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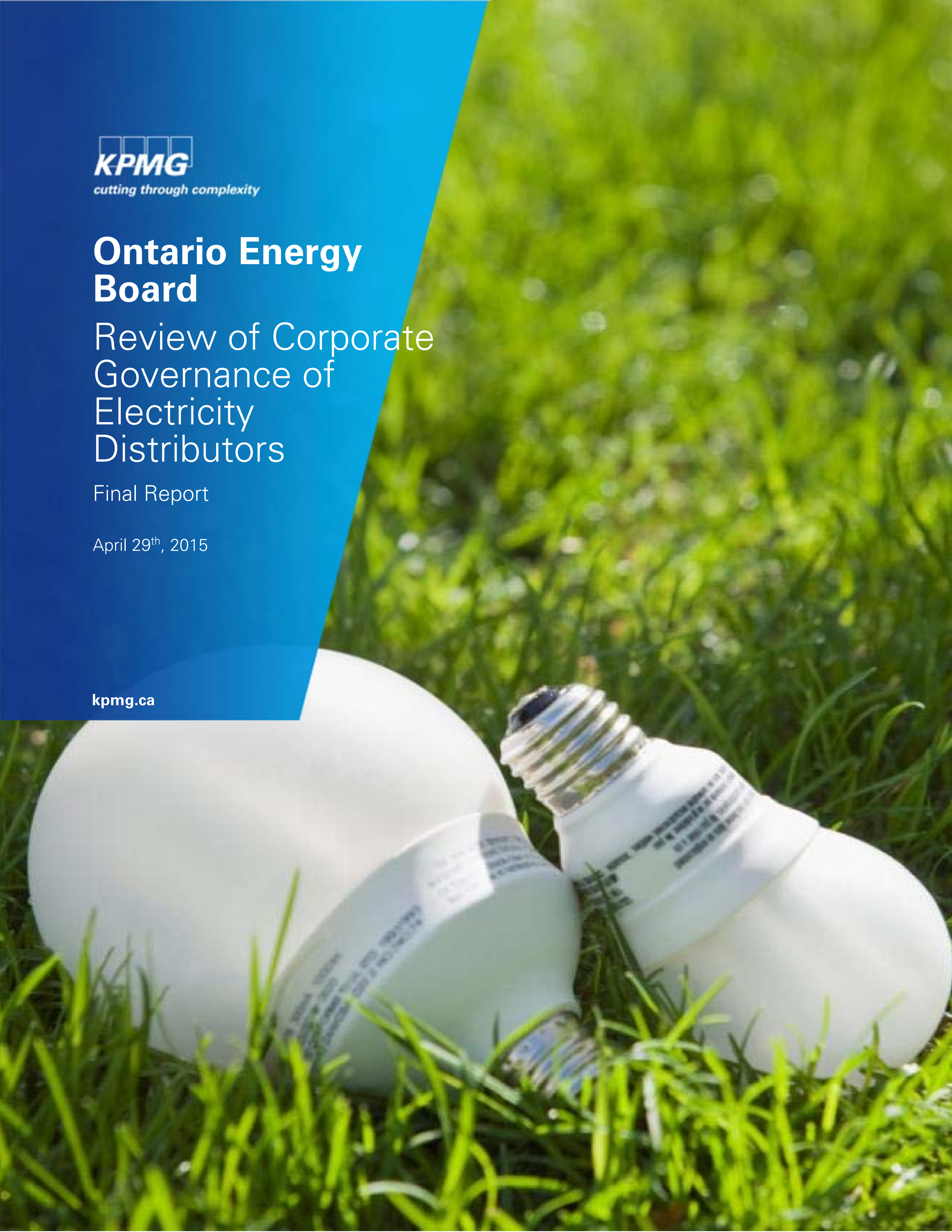
Ontario Energy Board

Review of Corporate Governance of Electricity Distributors

Final Report

April 29th, 2015



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Executive Summary

The Ontario Energy Board (OEB) is seeking to understand what leading practices are in place for corporate governance of local electricity distribution companies (LDCs) in the Province of Ontario. In addition, the OEB is also seeking greater insight into corporate governance requirements for regulated entities by regulators in other jurisdictions. To do this, the OEB engaged KPMG to undertake a regulatory jurisdictional scan of similar bodies, and to specifically engage with randomly selected LDCs within the OEB's jurisdiction to gain a deeper perspective. The jurisdictional research was subsequently expanded to include a review of corporate governance regulatory requirements for the financial services and securities industries. The research project has three distinct objectives:

- Assessment of the corporate governance structures and practices that are currently in place for electricity distributors;
- Jurisdictional review of leading practices; and
- Consultations with stakeholders, focusing on organizational structure and corporate governance policies.

Taken together, the objectives for all the components are to allow the OEB to gain a clear understanding of the definition of good governance for electricity distributors. The research may also provide opportunities for the OEB to determine if there are any opportunities to refine the LDC regulatory model based on leading corporate governance practices and experiences of other regulators.

Jurisdictional Regulatory Research Conclusions

The following are key conclusions that can be drawn from the jurisdictional research:

1. The OECD *Principles of Corporate Governance* was published in 2004. The principles are foundational for corporate governance effectiveness in both the energy and financial sectors. For energy regulators, there is broad variance for corporate governance requirements and expectations. Entities are governed by a range of existing regulation, based on the jurisdiction. Bedrock principles often include independence, transparency, and accountability. However, for energy regulators, in general, corporate governance guidance and requirements and methods to demonstrate effectiveness lag the financial and securities industry;

2. The financial and securities sector, particularly in the securities regulation sector, which has historically faced concerns surrounding integrity and adherence to regulation, requires significantly more filings than does the average energy regulator. As a result, it can be interpreted that filing

requirements should be determined by past entity behaviour, in an effort to remain non-intrusive but also address the particular challenges of the environment;

3. Filing requirements, in their nature, are past-facing and reactive. Requirements are often treated as a compliance checklist – provided that the documentation has been filed, the organization has "passed" for the year. Lessons from the financial sector, however, encourage a more proactive and targeted examination of regulated entities, where organizations that have changed their business strategy, made significant acquisitions or investments, increased risk-taking behaviour or are evolving their management-board relationship are examined in further detail. In the case of the financial sector, if these behaviours had been flagged by regulators at an earlier date, rather than ignored due to consistent fulfillment of filing requirements, regulators may have been able to intervene and take action prior to the failure of institutions. This has important implications for the LDCs in Ontario. They are highly variable in terms of their size and resources. Additional regulatory filing requirements may not have the overall desired effect of further aligning corporate governance practices of the sector with the OECD principles; and

4. In the case of energy regulation, this may mean examining key strategic and operational decisions such as new investments, partnerships, changes in affiliate strategy, increased financial or operational risk or a substantial change in Board independence. Simply increasing the number of filings or artifacts required is by no means a method of preventing unwise risk taking behaviour through ineffective strategic and/or major operational decisions.

LDC Research Conclusions

The following conclusions have been drawn from the LDC research and interview process. They are categorized according to the following themes:

- The LDC Corporate Governance Landscape;
- Corporate Governance Regulatory Guidelines & Filing Requirements; and
- Municipal Shareholder LDC Board Representation.

The LDC Corporate Governance Landscape

1. LDC corporate governance, from a Board composition perspective, is highly variable across the Province. It ranges from highly independent Boards supported by a professional skills and experience base representative of the major business requirements including strategy, knowledge of the utility industry, finance, legal/regulatory, customer service, health, safety and environment, etc. to those whose Board members are primarily

representatives of the municipal shareholder (councilors and/or town/city administrators); and

2. Conclusions about the overall effectiveness of an LDC's performance cannot be necessarily derived from its corporate governance makeup or the degree of Director independence. Performance is a by-product of Board decision making effectiveness, strategy, risk-taking behavior, operational, financial and regulatory management practices and unforeseen significant events;

Corporate Governance Regulatory Guidelines & Filing Requirements

3. It was generally recognized by the interviewees that adherence to the OECD principles of accountability, transparency and independence is foundational to effective corporate governance of the LDCs. The OEB, not unlike other energy regulators, does not publish a code or guideline specifying requirements for corporate governance for LDCs. It does have specific filing requirements for corporate structure and governance requirements. The Affiliate Relationships Codes issued by the OEB specify independence requirements for Board members of the regulated entity; and

4. LDCs have different corporate governance practices. This can be the result of their size, ownership structure, degree of municipal shareholder influence, complexity of the structure and operations, corporate strategy, and risk profile. A focus purely on the structure or artifacts of corporate governance may not help the OEB further mature its regulatory oversight of the LDCs.

Municipal Shareholder Board Representation

5. Many LDCs have a hybrid governance structure in place with Boards comprised of both independent Directors and those who are Councilors or city/town administrators. However, this can be challenging to Board independence and decision-making depending on the degree of municipal shareholder influence and control that is exercised locally. In keeping with OECD principles, it is incumbent upon a municipal shareholder to act *as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance…is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness; and*

6. Corporate governance maturity can face significant challenges including access to local Board nominees who possess the requisite skills and experience to govern an LDC, compensation and the degree of municipal shareholder influence on the Board. These challenges are further compounded if access to ongoing training and education of the Board is limited.

Recommendations

The following are recommendations for consideration by the Ontario Energy Board to assist the LDCs with maturing their corporate governance in lockstep with leading practices. There are many variables and influencing factors which can impact the overall performance of an LDC. However, an overall advance of governance practices within the LDC environment, over time, will provide the OEB with a stronger risk and evidenced-based approach to assessing the impact of improved governance on its regulatory oversight requirements for the sector. They are categorized according to the following themes:

- Corporate Governance Regulatory Guidelines & Filing Requirements; and
- Municipal Shareholder Board Representation.

Corporate Governance Guidelines & Filing Requirements

1. The OEB should establish guidelines for effective corporate governance for the LDCs. This is in keeping with practices established within the financial services sector. The OEB would be a leader amongst energy regulators in doing so. The guidelines should address:

   - The role of the Board of Directors – including oversight and stewardship of the strategic direction of the corporation, acting in the best interest of the corporation, legislative compliance and distinguishing between the role of management and that of the Board;
   - The composition of the Board of Directors – including the qualifications, skills and experience of the members to support the strategic, operational, financial, legal, regulatory, human resources (HR), information technology, customer service, etc. oversight responsibilities of the Board;
   - The unique challenges of corporate governance in a municipal shareholder environment — including conflicts of interest, and the skills and professional experience of Board members to oversee and govern an LDC;
   - Board effectiveness criteria – this would include criteria for the overall effectiveness of the Board as a whole and for individual Board members;
   - The Committee structure and roles and responsibilities (e.g. Audit & Finance, Governance & Risk, HR) – The Audit & Finance Committee focuses on matters of the integrity of financial and regulatory reporting and the effectiveness of the internal control framework. The Governance & Risk Committee typically focus on corporate governance matters including nominations, new member orientation, training and development, Board effectiveness and enterprise risk. Succession should take into consideration the unique challenges of the Board nomination and selection process in a municipal shareholder

environment. The HR Committee focuses on compensation and performance issues;

- Strategic planning requirements – including requirements for Board engagement, involvement in the development and performance reporting of the strategic plan;
- Risk governance and enterprise risk management – including Board oversight responsibilities of the enterprise risk management framework and supporting assessment, mitigation, monitoring and reporting requirements of management to the Board;
- Management reporting to the Board – this would include financial and regulatory reporting, progress against the strategic plan, operational key performance indicators including customer satisfaction, health, safety and environment, infrastructure performance and replacement, emergency response and crisis management, etc.; and
- The Role of Corporate Governance in the OEB's regulatory process – including how the guidelines can be supported through a self or third party assessment process with periodic examination of the governance practices by the OEB.

2. The OEB should strive to ensure that its regulatory oversight for corporate governance provides substantive evidence that the LDCs are maturing in this regard and are in lockstep with leading practices. The OEB can consider the following alternatives:
   - Periodic independent assessment (e.g. 2-3 year cycle) of the LDCs corporate governance practices against leading practices and/or guidelines established by the OEB. The assessment should be risk-based incorporating criteria that can assess the governance, operational, financial, regulatory and reputation risk that an LDC poses; and
   - An accreditation system by an independent accreditor organization that would assess the overall effectiveness of LDC corporate governance on a periodic basis. The accreditation model is common in the health care sector and can be used to measure an organization's capability in terms of operational effectiveness, health & safety and risk management as well.
3. The OEB should monitor leading behavioural indicators which may also be reflective of the effectiveness of overall corporate governance and decision-making effectiveness of an LDC. These indicators may include:
   - significant changes in the business strategy;
   - acquisitions or major investments;

- increased risk-taking behaviour;
- increased operational, health, safety or environmental incidents or;
- major changes to the Board composition.

Municipal Shareholder Board Representation

4. The OEB should encourage alternatives to reducing potential conflicts of interests of Board members who are municipal councillors or administrators. Alternatives can include:
   - Restricting municipal representation to the holding company level where the focus is primarily on the overall strategy of the LDC and the affiliates and the anticipated the return to the municipal shareholder; and
   - Providing required alternative forums for municipal councils to discuss, debate and question the Board and management team of the LDC on its overall strategic direction, operational effectiveness and return to the shareholder. This could occur through regularly scheduled appearance before Council or a Committee of Council.
5. The OEB should explore opportunities to ensure that the nominating process for Board members is conducted in an open, transparent and effective manner. This should be consistent across all LDCs. It should be based on explicit professional/experience/education and personal attributes criteria. The process should be inclusive of existing Board members and representatives of the municipal shareholder to achieve both independence and competency requirements of new Board members.
6. The OEB should actively encourage ongoing training and development of Board members through organizations such as the Institute of Corporate Directors, the Directors College, academic institutions, utility industry specific events and conferences and specialized regulatory awareness sessions that the OEB could offer to Board members.
7. The OEB should further examine the impact of the Board independence requirements under the Affiliate Relationships Code.

Context for the Research and Requirements of the Ontario Energy Board

The Ontario Energy Board (OEB) is seeking to understand the corporate government practices that are currently in place for local electricity distribution companies (LDCs) in the Province of Ontario. In addition, the OEB is also seeking greater insight into corporate governance requirements for regulated entities by regulators in other jurisdictions. To do this, the OEB engaged KPMG to undertake a regulatory jurisdictional scan of similar bodies, and to specifically engage with randomly selected LDCs within the OEBs jurisdiction to gain a deeper perspective. The jurisdictional research was subsequently expanded to include a review of corporate governance regulatory requirements for the financial services and securities industries.

Project Background

The importance of sound corporate governance has been increasing both from a regulatory and a public opinion perspective. Emphasizing this is a 2012 report prepared by the Ontario Distribution Sector Review Panel, titled *Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First*. In this, the panel states that given the importance of electricity distribution to the province's economy, it is extremely important that the Boards' of Directors of regional distributors display a high standard of corporate governance.

In addition to this external impetus, the OEB has recognized that a clear understanding of the present state of governance within Ontario's local distribution companies is important. Specifically, a greater awareness of the drivers and impacts of varying governance structures is essential. Seen in this way, the Corporate Governance Review project is a part of a long-term strategy to recognize good governance in the distribution sector, to encourage good governance that can inform and be relied upon in the OEB's regulatory review processes.

Project Objectives

The project has three distinct objectives:

- Assessment of the corporate governance structures and practices that are currently in place for electricity distributors;
- Jurisdictional review of leading practices; and
- Consultations with stakeholders, focusing on organizational structure and corporate governance policies.

Taken together, the objectives for all the components are to allow the OEB to gain a clear understanding of the definition of good governance for electricity distributors. The research may also provide opportunities for the OEB to determine if there are any opportunities to refine the LDC regulatory model based on leading corporate governance practices and experiences of other regulators. The research should provide the OEB with an understanding of how regulators globally understand, assess/monitor, and regulate corporate governance structures. The findings here will aid in understanding the governance of the entities that the OEB regulates and potentially allow for the evolution of the use of corporate governance as a regulatory tool for the OEB's review mandate.

Our Approach and Methodology

Corporate Governance Leading Practices

Corporate governance can be characterized by three key bodies: the shareholder, the Board of Directors, and the management. The interactions and responsibilities of these three bodies are foundational to enacting the rules, practices, and processes that define corporate governance.

Shareholder

The role of the shareholder[1] is to invest in the corporate strategy and direction, and this is achieved through a number of means. Shareholders have the ability to influence major strategic decisions through exercise of their voting right, as attached to shares, at shareholder meetings. They may also be responsible for electing Board members and thus mandate the size and composition of the Board.

For non-publically traded distribution companies in Ontario, shareholders typically are more closely involved with the business and have a higher likelihood of influencing strategic direction than do shareholders of most publicly traded entities. This is due to the fact that the key shareholder is typically the municipality and it thus acts with concerns broader than those that are simply fiduciary. Examples of specific shareholder involvement with Ontario LDCs are discussed in depth in the "Detailed Corporate Governance by LDC Sample" section.

Board of Directors

The Board of Directors, as defined by Industry Canada, is responsible for supervising the activities of the corporation and making decisions regarding those activities. This encompasses a number of tasks, including:

- **Strategic planning and succession planning**: adopting and developing a strategic planning process and plan, and coordinating succession planning and knowledge transfer for new executives and Board members;
- **Risk management**: identifying business risks and developing appropriate risk management strategies;
- **Communications**: adopting a communication policy and internal control and management information systems;
- **Executive management**: selecting executives and delegating expectations and responsibilities to enact strategy;

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[1] Definitions for terms can be found in Appendix 1.1

- **Continuing education**: providing continuing education and training for all other Board directors;
- **Assessments**: regular assessments regarding effectiveness and contribution (applies to committees as well); and
- **Conduct and ethics**: adopting a written code of business conduct and ethics across principles including conflict of interest, confidentiality, regulatory compliance, and reporting of illegal or unethical behavior.

Different Boards will undertake these tasks to varying degrees, dependent upon situation and governance structure. However, for a Board to be successful, all elements must be given consideration, even if only within the context of prioritizing key areas of focus.

Management

Management is the body that provides stewardship for the company and enacts the strategy articulated by the Board and supported by the shareholders. The cornerstone of this is day-to-day operations: the management is responsible for overseeing routine business affairs, including operations, strong performance in the marketplace, and strong performance against regulatory requirements and relative to competition, if relevant. Typically, the Board will also dictate responsibilities which the management team must be sure to fulfill.

Beyond the day-to-day responsibilities, management is also obligated to ensure the smooth functioning of all internal processes and management of interested parties and employees. Through regular dialogue with the Board of Directors, management supports the development of business plans, budgets, and goals that lead to the creation of shareholder value; regular dialogue also helps to ensure that the Board is kept abreast of current news from the business. Management also is responsible for the delivery on these plans through employee management, which should allow employees to align and execute on the strategy that has been set. Finally, management needs to maintain an effective system of internal controls to ensure the integrity and objectivity of company information.

It is worth noting that management and the Board must work together to make the best decisions for the organization as a whole. In the case of a tacit Board, management will lack the appropriate checks and balances to ensure strong operational behaviour. Beyond this, management and the Board must be governed by the same principles and values. It is the role of the regulator to ensure that these principles and values also align with what is best for the consumer and policy objectives.

Corporate Governance Evaluation Criteria

When performing the jurisdictional scan and in-person interviews, a set list of criteria for each of the three bodies outlined above was defined. This criteria helped to focus on the key areas of difference and similarities between each entity, as well as provided insight into the effectiveness of each body. Criteria was developed using input from the Directors' Toolkit published by KPMG Australia, the UK Corporate Governance Code, the OECD Principles of Corporate Governance and the OECD Guidelines on Corporate Governance of State-owned Enterprises.

While not exhaustive, the criteria provides a solid framework with which to structure thinking and approach for the research. Within the context of the jurisdictional research, the criteria was used as guiding direction for areas to explore further within different entities. However, for the LDC comparator research, the criteria listed was used explicitly to evaluate and compare entities.

Shareholder

Criteria considered were:

- **Independence:** evaluation of Shareholder's role in exercising responsibilities;
- **Remuneration:** analysis of the structure and transparency of policies surrounding Board of Directors and executive remuneration packages;
- **Board of Directors and management performance assessment:** frequency and objectivity of the Board of Directors, respective sub-committee, and management performance evaluations; and
- **Appointment of new directors**: evaluation of transparency of selection process in addition to onboarding and training protocol for new members.

Board of Directors

Criteria considered were:

- **Director conduct:** documents and processes governing director behavior;
- **Committee structure:** types of additional committees and relevant duties;
- **Director elements:** including Board size and composition (external* vs. internal members); remuneration; criteria for / skills required by Board members;

***NOTE**:

For this research, **EXTERNAL** in the context of a Board member refers to Board members who are **NEITHER** a representative of the shareholders nor of the management team.

Boards should be executing decisions independently and in the best interests of the corporation & the shareholders.

- **Meeting frequency:** number of meetings required and/or number of meetings in the past year;
- **Role in strategic planning:** Board of Directors' role in guiding corporate strategy and reviewing annual budgets or business plans;
- **Orientation and continuing education**: resources and programs provided by directors, as well as other knowledge management initiatives;
- **Self-assessment:** existing structure to evaluate Board effectiveness and expected follow-on actions; and
- **Risk management protocol:** adherence to and evaluation of risk management systems and the Board of Directors' role in risk oversight responsibilities.

Management

Criteria considered were:

- **Board of Directors' delegations to management:** evaluation of management's ability to execute on the Board of Directors' delegations and ensure that the Board of Directors is not acting in a day-to-day management capacity; and
- **Liaison to the Board of Directors and shareholder:** effectiveness of the formal communications by management to the Board and with other relevant interested parties.

Jurisdictional Regulatory Entities - Research Method

The regulatory entities chosen for the jurisdictional research were identified through discussion between the OEB and KPMG. Entities were selected from across Canada, US, UK and Australia to identify instances where the governance practices of regulated entities by regulatory bodies may be applicable or provide insight to the OEB.

The jurisdictional research was conducted in a two phase process. First, comparable energy regulators were examined to gain insights into whether or not they had established or were establishing requirements or guidelines for corporate governance for their regulated entities. Second, three leading regulators in the financial services industry and securities administration were also researched. These additional entities are representative of an industry which faces much stricter and more explicitly defined regulation for corporate governance. Although the nature of the regulation and the need for it varies between the energy and financial services and securities industries, leading practices for corporate governance were identified and provide useful input to the OEB and its regulatory oversight mandate.

Ontario Electricity Distributors - Research Method

The broad Ontario electricity distributor landscape, encompassing over 70 distributors, was initially narrowed to approximately twenty distributors for a review of publically available information. These twenty were chosen to gain a representative sample of the breadth of the Ontario LDC landscape, which includes wide variance in size and scope.

From these twenty, seven sample comparators were highlighted for detailed research and in-person interviews in order to gain a more detailed understanding of how corporate governance is being practiced for these entities. These seven were chosen through a process which took into account size, location, ownership and corporate structure in an effort to provide a broad and holistic view of the Ontario LDC governance landscape.

For these seven comparators, initial research was conducted using secondary sources. Following this, interviews with distributor leadership helped to confirm key points of research and allowed the distributors to provide insights into the respective governance structures, processes and challenges that they are facing.

Jurisdictional Research

Objectives

The intent of the jurisdictional research is to provide the OEB with an understanding of how other regulators define, assess/monitor, and regulate corporate governance within their regulated entities.

Energy sector regulators within and outside of Canada were researched in an effort to gain an understanding of their requirements for corporate governance for their regulated entities. A similar exercise was conducted for entities in financial services and security regulation.

Summary of Findings

Energy Sector

The following Canadian regulators were researched:

- Alberta Utilities Commission (AUC);
- Nova Scotia Utility and Review Board (UARB); and
- Québec régie de l'énergie.

While relevant, none of these provided a clear solution to the question of corporate governance. Each of the three used a Code of Conduct to provide a framework for the Governance of the regulator itself, or to provide specific expectations for the relationship between the regulator and the distributor

Rather than imposing clear corporate governance values on regulated entities, the researched regulators focused on regulation of dealings with customers. A possible hypothesis is that the fairness and effectiveness of customer transactions would be the ultimate goal of regulated entities; sample regulators emphasized the indicators of this, rather than using corporate governance as a proxy.

Filings varied between entities, with the most that was stated as required being an annual report with details on financials.

Following the Canadian provincial regulators, international regulators were researched to gain a broader understanding of corporate governance requirements. The entities researched were:

- Australian Energy Regulator (AER);
- Federal Energy Regulatory Commission (FERC); and
- Office of Gas and Electricity Markets (Ofgem).

A key finding was that none of these international energy regulators had explicit corporate governance requirements or guidelines in place for their regulated entities, although they did provide more robust guidance than the Canadian provincial regulators did. There are examples where the regulators encourage more transparency, compliance, and access to the entity's Board of Directors. For example, the US-based Federal Energy and Regulatory Commission has mandated that utilities submit a compliance filing demonstrating that it has a process in place that allows customers and other interested parties direct access to the Board of Directors.

Entities in Energy Regulation

Three areas from each entity were examined using publically available information:

- **Corporate governance values and codes of conduct**, typically from a code of conduct or stated values, to build an understanding of foundational expected behaviours. For example, in Ontario, distributors regulated by the OEB are currently governed by the Affiliate Relationships Codes, which set out standards and conditions for interactions between electricity distributors, gas distributors, transmitters and storage companies, and their respective affiliated companies, and includes standards for Board independence, separation between utilities and affiliates, and governance of financial transactions with affiliates;
- **Guiding documentation**, to understand how behaviours are enforced and standards are set; and
- **Filing requirements**, to understand expectations for utilities in demonstrating compliance with set standards for governance.

Australian Energy Regulator (AER)

The AER regulates energy markets and networks under national energy market legislation and rules, primarily related to energy markets in eastern and southern Australia. It enforces rules that are set by the Australian Energy Market Commission, especially in the National Energy Market and gas markets as operated by the Australian Energy Market Operator (AEMO).

The AER works closely with the Australian Competition and Consumer Commission to address misconduct in the energy market. Regulated entities determine their own Board structures and methods for compliance, but must provide filings for activities such as capital expenditure evaluation and review of financial planning. The AER collects information on economic benchmarking and annual reporting from regulated businesses using Regulatory Information Notices, which require statements and documents highlighting performance; it supplements this with targeted reviews.

Element	
Corporate governance values	AER's key values, for itself, include: • Encourage an overall culture of compliance through education, open publications, and active stakeholder engagement; • Use principles- and outcomes-based decisions when creating policy; and • Be a high performing and consultative agency that promotes long-term consumer interests while minimizing compliance costs.
Relevant documentation and enabling legislation	**National Electricity Law** **Natural Gas Law** **National Energy Retail Law and Rules:** gives AER the power to ensure compliance by energy business with obligations by monitoring compliance, investigating breaches, and initiating court proceedings.
Filing requirements	**Targeted compliance reviews** of provisions of national energy laws check baseline compliance. **Exception reporting arrangements** mean that energy business must report to the AER when it appears they may have breached legal obligations outlined under the AER's Retail Law and Rules; length of time after which breach must be reported depends on severity of breach. While there is no information on governance-specific filing requirements, **general information on the importance of fostering a culture of compliance** is readily available.[2]

Federal Energy Regulatory Commission (FERC)

FERC is an independent agency that regulates the interstate transmission of electricity, natural gas, and oil in the United States. It is independent from parties, and all FERC decisions can be appealed. FERC focuses primarily on transmission, transportation, and sales of energy, and accordingly has regulations in place to govern affiliate conduct and relations with customers and providers. However, as with the above regulators, FERC does not have explicit corporate governance requirements or guidelines in place for its regulated entities.

Responsibilities include:

- Regulating sales of electricity in interstate commerce;

[2] AER Compliance and Enforcement: Statement of Approach, 2014

- Reviewing mergers and acquisitions by electricity companies;
- Regulating the transportation of oil by pipeline;
- Licensing and inspecting hydroelectric projects; and
- Overseeing environmental matters related to these projects.

Element	
Corporate governance values	The commission has placed a strong emphasis on independence and transparency. Guiding principles for FERC itself include: • Organizational excellence; • Due process and transparency; • Regulatory certainty; • Stakeholder involvement; and • Timelines.
Relevant documentation and enabling legislation	**Electric, hydropower, and general statutes**, e.g. Energy Policy Act of 1992, Federal Power Act **Natural gas statutes**, e.g. Natural Gas Policy Act of 1978 **Oil statutes**, e.g. Interstate Commerce Act **Environmental and other statutes,** e.g. Clean Air Act, Clean Water Act **Affiliate Restrictions (2008):** govern the relationship between the franchised public utility with customers and its market-regulated power sales affiliate, including independence.
Filing requirements	In addition to regulatory filing requirements, the Commission also mandated that utilities submit a **compliance filing** demonstrating that it has a process in place that allows customers and other stakeholders' direct access to the Board of Directors to increase responsiveness to customers and other stakeholders.[3]

[3] In order 719-A, the Commission established an obligation for each RTO and ISO to establish a means for customers and other stakeholders to have a form of direct access to the RTO or ISO board of directors, and thereby, increase its responsiveness to customers and other stakeholders.

The Commission stated that it will assess each RTO's or ISO's compliance filing using four responsiveness criteria: (1) inclusiveness; (2) fairness in balancing diverse interests; (3) representation of minority positions; and (4) ongoing responsiveness.

The Commission also directed each RTO and ISO to post on its web site its mission statement or organizational charter.

Office of Gas and Electricity Markets (Ofgem)

In Great Britain, the Gas and Electricity Markets Authority (GEMA) sets strategy and policy priorities, and makes decisions on a regulatory matters such as price controls and enforcement.

GEMA governs Ofgem (Office of Gas and Electricity Markets of Great Britain), which functions as an independent National Regulatory Authority aimed at protecting interests of existing and future electricity and gas consumers. Ofgem's requirements with regards to the licensed companies are part of standard license conditions of the companies.

Until recently, Ofgem's corporate governance requirements for network companies centered on good financial governance. Requirements introduced by Ofgem in 2013 expand beyond previous "ring-fence" regulation designed to give early warning of financial pressures to consumers, such as cash flow restriction in times of early distress. The new regulations mandated major network licensees to have two sufficiently independent directors on their Boards in order to prevent conflicts of interest.

Element	
Corporate governance values	Transparency is a foundational value of Ofgem, which leads to practices such as: • Provision of full consultation opportunities for interested parties in approach, strategy, etc.; • Holding workshops and briefings for interested parties; and • Adherence to the principles of accountability, simplicity, and coherence in all communications and documents. Core values are: • Dedication; • Integrity; • Determination; and • Transparency. Non-exec members of GEMA must bring expertise in areas such as industry, economics, consumer and social policy, science and the environment, finance, and European energy issues. Independence of at least two Board members is required for network companies as part of Ofgem's licensing requirements.
Relevant documentation and enabling legislation	**Various energy acts,** e.g. Gas Act 1986, Electricity Act 1989, Utilities Act 2000, Competition Act 1998, Enterprise Act 2002 Internally, Ofgem creates an annual **Simplification Plan**, which lists the projects proposed for the year to support efficiency,

	regulatory processes, industry-facing regulation, customer-facing regulation, and regulatory strategies
Filing requirements	Filing requirements are specified by individual codes relevant to licenced companies. For example, some sample requirements of electricity distributors are: • A requirement to send a report on the outcomes and proposed changes to the Distribution Code after every review; and • Specific certificates, signed by the Board of Directors, in relation to financial resources. General guidelines restrict licensee relations with other companies and advise on financial holdings and treasury management; these suggest looking to "best corporate governance" for guidance rather than prescribing specific actions from the Board of Directors. The approach and expectations in relation to regulatory compliance is laid out in Ofgem's **Open Letter**, which shares tools and resources that Ofgem can provide to licensees to increase company engagement and encourage compliance with licence conditions or the requirements of consumer protection or competition legislation. Principles of compliance include: • Responsibility for compliance rests with Board of Directors of companies being regulated, and information must be accurately collected and reported to stakeholders and to Ofgem where relevant; • Ofgem will ensure clarity of regulatory requirements; • Ofgem will ensure the effective allocation of regulatory resource; • Ofgem will use appropriate incentives and interventions to secure compliance, meaning that approach and regulatory interventions, including investigations, will recognize that issues may differ in urgency, complexity, potential consumer or market detriment and between different types of regulated person; and • Ofgem will work in collaboration with others where appropriate. Targeted reporting, site visits, and independent auditors are used to ensure compliance.

Entities in Financial Services & Securities Regulation

The initial research of the energy regulators did not reveal substantive or explicit corporate governance requirements or guidelines that are imposed upon the regulated entities. Discussions with the OEB resulted in KPMG expanding the research to include leading financial services and securities regulators. Their practices and requirements may present opportunities for the OEB to consider as it assesses the role that corporate governance can play in the regulatory model for LDCs going forward.

The following regulators were researched:

- The Office of the Superintendent of Financial Institutions Canada (OSFI);
- The Ontario Securities Commission (OSC); and
- The US Securities and Exchange Commission (SEC).

The regulators of the financial services sector are more explicit than the energy regulators about corporate governance requirements for regulated entities. This is largely in response to the number of large-scale corporate failures, investigations and litigation that the industry has faced over the last twenty years. Organizations such as the OSC, the SEC and OSFI have established explicit requirements for corporate governance for their regulated entities which is supported by corresponding financial services, securities and regulatory legislation. For example, in January 2013, OSFI established a *Corporate Governance Guideline* which focused on three fundamental components of corporate governance for financial institutions including:

1. The role of the Board of Directors;
2. Risk governance; and
3. The role of the Audit Committee.

Office of the Superintendent of Financial Institutions (OFSI)

OSFI was created in 1987 to regulate and supervise Canadian financial institutions and private pension plans subject to federal oversight, to help minimize undue losses to depositors and policyholders and, thereby, to contribute to public confidence in the Canadian financial system. It is an independent, self-financing agency that reports to Parliament through the Minister of Finance. OSFI regulates and supervises all banks in Canada, and all federally incorporated or registered trust and loan companies, insurance companies, cooperative credit associations, fraternal benefit societies and private pension plans. OSFI's mandate does not include consumer-related issues or the securities industry.

Effective corporate governance is an essential element in the safe and sound functioning of financial institutions.

OSFI's Corporate Governance Guideline (Guideline), which was initially published in 2003, applies to all federally-regulated financial institutions (FRFIs) except the branch operations of foreign banks and foreign insurance companies. The purpose of the guideline is to communicate OSFI's expectations with respect to corporate governance of federally-regulated financial institutions. In 2010, OSFI established a dedicated Corporate Governance Division to review FRFI practices and to ensure FRFI compliance with the Guideline. The Guideline was updated in January 2013.

The main objectives of the revised Guideline are to:

- Ensure that FRFIs have prudent corporate governance practices and procedures that contribute to their safety and soundness;
- Promote industry best practices in corporate governance;
- Be consistent with OSFI's Supervisory Framework (2011); and
- Address international standards, as articulated by organizations such as the Financial Stability Board (FSB), the Organization for Economic Cooperation and Development (OECD), the Basel Committee for Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS).

The purpose of the revised 2013 guideline is to communicate OSFI's expectations with respect to corporate governance of federally-regulated financial institutions (FRFIs). It applies to all FRFIs other than the branch operations of foreign banks and foreign insurance companies. OSFI recognizes that FRFIs may have different corporate governance practices depending on: their size; ownership structure; nature, scope and complexity of operations; corporate strategy; and risk profile.

The revised guideline complements:

- Relevant provisions of the Bank Act, the Insurance Companies Act, the Trust and Loan Companies Act, the Cooperative Credit Associations Act and associated regulations; and,
- OSFI's Supervisory Framework and Assessment Criteria.

Element	
Corporate governance values	In January 2013, OSFI issued a Corporate Governance Guideline for its regulated entities which provides the fundamental components of corporate governance for federally-regulated financial institutions. The guidance focuses on three components of governance: • The role of the Board of Directors; • Risk governance; and • The role of the Audit Committee.

	OSFI has adopted the OECD's principles for corporate governance including: • Corporate governance is a set of relationships between a company's management, its Board, its shareholders and other stakeholders; • Corporate governance is the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined; and • Good corporate governance should provide proper incentives for the Board and management to pursue objectives that are in the best interests of the company and its shareholders and should facilitate effective monitoring.
Relevant documentation and enabling legislation	**Corporate Governance Guideline, January 2013, OSFI:** Covers the suggested requirements for effective governance including the role of the Board of Directors, risk governance and the role of the Audit Committee. The guideline complements relevant provisions of the *Bank Act, the Insurance Companies Act, the Trust and Loan Companies Act, the Cooperative Credit Associations Act* and associated regulations and OSFI's *Supervisory Framework and Assessment Criteria.*
Filing requirements	There are no explicit filing requirements. However, OSFI expected FRFIs to conduct a self-assessment of compliance with the Corporate Governance Guideline and to establish a plan to address any deficiencies. FRFIs should advise their OSFI Relationship Manager in writing of the results of their self-assessment and the related action plans by May 1, 2013. The self-assessments are to be retained by the FRFI and made available to OSFI upon request. Full implementation of the Corporate Governance Guideline by FRFIs is expected by no later than January 31, 2014. For directors of small and medium-sized FRFIs, OSFI offers seminars on the Corporate Governance Guideline commencing in the spring. FRFI Boards will be contacted directly with further details. The revised guideline is intended to support OSFI's Supervisory Framework. The Board and Senior Management are designated as key oversight functions in OSFI's *Supervisory Framework.* OSFI supervises federally-regulated institutions to assess their condition with federal laws and regulations. Supervision is carried out under a risk-based framework. Assessment criteria includes the quality of oversight and control provided by the Board and Senior Management of the financial institution including corporate governance.

Ontario Securities Commission (OSC)

The OSC is an independent Crown Corporation that is responsible for regulating capital markets in Ontario. It aims to protect investors from unfair, improper, or fraudulent practices; and to foster fair and efficient capital markets and confidence in capital markets.

For context, within Canada, each province has its own securities regulator, although the Government is working towards establishing a national securities regulatory system. Legislation is currently being drafted that may allow for a national system, but currently, provinces work together through the Canadian Securities Administrators (CSA) to develop uniform rules and national policies.

Element	
Corporate governance values	The OSC governs itself with three types of values, outlined in a **Code of Conduct**: • **Ethical values**: uphold public trust with a commitment to honesty and integrity consistent with legal and ethical obligations; • **Professional values:** competence, excellence, efficiency, objectivity, and impartiality; and • **People values**: respect, fairness, and courtesy in dealings with public and employees. Regulated entities are not given specific requirements for governance but are required by law to make certain information about activities and financial status available to the public. This includes requirements for accounting and auditing, certification of disclosure to investors, financial statements, and insider reporting.
Relevant documentation and enabling legislation	**Securities Act (Ontario)** **Commodity Futures Act (Ontario)** **Business Corporations Act** **Security Frauds Prevention Act** **OSC Code of Conduct** **Public Service of Ontario Act, 2006** **National instrument 58-101: Disclosure of corporate governance practices** **Registration Requirements, Exemptions, and Ongoing Restraint Obligations:** sets out various financial filing requirements for registrants, other than investment and mutual fund dealers

Filing requirements	Regulated entities must share: • Calculation of the firm's **excess working capital;** • **Annual financial statements** and interim financial information; and • Notice of **change in insurance** / claims made. Disclosures also must be made regarding: • **Identity of directors**, both independent and dependent, and **criteria for independence;** • Whether or not a majority of directors are independent, and if not, what the Board does to maintain independent judgment; • **Board mandate** and position descriptions; • Measures taken for orientation and **continuing education** of the Board; • Steps taken to promote **culture of ethical business conduct;** • Process for **nomination** of directors and **compensation;** and • **Standing committees** beyond audit, compensation, and nominating.

Securities and Exchange Commission (SEC)

In the US, the SEC holds primary responsibility for enforcing federal securities laws, proposing securities rates, and for regulating the securities, stock and options exchanges in the US.

The mission of the SEC is to:

- Protect investors;
- Maintain fair, orderly, and efficient markets; and
- Facilitate capital formation.

Since the 2008 financial crisis, the SEC has seen a large increase in the number of filings from the Enforcement Division, in relation to both individuals and companies.

Element	
Corporate governance values	The SEC has three key principles relating to governance of the companies it regulates, which are tied to different stakeholders: • Encourage transparency, accountability, and engagement with **shareholders;** • Create means for **investors** to register displeasure with Board e.g. through say in executive compensation, etc.; and • Ensure independence and objectivity within **boards.**

Relevant documentation and enabling legislation	**Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010:** Covers broad changes in US regulatory system, including consumer protection, credit ratings, transparency. **Sarbanes-Oxley Act of 2002:** Covers responsibilities of Board of Directors, creates criminal penalties, and requires SEC to create regulations. **Securities Act of 1933:** Covers fraud and access of information for investors; requirements for registration to sell securities. **Securities Exchange Act of 1934:** Covers creation of the SEC and outlines authority of the agency.
Filing requirements	Most US public companies must submit **quarterly and annual reports**, including financial reports, management discussion, and analysis report to outline operations. Sample **compensation requirements** include: • Disclosure of the **role of executive compensation consultants** and independence for members of compensation committees; • Disclosure on **compensation matters** e.g. ratio between CEO compensation and median for other employees; and • **Proof of independence** of directors on compensation committee. Sample **independence requirements** include: • Restriction of companies providing **non-audit services** to audit client to prevent conflict of interest.

Relevance and Applicability

Regulatory bodies in the financial services and securities industries have more robust frameworks which reinforce corporate governance values and principles. Stronger approaches are also in place to evaluate corporate governance effectiveness.

For example the *OECD Principles of Corporate Governance,* which are foundational to leading jurisdictional regulatory corporate governance frameworks, reflect the following six key principles:

I. Ensuring the Basis for an Effective Corporate Governance Framework

> The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the

division of responsibilities among different supervisory, regulatory and enforcement authorities.

II. The Rights of Shareholders and Key Ownership Functions

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

III. The Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

IV. The Role of Stakeholders in Corporate Governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

V. Disclosure and Transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

VI. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

In the subsequently *published OECD Guidelines on Corporate Governance of State-owned Enterprises, 2005,* the following principle was added:

The boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.

Similar to the OECD principles, The UK Corporate Governance Code emphasizes the following:

- *The objective of corporate governance is to facilitate effective and prudent management that can deliver the long-term success of the company;*
- *Boards of Directors are responsible for the governance of their companies;*
- *The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting;*
- *Corporate governance is therefore about what the board of a company does and how it sets the values of the company, and is to be distinguished from the day to day operational management of the company by full-time executives;*

The revised OSFI corporate governance guideline (2013) also reflects the OECD principles. The preamble to the guideline states:

The Organization for Economic Cooperation and Development (OECD) defines corporate governance as: "a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring."

Appropriate organizational structures, policies and other controls help promote, but do not ensure, good corporate governance. Governance lapses can still occur through undesirable behaviour and corporate values. Effective corporate governance is not only the result of "hard" structural elements, but also "soft" behavioural factors driven by dedicated directors and management performing faithfully their duty of care to the institution.

What makes organizational structures and policies effective, in practice, are knowledgeable and competent individuals with a clear understanding of their role and a strong commitment to carrying out their respective responsibilities.

OSFI builds on the OECD principles by clearly establishing Board oversight and engagement in the strategic direction, risk management and internal control of a financial institution:

The Board plays a pivotal role in the success of a federally-regulated financial institution (FRFI) through the approval of the FRFI's overall strategy and risk appetite, and its oversight of the FRFI's Senior Management and internal controls.

In the UK, the US and Canada, in addition to a broader set of legislative and regulatory components governing corporate governance effectiveness, there are also direct requirements for filing and proof of effectiveness through inspection and examination processes. For example, OSFI's revised corporate governance guideline (2013) supports its Supervisory Framework for financial institutions.

Values such as independence, transparency, and accountability are corporate governance cornerstones. Regulated entities in the financial services and securities industries in Canada and the US are required to demonstrate the values as basic standards of corporate governance effectiveness. The energy sector regulators generally support these core values for effective governance. However, regulated entities are generally not subjected to the same level of corporate governance oversight that the financial services and securities industries experience.

In Ontario, Section 2.1.2 of the Affiliate Relationships Code for Electricity Transmitters and Distributors does codify *that a utility shall ensure that at least one-third of its Board of Directors is independent from any affiliate.* However, it does not define explicit guidelines for corporate governance structure and behaviour.

Since the OECD principles were published in 2004, guidelines for and regulation of corporate governance have substantially increased. However, these do not guarantee better governance. It is worth noting that in the financial sector, despite stronger standards for corporate governance and more rigorous required findings, financial institutions regularly find themselves embroiled in financial and operational scandals leading to diminished reputation and regulatory and legal penalties regardless of corporate governance. OSFI highlighted this in the 2013 guideline:

Appropriate organizational structures, policies and other controls help promote, but do not ensure, good corporate governance. Governance lapses can still occur through undesirable behaviour and corporate values. Effective corporate governance is not only the result of "hard" structural elements, but also "soft" behavioural factors driven by dedicated directors and management performing faithfully their duty of care to the institution.

For example, investigation of the downfall of Lehman Brothers Holdings Inc. demonstrated that the artifacts and filings of corporate governance were present. Yet, gross strategic, operational and risk management lapses ultimately led to the unforeseen downfall of the organization.

An examiner's report[4] identified changes in business strategy and risk taking behavioural, rather than gaps in required filing, as significant factors that contributed to the Lehman Brothers' downfall; this can be more broadly

[4] United States Bankruptcy Court, Southern District of New York, Examiner Anton R. Valukas

expanded to include many of the bank collapses during the 2008 downturn. Behaviour changes to take on more risk, pursue risky new ventures, and change the overall business strategy provided indicators of increased instability and risk in the system, but went largely unnoticed due to the regular completion of required reports and filings. So long as these filings were completed, the broader behaviours and motivations behind business decisions were not questioned to the extent that they should have been. This is an applicable lesson to remember – business strategy, risk and corporate governance behaviour changes must be identified in a proactive manner, rather than reactively through artifacts and documentation.

Conclusions

The following are key conclusions that can be drawn from the jurisdictional research:

1. The OECD principles are foundational for corporate governance effectiveness in both the energy and financial sectors. For energy regulators, there is broad variance for corporate governance requirements and expectations. Entities are governed by a range of existing regulation, based on the jurisdiction. Bedrock principles often include independence, transparency, and accountability. However, for energy regulators, in general, the degree of sophistication of corporate governance guidance and requirements and methods to demonstrate effectiveness lag the financial and securities industry;

2. The financial and securities sector, particularly in the securities regulation sector, which has historically faced concerns surrounding integrity and adherence to regulation, requires significantly more filings than does the average energy regulator. As a result, it can be interpreted that filing requirements should be determined by past entity behaviour, in an effort to remain non-intrusive but also address the particular challenges of the environment;

3. Filing requirements, by their nature, are past-facing and reactive. Requirements are often treated as a compliance checklist – provided that the documentation has been provided, the organization has "passed" for the year. Lessons from the financial sector, however, encourage a more proactive and targeted examination of regulated entities, where organizations that have changed their business strategy, made significant acquisitions or investments, increased risk-taking behaviour or are evolving their management-board relationship are examined in further detail. In the case of the financial sector, if these behaviours had been flagged by regulators at an earlier date, rather than ignored due to consistent fulfillment of filing requirements, regulators may have been able to intervene and take

action prior to the failure of institutions. This has important implications for the LDCs in Ontario. They are highly variable in terms of their size and resources. Additional regulatory filing requirements may not have the overall desired effect of further aligning corporate governance practices of the sector with the OECD principles; and

4. In the case of energy regulation, this may mean examining key strategic and operational decisions such as new investments, partnerships, changes in affiliate strategy, increased financial or operational risk or a substantial change in Board independence. Simply increasing the number of filings or artifacts required is by no means a method of preventing unwise risk taking behaviour through ineffective strategic and/or major operational decisions.

LDC Research

Objectives

Seven distribution companies (LDCs) across Ontario were selected by KPMG from the broader Ontario environment in order to profile the different corporate governance structures, encompassing a variety of size and governance style. The OEB remained removed from the selection process and results are not attributable to individual LDCs in order to ensure an objective view of corporate governance practices.

This research has three objectives:

1. To delineate the corporate governance structures and practices that are currently in place;
2. To provide the OEB with a jurisdictional review of various industry practices regarding corporate governance; and
3. To provide information to enable the OEB to identify how to best achieve good governance in the electricity distribution sector and use it as a basis to consider regulatory opportunities for LDCs that practice effective governance.

Detailed descriptions of evaluation criteria was provided on page 7-9 of this report. As a reminder, the criteria at a high level for each stakeholder was as follows:

Stakeholder	Criteria
Shareholder	Independence, remuneration, Board of Directors and management performance assessment
Board of Directors	Director conduct, committee structure, director elements, meeting frequency, role in strategic planning, orientation and continuing education, self-assessment, risk management protocol
Management	Board of Directors delegation to management, liaison between Board of Directors and shareholder

Each comparator was researched for:

- Shareholder mandate: objectives and goals of the organization, along with shareholder involvement;
- Management of the board of directors: functions, rules, and tools governing director behaviour;

- Structural elements: guiding principles and committee structures;
- Director elements: including independence, remuneration, and skills and criteria; and
- Key processes: including meeting frequency, strategic planning, orientation/education, self-assessment, and risk management.

Summary of Findings

In the examined organizations, governance is established through a combination of documented guidelines/policies and established practices. The scope and degree of adoption of defined behaviours and processes for corporate governance does vary based on the size and degree of independence of the Board.

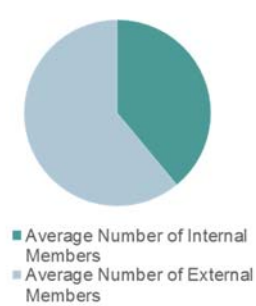
Overall, Boards and management in the comparators sample work closely to ensure strategic alignment, but with enough distance to maintain independence.

The seven comparators examined represented a range of companies that are representative of the size, corporate structure, geographic location, and ownership structure. Structure ranged from umbrella organizations with electricity generation, distribution, and other services included, to purely distribution-focused organizations. Shareholders were typically the municipality where the service resided. Closeness of operations between City Council and the company varied.

Detailed summaries of comparators can be found in Appendix 1.3.

Management of the Board of Directors

The average Board of Directors' size was eight, with a range between six and eleven. Boards are broken down between internal and external members as follows:



As a reminder, "external" refers to directors who are a representative of neither the shareholders nor the management team. As shown by the chart above, while internal members play a major role in Board composition, the majority of Board members are typically external – something that is important to maintain to ensure independence.

City Council is often involved with the selection of Board members or has active members sitting on the Board of Directors. However, overall independence is typically maintained by ensuring that a minority of Board members have ties to City Council.

Compensation ranged between $1,000 - $2,500 for the smallest organization and between $13,000 - $75,000 for the largest organization. Bonuses between $100 and $1,000 were offered at five of the seven comparator organizations.

Committees

Committee structure varied based on organizational size and corporate structure. Common committees included:

- Audit;
- Corporate governance;
- Human resources; and
- Investment oversight.

It is worth noting that two comparators had no committees at all, while one had all four listed here. Committee involvement depended on Board size and mandate.

Governance of Director Behaviour

Codes of Conduct that were examined, when existent, were typically issued by the shareholders or based upon commonly known legislation. Within these, common values typically included identifying conflicts of interest and contributing applicable industry knowledge – the first speaks to independence, and the second to leveraging the full skills of the director team.

Goals typically reflected a mix of delivering value to shareholders, providing safe workplaces for employees, and giving back to the community (including both ratepayers and, more broadly, any resident of the impacted municipality or region), particularly in the areas of environmental conservation. This three-pronged approach (shareholder, employee, community) can be a good model to ensure that all relevant parties are being considered in the decision-making process.

Key Processes

Key processes for comparison and the relevant findings were:

Process	General trends
Meeting Frequency	4-7 per annum, with more called as needed.
Strategic Planning	Boards were typically responsible for setting strategic planning in conjunction with management team.

Orientation and Continuing Education	Boards provided a range of staff training or collected materials.
Self-Assessment	Only a few Boards outlined regular processes to ensure effectiveness.
Risk Assessment	Risk management processes ranged from compensation review to customer payment collections.

Summary of LDC Interview Findings

There were a number of systemic findings which resulted from the interviews with the sample LDCs. These findings are grouped into the following themes:

1. Board Composition;
2. Board Structure;
3. Board Education, Development and Succession; and
4. Risk- based Strategic Planning.

Board Composition

Interview respondents reinforced the corporate governance leading practice that independence is vital to the effective functioning of the Board of Directors. However, this can be challenging in an LDC ownership environment where municipal representatives (e.g. councillors and/or city/town officials) sit on the Board. A prevailing view was that municipal shareholder representation on the Board should be minimized to ensure the Board is functionally aligned with the corporate strategy and always acts in the best interest of the corporation and the ratepayer. This can help minimize the potential for collision points on LDC vs. municipal strategic directions. It can also reduce personal conflicts of interests of municipal councillors and /or officials who may exhibit bias when advocating for constituency interests over the best interest of the corporation.

The interview respondents observed that municipal shareholder representation is better suited to the holding company level (assuming a holdco, regulated entity and unregulated entity Board structure is in place). This is typically where the strategy is set and shareholder input and local priorities are considered. The value of municipal representation at the LDC or affiliate Board level was questioned given the more regulatory, operational and service delivery focus of the LDCs and the affiliates. It was suggested that Board competencies aligned with the strategic, operational, financial and regulatory elements of the business is a critical corporate governance success factor. Adherence to this discipline from the holdco to the LDC to the affiliate Boards would reinforce both independence and competency based governance aligned with corporate governance leading practices.

Interviewees commented that staggered terms, Board succession planning and adherence to the Affiliate Relationships Code (ARC) requires discipline and diligence. However, the ARC requirements may be adding additional overhead to the governance structure of the LDCs and their holdco and affiliates. While others suggested that the ARC requirement may be creating “independence” in form only. Further, it was observed, that in certain instances, Board meetings for various entities (e.g. LDC, holdco and affiliates) within the corporate structure were considered to be more form than substance in terms of key decisions taken by the respective Boards. From an overall strategy, performance management and risk management perspectives it does raise the question of the value of independence as required under the ARC versus independent, efficient and effective governance decision making and overall value-for-money to the ratepayer.

It was noted that the respondents agreed that pro-active and transparent municipal shareholder relations are essential to good governance. The respective roles and responsibilities of the shareholder, council Board members, and city/town administrators in the governance and oversight responsibilities of the corporation should be codified and supported by education and training. Alternatives to direct municipal representation on the Board should be considered including offering the municipality observer status particularly at key strategic and business planning days on the Board calendar. Some LDCs did comment that they were providing regular updates at Council meetings throughout the year. This gave all Councillors the opportunity to ask questions of LDC management and the Board.

Board Structure

Across the sample LDC interview respondents, Board decision making is supported by a committee structure. The following is a typical committee structure (with some variation) in place at the LDCs:

- Audit & Finance;
- Governance & Risk; and
- HR.

A key emphasis was placed on strategic, major operational, regulatory, health and safety, and reputation risk over and above traditional financial reporting risk typically overseen by the Audit & Finance Committee. Many of the respondents have actively pursued the development and implementation of enterprise risk management programs for both small and large LDCs alike. KMPG believes this is a positive development given the nature of risk facing the LDCs. KMPG notes that certain LDCs that have enhanced their corporate governance structures to include a Governance & Risk Committee to accommodate enterprise risk management deliberations. This structure allows for greater consideration of financial planning and risks, Board governance issues including nomination and selection, succession and enterprise risk management. HR matters involving CEO performance, compensation and labour relations risks can be effectively managed through a dedicated HR committee.

KPMG suggests that the independence requirement of the ARC (*Section 2.1.2. A utility shall ensure that at least one-third of its Board of Directors is independent from any affiliate.)* may pose the following governance challenges:

- A coordinated effort and consistent deliberation of the risks within agreed risk tolerances may become more challenging across, for example, three governing bodies (holdco, LDC & affiliate Boards) for an LDC; and
- All of the governing bodies of an LDC and its affiliates may not be fully functioning in the spirit of leading practice corporate governance. Some may be performing corporate governance in "form" only to merely meet the requirements of the Code.

Board Education, Development & Succession

The interview respondents stressed the importance of Board member education, development and succession. Budgetary, time commitment and geographic challenges impeded the ability of Board members from pursuing education and development opportunities. However, KPMG observed that certain LDCs were incorporating communications and information technology to facilitate Board member remote participation and distant learning. It was observed by the respondent interviewees that Board members with formal training – Directors College or Institute of Corporate Directors (IDC) – have a broader, more informed and holistic approach to their responsibilities and decision-making approaches. They come to the Board table with a greater understanding of corporate governance leading practices and their fiduciary responsibility to the corporation including:

- Oversight and decision-making responsibilities;
- Delineation of governance and management responsibilities;
- Strategic planning;
- Risk management;
- Regulatory/legal responsibilities; and
- Internal control and financial reporting.

Ongoing education in both corporate governance and industry specific strategic and regulatory matters is viewed by the respondents as essential to ongoing corporate governance effectiveness.

Annual self-assessments supported by yearly development plans for both individual members and for the Board as a whole provide a sound basis to mature the effectiveness of corporate governance practices. Many of the respondents had such processes in place. However, consistency and follow-up to the assessment results were viewed as a work-in-progress.

Selection of Board members with varied education and experience reflective of the corporate strategic and risk management requirements is essential. Respondents indicated that education and professional experience of Board members should include:

- Power & utility sector experience;
- Legal/regulatory;
- Finance, audit and securities;
- Engineering;
- Customer service/social marketing;
- HR and performance management;
- Governance;
- Strategy:
- Information technology;
- Health and safety;
- Entrepreneurship; and
- Public policy.

Respondents indicated that the following interpersonal skills and attributes are essential for a highly effective board:

- Leadership;
- Integrity & ethics;
- Communications skills;
- Constructive questioning and debate;
- Critical/innovative thinking and decision making;
- Influencing and negotiating skills;
- Crisis management experience; and
- Team management experience.

Risk-based Strategic Planning

Interview respondents indicated that a proactive and highly engaged strategic planning process is essential to corporate success and overall Board effectiveness. It reinforces a long-range planning horizon which is essential for the utility business which has a planning time-frame in the range often in excess of 20 years.

KPMG observed that enterprise risk management with regular Board reporting (usually through the Governance and Risk Committee or the Audit & Finance Committee) ensures that the Board is informed and actively engaged in the discussion about mitigation strategies and contingency plans. Progressive utilities are aligning their corporate risk profile annual refresh exercises to the strategic planning cycle of the LDC. Major strategic objectives and action plans are profiled to ensure that mitigation strategies and contingency plans are adequately reflected in operating plans and budgets and management performance plans. Active escalation and discussion of the emerging risk profile through both formal and informal engagement of Board members is crucial.

Generally, many LDCs are in the early stages of risk-based strategic planning supported by enterprise risk management. Board decision-making processes and risk-based decision criteria require further maturity to improve overall corporate governance effectiveness and to ensure that the areas of highest risk (both as threat and opportunity) are receiving quality deliberation and decision-making time from the Board and adequate provisioning of resources for mitigation strategies and contingency plans. The risk agenda for LDC Boards continues to heighten given the challenges and costs of extreme weather, public safety and asset condition risks.

Conclusions

The following conclusions have been drawn from the LDC research and interview process. They are categorized according to the following themes:

- The LDC Corporate Governance Landscape;
- Corporate Governance Regulatory Guidelines & Filing Requirements; and
- Municipal Shareholder LDC Board Representation.

The LDC Corporate Governance Landscape

1. LDC corporate governance, from a Board composition perspective, is highly variable across the Province. It ranges from highly independent Boards supported by a professional skills and experience base representative of the major business requirements including strategy, knowledge of the utility industry, finance, legal/regulatory, customer service, health, safety and environment, etc. to those whose Board members are primarily representatives of the municipal shareholder (councilors and/or town/city administrators); and
2. Conclusions about the overall effectiveness of an LDC's performance cannot be necessarily derived from its corporate governance makeup or the degree of director independence. Performance is a by-product of Board decision

making effectiveness, strategy, risk-taking behavior, operational, financial and regulatory management practices and unforeseen significant events;

Corporate Governance Regulatory Guidelines & Filing Requirements

3. It was generally recognized by the interviewees that adherence to the OECD principles of accountability, transparency and independence is foundational to effective corporate governance of the LDCs. The OEB, not unlike other energy regulators, does not publish a code or guideline specifying requirements for corporate governance for LDCs. It does have specific filing requirements which cover the following governance elements: Size and independence of Board, Board mandate, Board meeting, orientation and continuing education, ethical business code of conduct, nomination process for Directors, and Board committees. The Affiliate Relationships Code specifies independence requirements for Board members of the regulated entity and the competitive affiliates; and

4. LDCs have different corporate governance practices. This can be the result of their size, ownership structure, degree of municipal shareholder influence, complexity of the structure and operations, corporate strategy, and risk profile. A focus purely on the structure or artifacts of corporate governance may not help the OEB further mature its regulatory oversight of the LDCs.

Municipal Shareholder Board Representation

5. Many LDCs have a hybrid governance structure in place with Boards comprised of both independent Directors and those who are Councilors or city/town administrators. However, this can be challenging to Board independence and decision-making depending on the degree of municipal shareholder influence and control that is exercised locally. In keeping with OECD principles, it is incumbent upon a municipal shareholder to act *as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance…is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness; and*

6. Corporate governance maturity can face significant challenges including access to local Board nominees who possess the requisite skills and experience to govern an LDC, compensation and the degree of municipal shareholder influence on the Board. These challenges are further compounded if access to ongoing training and education of the Board is limited.

Recommendations

The following are recommendations for consideration by the Ontario Energy Board to assist the LDCs with maturing their corporate governance in lockstep with leading practices. There are many variables and influencing factors which can impact the overall performance of an LDC. However, an overall advance of governance practices within the LDC environment, over time, will provide the OEB with a stronger risk and evidenced-based approach to assessing the impact of improved governance on its regulatory oversight requirements for the sector. They are categorized according to the following themes:

- Corporate Governance Regulatory Guidelines & Filing Requirements; and
- Municipal Shareholder Board Representation.

Corporate Governance Guidelines & Filing Requirements

1. The OEB should establish guidelines for effective corporate governance for the LDCs. This is in keeping with practices established within the financial services sector. The OEB would be a leader amongst energy regulators in doing so. The guidelines should address:
   - The role of the Board of Directors – including oversight and stewardship of the strategic direction of the corporation, acting in the best interest of the corporation, legislative compliance and distinguishing between the role of management and that of the Board;
   - The composition of the Board of Directors – including the qualifications, skills and experience of the members to support the strategic, operational, financial, legal, regulatory, human resources, information technology, customer service, etc. oversight responsibilities of the Board;
   - The unique challenges of corporate governance in a municipal shareholder environment — including conflicts of interest, and the skills and professional experience of Board members to oversee and govern an LDC;
   - Board effectiveness criteria – this would include criteria for the overall effectiveness of the Board as a whole and for individual Board members;
   - The Committee structure and roles and responsibilities (e.g. Audit & Finance, Governance & Risk, HR) – The Audit & Finance Committee focuses on matters of the integrity of financial and regulatory reporting and the effectiveness of the internal control framework. The Governance & Risk Committee typically focus on corporate governance matters including nominations, new member orientation, training and

development, Board effectiveness and enterprise risk. Succession should take into consideration the unique challenges of the Board nomination and selection process in a municipal shareholder environment. The HR Committee focuses on compensation and performance issues;

- Strategic planning requirements – including requirements for Board engagement, involvement in the development and performance reporting of the strategic plan;
- Risk governance and enterprise risk management – including Board oversight responsibilities of the enterprise risk management framework and supporting assessment, mitigation, monitoring and reporting requirements of management to the Board;
- Management reporting to the Board – this would include financial and regulatory reporting, progress against the strategic plan, operational key performance indicators including customer satisfaction, health, safety and environment, infrastructure performance and replacement, emergency response and crisis management, etc.;
- The Role of Corporate Governance in the OEB's regulatory process – including how the guidelines can be supported through a self or third party assessment process with periodic examination of the governance practices by the OEB.

2. The OEB should strive to ensure that its regulatory oversight for corporate governance provides substantive evidence that the LDCs are maturing in this regard and are in lockstep with leading practices. The OEB can consider the following alternatives:
   - Periodic independent assessment (e.g. 2-3 year cycle) of the LDCs corporate governance practices against leading practices and/or guidelines established by the OEB. The assessment should be risk-based incorporating criteria that can assess the governance, operational, financial, regulatory and reputation risk that an LDC poses; and
   - An accreditation system by an independent accreditor organization that would assess the overall effectiveness of LDC corporate governance on a periodic basis. The accreditation model is common in the health care sector and can be used to measure an organization's capability in terms of operational effectiveness, health & safety and risk management as well.
3. The OEB should monitor leading behavioural indicators which may also be reflective of the effectiveness of overall corporate governance and decision-making effectiveness of an LDC. These indicators may include:

- significant changes in business strategy;
- acquisitions or major investments;
- increased risk-taking behaviour;
- increased operational, health, safety or environmental incidents or;
- major changes to the Board composition.

Municipal Shareholder Board Representation

4. The OEB should encourage alternatives to reducing potential conflicts of interests of Board members who are municipal councillors or administrators. Alternatives can include:
   - Restricting municipal representation to the holding company level where the focus is primarily on the overall strategy of the LDC and the affiliates and the anticipated the return to the municipal shareholder; and
   - Providing required alternative forums for municipal councils to discuss, debate and question the Board and management team of the LDC on its overall strategic direction, operational effectiveness and return to the shareholder. This could occur through regularly scheduled appearance before Council or a Committee of Council.
5. The OEB should explore opportunities to ensure that the nominating process for Board members is conducted in an open, transparent and effective manner. This should be consistent across all LDCs. It should be based on explicit professional/experience/education and personal attributes criteria. The process should be inclusive of existing Board members and representatives of the municipal shareholder to achieve both independence and competency requirements of new Board members.
6. The OEB should actively encourage ongoing training and development of Board members through organizations such as the Institute of Corporate Directors, the Directors College, academic institutions, utility industry specific events and conferences and specialized regulatory awareness sessions that the OEB could offer to Board members.
7. The OEB should further examine the impact of the Board independence requirements under the Affiliate Relationships Code.

Appendix

Appendix 1.1: Terms and Definitions

Terms and definitions used throughout the body of this work can be defined as follows:

“board of directors” (also referred to as the “board”) means the body of elected or appointed members who jointly oversee the activities of a company or organization, and whose specific activities and methods of interaction with shareholders and management may differ based on mandate;

“corporate governance,” as defined by the OECD and referenced by the Canadian government, means a set of relationships between a company’s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring;

“corporation” means a body corporate with share capital, specifically one to which the regulations being discussed will apply;

“director” means a person occupying the position of director of a corporation, regardless of differing naming conventions;

“management” means the team of managers in charge of directing a company or organization through day to day activities and decision-making;

“mandate” means the authority to carry out a policy or a course of action, along with the expectation of fulfillment of this authority;

“shareholder” means a person who owns shares in a corporation, where, unless the articles provide otherwise, each share in the corporation entitles the holder to one vote and the larger the number of shares a shareholder holds, the larger the number of votes the shareholder can exercise;

“stakeholder” means a person or a group with an interest or concern, financial or otherwise, in the matter being discussed;

“strategy” means the overall direction and target working environment of an organization, including methods of operation for key business components and the basis on which it will interact with competition and the broader environment;

Disclaimer

KPMG's work was limited to our observations and recommendations identified and are based on the procedures outlined in the Engagement Scope section within this presentation. The scope of KPMG's engagement was by design limited. Therefore, the observations and opportunities should be considered in the context of those procedures and the scope of our engagement. KPMG did not perform a financial statement audit of the Ontario Energy Board (OEB). Nor does KPMG provide a legal opinion on the state of the elements of OEB's regulatory framework for electricity distributors. We relied on information, data and representations of the OEB, the local electricity distribution company interview respondents and information in the public domain from the energy, financial services and security regulators for the completeness of the background information and opinions provided. KPMG's role was to research leading and comparative corporate governance practices. The OEB and its Senior Management are responsible for the decisions to develop, refine and implement strategies and regulatory requirements to further enhance corporate governance practices of the local electricity distribution companies. Implementation of changes resulting from our observations and recommendations identified in this report will require the OEB to further plan and refine the opportunities identified to ensure that they will achieve satisfactory regulatory results.

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