Ontario Energy Board

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Draft Report of the Board

Corporate Governance Guidance for OEB Rate-Regulated Utilities

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EXECUTIVE SUMMARY

The Ontario Energy Board (OEB) is introducing new mandatory governance reporting and record-keeping requirements for rate-regulated utilities, including natural gas distributors, electricity distributors, electricity transmitters, and Ontario Power Generation (collectively, "utilities"). The OEB is also providing guidance on best practices in utility governance.

The guidance and new reporting and record keeping requirements are the culmination of research and consultation by the OEB on the topic of governance over the last two years, including targeted meetings with stakeholders in September 2016 and a meeting with utility CEOs in September 2017.

The OEB acknowledges that there is a broad range of literature on governance generally. Following the recommendations in two reports of expert consultants, the OEB has determined to focus its guidance on the governance practices of utilities that are of most significance to the OEB: those practices that are most closely aligned with the OEB's statutory mandate and those that support the achievement of regulatory objectives outlined in the Renewed Regulatory Framework (RRF).

In order to deliver on these objectives, the OEB is setting out guidance in the following areas of utility governance:

1. Director Independence
2. Director Skills
3. Board and Committee Structures and Functions
4. Supporting Documentation and Practices

The OEB believes that good governance is a significant contributor to excellence in utility performance and an important indicator of a utility's ability to achieve expected outcomes valued by customers. By implementing these new reporting and record keeping requirements, the OEB expects to encourage more robust governance practices throughout the sector. This in turn will strengthen management accountability, enhance overall utility performance, and improve outcomes for consumers.

The OEB will consider utility governance in the context of its ongoing evaluation of utility performance and rate setting.

New, annual reporting and record-keeping related to utility governance will be mandatory for the utilities. However, it will remain the choice of each utility whether to adopt the OEB's guidance in its governance architecture and functions.

The OEB will amend its existing annual Reporting and Record Keeping Requirements (RRR) to include these new utility governance reporting and record keeping requirements. To that end, the OEB will issue proposed amendments to the RRR in due course.

1. BACKGROUND: EXPERT ADVICE

In 2014, the OEB initiated a process to better understand the relationship between corporate governance practices and utility performance, and to consider options for the OEB to reflect the importance of corporate governance in its oversight of utilities. In the course of this project, the OEB commissioned two reports from organizations with expertise in corporate governance practices.

1.1 KPMG Report

The OEB first retained KPMG LLP (KPMG) to conduct research on the state of corporate governance practices in Ontario's licensed electricity distributors[1]. KPMG was also asked to look at regulatory best practices with respect to governance in other jurisdictions, and other business sectors (financial services and security regulators).

KPMG found that governance practices vary considerably across electricity distributors in the province, ranging from highly independent utility boards supported by strong professional skill sets to small boards whose members are primarily representatives of the municipal shareholder.

KPMG also found that "for energy regulators, in general, corporate governance guidance and requirements and methods to demonstrate effectiveness lag the financial and securities industry.[2]" KPMG indicated that "Lessons from the financial sector… encourage a more proactive and targeted examination of regulated entities[3]".

KPMG recommended that the OEB establish guidelines for effective corporate governance for regulated utilities, and that in doing so the OEB would be a leader among energy regulators. KPMG recommended that OEB guidelines should address, among other things:

- The role of the board of directors, including oversight and stewardship of strategic direction;
- The composition of the board, including the qualifications, skills and experience of directors to support the strategic, operational, financial, legal, regulatory, human resources, information technology, customer service and other oversight responsibilities of the board;

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[1] The KPMG Report is available on the OEB's website at https://www.oeb.ca/oeb/_Documents/EB-2014-0255/KPMG_Report_Corporate_Governance_20150429.pdf
[2] KPMG Report, page 4
[3] Ibid, page 5

- 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 a utility;
- Utility board committee structure and roles and responsibilities;
- Strategic planning requirements, including requirements for utility board engagement; and
- Risk governance and enterprise risk.

KPMG also suggested periodic assessment or accreditation of the utilities' corporate governance practices to ensure that they are maturing in lockstep with leading practices. For board members who are municipal councilors or administrators, KPMG recommended that the OEB restrict municipal representation to the holding company level or provide alternative forums for municipal councils to discuss and question the board and management team of the utility.

1.2 Elenchus Report

In 2016, the OEB retained Elenchus to build on the work carried out by KPMG and to provide expert assistance in developing the OEB's approach to utility governance.

As part of its work on developing guidance, the OEB required Elenchus to consult with stakeholders, including utility CEOs and board Chairs. This consultation was undertaken through stakeholder meetings, facilitated through the use of a framework, which included preliminary draft guidance on corporate governance prepared by Elenchus. In total over thirty CEOs, Chairs and other executives from gas and electricity utilities across the province participated.

Elenchus provided its final report to the OEB, incorporating feedback from the consultations as it considered appropriate. In its report, Elenchus recommended that the OEB's governance guidance give due accord to the significance of the independence, skills and experience of directors on utility boards as a means of ensuring appropriate decision-making that is in the best interest of the utility and its customers. The final report was published in early 2017.

Like KPMG, Elenchus recommended that OEB guidance should be proportionate in its scope, and should include more detailed provisions in areas of greatest significance to the OEB. Elenchus stated that by implementing corporate governance guidance, the OEB would be proactively protecting the interests of consumers, promoting efficiency and effectiveness, and facilitating a financially viable sector.

2 OEB GUIDANCE ON UTILITY GOVERNANCE

The OEB has benefitted from the work of KPMG and Elenchus. The OEB agrees with the observations made by both KPMG and Elenchus that it is appropriate for the OEB to consider and guide utility governance practices as a means of effectively discharging its mandate. In the OEB's view, guidance from the energy regulator presents a significant opportunity to promote better, more formalized governance practices in the energy sector.

The OEB's guidance is focussed on promoting quality decision-making and accountability in areas of the utility business most crucial for achieving regulatory objectives inherent in the Renewed Regulatory Framework (RRF):

- Alignment of shareholder and customer interests;
- Prudent decision-making with proper consideration of customer interests;
- Spending and investment discipline (capital spend, OM&A, major transactions);
- Sustainable financing; and
- Excellence and continuous improvement in utility performance.

In line with the recommendations of KPMG and Elenchus, the OEB's guidance reflects best practice while also drawing attention to areas of specific importance that result from the unique nature and circumstances of utilities, their ownership structures, and the risks assumed relative to other corporations. The OEB's guidance pertains to the following four areas:

1. Director Independence
2. Director Skills
3. Board and Committee Structures and Functions
4. Supporting Documentation and Practices

2.1 Director Independence

OEB Guidance

A. Independence: Utilities should have a board of directors at the utility level and a majority of those directors should be independent of the shareholder and any affiliate
B. Board Size: The board should comprise no less than five directors
C. Scope of Oversight: Shareholder agreements or directions that limit the board of directors from exercising its independent judgment should be avoided

Discussion

A. Majority Independence

The OEB expects utilities to have a board of directors that has oversight of all utility functions and is separate from the parent company. The OEB also expects that utility boards should be made up of a majority of independent directors.

This guidance is based on both existing Affiliate Relationships Code (ARC) requirements as well as recommendations made by KPMG and Elenchus. Both KPMG and Elenchus highlighted the importance of director independence as a principle that is foundational to effective corporate governance. Elenchus expresses support for governance at the utility level since this approach ensures a more dedicated focus on the regulated business rather than all the activities of a corporation[4].

The OEB has already imposed requirements on utility boards related to independence through the ARC for Electricity Transmitters and Distributors[5] and for Gas Utilities[6]. Taken as a whole, the ARC's requirements for independence, separation from other affiliates and conditions on sharing of resources, services or the provision of financial support among related entities necessitate utilities to have a separate board of directors that has oversight of the utility's operations.

The expectation that boards have a majority of independent directors reflects best practice generally. A director is considered independent if she or he is neither an employee nor director of an affiliate (including the parent or holding company) nor an employee or director of the majority or controlling shareholder. The general and pervasive preference for independent directors to constitute a majority on the board is grounded in the view that this arrangement best enables the board of directors to act in the best interests of the company without undue influence. Elenchus concluded that this best practice also applies to the regulatory domain.

Under the ARC, a minimum of one-third of the utility's board of directors must be independent of any affiliate. Further support for independence at levels beyond this minimum is also found in the Distribution Sector Review Panel's recommendation that at least two-thirds of the board

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[4] Elenchus Report, page 43

[5] https://www.oeb.ca/oeb/_Documents/Regulatory/Affiliate_Relationships_Code_ARC_Electricity.pdf

[6] https://www.oeb.ca/oeb/_Documents/Regulatory/Affiliate%20Relationships%20Code%20for%20Gas%20Utilities%20ARC.pdf

of directors of distributors should be composed of independent directors, and preferably 100% independent.[7]

While one-third independence is the requirement entrenched in the ARC, the OEB is of the view that the quality of governance is likely improved if the proportion of independent directors is greater than the current requirement under ARC. The OEB is of the view that a majority (over 50 percent) of directors should be independent. The OEB will consider amending the ARC in due course to reflect governance best practice in this regard.

B. Board Size

The proportion of independent directors on a board also raises the question of how large a board should be in order to be effective and provide high-quality oversight. A board that is too small may not be effective to handle its workload; one that is too large may be challenged to find consensus. The size of the board may also help to support a culture of independent-mindedness on a board overall.

As summarized by Elenchus, the Distribution Sector Review Panel recommended that boards should be adequately sized to have directors with an appropriate range of experience and skills[8]. The Organization for Economic Co-operation and Development (OECD) indicates that the ideal number of board members is between 5 and 10[9]. In the OEB's view, a minimum of 5 directors is required to provide a meaningful number of independent directors, to bear the prospect of including the requisite expertise, and to populate committees of the board among directors. Relative to smaller boards, such a size may also better accommodate non-independent directorships while maintaining majority independence.

C. Scope of Oversight

Another aspect of independent governance that is key to delivering outcomes of value to customers pertains to the scope of responsibilities charged to a board.

The OEB recognizes that shareholders have the ability to enter into shareholder agreements and to issue declarations that reserve certain decisions for themselves rather than having them reside with a board of directors. However, in the OEB's view, the use of such instruments runs counter to the principle that independent directors be able to exercise their judgment on all key aspects of the business. Elenchus states that while shareholder agreements "provide clarity

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[7] Elenchus report, p. 6

[8] Elenchus, page 7. Citing "Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First, Report of the Ontario Distribution Sector Review Panel", December 2012, p. 37.

[9] OECD "Practical Guide to Corporate Governance, Chapter 4 What To Do: Key Good Governance Practices." https://www.oecd.org/daf/ca/corporategovernanceprinciples/43654277.pdf

and certainty as to the roles and responsibilities of the board of directors, if they transfer significant decision-making authority there is less scope for the board of directors of the regulated utility to exercise independent judgment within the framework of good corporate governance."[10] The quality of governance may be reduced as a result. The OEB agrees with this concern, particularly where restrictions affect the ability of directors to act in the best interests of the utility and its customers. The inclusion of such restrictions in shareholder declarations or similar instruments should be avoided.

2.2 Director Skills

OEB Guidance

- The board as a whole must possess the complete range of skills necessary to execute its governance function and discharge its responsibilities effectively
- A matrix approach should be used to compile an inventory of director skills

Discussion

Both KPMG and Elenchus commented on the importance of director skills. KPMG recommended that the OEB establish guidelines and reporting requirements addressing the qualifications, skills and experience of utility board members to support the strategic, operational, financial, legal, regulatory, human resources, information technology, customer service or other oversight responsibilities of the utility board.

Similarly, Elenchus stated that directors must be skilled in a variety of areas (including technical skills such as legal, engineering, accounting, and regulatory, and governance skills such as integrity, collegiality, and strategic thinking) and must be committed to the long-term best interests of the utility, including balancing the interests of customers and shareholders. Elenchus also suggested that best practices dictate that boards should develop a skills matrix for directors.

The OEB agrees with the views of KPMG and Elenchus regarding the importance of director skills, the types of skill sets required for effective utility governance, and the value of a skills matrix as a useful tool to be used by utility boards. Directors with appropriate skills and experience provide greater confidence in the board's oversight of a utility's financial viability, quality, effectiveness, reliability and safety, as well as in its ability to deliver desired outcomes.

[10] Elenchus report, page 44

2.3 Board and Committee Structures and Functions

OEB Guidance

- Boards should ensure that they are structured to provide oversight of key functions of the utility business
- Committees of the board are an effective means of achieving appropriate oversight of key functions
- Committee members should possess the requisite skills to effectively discharge their responsibilities

Discussion

In order to perform effectively, boards must ensure that they can exercise effective governance over a number of key functions of the utility business.

Based on skills and functions highlighted by KPMG and Elenchus, the OEB's view of key utility functions in which the board should be involved are:

- Strategic planning
- Asset planning
- Audit
- Health and safety functions
- Executive compensation
- Risk assessment
- Regulatory and public policy activities
- Customer relations and human resources
- Succession planning

KPMG recommended that the OEB's guidelines and reporting requirements should address the role and function of the utility board of directors, including committee structure. KPMG provided guidance on the functions of specific committees, including recommendations for Audit & Finance Committees, Governance & Risk Committees, and Human Resources Committees[11].

Elenchus agreed with KPMG, and noted that core responsibilities of board stewardship concern strategy, risk, financial and operational performance and succession. It concluded that the structure of the utility board, including its committees, should support the effective and

[11] For KMPG's specific recommendations related to these committees, see p. 8-9 of the KPMG Report

efficient operation of the board, particularly the exercise of independent judgment in the best interests of the utility. Elenchus recognized that utility boards have a broad range of responsibilities, and acknowledged that the use of committees can be an effective and efficient way for boards to carry out their responsibilities.

The OEB recognizes that committees provide organizational structure while allowing for flexibility to adapt to changing demands. Committees are an efficient means of allocating time to specific functions, and to make use of specialized skills of members to perform key functions.

Although KPMG provides recommendations regarding committee structures and roles and responsibilities for each committee, the OEB will not point to any particular committee structure for utility boards as being optimal across the sector. The OEB sees less value in providing guidance that advocates for a certain board architecture, in part because an efficient arrangement for one utility may not be optimal for another utility with a different distribution of skills across its director membership. Rather, the OEB sees as more fundamental the need for directors to focus on certain key business challenges, and for the directors to possess skills appropriate to discharge their duties. In the OEB's view, the proper allocation of director skills to board tasks is what best delivers an effective and efficiently operating board of directors.

While the OEB will not provide specific guidance on governance structures, the OEB expects that utility boards should be able to demonstrate that the skills complement of directors adequately matches the areas of responsibility that have been assigned to them and to committees on which they sit. The OEB expects that a board will be able to describe how it exercises oversight of each of the key functions by reference to the complement of skills present on each assigned committee to which a key function is assigned. For example, the OEB would expect that members of any audit committee would generally have high levels of specific financial experience and formal qualifications. Similarly, human resources matters would be expected to be delegated to directors with appropriate experience on succession planning, executive recruitment and compensation, collective bargaining and other related domains.

2.4 Supporting Documentation and Practices

OEB Guidance

- Utility boards should have a written mandate and any committees of the board should have a written charter
- The mandates of boards and any committees should be documented
- Boards should have a written code of conduct
- Boards should provide orientation for new appointees and continuing education and/or other methods of broadening the skills of all directors

Discussion

A final aspect of utility governance has to do with the tools and processes that boards put in place to help to assure high-functioning, effective governance. Such tools can enable the board's conduct to meet the highest standards of skill, integrity and diligence and to ensure that directors continue to maintain the skill and knowledge needed to meet their obligations in an evolving sector.

On this topic, Elenchus identifies the following key best practices:

- The board should have a written mandate so that the responsibilities of the board and directors are transparent and well-defined[12]
- Any committee likewise should have a written charter to establish its purpose and responsibilities
- A board should have a written code of business conduct that is applicable to directors, officers and employees
- The board provides continuing education opportunities for all directors, to enhance their skills as directors and to ensure their understanding of the utility's business remains current[13]

The rationale for these resources and practices is evident. It is expected that written definitions and expectations ensure clarity and shared understanding of the roles and responsibilities of the board and directors, demonstrate commitment to the mandate, and bring transparency to the utility's corporate governance. Written codes promote integrity, deter wrongdoing and address issues around conflicts of interest, proper use of corporate assets, confidentiality, fair dealing with utility stakeholders, legal compliance and reporting of any illegal or unethical behaviour[14]. The provision of continuous education helps to promote continued fitness of directors for the responsibilities they bear.

The OEB is of the view that, in accordance with best practice as highlighted by Elenchus, utility boards should take steps to create and maintain this documentation and provide training.

[12] Elenchus report, page 62
[13] Ibid, page 68
[14] Ibid, page 72

3 REPORTING AND RECORD-KEEPING REQUIREMENTS

In this section, the OEB describes the new reporting and record-keeping requirements designed to obtain information about utility governance that supports assessment of whether and to what extent a regulated utility has the features laid out in the OEB's guidance. The OEB will issue proposed amendments to the RRR to reflect these new reporting and record keeping requirements in due course.

The OEB recognizes that these reporting and record keeping requirements are based on a utility structure that is a corporate body. The OEB will determine whether and how to modify actual reporting requirements to adapt them for utilities that are structured as a limited partnership rather than a corporation.

3.1 Director Independence

In order to assess the level of independence of its board, utilities will be required to report the following:

- The number of directors on the board of the utility
- The number of directors of the utility that are independent of affiliates; including the parent company or holding company and the majority or controlling shareholder
- Whether a utility director is a member of any other board and whether there are any board interlocks (i.e. where executive or director of one board is also a director of another board)
- Which of the directors is an employee or representative of a shareholder
- A brief description of any shareholder agreement or direction and the aspect of the utility business to which it pertains

Utilities will also have to maintain records of the following, so that they may be produced if requested:

- Any shareholder agreement or direction in place that may restrict the utility board's decision-making

Direction regarding the length of document retention will be provided as a next step in the consultation regarding amendments to the RRR that will follow.

3.2 Director Skills

Utilities will be required to report information that demonstrates how their utility board directors possess the skills expected of directors. This includes:

- Previous positions held by each director that demonstrate a director has specific skills or expertise.
- An explanation of what expertise and experience the director gained in each previous position, as well as details regarding the term/duration of the previous position.

Information provided should highlight skills and experience that are relevant to the utility business.

3.3 Board and Committee Structures and Functions

Utilities will be required to report on their utility board-level committee structures, including committee names, the function of each committee, director membership on the committees, and in such a manner that allows any overlapping or inter-locking committee membership, particularly between the utility and affiliated boards, to be identified. This will allow the OEB to assess concordance between tasks assigned to a committee and the skills and independence of that committee's membership, as an indication of the governance capacity and experience being deployed on a given business domain.

The following information about a utility board's committees and functions is required:

- Names, descriptions and functions of each utility-level board committee (e.g. Audit, Risk Management, Compensation, etc.)
- Committee membership
- A mapping of each key board function to committee mandates
- Indication of functions that are undertaken by each committee or heard at the utility board as a whole

3.4 Supporting Documentation and Practices

Utilities will be required to maintain records of the following, so that they may be produced if requested:

- A copy of any utility board code of conduct
- A copy of any written mandate for the board and written charter for each committee
- A description of orientation, training or other methods used to broaden and deepen the skills of existing and new directors

In order to enable verification of the accuracy of utility reporting, the OEB will define record keeping requirements related to the reporting above in a process regarding amendments to the RRR that will follow.

4 IMPLEMENTATION

The reporting and record-keeping requirements will be mandatory for utilities, but it will remain the choice of each utility whether to adopt the OEB's guidance in its governance architecture and functions.

Following the receipt of written comments from interested parties in response to this Draft Report of the Board, the OEB will publish a Final Report of the Board. This Final Report of the Board will describe the OEB's best practice guidance on corporate governance and will provide details regarding what will be captured by amendments to the RRR.

Following publication of the Final Report of the Board, the OEB will publish its proposed amendments to the RRR for gas and electricity. The OEB intends to incorporate the corporate governance reporting and record-keeping requirements into the *Electricity Reporting and Record Keeping Requirements* and the *Natural Gas Reporting & Record Keeping Requirements: Rule for Natural Gas Utilities*, and to require that reporting be provided or updated at least annually; the OEB may also require information to be updated within a reasonable period following any changes to the utility board. Input will be solicited from all interested parties, and the OEB will then publish the final amendments to the electricity and natural gas RRR to reflect new reporting and record keeping requirements related to utility governance.

Initial baseline reporting will be required from all utilities. Given the timing of this report, the OEB is considering what deadline to establish for this activity. Following initial baseline reporting, the OEB expects that utilities will file and/or maintain relevant data in accordance with the amended RRR.

Following the implementation of the new RRR requirements related to utility governance, the OEB will consider utilities' governance practices in the context of its ongoing evaluation of utility performance and rate setting.