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Greater Sudbury Hydro Inc.
REVISED Response to Undertaking J1.15
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Goodmans LLP

Barristers & Solicitors

250 Yonge Street, Suite 2400
Toronto, Ontario Canada M5B 2M6

Telephone: 416.979.2211
Facsimile: 416.979.1234
goodmans.ca

Direct Line: 416.597.4184
pruby@goodmans.ca

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Our File No.: 061319

By Facsimile

Brian Hewson
Chief Compliance Officer
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street
Toronto, ON M4P 1E4

Dear Mr. Hewson:

Re: Greater Sudbury Hydro Inc. Compliance with the Affiliate Relationships Code

We are the solicitors for Greater Sudbury Hydro Inc. ("GSHI") and are writing further to our letter of April 7, 2006. We are pleased to provide you with the action plan you requested with respect to GSHI's compliance with the Affiliate Relationships Code.

GSHI is in full compliance with its distribution license and the Affiliate Relationships Code. However, in the interest of minimizing regulatory action and in recognition that some of the comments made in your March 6, 2006 letter suggest improvements to GSHI's business practices, GSHI is willing to implement certain of your recommendations, particularly with respect to GSHI's interaction with the public.

However, GSHI does not accept your interpretation of its distribution license and the Affiliate Relationships Code. Our client's submissions concerning the correct interpretation of GSHI's distribution license and the Affiliate Relationships Code are provided in the attached brief of general submissions (which are tendered on behalf of GSHI and Essex Powerlines).

In summary, GSHI believes that it is in the best interest of electricity consumers, and compliant with the Code, for it to outsource to its affiliates all of the operations of GSHI, including line maintenance, billing, and customer services. This will allow the personnel involved in providing those services to be used in the most efficient manner without prejudicing electricity customers.

However, GSHI recognizes the CCO's concerns with respect to employee sharing. GSHI and its affiliates intend to restructure their operations so that electricity commodity related services are provided by individuals employed by a separate entity (an energy service provider) from the entity that provides the core distribution services. We note that GSHI and its affiliates are considering ceasing their provision of water heater, conservation and sentinal lighting services in light of your

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March 6 letter. We expect that within 60 days we will be able to advise you of the new arrangement. In the meantime, GSHI would appreciate any comments you have that would be of assistance to it in establishing this new arrangement.

GSHI does not propose to change the manner in which it engages in transfer pricing, i.e. cost-based transfer pricing because, among other reasons, GSHI may not outsource to a non-affiliate the services covered under its long time collective agreement.

Finally, GSHI is in the process of implementing your recommendations with respect to its marketing activities, particularly with respect to its website and bills. Once the new corporate structure of GSHI's affiliates is finalized (a pre-condition to finalizing changes to the websites and bill formats), GSHI intends to move quickly to make the changes you have recommended. In the meantime, GSHI is reviewing what changes it can make to its website and bills, without great cost, to address at least some of your recommendations in this regard pending the finalization of the corporate structure.

We are advised that you are currently working with the Electricity Distributors Association with respect to the general issues raised in your March 6 letter. GSHI strongly endorses your taking a holistic and industry-wide approach to these issues after consulting with distributors as a group. GSHI looks forward to participating in any stakeholder consultations in this regard.

We trust that you find this action plan satisfactory. If you have any questions or comments, please let us know.

Yours truly,

GOODMANS LLP

Peter Ruby
PDR/tg

Encl.
Copy: Doug Reeves, GSHI

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Overview

Recently the Chief Compliance Officer (the "CCO") of the Ontario Energy Board wrote to a number of municipally-owned electric utilities ("LDCs") with respect to compliance with the Affiliate Relationships Code (the "Code") and requested responses from them. On behalf of two of those LDCs (Greater Sudbury Hydro Inc. and Essex Powerlines Corporation), the following general submissions are provided to assist the CCO in his interpretation and application of the Code. In addition to these general submissions, Greater Sudbury Hydro Inc. and Essex Powerlines Corporation has or will provide to the CCO a response concerning the LDCs' specific circumstances.

The Code is intended to protect consumers from the abuse of market power by monopoly LDCs. It focuses on ensuring that licensed LDCs do not subsidize or inappropriately favour their own unregulated affiliates to the prejudice of consumers.

The Code is designed to enhance the development of a competitive market while saving ratepayers harmless from the actions of distributors with respect to dealings with their affiliates. In particular, "the standards established in the Code are intended to:

> (a) minimize the potential for a utility to cross-subsidize competitive or non-monopoly activities;
>
> (b) protect the confidentiality of consumer information collected by a transmitter or distributor in the course of provision of utility services; and
>
> (c) ensure there is no preferential access to regulated utility services."

It is essential that this intention of the Board be kept in mind by the CCO when the Code is interpreted:

> Although much has been written about the interpretation of statutes..., Elmer Driedger in Construction of Statutes (2nd ed. 1983) best encapsulates the approach upon which I prefer to rely. He recognizes that statutory interpretation cannot be founded on the wording of the legislation alone. At p. 87 he states:
>
> > Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament. [emphasis added][1]

LDC licences and the Code should be interpreted in light of this approach.

Properly interpreted, the provisions of the Code must advance the Board's objectives and not prejudice the attainment of the Board's legislative goal to "promote economic efficiency and cost effectiveness in the generation, transmission, distribution, sale and demand management of electricity and to facilitate the maintenance of a financially viable electricity industry"[2]. The CCO's interpretation of certain provisions of the Code does not meet this test and should be rethought.

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[1] *Re Rizzo & Rizzo Shoes Ltd.*, [1998] 1 S.C.R. 27 at para. 21.

[2] *Ontario Energy Board Act, 1998*, s. 1(1)(2).

Issues

The following conclusions of the CCO are at issue:

1. The electricity distribution license issued to LDCs and the provisions of the Code require that an LDC have at least one employee who has responsibility and authority for managing its operations and for ensuring that its distribution system is operated in accordance with all legal and regulatory requirements, and who is not shared with any affiliate.

2. Affiliates which provide services such as engineering, billing, construction and maintenance of electrical equipment and lines to an LDC are energy service providers. Therefore, LDCs in their dealings with such affiliates must adhere to the provisions of the Code that address the relationship between a distributor and an energy service provider affiliate.

3. In order to comply with the employee sharing restrictions of the Code, an LDC must ensure that shared employees who have access to confidential information or carry out the day-to-day operation of the distribution network are not involved in the affiliates' unregulated activities in the LDCs licensed service area.

4. An LDC providing services to or receiving services from an affiliate must conduct a "market review" to determine whether there is a market for the services. A determination that there is no market must be verifiable by auditable means. It is not permissible to bundle services in order to determine if there is or isn't a market price for such services.

There is no requirement that an LDC have at least one employee

The CCO has incorrectly concluded that the electricity distribution licenses issued and the Code require that an LDC have at least one employee who has responsibility and authority for managing its operations and for ensuring that its distribution system is operated in accordance with all legal and regulatory requirements.

There is no explicit authority supporting this conclusion in the *Electricity Act*, the *Ontario Energy Board Act*, corporate law or the Code, nor any supporting policy goal. The CCO appears to derive the one employee requirement from the simple fact that an LDC's distribution license gives it sole authority to own and operate a distribution system within its distribution territory.

The CCO's conclusion is premised on the incorrect assumption that employees are ultimately responsible for a corporation and that without an employee a corporation has no one to run it.

In reality, an LDC is governed by its directors – not its employees. As long as the appropriate corporate mechanisms are in place, an LDC can be operated without employees, and the Board can be confident that particular individuals identified in the LDCs corporate records are ultimately responsible for the actions of the LDC.

All LDCs in Ontario have been incorporated under the *Ontario Business Corporations Act* (the "OBCA"). All OBCA corporations must have at least one director and can have one or more officers, none of whom must be employees. The OBCA vests in directors and officers the fiduciary obligation to manage the business and affairs of the corporation in its best interests. Thus, all LDCs have one or more individuals who are "on the hook" and whose identities are

readily ascertainable. Employees only have the authority assigned to them by the officers and directors.

The goal of ensuring that one or more individuals have ultimate authority and responsibility for an LDC is not furthered by reading into a distribution license or the Code a requirement that the responsible individual or individuals be employees. If the directors, acting prudently and in the best interest of the corporation, determine that the traditional employee functions should be outsourced, subject at all times to the overall supervision of the directors, there is no reason to interfere with that determination, and indeed there is no intention to so interfere reflected in the relevant statutory provisions or codes.

Moreover, as long as the chain of corporate responsibility is properly maintained, it is in the interests of consumers that LDCs operate as efficiently as possible, which may in some cases suggest that all the operations of the LDC be outsourced.

LDC affiliates that provide only core electricity distribution services are not ESPs

The CCO has incorrectly concluded that LDC affiliates which provide services such as engineering, billing, construction and maintenance of electrical equipment and lines to an LDC are energy service providers ("ESPs") and, therefore, must adhere to the provisions of the Code that address the relationship between a distributor and an ESP affiliate.

The term "energy service provider", within the meaning of the Code, does not apply to providers of any service unrelated to the electricity commodity. The Code defines an ESP as:

> "a person, other than a utility, involved in the supply of electricity or gas or related activities, including retailing of electricity, marketing of natural gas, generation of electricity, energy management services, demand-side management programs, and appliance sales service and rentals" [emphasis added].

The word "involved" must be read harmoniously with the examples within this definition. The examples provide guidance as to the types of services encompassed by the ESP definition. All of the examples given in the ESP definition are electricity commodity related products or services. They are not core distribution services.

ESP definition's focus on electricity commodity related services is consistent with the Code's use of the word "supply" in defining an ESP. Throughout the *Electricity Act* and the *Ontario Energy Board Act*, the use of the word "supply" addresses electricity commodity. For example, section 25.30(1) of the *Ontario Energy Board Act* deals with "electricity supply from alternative energy sources and renewable energy sources". Similarly, in dealing with electricity commodity, as distinct from electricity distribution, the Board created the Standard Supply Service Code to address the default supply of electricity commodity by distributors.

The ESP definition's focus on electricity commodity related services is also consistent with the objectives of the Code, as set out in s.1. Electricity commodity related services are most vulnerable to anti-competitive practices by LDCs and the Code provides an elevated level of protection commensurate with that risk. Core distribution services do not carry with them the same level of risk and, therefore, the Board has not subjected them to the elevated level of protection.

The focus of the ESP definition on electricity commodity related services is also apparent from s. 2.2.4 of the Code. Read with the interpretation of the ESP definition proposed by the CCO,

s.2.2.4 would constitute a complete prohibition on personnel providing services with respect to the "day-to-day operation of the utility's transmission or distribution network" by any entity except the LDC itself. Had this been the Board's intention, it would have made such a major prohibition explicit – which it did not do. Read properly, s.2.2.4 only prevents the mixing in the same affiliate personnel providing electricity commodity related services and other services such as core distribution services.

Core electricity distribution services are part of an LDC's monopoly and should be provided in the most efficient manner possible so as minimize electricity distribution rates – which are based in part on those costs. As noted above, this is an explicit objective of the *Ontario Energy Board Act*.

That indeed the interpretation by the CCO of the ESP definition was not the result intended by the drafters of the Code is clear from the consequences flowing from the CCO's interpretation: An LDC could directly employ all employees providing core electricity distribution services, although those employees could also provide operations and maintenance services vis-à-vis municipal electricity, water, sewage and street lighting activities to affiliates involved in water, street lighting, etc. (even under the CCO's reading of the ESP definition, affiliates involved solely in water, street lighting, etc. are not ESPs). This would not result in any improved protection of the public over the current situation. Regardless of the direction of the service flow (to the LDC or from the LDC), the servicing activities would subject to the service contract and transfer pricing requirements of the Code. This transfer price regulation is what protects the public.

While there is no disadvantage to electricity consumers in this regard, there are advantages to allowing affiliates to provide core distribution services to an LDC. Firstly, an LCD is supposed to be focused exclusively on the operation of its distribution network; it makes little sense to make the LDC the "hub" of the provision of services to a municipality's various service areas. Secondly, the electricity regulatory burden (and related costs) is reduced by allowing a municipality's non-LDC affiliates to freely contract between themselves and the municipality. Thirdly, the time of core distribution personnel is most efficiently used if their excess capacity is used, and paid for, by affiliates doing non-electricity work (such as street lighting, water and sewage). As long as core distribution personnel are not also engaged in providing electricity commodity related services (with the associated elevated risks described above), it is to everyone's advantage to allow such efficient use of personnel.

An LDC's affiliate may do billing for the LDC

The CCO concluded with respect to billing services that "[i]n order to comply with the employee sharing restrictions of the Code, a distributor must ensure that shared employees having access to confidential information or carrying out the day-to-day operation of the distribution network are not involved in the affiliates' unregulated activities in the distributor's licensed service area." [emphasis added]. Effectively this would preclude an affiliate from engaging in billing services for an LDC (which always involves confidential information) – an outcome inconsistent with the Code.

Section 2.6.2 of the Code expressly allows the disclosure of confidential information for billing purposes:

> A utility shall not disclose confidential information to an affiliate without the consent in writing of a consumer, retailer, or generator, as the case may be, except where confidential information is required to be disclosed...for billing or market operation purposes... [emphasis added]

Therefore, affiliate employees are expressly allowed to provide billing services for an LDC. This is an express exception to the general prohibition on the disclosure of confidential information and sharing of employees. Similarly, s.2.6.2 allows confidential information to be disclosed to an affiliate if that disclosure is required for "market operation purposes".

Acting under this section, municipalities have had their billing for both their water and electricity services handled by the same employees within a municipally-owned affiliate. By doing so, they have achieved economies of scale beneficial to electricity consumers and municipal residents alike – consistent with the statutory objectives set out in s.1 of the *Ontario Energy Board Act*.

An LDC need not conduct an auditable market review

The CCO has concluded that an LDC providing services to or receiving services from an affiliate must conduct a "market review" to determine whether there is a market for the services and that a determination that there is no market must be verifiable by "auditable" means. He also concluded that it is not permissible to bundle services in order to determine if there is a market price for such services.

This reverse onus is not authorized by the Code. The CCO should not second guess the business judgment of an LDC's directors as to whether a market exists for the services the LDC requires.

Many municipalities which own LDCs have also formed "Servos", i.e. companies which on a "cost plus" basis provide distribution, operation and maintenance, construction and engineering and/or billing services to the LDC as well as to other municipal service providers such as water and street lighting. In establishing this structure, the directors of these LDCs have made a determination that:

a) it is more cost efficient to obtain a full suite of services from a single service provider than to administer the contracting and administration of services from a wide variety of service providers;

b) obtaining the desired bundle of services from a service provider outside of the community is not a suitable substitute for obtaining such services from a service provider actually based in the community who has complete and thorough knowledge of the community and who is able to respond to emergency situations with much greater speed;

c) particularly in the case of smaller or more isolated communities, it is not realistic to expect that a service provider originating from outside the community could establish a locally-based, knowledgeable and experienced team and provide the bundle of services more cheaply than a municipally-owned affiliate which already has the necessary resources at hand and does not need to incur the capital costs of establishing a local presence; and

d) a "cost plus" payment for the services is appropriate because it is below the price which a service provider coming from outside the community would have to charge to recover its costs.

These are all determinations which the Code leaves open to the directors of an LDC to make, acting reasonably and in the best interests of the LDC. While, as the CCO asserts in his letters, the directors may not bundle services artificially for the purposes of circumventing the requirements of the Code, there is nothing artificial or unreasonable about the conclusion that obtaining a suite of services from a single service provider with the necessary experience is a more efficient and cost-effective means of proceeding, particularly in a smaller or more remote community.

There is no requirement in the Code itself that a determination by an LDC that there is no market for a given service must be verifiable by auditable means. Directors should be presumed to have acted reasonably and in good faith and in the best interests of the corporation in determining whether a market realistically exists for the services they are seeking and/or whether a cost plus price is below fair market value, unless others can produce evidence to the contrary. Corporate statutes such as the OBCA already impose on directors an obligation to make determinations as to fair value[3], but do not prescribe a particular set of procedures which the directors must follow in making such a determination – a sensible approach as different circumstances may dictate that different procedures be followed.

[3] For example, in setting the price at which shares of the corporation are issued.

Thus, it may be appropriate for a large well-financed LDC within a centrally located and populous community to follow relatively expensive and elaborate procedures to make determinations; for small to mid-size LDCs in smaller or more remote communities it may well not. Similarly, a director may be required to take into account a collective agreement and labour laws that restrict the LDC and its affiliates' ability to contract out work to non-affiliates. In other words, in some circumstances it may be obvious to an LDC's directors that there is no market available to it with respect to certain services. It would be inefficient to require an auditable market review despite such an obvious situation.

A director's conclusion concerning the existence of a market or fair value is itself "evidence" of a determination in such matters. A common sense decision by a director to abstain from more elaborate procedures, particularly in the context of a smaller or midsize LDC, is permitted by the Code. Of course a director's determination on such matters is subject to question, both under the Code and under general principles of corporate law. The more elaborate and costly procedures the directors follow to assist them in their determination, the more they presumably insulate themselves from criticism or attack. However, the CCO should not require up-front auditable market evidence.

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