Ontario Energy Board

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Report of the OEB

Best Practices regarding Governance of 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 identifying best practices in utility governance. The OEB's objectives in setting out best practices and introducing new reporting on governance are to build upon the OEB's focus on utility performance and to allow the OEB to obtain insight into the quality and robustness of decision-making of the utility business. The combination of identified best practices and mandatory reporting are expected to support the OEB's ability to rely upon utility governance as an indicator of utility performance.

The best practices 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 meetings with utility CEOs in September 2017 and September 2018.

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 attention 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 help utilities deliver on these objectives, the OEB has identified best practices 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 identifying best practices and implementing new reporting and record keeping requirements in key areas of utility governance, the OEB expects to encourage more robust practices throughout the sector. This in turn will strengthen management accountability, enhance overall utility performance, and improve outcomes for consumers.

Although new reporting and record keeping related to utility governance will be mandatory for utilities, it will remain the choice of each utility to determine how best to structure its own internal governance. 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.

Information gained through the RRR filings will give the OEB insight into the robustness of a utility's internal controls and decision-making processes on matters of most relevance to the OEB. This will support the OEB's ability to make an informed assessment of the depth of review that the OEB may be required to undertake when assessing utility plans and proposals.

As the OEB gains insight and experience with the new reporting and record keeping related to utility governance, additional tools for measuring governance or more explicit guidance may follow.

1. DEVELOPMENT OF BEST PRACTICES: 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. These reports provide the foundation for the OEB's identification of best practices.

1.1 KPMG Report

The OEB first retained KPMG LLP (KPMG) to conduct research on the state of corporate governance practices among 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 diverse 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 noted that in doing so the OEB would be a leader among energy regulators. KPMG recommended that OEB guidelines should address:

- 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;

[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.

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. KPMG also suggested periodic assessment or accreditation of the utilities' corporate governance practices to ensure that they are maturing in lockstep with leading practices.

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 identifying best practices, 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. This final report was published in early 2017.

Like KPMG, Elenchus recommended that the OEB should focus its attention on 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 BEST PRACTICES IN UTILITY GOVERNANCE

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

2.1 Alignment with Renewed Regulatory Framework

The Renewed Regulatory Framework has already helped to modernize Ontario's natural gas and electricity sectors by:

- allowing utilities and the OEB to focus on outcomes valued by customers rather than inputs;
- providing more flexible options for rate setting to better align with business drivers;
- improving utility planning to better optimize infrastructure investments;
- giving consumers a meaningful voice in the development and review of utility applications; and
- making utility performance more transparent for ratepayers.

As another element of its performance-based approach to regulation, the OEB is also in the process of developing more extensive benchmarking as a means of enhancing the assurance that utilities are providing value for money. This initiative is expected to enhance utility performance and increase the effectiveness and efficiency of regulation. In a similar vein, the OEB expects that monitoring governance practices across the utility sector will provide the OEB with further insight into the linkages between internal processes and results for customers.

Following the recommendations of KPMG and Elenchus, the OEB has identified areas of utility governance practices that contribute most directly to achieving the regulatory objectives inherent in the Renewed Regulatory Framework:

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

The best practices highlighted by the OEB in this report draw 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 has identified four areas of governance that are particularly relevant to enhanced utility performance:

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

Best practices in these four areas are outlined below. The OEB recognizes that corporate governance more broadly is not reducible to these four indicators. However, these indicators will provide the OEB with insight into the robustness of utility internal controls and decision-making processes, which, in combination with other tools and assessments, are expected to support the OEB's ability to make an informed assessment of the depth of review that the OEB may be required to undertake when assessing utility plans and proposals. With greater knowledge of the processes, accountabilities, skills and directness of oversight over utility operation, the OEB can be better informed as to the scrutiny that may be required to ensure that a utility's planning, spending and forecasts are appropriate.

2.2 Director Independence

Best Practices

A. Independence: Utilities have a board of directors at the utility level and a majority of those directors are independent of the shareholder and any affiliate
B. Board Size: The board comprises no less than five directors
C. Scope of Oversight: Shareholder agreements or directions do not limit the board of directors from exercising its independent judgment

Discussion

A. Majority Independence

Best practice is for utilities to have a board of directors that has oversight of all utility functions and that is separate from the parent company. Best practice also suggests that utility boards should comprise a majority of independent directors.

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.

Best practices related to independence are based on 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 Affiliate Relationships Code (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 suggest that it is best for utilities to have a separate board of directors that has direct oversight of the utility's operations.

Under the current 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 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 a majority of directors are independent, as reflected in the work of KPMG and Elenchus. The OEB will therefore consider amending the ARC in due course to reflect governance best practice in this regard.

While director independence is generally defined as independence from the company, shareholder and any affiliate, the OEB considers that independent directors of the holding company board appointed to the utility board may also be considered independent on the utility board. In the OEB's view, this is a practical approach that provides a means for making use of expertise at the utility's disposal without sacrificing the objective of ensuring that utility decision-making is in the best interest of the utility, with due regard for the interests of customers.

[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

[7] Elenchus report, p. 6

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, best practice would suggest that 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 any 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 the board of directors.

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. Elenchus states that while shareholder agreements "provide clarity 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 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 quality of governance may be reduced as a result. Best practice suggests that such restrictions in shareholder declarations or similar instruments should be avoided.

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[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

[10] Elenchus report, page 44

2.3 Director Skills

Best Practices

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

Discussion

Both KPMG and Elenchus commented on the importance of director skills and suggested best practices to ensure that directors possess skills appropriate to their roles. 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 and the types of skill sets required for effective utility governance. It also sees value in the use of a skills matrix as a 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.

2.4 Board and Committee Structures and Functions

Best Practices

- Boards are structured to provide oversight of key functions of the utility business
- Committees of the board are used as a means to achieve appropriate oversight of key functions
- Committee members possess the requisite skills to effectively discharge their responsibilities

Discussion

In order to perform effectively, best practice dictates that the board of directors must be able to exercise effective governance over a number of key functions of the utility business. Areas identified by KPMG and Elenchus include:

- 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

In addition to key utility functions, KPMG recommended that the OEB address the role and structures of committees. KPMG provided guidance on the functions of specific committees, including best practices for audit and finance committees, governance and risk committees, and human resources committees.[11]

Elenchus agreed with KPMG on the importance of considering committee structures, and noted that core responsibilities of board stewardship concern strategy, risk, financial and operational performance and succession. 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. It concluded that the structure of the utility board, including any committees, should support the effective and efficient operation of the board, particularly the exercise of independent judgment in the best interests of the utility.

Based on best practice considerations highlighted by KPMG and Elenchus, the OEB agrees that committees can provide organizational structure while allowing for flexibility to adapt to changing demands. Committees may also be an efficient means of allocating time to specific functions, and to make use of specialized skills of members to perform key functions. One committee that may stand to provide the greatest value to a utility board is an audit and finance committee, given, as Elenchus notes, the importance of financial performance to the

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

provision of energy services and the need to consider detailed financial issues with the benefit of suitable expertise.

The OEB recognizes, however, that there is no particular committee structure for utility boards that is optimal across the sector, 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, what is more fundamental as a best practice is for the board of directors, individually and collectively, to possess the range of skills and expertise appropriate to effectively discharge their duties and to ensure the proper allocation of those skills to board tasks.

Director skills should inform committee membership selection, and the match between the skills present on a committee and the areas of the business it oversees should be tangible and documented rather than tacit. In other words, a board should be able to describe or demonstrate how it exercises oversight of each of its key functions by reference to the complement of skills present on each committee. For example, members of an audit committee would generally be expected to 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.

2.5 Supporting Documentation and Practices

Best Practices

- Utility boards have a written mandate and any committees of the board have a written charter
- Boards have a written code of conduct
- Boards 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.

The OEB agrees with the best practices identified in the Elenchus report:

- 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]

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 also promote integrity, deter wrongdoing and address issues regarding 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.

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

3 IMPLEMENTATION

This report identifies areas of governance that are of interest to the OEB as well as best practices in each of these areas. The OEB is not mandating adoption of any minimum governance standards. Rather, best practices are provided to assist utilities in assessing their own governance practices against broad standards of excellence that are considered to be best practice.

The OEB is committed to ensuring that rate regulated utilities are delivering the best value to their customers. The OEB is also committed to adopting more proportionate processes to monitor and assess utility performance. Having a better understanding of utility governance structures and practices that support utility decision-making will facilitate the OEB's achievement of both of these objectives. To that end, the OEB is implementing mandatory reporting requirements with respect to the four areas of interest laid out in this Report. Such measures will help to provide indication of a board's effectiveness at governing the utility it oversees – addressing a key deficiency identified by KPMG in its work for the OEB.

These requirements are designed to obtain information about utility governance that can be considered, as needed, in the context of regulatory reviews, including rate applications, compliance and performance audits, etc. The OEB intends to provide a structured template for recording such information in order to standardize the form of utility submissions, ensure completeness, and streamline review. The format of the reporting template will be subject to consultation.

The OEB will also provide in the expanded RRR the opportunity for utilities to explain their governance practices and supplement the information filed with additional discussion. This provision is expected to enable a utility to explain how its approach to governance, if it does not appear to represent best practice, nevertheless assures appropriate control and decision-making with due consideration for customers' interests.

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
- 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

In order that they may be produced if requested, utilities will also have to maintain records of 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. The information to be collected highlights skills and experience that are relevant to the utility business. 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.

3.3 Board and Committee Structures and Functions

Utilities will be required to report on any 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. The provision of such information 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

Best practice indicates that utilities should have certain documentation in place relating to a code of conduct, mandates, and training. In order that they may be produced if requested, utilities should maintain records of the following:

- 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

3.5 Structure and Form of the Reporting Requirements

The OEB intends to incorporate the 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*. Following publication of this Report of the OEB, the OEB will hold a consultation on its proposed amendments to the RRR for gas and electricity. Input on the structure and form of the RRR 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. Following the consultation on RRR amendments, the OEB will consider 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, the OEB will consider utilities' governance practices in the context of its ongoing evaluation and monitoring of utility performance and rate setting. As the OEB gains insight and experience with the new reporting and record keeping related to utility governance, additional tools for measuring governance or more explicit guidance may follow.