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Alan Hibben and David Denison
Premier's Advisory Council on Government Assets
1075 Bay St, Suite 830
Toronto, ON M5S 2B1

Dear Mr. Hibben and Mr. Denison:

Thank you kindly for taking the time to meet with us on January 19. On behalf of the OEA, I am very appreciative of the attention that you and the Council staff gave to our views on LDC consolidation issues. In addition, the open and candid discussion of where you and the Council are in the review process was most helpful.

As we discussed, the OEA has been active on LDC consolidation issues for a number of years. When the Ontario Distribution Sector Review Panel was considering consolidation in 2012, the OEA provided a very detailed and comprehensive submission covering many of the issues that we raised with you at our meeting this week. Subsequent to the Panel's public report, when the Government of Ontario determined that it would not proceed with the main Panel recommendation of forced contiguous consolidation of LDCs, we reiterated our key positions in summary form to the Minister of Energy. Finally, we have for a number of years participated in both the Ontario Minister of Finance and the Federal Minister of Finance pre-budget consultation processes, where we addressed in particular the tax-related aspects of LDC consolidation issues. *For ease of your reference, we have attached these documents to this letter.*

The OEA has always maintained that LDC consolidation would be beneficial to ratepayers, electricity sector participants, the Government of Ontario, and Ontarians more generally. Consolidation would result in a more efficient electricity distribution system, which would lower costs to ratepayers, allow utilities to invest in new and more innovative services, reduce the regulatory burdens in the system, and create greater capacity in the sector to deliver on government energy-related priorities such as the expansion of distributed generation.

Tax and regulatory issues have always been the most important barriers to consolidation of the LDC sector. We were very pleased that you identified addressing tax issues as a priority for the Council. The current rules pertaining to Departure Tax and Transfer Tax effectively prevent private sector capital from entering the Ontario LDC market, and thus drastically reduce the number of players who could participate in and encourage consolidation. In addition, these barriers limit the access to capital of existing LDCs, even though in some cases major capital infusions are required.

The OEA hopes that the Council recommends to the government that tax relief be granted to the industry in order to encourage consolidation transactions. If the Province chooses to offer tax relief – whether unilaterally or in cooperation with the Federal Government – it is the hope of the OEA that such relief be equally applicable both in scope and quantity to all LDCs in Ontario, and also that the tax relief be impartial as between transactions that involve 100% sales of LDCs or some fraction thereof. OEA members believe that non-discriminatory policies should be implemented by the government so as to allow for the maximum flexibility and creativity in concluding transactions that will best serve all stakeholders in each particular case.

In addition to tax issues, the OEA strongly believes that several regulatory issues should be addressed in order to better incent LDC consolidation. In some cases, tax relief alone may be insufficient to encourage consolidation to take place because of misunderstanding of the benefits of consolidation or local resistance to change. Moreover, existing economic distortions in the distribution sector caused by undesirable regulatory policies may in fact work against consolidation opportunities which might otherwise be seized more enthusiastically. These issues are spelled out in greater detail in the attached documents (see in particular pages 38 to 40 of the OEA's Submission to the Distribution Sector Review Panel), however, to briefly summarize, the OEA would ask that the Council consider making recommendations to the government with respect to:

- *Equal Treatment of All LDCs Regardless of Size*: LDC regulation in Ontario has been systematically biased towards reducing burdens on smaller LDCs as compared to larger LDCs, which has reduced the incentives for small LDCs to seek consolidation. OEB cost allocation policies, scrutiny of rate applications, required participation in OEB processes, accommodation of limited capacity to deliver on conservation priorities and other mechanisms should be reconsidered in light of systemic efficiency and incentives for consolidation. The status quo should no longer be accepted.
- *Eliminating De Facto Subsidization of Electrically Embedded Utilities*: A number of small LDCs across the province receive all or much of their electricity at low voltages from other distributors, rather than maintaining their own connections to the province's transmission grid. The fees charged to such embedded distributors do not reimburse the providers for the fully loaded cost of the service, and are effectively much, much less than the cost of owning and operating a direct connection to the transmission grid. The result is that electrically embedded utilities can maintain customer rates which are much lower than the neighbouring utility that is providing low voltage power, therefore reducing the incentive to consolidate (consolidation would result in the loss of the effective subsidy, and therefore higher rates for customers). As long ago as 2004 the OEB recognized that electrically embedded distributors should not be present in the system, and banned the creation of any new such distributors. However, no action has been taken to eliminate or actively discourage the continued existence of pre-existing electrically embedded distributors.
- *Greater Financial Incentives for Consolidation*: Existing policy allows the benefits of consolidation to be reaped by shareholders for a period of up to five years by delaying a review of customer rates. This mechanism is proving inadequate because the period may be alternately too short or too long: too short to capture a significant portion of efficiency benefits for shareholders after transaction costs are absorbed and implementation time is taken into account, and too long because the pressures of capital requirements would drive many LDCs to seek rates much sooner than every five

years. The OEB currently has a consultation process ongoing to consider exactly this issue, and the OEA would encourage that positive steps be taken to improve these incentives in conjunction with the government's decision on policies for consolidation.

- *OEB Capacity to Efficiently Process Consolidation Transactions*: Over the past few years several consolidation transactions have been considered by the OEB, often requiring upwards of a year to process from the date of application. However, if the government eliminates barriers to consolidation, the OEB could be faced with a comparative flood of transaction applications, potentially leading to disastrous delays in transaction execution. It is imperative that the OEB be prepared with a full complement of Board members, a cadre of knowledgeable staff who can address applications, and a streamlining of the policies and procedures to efficiently review transactions.
- *Stability of Capital Structure and Return on Equity Policies*: When valuing a regulated utility, a critical component of financial modeling is assumptions about future capital structure and return on equity policies. In Ontario over the past 15 years these policies have been commendably stable, typically operating by formulas which have been updated from time to time through transparent review processes. Recently, the OEB embarked on an important review of distribution rates, and has been considering whether to change the balance between fixed and variable components of distributor revenue streams. The OEA does not wish to make any comment on this process itself, as various points of view no doubt have merit. However, it is apparent that changing something so economically fundamental as the volatility of revenue streams could subsequently lead the OEB to reconsider broader economic issues such as appropriate capital structure and return on equity policies. The timing of such changes could destabilize the valuation of distributors, right at the time when the government is encouraging transactions by changing its tax and other policies. Such coincidence would be extremely unfortunate.

The OEA would be pleased to assist the Council in any way that it is able with respect to LDC consolidation issues. If there is further information that we might provide, we would be happy to deliver what we have on hand, or to gather new information. If you have any questions about any of the materials and information we have included with this letter, please do not hesitate to contact me or our Vice President of Government Relations and Communications, Tina Arvanitis at 647.920.3269 or tina@energyontario.ca.

Thank you again for your time and attention, and we very much look forward to the results of your work.

Best regards,

Bob Huggard
President and CEO
Ontario Energy Association