended to improve operational efficiencies amongst utilities that are affiliates.[84]

A number of U.S. code and affiliate transaction audits in New Jersey and Pennsylvania have disclosed instances where utilities have developed internal capabilities such as systems that provide an interface between geographic information and work management systems that prove to have the potential for sale to other businesses. In some of those cases[85], transfer pricing to an affiliate for development and exploitation

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[83] The merits of the alternative approach presently set out in Electricity ARC section 2.2.4 were questioned when the CRTC reviewed Bell Canada's transfer pricing policies (Telecom Decision 86-17 at pages 60-62). An intervenor suggested that "it is unfair to subscribers that assets be transferred at net book value when their sale in the marketplace could result in a greater return".

[84] Page 81, EUB decision 2003-040. Note that there are comparatively few utilities that are affiliated in Ontario, and that the Electricity ARC (but not Gas ARC) provides for asset transfers at net book value.

[85] As advised by Liberty Consulting.

has not considered the market value of the businesses, discounted for development risk.

**Analysis**

Changing the Electricity ARC to parallel the Gas ARC asset-transfer rules which require asset transfers to be evaluated at the higher of market price or net book value would provide more protection to ratepayers. The requirement for an independent evaluation may also assist future ratemaking by providing better documentation. However, the independent evaluation requirement may increase compliance costs.

Experience in U.S. jurisdictions has raised for consideration in the Ontario context the merits of making explicit that market valuation requirements apply not only to physical assets, but also to intellectual property.

Although asset transfers have not been common in the electricity sector, the Board could consider amending the Electricity ARC to clarify the desire to increase consumer protection. Stakeholder comments on the need for new asset transfer pricing rules are welcome.

## 2.7 Application of the Electricity ARC to Small Distributors

**Should the Electricity ARC rules or exemption process treat small distributors differently?**

The Electricity ARC exemption process may be of special interest to smaller distributors, a number of whom have supported their exemption requests by citing costs of compliance. The Board does not generally grant exemption requests based only on concerns about costs. Exemptions have been granted where a well-documented argument is made, such as that operations of the utility and affiliate are so intertwined that separate staff is cost prohibitive.[86] Code exemptions have not been granted to electricity distributors based simply on their size.

The issue here is whether the Electricity ARC rules or exemptions should treat small distributors differently.

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[86] The leading electricity sector ARC exemption decision is EB-2002-0365 involving Orillia Power. An exemption from the employee sharing, physical facilities and information services rules was also granted to the Fortis group of distributors (Fortis Ontario Inc., Fortis Ontario Generation Corporation, and Cornwall Street Railway Light & Power Company Limited). In addition, Canadian Niagara Power (a member of the Fortis group), in its capacity as one of the licensed transmitters in the province, received an exemption from the employee and physical sharing provisions.

## Current Electricity ARC Provisions

At present, the Electricity ARC applies the same set of rules to all affiliates regardless of size. The *OEB Act* provisions prescribing the grounds for granting a licensing exemption from the Electricity ARC provide no direction for blanket exemptions or special treatment for small electricity distributors. Compliance Bulletins also have not provided different treatment for smaller utilities.

## Gas ARC

The Gas ARC, unlike the Electricity ARC, explicitly addresses the right to request a code exemption. The Board has not adopted a general policy of exempting smaller gas utilities from code compliance.[87]

One small Ontario natural gas distributor has received several code exemptions. The settlement agreement reached among stakeholders (including HVAC) and accepted by the Board in an NRG rates proceeding stated “all parties agreed that the exemption application should be granted for NRG as it is a small utility with no affiliate providing energy services outside the corporate group”. [88] The utility renewed the exemption request in 2003 and the Board commenced a separate proceeding. The Board eventually accepted NRG’s request for an exemption from, among others, the independent director (section 2.2.1) and employee sharing (2.2.3) rules of the Gas ARC. Compliance costs were cited in support of the request. When granting the exemption, the Board specified that no NRG affiliates could provide energy services outside of the corporate group.[89]

## Other Jurisdictions

Only a few North American regulators have granted small privately-owned utilities a blanket affiliate code of conduct exemption. The NARUC Report lists the Kentucky code, which exempts utilities with gross revenues of less than $10 million.[90] The code decisions of some other regulators did invite small distributors to apply for exemptions where appropriate.

The NARUC Report also indicates that a number of small U.S. utilities are not subject to regulation and associated codes because they are non-profit co-ops.

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[87] The Gas ARC amendments did clarify that non-rate regulated gas utilities were not subject to the Gas ARC.
[88] See section A.2(a), RP-1999-0031, Agreement Among Interested Parties.
[89] RP-2002-0147, EB-2003-0017.
[90] Page 22, NARUC Report.

## Analysis

The Board has never before granted small utilities blanket code exemptions. There are strong arguments for regulatory consistency among Ontario electricity distributors. Moreover, even customers of smaller utilities should receive the basic protections afforded under the ARC rules.

An alternative approach is to take into account the wide variety in size of Ontario utilities when designing specific code rules. This occurred in the introduction of threshold tests in the Gas ARC transfer pricing amendments, which take the form of the lesser of a fixed dollar or percentage of the revenue test. Suitable two-part thresholds in any new Electricity ARC transfer pricing rules could comprise a practical method for addressing how to apply a common set of rules to distributors of varying sizes. Similar concerns would arise when larger distributors engage in low dollar value transactions. The details of the threshold tests could take into account any serious cost versus benefit concerns in the electricity sector.  A percentage of the revenue threshold test could ensure that the affiliate transactions of the smaller distributors generally remain subject to the ratepayer protection offered by the Electricity ARC.

Currently distributors can use the existing ARC exemption process for dealing with any specific well-supported cases that require different code treatment.

There are strong arguments for regulatory consistency among Ontario electricity distributors. Moreover, even customers of smaller utilities should receive the basic protections afforded under the ARC rules.

Staff is of the view that regulatory consistency is required in how the Electricity ARC treats utilities of different sizes. Comments are welcome on the potential role of thresholds discussed above and whether stakeholders would benefit if provided with more details on the criteria and process for an Electricity ARC exemption request.

## 2.8 Conclusion

In Staff's view, the analysis has shown that the Electricity ARC is robust and remains relevant to the needs of the Ontario electricity sector. Staff's research has indicated several issues that merit consideration by the Board and potentially changes to some provisions of the Electricity ARC. Issues that have been identified for consideration by the Board include:

i) the relative roles of efficiency and competition considerations as reflected in the purpose section of the Electricity ARC;

ii) the potential for further clarification of the employee sharing rules; and

iii) the applicability of more detailed transfer pricing rules for products and services, outsourced utility activities, shared corporate services and asset transfers.

On balance, Staff's working conclusion is that the current definitions of energy service provider and confidential customer information are suitable. Staff's analysis also raises questions regarding the percentage of utility independent directors mandated in the Electricity ARC and the need for more detail on the criteria and process for an Electricity ARC exemption request.

All stakeholders, including electricity distributors, ratepayer and consumer groups, third-party service providers and other interested parties are invited to provide their comments on the issues discussed in this Staff Research Paper.