EB-2014-0138

ONTARIO ENERGY BOARD

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch.B, as amended;

AND IN THE MATTER OF a consultation by the Board to consider changes to its policies relating to service area amendments and mergers, acquisitions and divestitures.

SUBMISSIONS
ON BEHALF OF THE
SCHOOL ENERGY COALITION

May 5, 2014

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INTRODUCTION

1.1 ***Introduction***

1.1.1 On March 31, 2014 the Board issued a letter releasing a staff discussion paper (the "Staff Report") on service area amendments and distributor consolidation. The letter seeks comments from interested parties, both on the Staff Report, and on other issues within these policy areas.

1.1.2 These are the submissions of the School Energy Coalition.

1.1.3 SEC has long been concerned that the current SAA and MAADs policies of the Board may have the unintended effect of harming the ratepayers through the economic efficiency approach to transactions. We have been active recently in specific SAA and MAADs applications, and of course we have been very concerned with the rate impacts of past transactions, as harmonization proposals have come forward.

1.1.4 These submissions are organized into three sections. First, we look at some general principles that we believe should guide the Board in considering this area. Second, we look at specific questions relating to Service Area Amendments. Third, we consider certain changes to the policies regarding MAADs.

1.2 ***Next Steps in this Consultation***

1.2.1 SEC also notes that it has a fundamental concern with the process options for this consultation. The issues raised here are highly significant, and could affect costs to ratepayers, investment in infrastructure, and the financial health of the sector for many years to come. In its letter of March 31, 2014, the Board indicated that it had not determined the next steps in this consultative process.

1.2.2 In SEC's view, the parties and the Board would benefit greatly from a dialogue on these issues. While SEC has strong views on the issues, as can be seen in these submissions, we are also very aware that these issues are complicated, and that other stakeholders have good ideas that should influence the Board's policies as well.

1.2.3 The Board has a number of different approaches to consultations, depending on the nature of the issues, the diversity of views, and any external time constraints. Those approaches range from one round of input, followed by a draft policy, to consultations that are effectively a series of public hearings and/or workshops, and many variations in between. Not every consultation requires the whole nine yards, and the Board has been able in the past to tailor many of its consultations to fit the particular circumstances

1.2.4 SEC recommends to the Board that, before the Board starts to consider the policy options being proposed by SEC and others, the Board should convene a stakeholder

conference to allow for a dialogue between stakeholders. After that, stakeholders should be encouraged to reply to the comments of others, both in their original submissions and at the stakeholder conference. Stakeholders should also be encouraged to modify their own proposals in light of the ideas and comments from others.

1.2.5 In our submission, there is likely more common ground on these issues than will be apparent when looking at the first submissions. Communications between the stakeholders will, in our view, allow those common views and proposals to emerge, and provide the Board with a stronger foundation on which to develop its policies.

1.3 ***Summary of Submissions***

1.3.1 ***Competitive Market Paradigm.*** SEC's views on these issues are based on the principle that, in keeping with the Board's customer-focused approach to regulation, the central foundation of any SAA or MAADs transaction must be the long term value proposition for the ratepayers. This is consistent with the competitive market paradigm, i.e. in the long term transactions must benefit the customers based on increased value for money. If they do not, the company will lose customers to competitors, in most cases making the transaction a failure. The Board's approach should emulate this competitive market result.

1.3.2 ***Practical Test.*** To this end, SEC proposes a three part test for Board approval of any rationalization transaction, whether SAA or MAADs:

(a) Will any of the customers affected be asked to pay more for the service as a result of the transaction (no matter how far in the future)? If no, then the transaction is neutral or better for all of the customers.

(b) If there is a price increase for any customers, will the customers who will experience a price increase get increased value equivalent to or better than the price increase? If no, then the competitive market paradigm says this transaction is not in the customers' interests, and if not for the monopoly they would walk away from the supplier.

(c) If the price increase is justified by the increased value of the service, will it in any case exceed the willingness of the customers to pay for increased value. A Mercedes may in fact be a better car, and worth the extra money, but most customers still will not want to buy a Mercedes (and shouldn't be forced to do so).

1.3.3 ***Service Area Amendments***. SEC proposes that SAA transactions, if not arranged by agreement (the preferred option), should be considered by the Board using the above general test.

1.3.4 SEC also expands on the idea, floated in the Staff Report, of open competition for unserved areas. In our expansion, all areas unserved or lightly served by an incumbent (for example, with only rural service) should, when growth is projected, be open for competition by any distributor. The incumbent would often have an advantage, and contiguous distributors may also, but there would also be a big advantage to any distributor that is able to operate its system, and expansions, in an efficient manner. Those distributors may be able to provide the best value proposition for the ratepayers, and thus maximize the public interest over the long term.

1.3.5 To support this approach to SAA transactions, SEC proposes allowing distributors to put lightly served areas in play, even if they are not the incumbent, through the presentation to the Board of a rationalization plan for review and assessment. SEC also proposes involuntary transfers of existing assets by incumbents, at a reasonable price, if a new distributor is chosen for an area. Finally, SEC recommends that the Board initiate competitions for areas in which there are multiple distributors currently serving a single municipality.

1.3.6 ***MAADs Policies.*** SEC proposes that the Board either clarify or amend the No Harm Test to be consistent with the three step test above, in keeping with the increasing focus on the customer in the RRFE.

1.3.7 In addition, SEC proposes that every MAADs application be required to include a rate and investment plan by the applicants, setting out the value proposition to both the new ratepayers, and the legacy ratepayers. This value proposition – whether increased services/investment, or reduced prices, or both – should form the basis for the Board's determination of whether the transaction is in the public interest. In our proposal, the applicants have a broad discretion as to the time frames, and the mechanisms, to be included in their rate and investment plan, as long as in the end the ratepayers' value for money is enhanced and the three step test is met.

2 GENERAL PRINCIPLES

2.1 *Introduction*

2.1.1 SEC has observed over the last few years that distributor consolidation (of which service area amendments are a part) has become accepted by all parties – almost as a matter of faith - as of value to the sector. We all appear to believe that consolidation is, by definition, good for everyone.

2.1.2 That is not, in our view, correct. Consolidation done the right way is good, as it rationalizes an overly fragmented industry. Consolidation done the wrong way will harm the ratepayers and undermine the goals of electricity regulation as set out in the Ontario Energy Board Act.

2.2 *Rationalization in the Context of Monopsony*

2.2.1 In the private sector, companies – whether buyers or sellers – are assumed to make logical decisions based on their own interests. Companies buy other companies because it will improve their ability to compete in the market, i.e. their customers will buy more of their products, either because the products will be better, or because the cost will be reduced relative to the competitors. Companies buy the assets of other companies – patents, franchise rights, market segments – because they can improve their own relative competitiveness through adding a part they are missing. Companies and their shareholders sell their companies or some assets when the purchaser is more able to compete in serving the customers than the vendor. That purchaser advantage is in part the basis for the price premium on acquisition.

2.2.2 Governments still have competition regulators, to ensure that parties do not abuse the freedom of the marketplace, for example through abuse of their dominant position. However, that is intended to make the marketplace work, rather than to restrict the freedom for companies to make economically efficient decisions.

2.2.3 Many in the industry, and perhaps in government, would like to see a free market paradigm for the distribution sector. The market restructuring included, after all, a strong push for the munis to act like private companies, so many today would like the consolidation marketplace to adopt that same paradigm.

2.2.4 In our view, that is not realistic. The distributors do not operate in a competitive market, and relying on their self-interested decisions will not, as it might in a competitive marketplace, result in companies that are better able to serve /their customers. In a monopoly situation, it is not true that on consolidation prices go down and/or the product gets better. Prices can go up, and service quality can fall, because the monopoly status protects the purchaser.

2.2.5 For this reason, the Board exists to be the proxy for the competitive market. In the context of SAA and MAADs, that means establishing a set of policy guidelines for transactions that forces buyers and sellers to make the same sort of decision they would make in a competitive environment.

2.2.6 The Board is also the competition regulator in this market, charged with the role of ensuring that parties do not abuse their position in the market through anti-competitive activities and decisions.

2.2.7 In our submission, the Board should establish its policies in this area on the basis that it is trying to emulate a smoothly functioning market. To achieve that, the last thing the Board wants to do is leave everything to the "market" players, since they are not in fact driven by competitive market influences.

2.2.8 ***Rationalization as the Goal***. We talk about distributor consolidation, but in our view that is a misnomer. The goal is distributor rationalization, and the distinction between the words is not semantics.

2.2.9 The term consolidation imports the assumption that fewer companies serving this market will be better, largely due to economies of scale.

2.2.10 There is no reasonable likelihood that assumption is correct, in and of itself. If all Ontario distribution was provided by five companies – Hydro One, Toronto Hydro, Ottawa Hydro, Powerstream, and EnWin – no-one would think that was the right answer. Further, if you look at the current rates of those five companies, the total cost of distribution would have to increase by about 24%[1], less any economies of scale. Consolidation would not produce economies of scale sufficient to produce a net saving. That is just one example. Many other examples of an end-state produce equally unhappy results.

2.2.11 In our submission, the goal should be distributor rationalization, just as in the competitive market the influences of competition force companies to rationalize. Rationalization implies, not just a reduction in number of distributors, but an optimization of both the number, and the eventual acquirors. The eventual number will likely be less, due of course to economies of scale. Also, the most efficient, well-run companies will be more likely to be acquirors, since that is the best way to optimize the efficiency of the industry as a whole.

2.2.12 ***Monopsony.*** Into this issue has to be thrown the problem of monopsony. If a monopoly is market dominance by one seller, a monopsony is market dominance by one buyer. Although in a pure monopsony there is only one buyer, in most practical cases there are multiple buyers, but one has such a dominant position that they

[1] The total Dx revenue per customer figures for the five in 2012 were $1,032.86, $759.44, $505.21, $495.01, $599.96 respectively. Weighted at 50%, 26%, 8%, 8%, and 8%, in this example, produces an overall distribution revenue in 2012 of $4.12 billion, about $809 million more than actual distribution revenues in that year.

effectively set the prices and terms. While normally this drives the prices of goods down (Walmart is accused of this, for example), a monopsonist seeking to be a dominant seller as well can use predatory (high) prices to drive competitors out of the market, thus increasing its dominance on the selling side.

2.2.13 In Ontario, Hydro One provides distribution service to about 25% of the province's distribution customers, but collects more than 38% of the distribution revenue in the province[2]. Its average distribution revenue per customer is about 85% higher than the average of the rest of the industry[3], even when high cost of distributors like Toronto Hydro is included on a weighted basis. If Hydro One is compared to the simple average of the rest of the industry, their Dx revenue per customer is almost double the average of everyone else[4].

2.2.14 For the customers, this is a problem by itself, because a quarter of them are already served by this high cost provider. It is made much worse, however, when Hydro One becomes a monopsonist, offering high prices to many municipalities to acquire their municipally owned electricity distributors.

2.2.15 In our submission, when one party is using their dominant market position, and deep pockets, to prevent other companies from buying distributors, it is the responsibility of the Board as regulator to step in and police the marketplace.

2.2.16 ***Competitive Market Paradigm.*** This leads us back to the paradigm of the competitive market. In theory, at least[5], one company can acquire all or part of another company only if one of two things is true:

(a) The combined entity will be able to offer its products at a lower price to all of its customers; or

(b) The products of the combined entity will be superior to the products of the original entities, so customers will be willing to pay more.

2.2.17 In either case, this is at least in part about price, the great leveler in the competitive market, in the sense that the resulting value proposition must be better for the customers or the transaction will not make sense. For each customer where the price goes up for the same product, they will look elsewhere for that product. Where the product is improved, the price can only go up to the lesser of a) the value of the original product plus the improvement, and b) the highest price the customers are willing to pay for the product, regardless of quality.

2.2.18 In our submission, the overriding test the Board should apply in both SAA and

[2] All figures from 2012 Electricity Yearbook.
[3] $1032.86 vs. $558.10.
[4] This does not include Hydro One's rate proposals for the next five years, as set out in EB-2013-0416.
[5] Of course, in practice the market doesn't always work exactly this way.

MAADs situations follows the competitive market paradigm, and can be described in three steps:

(a) Will any of the customers affected be asked to pay more for the service as a result of the transaction (no matter how far in the future)? If no, then the transaction is neutral or better for all of the customers.

(b) If there is a price increase for any customers, will the customers who will experience a price increase get increased value equivalent to or better than the price increase? If no, then the competitive market paradigm says this transaction is not in the customers' interests, and if not for the monopoly they would walk away from the supplier.

(c) If the price increase is justified by the increased value of the service, will it in any case exceed the willingness of the customers to pay for increased value. A Mercedes may in fact be a better car, and worth the extra money, but most customers still will not want to buy a Mercedes (and shouldn't be forced to do so).

2.2.19 In our submission, the above three-step analysis fairly emulates how the M&A market is supposed to work in a competitive environment, and therefore is an appropriate policy framework within which a regulator should determine the appropriateness of proposed rationalization transactions.

2.3 ***Perspective – Ratepayer vs. "Public Interest"***

2.3.1 The Board acts in the public interest, not just the interests of the ratepayers. Any policy that deals only with the immediate ratepayer component of the public interest is not likely to be sufficiently robust to meet the Board's public interest mandate[6].

2.3.2 A problem has arisen, though, because the Board has in its current policies equated the public interest to economic efficiency, determined on the basis of short and medium term improvements to economic efficiency.

2.3.3 ***Economic Efficiency - the Delta Issue.*** If you only look at the delta between economic efficiency today, and economic efficiency after the transaction, you create a bias in favour of the least productive acquirors, since they are the ones that can reduce their costs more through acquisitions. They have higher costs to reduce.

2.3.4 In our submission, the current test, which looks at whether the applicant can show economies arising out of the transaction, is skewed in favour of Hydro One and others with higher costs. In the case of a distributor like Norfolk Power, for example, Hydro

[6] Although, as we argue later, as the time horizon gets longer, the interest of the ratepayers and the overall public interest, including the interests of the distributors and their shareholders, will converge.

One can show that it has people all over the place, and therefore can serve those customers without any incremental personnel. On the other hand, it can also show, because it is so large, that it can offer jobs to all of the current employees of Norfolk Power.

2.3.5 This is not efficiency. If an acquiror is inefficient, the fact that it will be less inefficient after a transaction does not make it efficient. It just means increasing the number of customers served by an inefficient service provider. This is not how the competitive market works.

2.3.6 ***What is the Public Interest?*** SEC believes that there is a public interest in economic efficiency, but the goal should be to maximize the number of customers that are served by the most efficient companies. This is just the same as the competitive markets.

2.3.7 What is interesting here is that distributors sometimes resist looking at this from the point of view of the customer. That is exactly wrong. The test should be "Are the customers better off?" In the long term, if the industry shifts towards more efficient companies serving more of the customers, the customers will be better off.

2.3.8 Another way of looking at this is to ask what is the long term goal? Is the goal to have all customers served by fully efficient distributors? Or, is the goal to maximize the price paid to shareholders for utilities or utility assets?

2.3.9 In our submission, no part of the Board's statutory mandate is to maximize amounts paid to the municipalities that own distributors. If that result produced a worthwhile goal – such as better value for money for ratepayers – it would be a useful step. There is no indication that has been the case in the industry generally (although in some cases it has been true). Therefore, SEC believes the Board should focus on the real goal, which is a fully efficient system providing value for money to the ratepayers.

2.3.10 ***Quality vs. Cost.*** This does not mean that rates can never go up. SEC's members are aware, as are all customers, that some distributors still underinvest in both the operation and the renewal of their systems. In the end, someone will pay for that, and that will be us. Good distributors recognize that, and develop a spending and investment plan to ensure that their system is reliable, safe, and sustainable, while keeping close control over the cost to do so. The RRFE instantiates that concept in Board policy.

2.3.11 The ratepayers' interests, and the public interest, are in this, as in many other aspects of these issues, congruent over the long term. This is why, in our comments above, we emphasize that sometimes a transaction includes increased value, and ratepayers pay for that increased value.

2.3.12 This is a critical point. Efficiency does not mean "lowest cost at all costs". Efficiency means appropriate value for money. As we will note in our specific comments on

MAADs transactions later in these submissions, acquirors should have a plan to achieve appropriate value for money when they make an acquisition, and the Board should consider that plan before approving any transaction.

2.4 ***Regulator as Protector of the Ratepayers***

2.4.1 There is a question of whether it is the Board's responsibility to protect the ratepayers in these situations. In our submission, the answer is "If not the Board, who?".

2.4.2 Assuming someone must have responsibility to protect the ratepayers, there are really only four choices:

(a) The distributors themselves.

(b) The shareholders of the distributors (the vendors).

(c) The provincial government.

(d) The Ontario Energy Board.

2.4.3 ***The distributors.*** In a competitive market, it is the companies themselves that "regulate" transactions, for the most part, because market influences generally force them to act rationally in the interests of their customers. While it doesn't always work, it does most of the time. Customers possess the ultimate power in the competitive market, as long as they are willing and able to use it.

2.4.4 The same is not true in a monopoly situation. Customers can't vote with their feet. And, absent the customers' ability to make choices, there is no reason for companies to make decisions in their interests.

2.4.5 This is exacerbated in the case of municipally-owned distributors. Decisions on sale or merger are generally made by local politicians, not by utility management. We have seen more than one example over the years of a utility executive opposing the municipal position in a transaction, and not being there the next year.

2.4.6 ***The shareholders.*** The shareholders are also not going to protect the ratepayers in most cases. Most shareholders are municipal corporations, and have a very specific political time frame. A transaction that delivers maximum value within that time frame will be approved. Longer term impacts are not part of the equation.

2.4.7 This sounds cynical, but the facts bear this out. More than a hundred distributors have been sold. In only a handful of those transactions did the shareholders see it as in their interests to protect the ratepayers (as opposed to getting a new arena for the town).

2.4.8 In theory, ratepayers could organize to apply political pressure on their local

governments, preventing transactions that will hurt the ratepayers in the long run. That has not yet happened, and if it did it would not really be in the public interest. The public interest is, in our view, served by rational decisions by the regulator protecting the ratepayers, not politicization of the issue.

2.4.9 ***The provincial government.*** The one shareholder who could have a significant impact is the provincial government, in two ways. First, they could control their own distributor, Hydro One. Second, they could establish a set of rules for distributor rationalization that protect ratepayers of all LDCs.

2.4.10 Neither has happened. With respect to Hydro One, they appear to have been given free rein. With respect to protection of the ratepayers, the government appear to think that has been delegated to the Board[7].

2.4.11 ***The Board.*** This leaves the Board, or no-one. SEC submits that transactions – whether small SAA, full-scale acquisition, or anywhere in between – should be approved by the Board only when the Board is satisfied that, in the long term, the goal of having as many ratepayers as possible served by the most efficient distributors will be achieved.

2.4.12 ***Direct Ratepayer Involvement***. To the extent that SAA and MAADs transactions have to be adjudicated on a contested basis by the Board, it is the Board's standard practice to allow affected ratepayers to be fully involved.

2.4.13 In addition, however, SEC believes that the Board should signal to distributors that they are encouraged to consult with ratepayers and their representatives whenever SAA and MAADs transactions are being negotiated. Given SEC's view of the principles at play, those most affected should be engaged.

2.4.14 This does not mean bringing ratepayers to the negotiating table. It does, however, mean talking to those affected before the deal is structured, when ratepayer input and support can still help inform the transaction.

2.5 ***Municipal Boundaries***

2.5.1 The Staff Report asks whether, in light of the RRFE and other factors, the Board should now prefer transactions that align distributor service territories with municipal boundaries.

2.5.2 SEC believes that the underlying principle is sound, but the proposed policy is not. The growth of urban areas doesn't always respect the political boundaries of the municipality, or the distribution system of the incumbent distributor.

[7] See letter from the Minister of Energy, attached to the Final Argument of Norfolk Power in EB-2013-0187.

2.5.3 As we note in more detail later, in our view rationalization should respond to the demographic reality. This means that generally where urban growth has taken place, the incumbent urban distributor should often serve that growth if its system is configured, or can be configured, to do so in a cost effective manner. There are many exceptions to this, but as a general principle we believe it is more appropriate than following municipal boundaries.

2.6 ***Conclusion***

2.6.1 The principles set forth above describe a customer-focused approach to SAA and MAADs transactions, in which the Board emulates the competitive markets by acting in the long term best interests of the ratepayers. In the long term, those interests are consistent with the public interest, and with the interests of the distributors.

3 SERVICE AREA AMENDMENTS

3.1 *Introduction*

3.1.1 In this section, SEC considers how the principles discussed above, as well as other general principles applicable to applications, should be applied by the Board in SAA transactions.

3.1.2 While we have tried to respond directly to the Staff Report, in some cases our analysis below includes additional issues that we believe should also be discussed.

3.2 *Co-operation vs. Conflict*

3.2.1 SEC's first principle driving all of its activities in the energy field is "Always look for win-win solutions." This stems from a fundamental belief that people working together to find solutions – talking rather than fighting – will generally come up with better answers. They will be more creative and more nuanced, certainly, but also ultimately more successful because of the common buy-in by those affected.

3.2.2 The Staff Report expresses the Board's preference for service area amendments presented by agreement between the distributors affected. In general, that is a good thing.

3.2.3 However, it is important to note that a "deal" between two distributors does not have to be driven by the best interests of the ratepayers. Often it is, but each distributor has their own agenda. If a distributor in principle wants to expand their service territory, that goal will not necessarily be driven by ratepayer benefits. Sometimes it will be driven by the belief that reducing costs through adding new customers is easier than reducing costs through improved operational procedures or tighter cost control.

3.2.4 This does not mean that agreements for SAAs between distributors should be discouraged. Rather, it is submitted that even if there is an agreement, the Board retains its role of ensuring that the transaction is in the public interest, meaning the interest of the ratepayers in the long term.

3.2.5 In this regard, it is important to note two additional points.

3.2.6 First, the ratepayers in need of protection are the ultimate end-users. This is important because, in many SAA situations, the immediate "ratepayer" is a developer. The primary interest of the developer is in reducing the short term capital cost, so that customer will be driven by the up-front connection cost. The impact on end-users is more often a longer term question, of which connection cost is one, sometimes fairly insignificant, component.

3.2.7 Second, the Board must always be conscious that there may be inequality of bargaining power between distributors, so voluntary deals may in reality be closer to imposed arrangements. This is particularly true where one party – often Hydro One – has rigid policies limiting its willingness to negotiate on a level playing field.

3.3 ***"Open for Competition"***

3.3.1 The Staff Report invites consideration of the idea that, where areas are currently not served by a distributor, and have two or more distributors that are contiguous to the unserved area, that area should be considered "open for competition" between those distributors. SEC is generally supportive of that concept.

3.3.2 It does, however, raise three issues that should be addressed:

(a) What does it mean that an area is "unserved"?

(b) Why should the competition be limited to contiguous distributors?

(c) What does it take to win this competition?

3.3.3 ***Unserved Areas.*** Very little of Ontario is in what could really be called "unserved areas". Pretty well all of Ontario that is not within the franchise area of another LDC is in the franchise area of Hydro One. Further, while Hydro One in those areas may not have extensive infrastructure, it is rare, except in the far north of the province, that a physical area is not sufficiently close to existing infrastructure to be capable of distribution service if that is required.

3.3.4 Thus, in our submission this concept should be treated as open competition for areas that are "lightly served", which in most cases will mean they have service suitable for a rural area, but not sufficient for a new subdivision or business hub.

3.3.5 Of course, in many cases this will be an area that is in the Hydro One service territory, and the policy amounts to allowing other LDCs to bid to serve customers in Hydro One's territory. Generally, SEC believes that is the appropriate result, but it is not without complications.

3.3.6 Of those, the most important is understanding the nature of the incumbent advantage, if there is one. That is tied up in the issue of how a distributor would win such a competition, discussed below.

3.3.7 ***Potential Bidders.*** The Staff proposal, as we understand it, is that only contiguous distributors could bid. SEC does not see why it should be limited to that subset. If a distributor wishes to bid on the area under discussion, in our view they should be allowed to do it, as long as the test of who wins is a sensible one. Limiting the bidders should be done by getting the test right, so that only those who could see themselves as

the right service provider will go to the time and expense of bidding.

3.3.8 We understand that, in the vast majority of cases, a distributor that is not currently connected to the service territory will have a hard time winning the competition, but it is not impossible.

3.3.9 Just as one example, imagine[8] that the City of Waterloo identifies the area immediately to the northeast as their principal area of urban growth over the next decade, with ten thousand new homes, plus related businesses and institutional users. The area is in Hydro One territory, and is not contiguous with any other LDC except Waterloo North. Waterloo North is not interested in building to serve that area, but both Guelph Hydro and Cambridge and North Dumfries are. Both see the added service territory as part of larger expansion plans in the area.

3.3.10 The two non-contiguous bidders would certainly have their work cut out for them, but would they be at any more disadvantage than Hydro One, which is no more "local" than they are? In our submission, they should not be disqualified from seeking the opportunity solely because they are not contiguous.

3.3.11 ***Test of the Winner.*** The whole idea of competing for underserved service territories works only if the method of determining the winner is the right one.

3.3.12 Consistent with our discussion of the principles, SEC believes that an open competition for a service territory should not be about the initial cost to connect new customers, nor about who can serve the customers at the lowest initial cost. In the longer term, the best distributor for any service territory will be the one who can provide those customers with the greatest value for the price they will be charged over time. In a customer- centric model, that is the only test that properly reflects the interests of the customers and focuses on the value proposition to the end-user.

3.3.13 We are well aware that this probably means Hydro One cannot – at least in their current state – bid successfully to serve most areas of its own service territory. Someone else will in most cases be able to do it better, while charging the customers less and still making their normal rate of return. This could lead to a creeping erosion of the Hydro One service territory.

3.3.14 In our view, this is the right answer. Whether Hydro One's rates for customers, even in urban density areas, are high as a result of diseconomies of scale, or weak management, or historical anomalies, or some other cause, Hydro One should not be adding more customers, even within their own territory, until they get their costs under control**.** Uncompetitive distributors should see their market share diminish, just as would be the case in a competitive marketplace.

[8] This is a hypothetical, so whether the specific details are accurate is not the point. We are not sufficiently familiar with the local demographics in Waterloo to know whether the example is realistic.

3.3.15 We note that Hydro One is the example, because so many areas of urban growth are in Hydro One service territories. This principle, however, should not be limited to Hydro One. In any situation in which a high cost provider is the incumbent, other distributors that can provide better value at the same or lower price should be able to demonstrate that, and win the bid.

3.4 *Growth of Urban Areas*

3.4.1 The circumstance most likely to generate such an open competition is the expansion of an urban area. This raises a number of issues.

3.4.2 ***Municipal Boundaries vs. Demographic Boundaries.*** As noted earlier, the issue is not whether a service area is within a municipal boundary or not. The growth of an urban area will not always follow the political divisions.

3.4.3 For example, if the metropolitan area of Hamilton is actually growing on Hamilton Mountain, and outside of the political boundaries of the actual City, the political boundary should not determine rational electrical distribution. The same is true if Ajax is expanding outside of the Town of Ajax, or Cambridge is expanding outside of the City of Cambridge. In each case, the population will go where it goes, and the electricity distribution sector – including its regulator - should respond to those demographic realities.

3.4.4 ***Existing vs. Future Customers and Assets.*** One question that flows from this is whether SAA applications should be limited to existing customers/developments seeking immediate connection.

3.4.5 In our view, this is not consistent with the Board's increasing emphasis on regional planning, and planning generally. The sensible way to plan and implement electricity distribution infrastructure in a new growth area is to identify the area in advance, and choose who will serve that area. Then that distributor can make economically rational decisions to serve the area at the greatest value for the least cost, through a multi-year infrastructure and operating plan.

3.4.6 SEC therefore proposes that, if a municipality or other entity has prepared, or prepares in the future, a growth plan, then whether or not that plan is limited to the political boundaries of the municipality, the Board should invite all distributors, including the incumbent, to provide proposals to serve that territory. Proposals should cover the whole territory, and the Board's decision on that territory should include the whole area of potential future growth.

3.4.7 We would also go one step further. SEC would propose that any distributor, whether or not an incumbent, should be free to file with the Board an expansion plan that includes the lightly served service territory of another distributor. If the Board

determines, after a review and public comment, that the plan may have merit, then the plan should operate as the start of a competitive process to determine who should serve that area.

3.4.8 These two proposals depend for their efficacy, of course, on the test we have previously proposed. That is, the winner of any such competition should be the distributor that can provide the most long-term value for the ratepayers relative to the price they will be charged for that value. This means that in most cases there will be advantages to the incumbent, advantages to contiguous distributors, and advantages to highly efficient distributors. Those advantages will not necessarily be enjoyed by the same LDC, and the Board will, through a competitive process, have an opportunity to determine how the ratepayers in that area can best be served.

3.4.9 ***Involuntary Transfers of Assets.*** In many SAA situations, the most sensible result, if the incumbent is not retaining the area, is that existing assets of the incumbent be transferred to the new distributor[9]. This would be especially true if the idea of an open competition for some areas is adopted by the Board.

3.4.10 It is not clear to us that the Board currently has the power to order such transactions if the incumbent does not want to sell. In our view, the Board should strongly encourage incumbents to sell existing assets at reasonable prices if a new distributor is chosen for an area.

3.4.11 Where the incumbent is unwilling, then if the Board does have some or all of the power to force an involuntary transfer, it should exercise that power consistent with the principles outlined earlier. If the Board does not have that power, then in our view it should seek it from the government, so that the Board can carry out its mandate with respect to SAAs as completely as possible.

3.4.12 ***Existing Anomalies.*** There are a number of existing anomalies in which a local distributor serves part of an urban area, and Hydro One serves the rest. Kingston and Sudbury come immediately to mind, but there are several others.

3.4.13 SEC believes that the Board should encourage Hydro One to divest itself of those service territories that are clearly within the "natural" service area of a local distributor. In the event that encouragement is not sufficient to cause the efficient result, in our submission the board should use whatever powers are available to it to force the issue, and cause that result to occur.

3.5 ***Discontiguous Service Areas***

3.5.1 A number of distributors have discontinuous service areas. The question arises whether, and if so how, they should be allowed to seek to connect them.

[9] With the exception, obviously, of assets that still serve another area of the incumbent, as is sometimes the case.

3.5.2 ***Distributors' Long Term Rationalization Plans.*** In our view, any distributor should be allowed to file with the Board on the public record a long term plan for rationalization of their own service territory, including acquisitions of other territories consistent with their plan. If the Board considers that the plan might be a good direction, the distributor should first negotiate with any other affected distributors. Where negotiations are not successful, the Board should assess whether the goal of industry rationalization supports Board involvement in ordering implementation of the plan, or a variation of that plan.

3.5.3 A good example may be Powerstream. Powerstream may well determine that, having acquired Aurora and Barrie, it is sensible to serve the entire territory from the northern boundary of the City of Toronto to and including Barrie. Such a plan would likely include acquisitions of two LDCs – Newmarket-Tay and Innisfil – plus an SAA application for a large area of Hydro One territory between Barrie and the northern GTA.

3.5.4 Powerstream would, in our proposal, be free to file with the Board a plan to consolidate this entire area, showing in particular how it would benefit the ratepayers through this region in the long term. The Board could then consider that plan (either by way of hearing, or through some form of open competition, or both), and determine if it is in the best interests of the ratepayers.

3.5.5 Our proposal is that there then be two results from a favourable Board decision.

3.5.6 First, Powerstream would be empowered to negotiate for the purchase of (or merger with) Newmarket-Tay and Innisfil. Neither would be under any obligation to sell, but both negotiations would benefit from the Board's predetermination that the overall plan is in the best interests of the ratepayers.

3.5.7 Second, Powerstream would be encouraged to negotiate with Hydro One for the service territories included in the plan that are Hydro One areas. In the event that negotiations were unsuccessful, then on condition that the acquisitions or mergers of the other two had been agreed, the Board would be in a position to require the transfer of the Hydro One territories at a reasonable price.

3.5.8 This situation could play itself out in a number of areas around the province. It has the advantage that it depends on distributors developing thoughtful rationalization plans that can stand up to public scrutiny. It has the further advantage that, because the overall plan is considered from the public interest perspective, the affected parties, including Hydro One, will be inclined to seek negotiated settlements on reasonable terms, rather than risk either public resistance or the uncertainty of an adjudicated result.

3.5.9 In negotiations such as these, as well as in a number of potential negotiated results

considered in these submissions, SEC notes that it believes the ratepayers should be consulted (although not participants). As noted earlier, if the Board adopts a customer-centric model to rationalization transactions, then the utilities would benefit from having the customers involved.

3.6 ***Conclusions***

3.6.1 In SEC's view, the Board's policies in SAA applications should be based on the three part test set out in para. 2.2.18 above. One mechanism for doing so is the idea of "open competition", proposed in the Staff Report but expanded above. Another is a distributor rationalization plan.

3.6.2 SEC believes that, for the industry to rationalize within a reasonable time, the Board should take a more activist approach. The proposals set forth above would push the agenda forward by giving a clear set of principles for distributors to follow, and mechanisms to ensure that the long term public interest is served.

4 MAADS POLICIES

4.1 *Introduction*

4.1.1 SEC's proposed changes to the Board's policies on MAADs flow directly from the principles outlined in section 2 of these submissions, and are consistent with our detailed comments on SAA applications. Many of those comments apply to MAADs as well.

4.1.2 There are two specific areas in which we believe that major changes are appropriate: clarification of the "no harm test", test and as a result changes to the material to be filed to obtain a MAADs approval. We will also comment briefly on the proposal in the Staff Report to add an ICM to Annual IR in MAADs situations.

4.2 *"No Harm" Test*

4.2.1 As the Staff Report correctly points out, the No Harm Test has been interpreted in the past to be a test of short-term economic efficiency. It has not, for the most part, focused on the long term prices charged to ratepayers.

4.2.2 This may simply be the result of the cases that the Board has had to consider. There have rarely been contested cases where the prices ratepayers will face in the future have been at the core of the debate.

4.2.3 SEC has provided detailed submissions on the No Harm Test in our final argument in EB-2013-0187, the proposed Hydro One acquisition of Norfolk Power. We will not reproduce those submissions here.

4.2.4 Consistent with the General Principles outlined earlier in these submissions, SEC believes that the public interest, in the context of distributor consolidation, is in the rationalization of the sector. Rationalization means – similar to the competitive markets – maximizing the value proposition for the customers, such that the customers get the most value for the price they are paying, and are not asked to buy a more expensive product than the one they need.

4.2.5 These two concepts – value for money and willingness to pay – when measured in the long term, are the best tests of the public interest in these transactions. If a transaction meets these tests, by definition economic efficiency will be maximized, and the financial viability of the distribution sector will be enhanced.

4.2.6 Earlier in these submissions, SEC proposes a three step test of a transaction based on these principles. It is copied below:

(a) Will any of the customers affected be asked to pay more for the service as a

result of the transaction (no matter how far in the future)? If no, then the transaction is neutral or better for the customers.

(b) If there is a price increase for any customers, will the customers who will experience a price increase get increased value equivalent to or better than the price increase? If no, then the competitive market paradigm says this transaction is not in the customers' interests, and if not for the monopoly they would walk away from the supplier.

(c) If the price increase is justified by the increased value of the service, will it in any case exceed the willingness of the customers to pay for increased value. A Mercedes may in fact be a better car, and worth the extra money, but most customers still will not want to buy a Mercedes (and shouldn't be forced to do so).

This test may in fact be what the Board intends as the fullest possible expression of the No Harm Test. If that is the case, then all stakeholders would benefit if the Board clarified that fact.

4.2.7 In the alternative, if the No Harm Test is not essentially the same as the three step test SEC has proposed, SEC believes the old test should be retired, to be replaced by this new test.

4.3 ***Acquisition Rate and Investment Plan***

4.3.1 A theme throughout these submissions is that the relationship between the prices the affected ratepayers will pay, and the value they will receive, is central to whether a transaction should be approved by the Board.

4.3.2 ***Requirement to File an Plan.*** To assist the Board in determining the value proposition for the ratepayers inherent in the transaction, SEC proposes that distributors seeking approval for a MAADs application should be required to file a comprehensive rate and investment plan for the combined entity. Approval of that plan by the Board should be the key step in approval of the transaction.

4.3.3 SEC emphasizes that it is not proposing a simple rate harmonization plan. Instead, SEC is proposing that the onus be squarely place on the proponents of a transaction to show that the transaction is in the long term best interests of <u>each</u> of the groups of affected ratepayers.

4.3.4 The reason a transaction will be a good step in the rationalization of the sector will not always be economies of scale and price impacts, although those impacts will often be relevant. If it was only a matter of all ratepayers getting lower prices, then no MAADs transaction could never be approved unless the parties to the transaction were equally efficient, with close to equal prices. If there is any material inequality, then unless it is

covered by the economies from the transaction, it would prevent a transaction based solely on savings. Someone`s prices are going to go up.

4.3.5 That is not what is being proposed. Different situations, and different affected parties, can benefit from the transaction in different ways. The ratepayers of one distributor can benefit from economies of scale in being served by a larger entity. The ratepayers of a second distributor can benefit because they were going to lose a key employee, and would not have been able to replace him/her at reasonable cost. The ratepayers of a third distributor can benefit from the addition of a 24/7 control room, or expanded bill payment options, or other indicia of a larger, more modern distributor. The ratepayers of a fourth distributor can benefit from an acquiror willing to make needed capital investments in the distribution infrastructure. There are many examples.

4.3.6 SEC is therefore proposing that the applicants be required to demonstrate how they are going to ensure that the ratepayers of each of the distributors involved will benefit from the transaction. That benefit has to be related to the price they will pay. If the price for any of the groups of ratepayers is to go up, the value must go up accordingly, and must not be beyond what those ratepayers, acting reasonably, would be willing to pay.

4.3.7 In our submission, requiring such a plan is not a hardship for distributors involved in MAADs applications. Any company engaging in a merger or acquisition should, in the normal course, have a plan for how they will respond to the transaction. This is standard practice, and any company that doesn't do it shouldn't be engaging in such transactions anyway.

4.3.8 ***Nature of the Plan***. SEC is proposing that there be as few restrictions on the components of the plan as possible. Applicants should be free to propose whatever combination of rate plans, conditions, investments, and other elements that achieve the result of benefiting all of the affected ratepayers over the long term.

4.3.9 So, for example, SEC does not propose that the plan have a particular time frame. In the simplest case, two merging utilities could propose that, in two years (or three, or seven), they will harmonize rates. The plan could show economies of scale and other cost reductions that will allow them to have lower rates for both ratepayer groups on harmonization.

4.3.10 At the other extreme, an applicant could file a completely open-ended plan, with no sunset date. For example, a high-cost utility acquiring a lower cost utility could state that it plans to get its costs in line with industry norms, but doesn't have all the details of how it will achieve that yet. It could propose a rate trajectory for the acquired utility, such as Annual IR, perhaps with additions for capital investments known to be required at the time of the acquisition, and then accept a condition that it cannot harmonize rates until the rates for its legacy customers are below that projected rate trajectory, however long that may take.

4.3.11 Another plan could demonstrate that the acquired utility's rates are 20% lower than a reasonable level, and the reason is past underinvestment in infrastructure. The plan could show that it will result in an increase in rates, but a greater increase in value to the ratepayers. The plan could even show that the investments would have to be made sooner or later, but if made later would be at greater cost and risk.

4.3.12 The list of examples is long. The plan should in all cases show two things:

(a) Rates throughout the period until harmonization; and

(b) The details of any other value to be added, and the relationship of the incremental price impact to the incremental benefit to the ratepayers.

4.3.13 In our submission, a requirement to do a thoughtful and thorough plan for the Board to review is the added step needed to ensure that rationalization of the sector is truly rationalization, and not just consolidation to reduce numbers. It is also consistent with the entire theme of RRFE, which is based on having good plans, and implementing them well, at all times with a strong customer focus.

4.3.14 The Board requires distribution system plans, and regional planning, and has expanded its emphasis in both areas. A rate and investment plan for a MAADs transaction is no less necessary.

4.4 ***Annual IR with ICM***

4.4.1 SEC does not agree with the proposal in the Staff Report to allow an expanded ICM to be added on to Annual IR after a MAADs transaction. The whole point of Annual IR is that the ratepayers are protected by the low rate increase, with no other bells and whistles. The staff proposal would turn Annual IR into Selective IR, in which the full impacts of a utility's costs would be ignored – deliberately – by the Board as long as the utility wanted. This does not protect the ratepayers.

4.4.2 On the other hand, adding an ICM to Annual IR in the context of a rate and investment plan may, in some circumstances, be appropriate. SEC believes that it is possible to have many examples in which the benefits for affected ratepayers are delivered in a MAADs transaction. There is in our view no value to ruling out this option in such a plan. The Board would of course have to ensure that appropriate ratepayer protections were added, and in many cases that could end up being something similar to Custom IR, but the option should still be possible where warranted.

4.4.3 Thus, SEC opposes the staff proposal as a standalone change, but does not believe it should be ruled out a priori where appropriate in the context of a specific rate and investment plan.

5 OTHER MATTERS

5.1 ***Costs***

5.1.1 The School Energy Coalition thanks the Board for allowing us to participate in this consultation, and hereby requests that the Board order payment of our reasonably incurred costs. It is submitted that the School Energy Coalition has participated responsibly in a manner designed to assist the Board as efficiently as possible.

All of which is respectfully submitted.

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Jay Shepherd
Counsel for the School Energy Coalition