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BY EMAIL and RESS

September 19, 2010
Our File No. 20100248

Ontario Energy Board
2300 Yonge Street
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Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2010-0248 – Gas ARC and RRR Amendments

We are counsel for the School Energy Coalition. Pursuant to the Board's letter dated July 29, 2010, these are SEC's submissions with respect to the proposed amendments to ARC and RRR relating to affiliates that own and operate qualifying facilities.

Interest of Schools

The Board will be aware that schools have a range of interests in the activities of regulated utilities in the area of renewable energy generation. Schools are, as ratepayers, concerned for example with hidden subsidies of non-rate-regulated activities, and with redirection of the focus of rate-regulated activities to benefit non-rate-regulated activities. Schools are, as hosts and potential hosts of renewable generation, also concerned that the Board not allow utilities to engage in anti-competitive activities. One of the key purposes of ARC is to prevent just that eventuality.

It was for this reason that SEC provided extensive submissions in EB-2009-0411, where some of the same issues arose with respect to electricity distributors. While the issues for gas distributors are not precisely the same, our overall concern has not changed. In our view, the way to maximize the government's goal of increased renewable generation is to support a robust competitive market. Giving regulated utilities special market advantages was not, in our opinion, the government's purpose in allowing them to own qualifying facilities, and should not be the result of Board rules or policies. The Board should be ensuring that ownership of a qualifying facility by an affiliate or the utility is largely neutral, but should be doing so not by removing protections with respect to affiliate ownership. Rather, the Board should be enhancing protections with respect to utility ownership.

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SEC recognizes that the Board largely rejected our submissions in EB-2009-0411, so we will not repeat all of them here. However, we do ask the Board to review them again in the context of this proceeding, together with the submissions below, as we are very concerned that if gas distributors have the same broad freedoms to leverage their entry into renewable generation, the government's goals will be undermined and the ability of schools to remain in the forefront in this area will be restricted.

General Submission

Because of the strong interest of schools in this area, these submissions are in large part an attempt to "sound the alarm".

Ten years from now, many schools will have renewable installations on their roofs or grounds. The process has already started, with the first installations completed and many competitions for this business going on right now across the province. We fully expect, for example, that solar on the roofs of schools will be a ubiquitous and symbolic statement about Ontario's leadership in the move to renewable energy.

Schools, however, will likely not own the qualifying facilities on their roofs. It is not their area of expertise. Rather, schools will usually (although perhaps not always) form partnerships with companies in the solar business to provide a full turnkey package. The roles of the schools would be as host, and as teachers, utilizing the qualifying facilities to teach a new generation of Ontario children.

Will gas and electric utilities be amongst the companies that bid for the right to provide these turnkey projects? The answer is likely yes. While not all gas and electric distributors have the interest or expertise in this area, some do, and the government has signalled to them that they should consider this new business activity. Further, schools have active partnerships with the distributors already, in the areas of DSM/CDM, safety, infrastructure, etc. In many parts of the province the local school board and the local utilities are among the most important actors in the well-being of the community.

What the Board's proposed amendments, in this case to the Gas ARC, suggest is that gas distributors will now be free to enter the qualifying facility business and fully intermingle it with their regulated activities. Schools feel that will put them at a disadvantage in their dealings with gas distributors, not just with respect to qualifying facilities, but in other important areas as well.

Just one example may show how that is likely to unfold.

Right now, schools and gas distributors work together on conservation initiatives. Not only do the gas distributors provide their expertise, encouragement and incentives to move space heating, water heating, and similar projects forward, but increasingly they look at the conservation projects of schools on a holistic basis. This is, in fact, a good idea, and one that schools often encourage. In this period when things like real-time energy monitoring and similar initiatives are actively on the table, a narrow focus on space heat, or lighting, or any other single component of the energy picture, is unnecessarily limiting.

But under the Board's proposed new rules, utility or utility affiliate personnel that are working with schools on conservation can now use the information they gather in that process in their QF business. There are no restrictions and, indeed, the Board is essentially giving the utilities express permission to integrate their conservation and QF businesses. Schools can now no longer trust the utility to remain focused on the conservation project. Instead, they have to be concerned with whether everything they say and do becomes part of a competitive business of the utility.

Why is this a problem? There are three main concerns:

1. ***Focus.*** When schools deal with utilities, they want to be confident that their trusted utility partner will remain focused on the issues at hand, and will not be looking to gain a collateral advantage. That mutual trust is a key aspect of the relationship between schools and utilities. Conservation programs, for example, are very important to schools, and it would be a significant disadvantage if utility partners start to see their conservation activities as having a more important or more profitable additional purpose.

2. ***Competition.*** Schools actively seek out competitive bids for major projects such as QFs. In most cases, the competitive process is a requirement, but with few exceptions that process is in any case the way school boards ensure they are getting the best price. If the participants in the QF market start to believe that gas distributors will have an unfair advantage in bidding to school projects, some of the competitors will not bid at all or, if they do, they will not give their best bid because they will assume they have a limited chance of winning anyway. Overall, the economics of QFs to schools will be changed in a negative way if gas distributors are given an unfair market advantage.

3. ***Legal Issues.*** While schools seeking competitive bids do have a range of legal protections, the fact that gas distributors are bidding and have information that other bidders do not have could leave schools open to legal challenges. A prudent school will either have to provide a different (and generally more expensive) level of disclosure to all bidders to ensure that they have everything that the gas distributors may have, or, more likely, will have to limit the information they share with the gas distributors in their conservation activities. Rather than run the risk of a disruptive and unproductive lawsuit, the schools will seek to keep the information available to all bidders as equal as possible. The easiest and safest way to do so is to ramp back the level of collaboration with gas distributors on conservation programs.

While some of these issues are specific to schools, for the most part we believe that any potential customer of the QF business of a gas distributor will have some or all of these concerns.

We therefore believe that the Board should not be removing protections in ARC. Instead, in our submission the Board should be looking at the QF business of gas distributors generally (whether in the utility or any affiliate), and identifying where the regulated activities could be used or abused to benefit the competitive business. Everywhere that is true, the Board should be reinforcing the rules for utility-owned QFs to make sure unfair results do not occur. This is, in our view, the best way to ensure that the choice of ownership is neutral, while at the same time carrying out the Board's ratepayer protection mandate.

Specific Comments

Against the background of the general comments above, SEC has the following specific submissions on the proposed changes to ARC and RRR:

1. ***Employee Sharing and Physical Separation.*** We have given an example above of the harm that can arise if the same employees are engaged in regulated activities, such as DSM programs, and unregulated activities such as QFs.

   Two other comments are appropriate on this subject.

   First, one of the concerns that electricity distributors had is that they could not engage in QF activities if they were not allowed to share employees, because they are too small to have a freestanding QF business. If that is true of some electricity distributors, it is not true of gas distributors. Relaxing this restriction does nothing to enable gas distributors to get into the QF business. All it does is ensure the commingling of regulated and unregulated activities to the potential disbenefit of the customers of both. The same, by the way, is true of physical separation, and for the same reason. Gas distributors do not need to share space with affiliates to make the economics work. They already have sufficient economies of scale.

   Second, the Board has proposed that gas distributors be allowed to have the same employee who controls access to a utility service deal with customers on QF matters. This is particularly problematic. It implicitly permits the utility to, for example, restrict access to utility programs to those who have or are willing to engage in QF partnerships with them. The utility can require a school, if it wants to participate in a "building envelope" project, to accept the solar facility that the utility has decided to bundle with it. Or, the utility may not make that an explicit condition, but make it clear that those who are "working with them" on solar get priority. None of this is acceptable behaviour on the part of regulated utilities enjoying a public monopoly, and should not be permitted by Board policy.

2. ***Term of Affiliate Contracts.*** The Board's letter does not, it appears to us, contain a rationale for extending the term of affiliate contracts to 20 years for QFs. We understand that there may well be circumstances in which a twenty year contract makes sense, and the ratepayers and markets are still protected. However, there will be other cases in which that is not true.

   In our submission, contracts should be available for more than five years only if similar goods and services are available in the market for the longer period on similar terms, e.g. where the affiliate is just as committed to the term as the utility. For example, if a utility wants to offer maintenance services at fully-allocated cost for twenty years, this amendment would allow that to take place. That is fine as far as it goes, but what is likely in practice is that the affiliate will take the services as long as they are less than market, and then will change to market or in-house provision of the services when that is cheaper. When that happens, as we have seen several times recently with electricity distributors, there are suddenly additional costs that have to be borne by the ratepayers. Those employees who were doing the work remain with the utility, but now part of their cost is not defrayed by those services. They just have less to do, and the ratepayers pay the price. Alternatively, some have to be let go, and the ratepayers will bear that cost. Neither result is fair.

Instead, a better policy would be that affiliate contracts with QFs can be for periods longer than five years, as long as the terms of those contracts mirror the market and adequately protect the ratepayers in all circumstances.

3. ***Business Case.*** The Board's letter relies, for this issue, on the premise that if a gas distributor builds qualifying facilities itself, it will not be required to do a business case. Therefore, it should not be required to do so if it carries on the same activity through an affiliate.

   In our view, the premise is incorrect. If a gas distributor builds a QF within the utility, the first interrogatory in their next rate case is going to be a request for the business case, in order to ensure that the plan and analysis properly distinguished between regulated and unregulated activities. The gas distributor will have a business case, because as well-run businesses gas distributors don't engage in major projects without an appropriate level of planning scrutiny and management approval.

   Since proper planning requires a business case analysis anyway, and is standard practice for distributors, the only affect of the Board's proposed change to the rules would be to allow the gas distributor to withhold disclosure of their business case in rate proceedings. The fact that a review of the business case is an important way to ensure that fairness is being achieved, can be met with the argument that the Board has consciously removed the business case requirement as a part of regulated activities. Therefore, whether the utility has it or not, it has nothing to do with their regulated activities, so does not have to be shared with the regulator.

4. ***Business Case – Idem.*** The Board's letter, on this point, seems to focus on the business case for the project, but that is not the only aspect in which this could arise. A gas utility can, for example, decide to locate certain of its shared service activities in the QF affiliate, and have the utility buy them from the affiliate. The Board notes in the letter that new sections 2.3.2A and 2.3.3.3 are both restricted to goods, services or assets that are exclusively used for QFs. On its face, that would seem to solve this problem, but we do not believe that is the case.

   The difficulty, in our view, is that utilities that carry on their QF business through an affiliate will have no reason to purchase goods, services, or the use of assets that are truly exclusive to a QF business, because they don't have such a business themselves. Our concern is that, rather than treat the new sections as not applying in any circumstances, gas distributors will seek to create a category of situations in which these exemptions are intended to apply. Conservation is one obvious business area that is likely to be raised, but that would not be appropriate, and we cannot think of any others in which it would be.

The one area in which these exemptions could legitimately apply is where a gas distributor carries out a QF business in an affiliate, and a similar business in the utility. In that case, there may be QF-specific goods and services that the affiliate can provide to the utility, and vice versa. If that is the category to which the exemptions are intended to apply, we submit that the Board should limit those exemptions to that precise situation. Alternatively, if the exemptions are intended to apply to a broader category of goods, services and assets, in our submission the Board should provide examples of what it intends so that the provisions are more clearly understandable.

5. ***Transfer Pricing.*** We are unclear on the Board's intent with the proposed changes to remove consideration of market prices from transfer pricing. Not only should, in our view, the unregulated business consider the relationship between fully-allocated cost and market price in determining whether to in-source or out-source an activity (a decision that is not regulated, of course), but on the regulated side the management of the utility should use its goods, services and assets to the best possible advantage, including consideration of the market.

   The best example of this is probably real estate. A gas distributor has office space available in one of its buildings pending use of that space in the future for the regulated activity. Its cost of the space, largely already paid for by the ratepayers, is quite low. However, what it could get on the market is much more. Why would management rent that space to the QF affiliate at cost, rather than get full market rent?

   In our submission, management of the utility should in all cases consider the most prudent use of resources, and that should include consideration of market prices where relevant to that decision.

6. ***Transfer Pricing – Taxes.*** We continue to be concerned with the fact that QFs have significant tax breaks, which will result in tax savings to the utility. The end result, as we have seen in other cases before this Board, is that under the standalone principle the utility collects money for taxes, but instead diverts that ratepayer money to their unregulated business rather than paying those taxes. In the context of QFs, this arises in two ways.

   First, where a QF is built by the utility, the tax breaks are within the taxable distributor. Under the rules currently being applied by the Board, the tax breaks – which require both the QF deduction and the regulated taxable income in order to have value – are allocated entirely to the unregulated activity, even though that activity could not enjoy the benefits without the regulated activity. We believe this is unfair to the ratepayers, but it is not the subject of this consultation.

   Second, and applicable here, if a QF is carried on in an affiliate, in general the use of the QF to shelter regulated income is not allowed under the tax rules. The Board's principle that ARC should be neutral between utility and affiliate ownership could be seen as permission for the gas distributors to engage in tax planning transactions designed to achieve this result in the affiliate. Some transactions that might be considered include non-standard business structures (partnerships, trusts, co-ownership arrangements, etc.), all of which create specific risks and issues for the regulated entity. Other transactions include use of the regulated entity until the tax breaks are used, and then a transfer to an affiliate, or redirection of utility income to the affiliate through interest and dividend transactions or other means. Enbridge is already engaged in one of the latter tax planning transactions with its parent.

These are only a few of the examples that could be given. Our concern is that the principles being proposed by the Board in these amendments - economic neutrality and transfer pricing without consideration of market value – may be construed as opening the door for more aggressive and more risky tax planning by the gas distributors.

7. ***Financial Transactions with Affiliates – Equity Limit.*** The Board is proposing that a regulated utility can use 100% of its equity to finance qualifying facilities. This appears to us to be mathematically incorrect and contrary to both the Board's policy on utility capitalization, and the law in this area.

   A gas distributor is expected to have a certain level of equity as part of its capital structure, and the level of equity thickness is a key consideration in the Board's determination of risk. The ratepayers pay for the use of that equity in ROE, and the ratepayers are entitled to expect that the equity they pay for is used for the services being provided to them.

   What the Board appears to be proposing in this amendment is that the gas distributor can use 100% of the equity that ratepayers are paying to use, instead to finance QFs. When we first realized this is the apparent interpretation of the amendment, we assumed that we must be mistaken, and if that is not what the Board intends, we would ask that the Board clarify.

   However, if our interpretation is correct, we believe that is simply wrong. Ratepayers pay to have a utility properly financed. If 100% of the equity is used for unregulated activities, the result is that the regulated activities are 100% debt financed. If this is proper utility management, then in our submission ratepayers should only pay the cost of 100% debt financing, not the higher cost of equity.

   In our submission, not only is the 100% limit, inappropriate, but the 25% currently allowed is not appropriate either. It is submitted that this rule should be replaced by a rule that the limit on aggregate financing of both affiliates and unregulated businesses should be the amount by which the actual shareholder's equity of the utility exceeds the deemed equity calculated in accordance with the Board's rules. That is, if the shareholder wants to increase the equity thickness to fund non-utility activities, that's fine. For the equity the ratepayers are paying to use, that should be used to benefit the regulated business.

8. ***Financial Transactions with Affiliates – Debt Rate.*** The changes proposed by the Board assume that a utility has an unlimited right to use the utility creditworthiness to borrow for unregulated activities. This was never our understanding. Every dollar that the utility borrows for unregulated activities increases the overall level of risk and therefore the cost of borrowing. As the Board saw with electricity distributors that were heavily into unregulated activities, the bond rating agencies regularly cited these activities as increased risk factors.

If the gas distributors have an unlimited right to do this, it will inevitably increase their cost of debt.

It was always our understanding that, if borrowing for unregulated activities was immaterial, it could be ignored. However, it is becomes a material amount, it is appropriate for the Board to investigate the impact on the cost of debt, and make adjustments to rates accordingly. This did not happen in practice, because of the "pure utility" concept that is built into the Undertakings for both Union and Enbridge. Unregulated activities inside the utilities have been very limited since the "pure utility" approach was instituted. Further, the risk of the same thing happening via affiliates was avoided by section 2.4.2 of ARC.

The proposed amendment section 2.4.3 would turn this on its head, allowing extensive leveraging of unregulated activities at ratepayer expense. This is not, in our view, appropriate.

9. ***Equal Access to Services.*** The proposal to remove the restrictions in section 2.5.1 and 2.5.2 as applied to QFs concerns us. As we have noted earlier, the bundling of QF proposals with, for example, conservation, could seriously disadvantage customers such as schools, and/or undermine the success of DSM programs. At the very least, it is submitted that the utility should remain prohibited from saying or implying that any utility service will be more readily available, or better, or cheaper if a customer elects to do business with their QF business.

Conclusion

Some of the submissions above are specific to the wording or intent of individual changes proposed. Many of them, however, flow from a single issue. In our view, there is no evidence that the harms for which the ARC was created have in any way been removed or reduced by the decision to allow gas distributors to own QFs. Therefore, absent such evidence, the Board in removing those restrictions may be implicitly stating that it no longer intends to protect against those harms. We do not believe that is what the Board intends.

We hope the above comments are of assistance to the Board, and welcome the opportunity to participate further in this consultation should the Board elect to obtain further input. We request that the Board pay our reasonably incurred costs in accordance with Attachment C to the Board's letter.

All of which is respectfully submitted.

Yours very truly,
JAY SHEPHERD P. C.

Jay Shepherd

cc: Wayne McNally, SEC (email)
Interested parties (email)