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VIA E-MAIL AND WEB POSTING

November 4, 2013

To: All Licensed Electricity Distributors
All Participants in Consultation Process EB-2012-0397
All Other Interested Parties

Re: Facilitating Electricity Distributor Efficiency
Board File No.: EB-2012-0397

The Board issued its Renewed Regulatory Framework for Electricity Distributors ("RRFE") in October 2012. Under the new framework the Board's approach to regulation is more outcome based regulation with a focus on increasing efficiency and performance in the sector. The rate-setting policies of the Board under the RRFE are directed at incenting improved performance and increasing productivity.

On February 11, 2013, the Board issued a letter announcing the commencement of an initiative to assess how the Board's approach to the regulation of electricity distributors may affect the ability of distributors to realize operational or organizational efficiencies that benefit consumers and that are incented under the Board's rate-setting mechanisms.

This letter sets out details of two new policy reviews being initiated by the Board in the context of its initiative regarding the facilitation of electricity distributor efficiency.

Background

The Board engaged Navigant Consulting Ltd. (“Navigant”) to undertake a survey of stakeholders, including distributors and representatives of consumers, regarding their views on potential changes to the Board’s regulatory requirements that may facilitate efficiency improvements. Navigant’s findings were included in a report released on February 25, 2013, and were the subject of discussion at a Stakeholder Meeting held on February 27, 2013. Over 80 participants representing distributors, consumers and other stakeholders participated in the Stakeholder Meeting. A transcript of the meeting is available on the Board’s website.

Stakeholders offered a number of comments and suggestions for changes to the Board’s regulatory requirements that would allow for the achievement of efficiency gains through consolidation or economies of scale or scope. These comments included suggestions relating to the Board’s rate-setting policies associated with mergers and acquisitions, as well as the Board’s service area amendment and long term load transfer policies. Also, there were suggestions made relating to expanding on activities that distributors can perform and relaxing certain requirements of the Board’s Affiliate Relationships Code for Electricity Distributors and Transmitters (the “ARC”).

A summary of the feedback received during this consultation to date is attached as Appendix A to this letter.

Policy Review of MAADs and Service Area Amendment Policies

Having considered the input received from stakeholders, the Board has determined that it will proceed with two policy reviews, as discussed in greater detail below. The first initiative will focus on the Board’s policies regarding merger, amalgamation, acquisition and divestiture (“MAADs”) transactions. The second initiative will focus on policies related to service area amendments, including long-term load transfer arrangements. The Board considers a review of these policies to be of particular importance in terms of alignment with the efficiency objectives that underlie the RRFE.

These two policy reviews will consider the continued appropriateness of the Board’s current relevant policies to determine what, if any, changes might further facilitate distributor efficiency. Potential changes will be assessed against the benefits and costs to ratepayers, the impact on efficiency and implementation issues.

The Board will announce at a future date, additional initiatives in response to stakeholders' suggestions for other changes (such as changes to the ARC).

MAADs Policy Review

The Board's policy with regards to rate issues associated with MAADs transactions was established in 2007, and is found in its *Report of the Board regarding Rate-making Policies Associated with Distributor Consolidation* (EB-2007-0028). Among other things, the policy allows distributors that have completed a MAADs transaction to delay rebasing of their rates for up to 5 years. The purpose is to give the consolidated entity time to retain savings to offset costs of the transaction while protecting the interests of consumers.

Distributors reported that one of the reasons for not considering consolidation is the risk that transaction costs would not be recovered within the 5 year timeframe or that the shareholder would not benefit from any efficiency savings. Distributors suggested that, to facilitate consolidation in the sector, the Board should permit a longer delay for the first rebasing after a MAADs transaction.

With the implementation of the new rate-setting mechanisms under the RRFE the Board considers it timely to review its policies regarding the rebasing of distributor's rates following a MAADs transaction.

Distributors also suggested that if merged distributors are permitted to delay the timing of their next full cost of service/rebasing application beyond 5 years, the Board should consider adopting policy changes that would address the capital investments made during that extended period. The Board intends to consider this issue as part of its MAADs policy review.

Service Area Policy Review

The Board's principles and policy with respect to service area amendments are set out in the Board's February 27, 2004 Decision with Reasons issued in relation to nine separate service area amendment applications (RP-2003-0044). Subsequent service area amendment applications have been consistent with those principles.

During the February consultation, distributors suggested that there is potential for increased efficiencies if it were possible to expand their service territory to municipal boundaries and/or to assume a service territory that is immediately adjacent to their existing service boundaries. Given the changes in the sector and the implementation of the RRFE with a focus on efficiency and continuous improvement the Board considers it appropriate to review the policy set out in EB-2003-0044.

As part of this policy review, the Board will also consider its policy with respect to service area amendments that deal with long term load transfers.

Next Steps

The Board will initiate the policy reviews with an issuance of two Board staff discussion papers later this year. These discussion papers will provide an overview and rationale for the current policies, the issues raised in consultations as well as an estimate of the costs and benefits of any change in the current policies. Further steps will be announced following the issuance of the discussion papers.

If you have any questions regarding the MAADs policy review, please contact Paul Gasparatto at paul.gasparatto@ontarioenergyboard.ca or at 416-440-7724. If you have questions regarding the service area policy review, please contact Ashley Hayle at AshleyDawn.Hayle@ontarioenergyboard.ca or at 416-440-7721. The Board's toll free number is 1-888-632-6273.

Yours truly,

Original signed by

Kirsten Walli
Board Secretary

Appendix A

Summary of Comments and Suggestions Raised in the Consultation to Date

The following is a summary of the suggestions received from stakeholders in the consultation. As indicated in the Board's letter, some of the suggestions that are described in this summary are the subject of the two new policy reviews. The letter also indicates that certain other suggestions set out in this summary will be considered in future initiatives.

General Comments

Changes in regulatory requirements that may facilitate distributor efficiency focused on two categories: economies of scale/scope (operational efficiency) and facilitating consolidation.

Many distributors felt that efficiencies could be achieved through consolidation. However, some distributors and other stakeholders were of the view that for a variety of reasons there is little appetite among shareholders of existing smaller distributors to pursue consolidation. The key regulatory changes distributors suggested to facilitate consolidation include revising the Board's merger, amalgamation, acquisition and divestiture ("MAADs") transaction policies with respect to rate rebasing, the Board's service area amendment policies, and the Board's treatment of long term load transfer arrangements. These are discussed further below.

The opportunities identified by distributors for operational efficiency gains involved the expansion of their business activities. Some opportunities involved increasing the scale of a distributor's operation (i.e., providing services to other distributors). Others focused on increasing the scope of a distributor's operation, to allow for the provision of non-distribution services (i.e., water & wastewater operations, street lighting, etc.). In addition to providing services to other distributors, or to their municipal shareholder, or even to other non-shareholder municipalities, some distributors also wish to offer non-distribution services both inside and outside of their licensed service area.

Distributors suggested that engaging in additional activities would permit them to spread the fixed-cost elements of their operation over a greater number of customers, thus making per-customer costs lower for all, and would also enable them to use new and more effective technologies which require a larger customer base in order to be economic.

The key regulatory changes distributors suggested for facilitating operational efficiencies include removing restrictions on the activities that a distributor may undertake, relaxing the requirements set out in the Board's Affiliates Relationships Code for Electricity Distributors and Transmitters ("ARC"), and allowing distributors to provide distribution services to other distributors.

The following is a summary of the specific suggestions made by distributors. These have been divided into those that would create opportunities to facilitate consolidation in the distribution sector and those that create opportunities for operational improvements (i.e. scope & scale).

1. FACILITATING CONSOLIDATION

- The Board's policy with respect to MAADs should allow distributors to recover costs and keep efficiency savings for more than 5 years or beyond the period of 1st rebasing following a MAADs transaction.

  Distributors reported that one of the reasons for not considering consolidation is the risk that transaction costs would not be recovered with the 5 year timeframe or that the shareholder would not benefit from any efficiency savings. Due to the fact that any savings would go back to the ratepayer at the next rebasing rate proceeding, shareholders are concerned that they would not have the time to recoup transaction costs or other productivity investments.

  Distributors suggested that the Board develop a rate-setting approach that would allow distributors to continue to recover transaction costs, or efficiency savings, beyond the first rebasing period after a MAADs transaction or allow consolidated distributors to delay rebasing beyond the 5-year period.

- Where a consolidated distributor goes beyond an initial 5-year rebasing period, the Board should allow a distributor the ability to include increased capital expenditures in rate base between periods of rebasing.

Distributors raised the issue of how capital investments between rebasing periods are treated if distributors elect to stay out longer to recover efficiency savings. Distributors explained that the longer period between rebasing may mean that they would have issues with being able to finance capital expenditures. Also, if increases in capital assets are added to the rate base in large lump sums (i.e., every five years or longer), this can result in larger one-time increases in rates. In the view of distributors, consolidations are largely seen as generating operational savings and capital is less affected and should therefore be recovered.

Distributors suggested that the Board consider a mechanism that would allow ongoing capital expenditures to be factored into rates following a consolidation without requiring a full rebasing.

- <u>The Board approach to service area amendments should give consideration to promoting the growth of the local/urban distributor.</u>

A number of distributors expressed concerns that the Board's current service area amendment practice gives preference to the incumbent distributor (i.e. the distributor who is licensed to provide service in the area). According to distributors, this is so even in cases where the area being developed, while in the incumbent's licensed service area, is currently not physically serviced by the incumbent, but does lies within the municipality boundary of the local/urban distributor.

These distributors suggested that it would be more efficient to allow the local/urban distributor to serve areas where the incumbent distributor does not currently have assets. However, local/urban distributors argued that they are limited in their ability to expand their service territory because the Board's practice places the onus on them to justify the expansion.

- <u>The Distribution System Code requirement to eliminate existing load transfers between distributors by June 2014 should be reviewed.</u>

Distributors suggested that the existence of long term load transfers adds to the efficiency of distributors and that the Board's requirement to eliminate these business arrangements may lead to greater inefficiencies and increased costs for ratepayers. Distributors and some other stakeholders suggested that the policy should be reviewed in light of changes to the sector.

- Premiums paid for assets should be permitted to be included in rate base.

  Distributors suggested that that as the buyer in an acquisition typically pays a premium for the assets purchased, there should be consideration of a policy that allows the purchaser to recover the premium as an asset in rate base. Such a policy would provide distributors and their owners with greater certainty of recovery of the premium which is the recognition of the value of the assets.

2. FACILITATING OPERATIONAL EFFICIENCY (SCOPE & SCALE)

- Allow distributors to provide services in other service areas at the request of the incumbent distributor, through a change in the licensed service area.

  Currently, distributors can provide distribution services only within their licensed service areas. Distributors suggested that if they were allowed to provide and share services with other distributors, efficiency for both the service provider and the recipient could be enhanced. Distributors recommended that the Board consider amending licence conditions to provide for service areas that overlap.

- The ARC should be revised with the purpose of permitting greater use of distributor resources.

  One of the options for the shareholder of a distributor is to create an affiliate through which services can be provided. However, distributors view the restrictions set out in the ARC make creating and operating an affiliate inefficient. Distributors cited several specific provisions of the ARC that they see as creating barriers to operational efficiencies, and suggested the following:

  - Allow unlimited sharing of distributor employees with an affiliate which is engaged in providing utility-type services (e.g. street lighting, water and waste water billing) or providing services to other distributors.

    If an affiliate is ultimately needed to provide a service, distributors believe it would be more efficient to utilize distributor staff, where necessary, to provide the service. However, with one exception the ARC provisions do not allow employees to be shared with an affiliate who is an energy service provider if the employee is directly involved in collecting, or has access to, confidential information. A number of distributors expressed the view that this restriction on employee sharing is unnecessary and not relevant to the activities which might be carried out by an affiliate. In their view, in many instances, the customer information which utility employees have access to would not confer any benefit to the employees conducting work on behalf of the affiliate.

- <u>Allow contracts between distributors and affiliates to be for terms longer than 5 years.</u>

  Distributors suggested that the general limitation on contract length in the ARC and the requirement to go through a re-bidding process after 5 years leads to inefficiency in contracting. The 5-year term is viewed as insufficient to allow for the recovery of start-up costs by the entity providing the service. Several distributors argued this rule puts the affiliate at an unfair competitive disadvantage relative to other bidders when it comes to the point of contract renewal.

- <u>Allow distributors to sell services to an affiliate on a “benchmark” basis rather than based on fully-allocated cost.</u>

  A number of distributors indicated that the transfer pricing requirements in the ARC are unduly restrictive. Distributors suggested that the Board consider amending the ARC to permit the use of benchmarking, as an alternative to fully allocated costing, for the purpose of establishing a reasonable transfer price.

- <u>Revenue from non-distribution activities should but be not used as revenue offset for rates.</u>

  Distributors suggested that eliminating the policy of requiring distributors to offset their distribution revenue with non-distribution revenues (such as those earned from billing for water services) would provide an incentive to both a shareholder and distributor to undertake non-distribution activities more often, which can reduce electricity distribution costs.