

**Ontario Energy Board**



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# **Rate-making Associated with Distributor Consolidation**

**Report of the Board**

July 23, 2007

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## Table of Contents

<b>1</b>	<b>INTRODUCTION .....</b>	<b>1</b>
<b>2</b>	<b>THE BOARD'S APPROACH .....</b>	<b>3</b>
2.1	Scope.....	3
2.2	Regulatory Treatment of Costs and Savings .....	4
2.2.1	Time to Retain Savings to Offset Costs .....	4
2.2.2	Net Impacts at Time of Rate Rebasing .....	7
2.2.3	Addressing Rate Harmonization .....	7
	<b>APPENDIX: LIST OF PARTIES THAT PROVIDED WRITTEN COMMENT ON MARCH 5, 2007 DISCUSSION PAPER .....</b>	<b>I</b>

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# 1 Introduction

Earlier this year, the Board initiated a consultative process focusing on the regulatory treatment of certain rate-related issues associated with consolidation in the electricity distribution sector. The purpose of the consultation was to assist the Board in developing a policy framework on relevant rate-making issues and to provide greater predictability for distributors and other stakeholders in relation to those issues.

On March 5, 2007, the Board released a staff paper (the “Discussion Paper”) that outlined a number of proposals. The Board received written comments on the Discussion Paper from 13 interested parties. A list of those parties is set out in the Appendix and their written comments can be viewed on the Board’s website.

The Discussion Paper identified, and stakeholders have confirmed, the following as principal rate-making issues warranting consideration by the Board at this time:

- the timing for rate rebasing;
- whether rate recovery of transaction costs should be allowed;
- whether efficiency savings resulting from consolidation accrue to the shareholder, ratepayers, or both; and
- whether the Board should require rate harmonization.

This Report sets out the Board’s policy on each of these rate-making issues in the context of certain transactions in the electricity distribution sector. Application of the policy will create a more predictable regulatory environment for distributors that are considering consolidation, thereby facilitating planning and decision-making and assisting distributors in determining the value of consolidation transactions. The Board’s approach as set out in this Report builds on and complements the work of the Board in relation to incentive regulation, and addresses the issues in a manner that does not unnecessarily increase the regulatory burden on distributors or other interested parties.

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## 2 The Board's Approach

### 2.1 Scope

The policy set out in this Report applies to transactions between electricity distributors that result in a single, rate-regulated licensed electricity distributor (the “consolidated entity”). Specifically, and for the purposes of the policy set out in this Report, “consolidation” means a transaction whereby either:

- a distributor sells or otherwise disposes of its distribution system as an entirety or substantially as an entirety to another distributor; or
- a distributor amalgamates with another distributor.

These transactions are captured in sections 86(1)(a) and 86(1)(c) of the *Ontario Energy Board Act, 1998* (the “Act”), respectively, and are a subset of the merger, acquisition, amalgamation and divestiture (“MAAD”) transactions that are subject to Board approval.

There are various other transactions or arrangements that might be pursued by distributors for strategic or other reasons, some of which are MAAD transactions that are subject to Board approval under 86 of the Act while others are not. The Board recognizes that some of these other transactions or arrangements can facilitate the delivery of innovative and more cost-effective distribution services, and can be beneficial to both shareholders and ratepayers. It is not the Board's intention to discourage distributors from pursuing transactions or arrangements that increase efficiencies. At this time, however, the policy set out in this Report is focussed on those transactions that the Board has identified as being most closely aligned with the spirit in which the policy was developed. Distributors that elect to engage in other transactions or arrangements that they believe fall within the spirit of the policy may, at

the relevant time, request that the Board extend the application of one or more elements of the policy to them.

## **2.2 Regulatory Treatment of Costs and Savings**

There are different circumstances among distributors and different motivations for consolidation transactions. Each transaction may be based on a different rationale and each offers the potential for different kinds of benefits that vary in nature, timing, and certainty. Given the diversity of distributors in Ontario, it is a challenge to design and implement regulatory mechanisms to meet all of their needs.

Nonetheless, a general approach can recognize diversity, and can do so without compromising predictability. Allowing a consolidated entity to propose (within an acceptable range) a time for rebasing that best suits its unique circumstances does this. Flexibility on the timing of rebasing in combination with the Board's existing price cap incentive regulation gives the consolidated entity time to retain savings to offset costs while protecting the interests of consumers.

### **2.2.1 Time to Retain Savings to Offset Costs**

In general, consolidation costs may include out-of-pocket/transaction costs, acquisition premiums, and restructuring costs. Regardless of the nature, timing, or certainty of expected benefits of a consolidation, the ability to retain any achieved savings for a sufficient amount of time to provide a reasonable opportunity to at least offset the costs of a transaction will be an important factor in a distributor's consideration of the merits of consolidation.



## Timing for Rebasing

Distributors that apply to the Board for approval of a consolidation transaction may propose to defer the rate rebasing of the consolidated entity for up to five years from the date of closing of the transaction. The closing date often occurs within 12 to 18 months of approval of the transaction by the Board, which is within the 18-month period during which a MAAD transaction approval typically remains in effect before expiring.

The five-year limit is based on a review of other jurisdictions, which suggests that five years is a reasonable time period. Also, to date, the maximum duration of a rate plan implemented by the Board for a gas or electricity distributor has been three years. It is premature to offer an option to defer rate rebasing for more than five years until greater experience with multi-year rate plans is gained by distributors, other stakeholders and the Board.

Allowing a distributor the option of scheduling the rate rebasing for the consolidated entity at any time up to the five-year limit accommodates distributors that may require an increase in operating, maintenance or capital expenditures shortly after closing of the transaction, as well as distributors that wish to have the benefit of a longer period in which to off-set transaction costs with efficiency savings. This flexibility does not come at the expense of consumer interests or financial viability, which are adequately protected through the Board's licensing regime and price cap incentive regulation mechanism.

A distributor will be required to specify its proposal for rate rebasing as part of the MAAD application. In the normal course, the expectation is that the distributor's proposal for rebasing will be rejected by the Board panel assigned to hear the MAAD application only on the basis of compelling evidence that the proposal would not result in just and reasonable rates.

Where a consolidated entity's rebasing is deferred through application of the policy set out in this Report, its rates would be subject to a normal annual rate adjustment under incentive regulation until that rebasing. The rates of the consolidated entity are not expected to be subject to rebasing before the end of the deferral period other than through an eligible off-ramp or Z-factor under incentive regulation.

### **Multiple Transactions**

Some flexibility should be afforded where a consolidated entity whose rebasing has been deferred through the application of the above policy subsequently enters into a further consolidation transaction before the end of the deferral period. The Board may therefore allow a new deferral period of up to five years, from the date of closing of the new consolidation transaction, where parties to the consolidation demonstrate in their MAAD application the need for, and benefits of, such a deferral.

This is not intended to allow the deferral of rate rebasing indefinitely, especially to the extent that ratepayers may somehow be disadvantaged. In some consecutive consolidations, especially those entered into near the end of a deferral period, extending the deferral by another five years may not be appropriate. The onus will be on the applicant(s) to clearly justify the need for, and benefits of, a further deferral and to demonstrate to the satisfaction of the Board that ratepayers will not be adversely affected by the deferral.

### **Rate-making During Deferral Period**

Until the form and approach to 3<sup>rd</sup> Generation IRM are determined by the Board, the incentive regulation plan that a distributor will be subject to for the duration of the consolidated entity's deferral period will be 2<sup>nd</sup> Generation IRM. Afterwards, the incentive regulation plan that a distributor will be subject to for the duration of the consolidated entity's deferral period will be the plan that the distributor was subject to at

the time of the MAAD application, even if this means that individual (and different) rate plans will be maintained until rebasing.

### **2.2.2 Net Impacts at Time of Rate Rebasing**

Rebasing at the end of an incentive regulation term ensures that ratepayers also benefit from savings achieved. This occurs regardless of whether the efficiency is the result of consolidation or some other factor. The policy set out in this Report capitalizes on incentive regulation to allow the net savings of a consolidation to accrue to a distributor's shareholder for a more extended period. It is not appropriate for a distributor to also be permitted to recover an acquisition premium or net consolidation losses in whole or in part through rates while retaining the realized benefits of the transaction over the deferral period. Either the distributor retains the benefits of consolidation over the deferral period to offset the costs, or the distributor can apply to recover the costs net of the benefits in rates. Further, the Board has traditionally used net book values in determining rates after ownership changes.

### **2.2.3 Addressing Rate Harmonization**

Some flexibility remains appropriate with respect to whether rate harmonization should proceed in each case. That flexibility exists today.

Currently, the filing requirements applicable to MAAD transactions ask parties to indicate in their application whether they intend to undertake a rate harmonization process after the proposed transaction is completed and, if they do, to provide a description of the plan. The Board does not intend to eliminate that requirement, as this can be informative as to the intentions of the consolidated entity. However, the issue of rate harmonization in the context of a consolidation transaction is better examined at the time of rebasing, because this is when the consolidated entity will apply for its combined revenue requirement.

Distributors that consolidate will therefore be required to address the issue of rate harmonization at the time of rate rebasing of the consolidated entity. The distributor will need to provide a statement as to whether it intends to undertake rate harmonization or, if not, the justification for not doing so. Where the distributor does intend to harmonize rates, the distributor will be required to file its proposed plan at the time of rebasing.

## Appendix: List of Parties that Provided Written Comment on March 5, 2007 Discussion Paper

The March 5, 2007 Staff Discussion Paper on the Rate Making Policies Associated with Distributor Consolidation is available on the Board's web site at [http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects\\_ratemakingpolicies.htm](http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_ratemakingpolicies.htm).

Interested Party	Link to Comments
Chatham Kent Hydro	<a href="#">Comments</a>
Energy Cost Management Inc.	<a href="#">Comments</a>
Electricity Distributors Association	<a href="#">Comments</a>
Energy Probe Research Foundation	<a href="#">Comments</a>
Hydro One Networks Inc.	<a href="#">Comments</a>
Horizon Utilities Corporation	<a href="#">Comments</a>
Hydro Ottawa Limited	<a href="#">Comments</a>
London Property Management Association	<a href="#">Comments</a>
Norfolk Power Distribution Inc.	<a href="#">Comments</a>
PowerStream Inc.	<a href="#">Comments</a>
Power Workers' Union	<a href="#">Comments</a>
School Energy Coalition	<a href="#">Comments</a> <a href="#">Supplemental Comments</a>
Vulnerable Energy Consumer's Coalition	<a href="#">Comments</a>