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October 26, 2007

**VIA Email and Courier**

Ms. Kirsten Walli  
Board Secretary  
P.O. Box 2319  
2300 Yonge St.  
Toronto, ON  
M4P 1E4

Dear Ms. Walli,

**Re: PROPOSED AMENDMENTS TO AFFILIATE RELATIONSHIPS CODE  
FOR ELECTRICITY DISTRIBUTORS AND TRANSMITTERS  
BOARD FILE NO: RP-2007-0662**

Please find comments filed on behalf of VECC in the above noted proceeding.

Yours truly,

Michael Buonaguro  
Counsel for VECC  
Encl.

## **Electricity ARC Amendments**

### **Comments of the Vulnerable Energy Consumers' Coalition (VECC)**

#### **Summary**

*The Ontario Energy Board (the "Board") has given notice under section 70.2 of the Ontario Energy Board Act, 1998 (the "Act") of proposed amendments to the Affiliate Relationships Code for Electricity Distributors and Transmitters (the "Electricity ARC" or the "Code").*

VECC believes that most of the proposed amendments are appropriate, but is concerned that some of the premises about the future shape of the Ontario retail electricity market, for example Load Serving Entities, and reopening of the retail market, Smart Meters and TOU rates that seem to have prompted some of the changes, particularly in regard to retailer affiliates, may not happen. If that is the case, VECC suggests some of the changes provide too much latitude in the distributor-retailer relationship and too little protection for electricity consumers.

In addition, VECC does not agree with the removal of the requirement for evidence of fair market value for Shared Corporate Services (if a market exists). The use of the fully allocated cost of the service provider has been accepted as default in the Gas ARC, but if the Board's three prong test for Shared Corporate Services is to remain as a tool, then there should be a parallel requirement to the Gas ARC for documentation of a reasonable Cost Allocation methodology such as the methodologies that Hydro One and Toronto Hydro were directed to implement. Symmetry between the provisions of the Gas ARC and Electricity ARC is important in this regard.

#### **A. Section 1.1 - Purpose of the Code**

*"The Board is proposing to amend that section by adding the objective of preventing a utility from acting in a manner that provides an unfair business advantage to an affiliate that is an energy service provider".*

VECC agrees with the Board that preventing transmitters and distributors from using their monopoly position in a manner that is or can be harmful to the interests of customers is within the scope of its authority. "Harm" in this context can take a variety of forms, from customer confusion to reducing alternative competitive offerings available to (and increasing prices payable by) ratepayers for different products or services.

*The Board is also proposing to amend section 1.1 of the Electricity ARC to more clearly identify a further objective; namely, that of "preventing customer confusion that may arise from the relationship between a utility and its affiliate".*

VECC supports this addition in principle. The practical concern is what constitutes "consumer confusion". First a definition would be helpful. Second,

some criteria such as Complaints, evidence of slamming or other practices and some guidance as to how to assess confusion is required in this regard.

## **B. Section 1.2 - Definitions**

*The Board is proposing to amend section 1.2 of the Electricity ARC to add new definitions of "Affiliate Contract", "direct costs", "fully-allocated costs", "indirect costs", "market price", "shared corporate services", "utility asset" and "utility revenue", and to remove the current definition of "fair market value". These proposed amendments support the proposed introduction of the new transfer pricing provisions described in section E below, and are to the same effect as the parallel definitions in the Gas ARC.*

*The Board is also proposing to amend section 1.2 of the Electricity ARC to add a new definition of "strategic business information", to support the proposed introduction of a new section that restricts a utility from providing that information to certain affiliates*

VECC supports these additional definitions in principle.

However, it is suggested that the definition of Energy Service Provider should be expanded to include (smart) metering services. If affiliates enter this field then they should be subject to all of the provisions regarding consumer information.

VECC also does not support the elimination of the definition of "fair market value". FMV is the goal that the utility should strive to attain for all purchased services and in particular services purchased from, or provided to affiliates should be transacted at FMV. FMV does not mean market price; it is a measure of the benefit (value) that a service provides.

## **C. Section 2.1 - Degree of Separation**

*The Board is proposing to amend section 2.1 by eliminating the requirement in section 2.1.2 that a utility be physically separated from any affiliate that is an energy service provider. The Board is satisfied that the elimination of this requirement, which will provide utilities with additional flexibility in terms of their arrangements, will not create the potential for material incremental harm in light of the other provisions, existing and proposed, of the Electricity ARC.*

VECC has no comment.

#### **D. Section 2.2 – Sharing of Services and Resources**

*The Board is proposing to amend section 2.2 to eliminate the prohibition, currently set out in section 2.2.4, against a utility sharing operating employees with an energy service provider affiliate. The general prohibition on sharing employees with access to confidential information contained in section 2.2.3 of the Electricity ARC, and the proposed new prohibition on the provision of “strategic business information” discussed in section F below, are considered sufficient to provide the necessary safeguards.*

VECC is concerned that the elimination of the prohibition on sharing employees places significant onus on an employee not to share confidential information in inadvertent ways. Maintaining the current requirement would be the most appropriate protection if it was anticipated that the retail market may reopen at some future date. However, VECC accepts the inefficiencies that this may cause with respect to CDM, so since the greatest potential harm to consumers is with regard to Energy Service Providers VECC suggests that if the market changes the prohibition on sharing employees should be revisited.

*The Board is also proposing to add a new section to this part of the Electricity ARC that clarifies that the transfer pricing rules contained in section 2.3 do not apply to utilities and affiliates sharing services in emergency situations. In such cases, a reasonable cost-based price would be determined afterwards. This proposed amendment provides utilities with greater regulatory certainty and flexibility in responding to emergency situations.*

VECC agrees but suggests that guidance on “emergency situations” (even a definition) would be helpful.

#### **E. Section 2.3 – Transfer Pricing**

*The Board considers that it is appropriate to adopt the Gas ARC transfer pricing provisions in the Electricity ARC, with certain modifications.*

##### *i. Section 2.3.1 - Term of Contracts with Affiliates*

*It is proposed that section 2.3 be amended by adding a five-year limit on Affiliate Contracts,*

##### *ii. Section 2.3.2 – Outsourcing to an Affiliate*

*It is proposed that section 2.3 be amended by adding a requirement that a utility complete a business case analysis before outsourcing to an affiliate a service, product, resource or use of asset that the utility currently provides internally.*

*The Board is also proposing that the business case requirement not apply to an Affiliate Contract that has an annual value of less than \$100,000 or 0.1% of the utility’s utility revenue (defined to exclude revenue from commodity sales), whichever is greater.*

VECC suggests that the Board mirror the similar provision in the Gas ARC, which requires a business case to be repeated at least once every five years. The

proposed approach seems inconsistent with the proposed five-year limit on the term of Affiliate Contracts.

*iii. Section 2.3.3 - Transfer Pricing Where a Market Exists*

*It is proposed that section 2.3 be amended to add more detailed market-based transfer pricing rules to be applied where a reasonably competitive market exists for a service, product, resource or use of asset that is provided by an affiliate to a utility or by a utility to an affiliate.*

*Board is also proposing that the market tendering requirement not apply to an Affiliate Contract that has an annual value of less than \$100,000 or 0.1% of the utility's utility revenue, whichever is the greater.*

VECC finds this amendment to be appropriate.

*iv. Section 2.3.4 - Transfer Pricing Where No Market Exists*

*It is proposed that section 2.3 be amended to clarify that cost-based pricing is to be determined on the basis of fully-allocated costs, including a return on invested capital that is no higher (where the utility is acquiring the service, product, resource or use of asset) or no lower (where the utility is providing the service, product, resource or use of asset) than the utility's approved weighted average cost of capital.*

VECC agrees with this amendment and the addition of a new section, similar in intent to a provision of the Gas ARC, which would require a utility to obtain details of the affiliate's cost determination whenever cost-based transfer pricing is used.

*v. Section 2.3.5 - Transfer Pricing for Shared Corporate Services*

*Unlike the Gas ARC, the Electricity ARC does not currently contain provisions relating specifically to the pricing of shared corporate services. It is proposed that section 2.3 be amended to expressly allow the use of cost-based pricing for shared corporate services.[Emphasis Added] An accompanying definition of "shared corporate services", which is the same as the definition of "shared core corporate services" in the Gas ARC, is also proposed to be added to section 1.2 of the Electricity ARC. These proposed amendments accept that cost-based pricing will always be appropriate in relation to shared corporate services.*

*The Proposed Amendment is as follows:*

**2.3.5 Shared Corporate Services**

2.3.5.1 Despite sections 2.3.3.1 and 2.3.3.6, for shared corporate services, fully allocated cost-based pricing (as calculated in accordance with sections 2.3.4.1 and 2.3.4.2) may be applied between a utility and an affiliate provided that the utility complies with section 2.3.4.3.

VECC disagrees with this amendment because it does not require the parallel Gas ARC requirement for a reasonable cost allocation methodology, which by implication and practice, requires a review of market services or prices:

2.3.11.3 Reasonable cost allocation shall be applied to all shared corporate services. The methodology for this calculation shall be documented under section 2.2.1(c). (Gas ARC)

The only requirement is compliance with 2.3.4.3:

*2.3.4.3 Where a utility pays a cost-based price for a service or resource that is obtained from an affiliate, the utility shall obtain from the affiliate, from time to time as required to keep the information current, a detailed breakdown of the affiliate's fully-allocated cost of providing the service or resource.*

In the recent Regulatory Cost Allocation Model review for EGD (EB-2006-0034) and in Toronto Hydro's review of Shared Corporate Services in its current rate application (EB-2007-0680), the key tool to assess the reasonableness of Shared Corporate Costs is the application of the Board's three prong test:

- the service is needed by the utility;
- the costs are appropriately allocated; and
- there is a benefit/ cost for ratepayers.

The third prong requires the examination of market prices for similar services. It would undermine the application of the tests if there was no requirement to apply the tests, including prong 3-to search for comparable services and costs at least in cases where a market exists. (note-no requirement for tendering)

Periodic reviews of Shared Corporate Services in rebasing years or cost of service applications is an important consideration in ensuring rates are just and reasonable. A "reasonable" cost allocation methodology should be required and documented. The sophistication of this CCA methodology is a function of the complexity and cost of the shared services and a threshold for the requirement to document the CCA methodology could be appropriate to reduce burden on small utilities.

Removal of this requirement could prompt the gas utilities and larger Electricity Distribution utilities to abandon their Board-Approved CCA methodologies.

Ratepayers must have the option to file a complaint under ARC if they have evidence that Shared Corporate Costs are inappropriate the lack of documentation of the CCA methodology will make this difficult if not impossible.

*vi. Section 2.3.6 - Transfer Pricing for Transfer of Assets*

*Currently, assets sold by a utility to an affiliate are to be priced at no less than the net book value of the asset. It is proposed that section 2.3 be amended to require that utility assets sold or transferred to an affiliate be priced at the higher of the market price or net book value, and that an independent assessment of the market price be obtained where the net book value of the asset exceeds \$100,000 or 0.1% of the utility's utility revenue, whichever is the greater.*

VECC finds this amendment to be appropriate.

The remaining issue is the disposition of the gain on sale (sale price net of transaction costs). Is 50:50 sharing such as the case for land, or does the shareholder keep all the gain? VECC's position is that sharing of the gain should be consistent with the gain on disposition of land.

**F. Restriction on Provision of Strategic Business Information**

*The Board is therefore proposing to amend section 2.6 of the Electricity ARC by adding a new section 2.6.4 that prohibits a utility from providing such strategic business information to an affiliate that is an energy service provider.*

VECC supports this amendment.

**III. Anticipated Costs and Benefits**

*The mandating of competitive tendering will better ensure that utilities are pricing affiliates transactions appropriately. The fact that this requirement does not apply to shared corporate services will provide utilities with greater flexibility in relation to the acquisition of those services and with greater certainty in relation to the pricing of those services. The inclusion of a definition of "shared corporate services" also provides greater certainty, and the definition is sufficiently broad to allow considerable operational flexibility.*

*The requirement that a utility obtain details of the affiliate's fully-allocated costs in situations where cost-based pricing is used is not expected to have ongoing cost implications for utilities once initial suitable arrangements have been made. Availability of this information will benefit all stakeholders in relation to the review of the pricing of affiliate transactions in rate cases and in relation to enforcement of the Electricity ARC.*

VECC reiterates its submissions that not requiring a documented robust CCA methodology for electricity distributors (at least the larger ones) will diminish the Board and ratepayers ability to review the prudence of the costs using the Board's three prong test.

**Cost Award**

VECC respectfully submits that it is eligible for a Cost Award in this proceeding and requests that it be reimbursed for the legitimate costs.