Ontario Energy Association

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The Honourable Charles Sousa
Minister of Finance
c/o Office of the Budget
Frost Building South, 4th Floor
7 Queen's Park Crescent East
Toronto, ON M7A 1Y7

Dear Minister Sousa:

On behalf of the Ontario Energy Association's (OEA) Board of Directors and members, I would like to offer our appreciation for the opportunity to participate in Ontario's 2015 provincial pre-budget consultation.

The Ontario Energy Association (OEA) aspires to be the most credible and trusted voice of the energy sector. We earn our reputation by being an integral and influential part of energy policy development and decision making in Ontario. We represent Ontario's energy leaders that span the full diversity of the energy industry.

Ontario continues to experience fiscal challenges. By removing barriers to the consolidation of Ontario's electricity local distribution companies (LDCs) the province can help mitigate future cost increases that are ultimately borne by energy customers, and also assist LDCs in upgrading infrastructure with the assistance of private capital. Bold policies have allowed Ontario to attract investment in generation infrastructure over the past several years and the province therefore enjoys sufficient supply to meet the energy demand needs of all customers. However, increased investment in the distribution sector is needed to ensure Ontarians continue enjoying access to an affordable and reliable supply of electricity, and now is the time to focus on providing electricity distribution services more efficiently to energy customers. The OEA believes that this can be achieved by incentivising LDC consolidation and removing barriers to private investment in LDCs.

We look forward to continuing the dialogue with your government on how changes to Ontario's energy sector can help create new investment opportunities in Ontario, generate savings for Ontario families and businesses, and continue repositioning the energy sector to support economic growth. If you have any questions regarding this submission please contact me or our Vice President of Government Relations and Communications, Tina Arvanitis at 647.920.3269 or tina@energyontario.ca.

Let’s unravel the most complex energy challenges, together.

Best regards,

Bob Huggard
President and CEO
Ontario Energy Association

CC: The Hon. Bob Chiarelli, Minister of Energy
Mr. Scott Thompson, Deputy Minister of Finance
Mr. Serge Imbrogno, Deputy Minister of Energy

ONTARIO ENERGY ASSOCIATION

2015 PRE-BUDGET SUBMISSION

FEBRUARY 2015

To shape our energy future for a stronger Ontario.

Ontario Energy Association

ABOUT
THE OEA

The Ontario Energy Association (OEA) aspires to be the most credible and trusted voice of the energy sector. We earn our reputation by being an integral and influential part of energy policy development and decision making in Ontario. We represent Ontario's energy leaders that span the full diversity of the energy industry.

The OEA takes a grassroots approach to policy development by combining thorough evidence based research with executive interviews and member polling. This unique approach ensures our policies are not only grounded in rigorous research, but represent the views of the majority of our members. This sound policy foundation allows us to advocate directly with government decision makers to tackle issues of strategic importance to our members.

Together, we are working to build a stronger energy future for Ontario.

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EXECUTIVE SUMMARY

Rationalising Ontario's Electricity Distribution Sector to Address Rising Costs to Customers

The Ontario Energy Association (OEA) welcomes the commitment of the Government of Ontario to strengthen its fiscal management in an effort to pave the way to balanced budgets. The OEA's key contribution to Ontario's pre-budget process is to demonstrate how the energy sector can assist the government in meeting its overall policy objectives by ensuring affordable, reliable, and sustainable energy for Ontario consumers at the residential, commercial, and industrial levels. The importance of Ontario's energy sector cannot be underestimated:

- Ontario's electricity sector is an $18 billion annual industry[1] that employs approximately 95,000 people in the province, 65,000 of those directly[2]; and
- Natural gas distribution in Ontario is a $1.2 billion annual industry that directly employs over 4,300 Ontarians[3].

In order to help address some of Ontario's fiscal challenges, the OEA's 2015 pre-budget submission will focus primarily on means to **incentivise consolidation of electricity Local Distribution Companies (LDCs) and remove barriers to private investment in LDCs.**

Our recommendations would create new investment opportunities for energy companies, will generate savings for Ontario families and businesses, and will continue repositioning the energy sector to support economic growth.

1 Government of Ontario's Long-Term Energy Plan, 2013
2 Government of Ontario's Long-Term Energy Plan, 2010
3 Canadian Gas Association, 2013

RECOMMENDATIONS

INTRODUCTION

Over the last few years, Ontario's electricity LDCs have been given new obligations in addition to their core distribution business functions. For example, LDCs are connecting an increasing amount of renewable generation projects, meeting conservation and demand management (CDM) targets, and installing smart meters in Ontario homes. In addition, many LDCs are facing increasing capital demands owing to population growth, densification of urban centres, and ageing infrastructure.

In April 2012, the Ontario Minister of Energy established the Ontario Distribution Sector Review Panel (the "Panel") to provide expert advice to the government on how to improve efficiencies in Ontario's electricity sector with the aim of reducing the financial cost of electricity distribution for customers. In December 2012, the Panel delivered their report, Renewing Ontario's Electricity Distribution Sector: Putting the Consumer First, that reviewed Ontario's electricity distribution sector and made many recommendations.

The OEA believes that the Panel Report is a useful document, particularly with respect to its explanation for the need to pursue consolidation in Ontario. Although the OEA does not support a few of the conclusions drawn and recommendations made in the Report, we hope that the government will strike a course with new policy direction that emphasizes positive incentives for consolidation.

In 2014 and 2015 the OEA made presentations to the Premier's Advisory Council on Government Assets in which it reiterated its views on removing regulatory and taxation barriers to LDC consolidation.

In support of our advocacy of consolidation of electricity LDCs, the sub-sections below convey the OEA's recommendations to incentivise consolidation and remove barriers to private sector investment by addressing both regulatory and tax issues.

RECOMMENDATION 1: ELIMINATE TAX BARRIERS

The OEA recommends that the Government of Ontario grant tax relief to LDCs in order to encourage consolidation transactions.

Municipally-owned electricity LDCs in Ontario have limited financial resources with which to invest in critical infrastructure. Certain existing tax policy instruments continue to deter them from attracting private capital or from seeking voluntary mergers with private entities, either of which could solve access to capital issues. One example is the Transfer Tax that creates a distorted playing field for electricity distribution companies. The Electricity Act, 1998 imposes a 33% Transfer Tax on any sale of assets owned by a municipal LDC, payable to the Ontario Electricity Financial Corporation (OEFC). The OEFC uses proceeds from this tax, along with other revenue sources, to pay off the stranded Ontario Hydro debt.

Likewise, a Departure Tax is applied on the sale of municipally-owned LDCs to private entities. Such sales result in a deemed disposition of the entire LDC, regardless of the actual stake that is transacted. There are significant tax consequences resulting from this disposition and they too prevent private capital from flowing into Ontario's LDCs.

Federal legislation exempts LDCs that are at least 90% owned by a municipality or province from paying federal income tax, while parallel provincial laws direct such LDCs to instead make payments in lieu of taxes (PILs) to the OEFC. However, transfers of more than 10% of assets to private investors result in LDCs leaving the PILs regime and being subject to both the Transfer and Departure Taxes.

One of the reasons for excluding transactions with private entities was that such an exemption would result in reduced revenues to apply to the stranded Ontario Hydro debt by creating "tax leakage" of revenues to the federal government. Historically, the Government of Canada accommodated such situations by agreeing to forego collection of income taxes for a period of time from provincially- or municipally-owned public utilities which changed hands, allowing provincial governments to continue to collect PILs. The Ontario Government should seek such an accommodation from the federal government again. For example, a 10-year deal with the Government of Canada would allow the province to capture more than fifty percent of future "tax leakage" on a net present value basis.

Changing the Electricity Act's tax policies in a manner consistent with the Province's interest in eliminating the stranded Ontario Hydro debt would be a strong contributor to a healthier electricity distribution sector in the future, with greater capacity to deliver benefits to customers.

RECOMMENDATION 2: ADDRESS REGULATORY ISSUES

The OEA recommends that the Government of Ontario rectify existing regulatory policies that discourage LDC consolidation.

In addition to the taxation issues discussed in recommendation 1, 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. The OEA asks that government address the following regulatory policy issues:

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 through 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.

RECOMMENDATION 3: PUBLIC-PRIVATE PARTNERSHIPS

The OEA recommends that the Government of Ontario review the regulatory and legislative framework for LDCs to ensure that private sector investments can flow to LDCs where economical.

The continued exclusion of the private sector from the Ontario electricity LDC sector has reduced the options for capital-raising, prevented monetization of municipal value, and has discouraged additional consolidation and efficiency in the sector. For example, the fact that access to Infrastructure Ontario funding is limited to utilities that are 100%-owned by municipalities punishes those municipally owned utilities that have chosen to privatize up to 10% of their assets and, as such, forego access to cheaper public funding. Many of the OEA's electricity LDC members believe that greater private sector involvement would be beneficial for the sector, and LDCs must not be penalised for choosing to partner with private sector companies.

SUMMARY

Recommendation 1: Eliminate Tax Barriers

The OEA recommends that the Government of Ontario grant tax relief to LDCs in order to encourage consolidation transactions. Concurrently, the government should consider solutions addressing the potential loss of PILs revenues accruing to the OEFC that are used for paying off the stranded Ontario Hydro debt.

Recommendation 2: Address Regulatory Issues

The OEA recommends that the Government of Ontario rectify existing regulatory policies that discourage LDC consolidation.

Recommendation 3: Public-Private Partnerships

The OEA recommends that the government of Ontario review the regulatory and legislative framework for LDCs to ensure that private sector investments can flow to LDCs where economical.

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