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April 13, 2015

The Hon. Bob Chiarelli
Minister of Energy
MINISTER'S OFFICE
Hearst Block, 4th Floor
900 Bay Street
Toronto, ON M7A 2E1

Dear Minister Chiarelli:

RE: Regulatory Barriers to LDC Consolidation

Thank you kindly for taking the time to meet with us on April 1, 2015, to discuss the regulatory barriers to LDC consolidation, and thanks also to your staff for extending the invitation.

As you know, the OEA has been pursuing the issue of regulatory changes relating to consolidation for many years. Recently, we had discussions with both the Premier's Advisory Council on Government Assets and your staff. These are the same five regulatory recommendations that we addressed with the Ontario Distribution Sector Review Panel in June and July 2012 as well as with you and your staff on April 16, 2013 when you were first appointed as Ontario's Minister of Energy. Recommendations on LDC consolidation have also been key components of OEA pre-budget submissions from 2012 to 2015. On behalf of the OEA, I am very appreciative of the attention that you gave to our recommendations on LDC consolidation barriers at our meeting. I thought it might be helpful to you and your staff if I followed up with a note from our meeting in hopes that we can move forward together on the five regulatory recommendations we discussed.

Although we are both in agreement that tax relief is necessary to drive LDC consolidation, **tax relief alone is not sufficient: the OEA strongly believes that in addition to tax relief, several regulatory issues must be addressed in order to better incent LDC consolidation.** This is because in some cases, tax relief alone may be insufficient to overcome 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 that might otherwise be seized more enthusiastically. Thus, **it is only a combination of both regulatory changes and tax relief that will lead to LDC consolidation in this province.**

<u>5 REGULATORY BARRIERS TO LDC CONSOLIDATION</u>:

1. EQUAL TREATMENT REGARDLESS OF SIZE

As mentioned in our meeting, the three principles in question are:

i) A fair allocation of regulatory cost, based on the actual burden to the OEB of each LDC's activities, which is currently lacking;
ii) The design and application of appropriate regulatory model options, some of which currently

allow smaller utilities to escape scrutiny for a substantial period of time;
iii) Consistency of application of all regulatory policies across all LDCs.
Also as noted at our meeting, this is a long-standing issue which is well understood by the regulator, but on which there has been little action to date. **It is important to take action now if the government wishes to achieve its consolidation goals over the next few years.** As you yourself have publicly stated, maintaining the current LDC structure in a province of only five million customers just doesn't make sense. Equal treatment regardless of size means that smaller utilities would be encouraged to consolidate if they were to face tougher regulatory scrutiny and greater regulatory costs than they have in the past, as the alternative for them would be to face higher costs, and hence higher customer rates, without delivering any corresponding benefit to their shareholders. **In fact, a fair and equal regulatory burden would probably do more to encourage consolidation of smaller utilities than any tax relief is likely to do.** Over the past number of years, many small utilities have received cash offers at substantial premium prices, and have rejected all of them; these offers came from multiple municipal utilities across the province. **If smaller LDCs repeatedly rejected those tax free offers, why would the government's proposed tax relief suddenly cause them to accept new, similarly tax free offers?**

2. ELECTRICALLY EMBEDDED UTILITIES

As we discussed, **electrically embedded utilities are effectively being subsidized;** their ratepayers are paying lower rates, while Hydro One ratepayers are paying more than they should (most, but not all, embedded territories are within Hydro One's service area; for ease of description, only Hydro One is referred to, but the same arguments would apply to any utility serving embedded territories). The existing situation of many embedded utilities is a relic of the old Ontario Hydro system, and has never been addressed in the post-*Electricity Act* era. Just the re-opening of the issue by the OEB, for example through the initiation of a generic hearing on the appropriate price structure for services to embedded territories, would likely drive many of these smaller utilities to reassess their future, and likely consider consolidation options. **Any rational review of this policy would make prices across Ontario more fair and realistic than they are today, especially for customers of embedded utilities.** An immediate step that could be taken, which would not likely require a long regulatory process, would be to dramatically increase the efficiency targets and expectations for any utility territory that is electrically embedded; since those LDCs don't carry the burden of owning assets to connect to the transmission grid, they should be expected to achieve benefits for customers in other ways. As mentioned in our meeting, the OEB does not currently take this appropriately into account in its ratemaking. Even if addressing this issue did not immediately lead to consolidation, the rebalancing of costs between Hydro One and the embedded territories would be beneficial to Hydro One and its customers, and would send a positive signal to investors in Hydro One that the Province is taking the need for fair regulation seriously.

3. GREATER FINANCIAL INCENTIVES

Given the OEB's recent announcement of a new policy, no further action is required. While the announced policy as of yet only addresses some of the concerns our LDC members have, it is a step in the right direction, and our LDC members will continue to work with the OEB to refine the policy.

4. OEB CAPACITY TO EFFICIENTLY PROCESS TRANSACTIONS

Direction to the OEB with respect to the scope and possibly the timelines for MAAD applications would be welcomed and appreciated. While historically the OEB dealt with MAAD applications relatively efficiently, in recent years both the scope of the reviews and the time required to complete them have expanded dramatically. Also, if the government's pro-consolidation policy is effective and there is a surge in MAAD applications, it is not clear that the OEB has the appropriate capacity to respond, though we were somewhat encouraged that the regulator has indicated they recognize this possibility. More generally, the OEB's capacity to manage its affairs has been an escalating issue: the emphasis on part-time Board members, and the lack of internal staff resources to manage Board processes has become a challenge for the industry. **As you rightly noted in our meeting, the cost of all OEB resources is ultimately borne by the utilities and their customers, and so we find it striking that the OEB has been resisting calls to expand its resourcing even though the sector itself has effectively expressed its willingness to fund such an expansion.** LDCs would prefer to see more full-time members of the Board who could become experts in their field and who could apply policy consistently across cases; increased development of internal staff capacity to address policy issues rather than relying on consultants would also improve consistency of OEB policy and decisions.

5. STABILITY OF CAPITAL STRUCTURE AND RETURN ON EQUITY POLICIES

On Thursday, April 2, 2015 the OEB released a new policy on *Distribution Rate Design for Residential Customers* (EB-2012-0410). This was the culmination of a long policy process that has been debated for some time. It is a significant change to the business of distributors, and is the first part in the intended implementation of changes to the way distributors collect revenue. Regardless of the merits or the public and industry reaction to this new policy, it represents a significant change to the revenue risk faced by distributors. If the OEB carries through with their stated intention to spread the use of this new policy to other customer classes, there will be significant additional change to the nature of the distribution business in Ontario. Many commentators and analysts might expect that a next step for the OEB, in light of this change, would be to review the policies for capital structure and return on equity currently in place (those policies are closely related to the perceived risk associated with operating a utility, so if the utility risk profile changes, this policy would be expected to change as well). While this may or may not be appropriate, the timing is unfortunate. Capital structure and return on equity policies are among the most fundamental with respect to the valuation of utilities; uncertainty in the future of these policies means uncertainty with respect to the market value of Ontario utilities. If the next few years are meant to be a special "window" for consolidation activity, then destabilizing the expected market value of utilities at this time would be extremely counterproductive. **It would be helpful if the OEB and/or the government could make a statement to the effect that notwithstanding the changes to rate design implemented or intended by the OEB, there will be no modification to existing capital structure and return on equity policies until the proposed rate design changes are fully implemented and allowed to operate for a period of time. This would signal that there will be stability in these critical policies until beyond 2020.**

NEXT STEPS

The OEA has always promoted LDC consolidation and agrees with you and your government 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. I appreciate your staff's comments that in the past the regulator was unwilling to proceed on the above regulatory recommendations due to presumptions about the political acceptability of such changes; which is why it is that much more **important for the government to publicly signal its support for the OEB's undertaking of these critical changes. The OEA looks forward to hearing from you on this time sensitive file given the pending release of the final report of the Premier's Advisory Council.**

Thank you again for your time and attention. If you have any questions about any of the 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.

Best regards,

Bob Huggard
President and CEO
Ontario Energy Association

cc: Andrew Teliszewsky, Chief of Staff, Office of the Minister of Energy
Dan Moulton, Policy Advisor, Office of the Minister of Energy