

# ONTARIO ENERGY BOARD



## EB-2014-0138

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# Report of the Board

## Rate-Making Associated with Distributor Consolidation

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## **A. INTRODUCTION**

The Ontario Energy Board's renewed regulatory framework is a comprehensive performance based approach to regulation. The framework sets expectations that electricity distributors will seek out efficiencies to increase productivity and manage costs. The OEB issued a [letter](#) on February 11, 2013, announcing an initiative to assess how the OEB's regulatory requirements for electricity distributors may affect the ability of distributors to realize operational or organizational efficiencies (EB-2012-0397).

Consultations with stakeholders took place in early 2013 to review potential changes to the OEB's regulatory requirements that may facilitate efficiency improvements. On November 4, 2013, the OEB issued a [letter](#), announcing that it would proceed with a further review of its policies related to service area amendments ("SAA") and rate-making associated with merger, amalgamation, acquisition and divestiture ("MAADs") transactions.

The report of the Ontario Distribution Sector Review Panel, issued in December 2012, set out a vision for consolidation resulting in the less costly and more efficient delivery of electricity, with a predicted cost savings of \$1.2 billion over the next ten years. When the Minister of Energy responded to the Panel's report, he indicated that he expected that the sector would find ways to achieve those savings through more efficient service delivery, including negotiated consolidations. This view was carried forward in the government's December 2013 Long Term Energy Plan ("LTEP"), where it is stated that the government expects electricity distributors to pursue innovative partnerships and transformative initiatives that will result in savings for electricity ratepayers.

On March 31, 2014, the OEB issued a OEB staff [Discussion Paper](#) (the "Discussion Paper") providing background on the current policies, summarizing stakeholder input received in relation to those policies, and setting out questions for stakeholder comment with respect to potential changes to those policies.

On November 13, 2014, the Advisory Council on Government Assets issued its findings which included the view that consolidation was needed to encourage modernization of the electricity distribution system.

After considering the government's policy expectations, the results of the consultations, and the OEB's own expectations that the distribution sector should continue to seek out efficiencies especially through consolidation, **the OEB has concluded that it will proceed at this time with amendments to its rate-making policy associated with electricity distributor consolidation.**

This Report sets out the OEB's amendments to its rate-making policy for electricity distributors following a MAADs transaction.

The OEB has identified two specific policy matters that it intends to address at this time:

- The duration of the deferral period for rebasing following the closing of a MAADs transaction; and,
- A mechanism for adjusting rates to reflect incremental capital investments during the deferred rebasing period.

The amendments to the OEB's policy in relation to each of these matters are discussed below. The OEB has also provided clarification regarding the incentive rate mechanism that will apply to a distributor during a rebasing deferral period.

### **B. DEFERRAL PERIOD FOR RATE REBASING**

***Consolidating distributor(s) may elect to defer rebasing for a period of up to 10 years after the closing of the transaction.***

*Consolidating entities that elect a re-basing period of up to five years after the closing of the transaction may do so as set out under the current policy<sup>1</sup>.*

*Consolidating entities may also apply for an extended rate rebasing deferral period of up to 10 years. For the extended period (i.e. – the period between year 5 and year 10), the OEB will require the consolidating entity to implement an earnings sharing mechanism. The earnings sharing split shall be a 50:50 sharing with customers where the return on equity for the consolidated distributor is greater than 300 basis points above the allowed rate of return for the consolidated distributor.*

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<sup>1</sup> Report of the Board regarding Rate-Making Policies Associated with Distributor Consolidation, issued July 23, 2007.

The OEB's current policy with regards to rate issues associated with MAADs transactions was developed in 2007, and is found in its [\*Report of the Board regarding Rate-making Policies Associated with Distributor Consolidation\*](#) (the "2007 Policy").

Under the 2007 Policy, when a distributor applies for approval of a MAADs transaction it may propose to defer rebasing of the rates of the consolidated entity for up to five years from the date of the closing of the transaction. The purpose of this policy is to allow the net savings of a consolidation to accrue to a distributor's shareholder(s) for an extended period. The OEB recognized that providing a reasonable opportunity to use savings to at least offset the costs of a MAADs transaction is an important factor in a utility's consideration of the merits of a given consolidation initiative. The five-year period was selected based on a review of practice in other jurisdictions, and taking into consideration the fact that the maximum duration of any rate plan for distributors at the time was three years.

The principal focus of distributor comments received both through the 2013 consultation and the responses to the Discussion paper, was concern regarding the length of time over which rebasing of a consolidated entity's rates can be deferred.

It is the view of distributors that the current policy may not provide sufficient time to achieve the savings and efficiency gains necessary to enable the recovery of transaction costs. Distributors expressed the view that the risk for shareholders of not recovering transaction costs is a significant impediment to consolidation.

Distributors explained that the transition and integration costs of a MAADs transaction, although largely incurred upfront can continue for two to four years following the completion of the transaction. Whereas efficiency gains and savings resulting from the transaction will not start to be realized until the transaction is completed and the new entity has begun to operate. Distributors indicated that given the nature and timing of these costs and savings, annual net benefits (operational costs less transition and integration costs) are in many cases negative during the first two to four years. Therefore, it may take anywhere from six to ten years to reach a break-even point, where the cumulative savings exceed the cumulative acquisition and integration costs.

Distributors therefore suggested that greater flexibility in terms of the rebasing time frame and the ability to retain any achieved savings for a longer deferral period will provide encouragement to those who may be interested in pursuing consolidation opportunities.

Representatives of consumers expressed the view that savings that result from a MAADs transaction should be shared equitably between the distributor's ratepayers and the distributors' shareholders. There are concerns that extending the deferral period will provide an opportunity for shareholders to retain more savings than those necessary to recover costs, which may result in a windfall for shareholders at the expense of ratepayers. Ratepayer representatives suggested that for the rebasing to be deferred, other benefits for consumers would need to be provided, either in the form of new services or, of a certainty of savings that would continue after the rebasing.

Consumer representatives also suggested that allowing a distributor to choose its own time for rebasing may not benefit consumers. A distributor that is able to cut costs could delay rebasing to keep its savings, but a distributor who experiences higher costs would rebase immediately in order to pass those incremental costs on to ratepayers. Such an approach would relieve the shareholders of risk at the expense of the ratepayers. There were also concerns expressed that allowing shareholders to recover additional savings may reduce the market forces that lead to efficient consolidations.

### **OEB Policy**

The OEB believes that the decision to extend the deferred rebasing period for distributors who are party to a MAADs transaction supports the OEB's own expectations, as well as those of the government, that the distribution sector should continue to seek out efficiencies, especially through consolidation.

The OEB has determined that providing an extension of the allowed deferral period to up to 10 years after the closing of the transaction, would address distributors' key concern about the 2007 policy; would reduce the risk of a MAADs transaction, which may encourage more consolidation; and would provide distributors with the flexibility to manage their own, unique circumstances.

The OEB believes that the requirement for the MAAD's application to include an earnings sharing mechanism (ESM) will address ratepayer concerns that the accumulated savings could amount to a windfall for shareholders.

The ESM would operate during the term of the extended deferred rebasing period. (i.e. – for any extended periods beyond the initial five year deferral period). The ESM would be in keeping with the OEB's current incentive rate-making policy under which a

regulatory review may be initiated if a distributor's annual reports show performance outside of the +/- 300 basis points earnings dead band. In the case of a MAADs transaction, if the consolidated entity's actual ROE rose above the 300 basis points over the allowed ROE, the ESM will be implemented. The ESM for the purpose of the extended period will employ a 50:50 sharing with customers of excess earnings. This sharing provides for the shareholders to continue to recover transaction costs while ensuring customers of the consolidated entity will benefit from the efficiencies and savings the new distributor has achieved.

During the deferred re-basing period, whether up to five years or beyond five years, once the original incentive rate-making period of one of the distributors who are party to the transaction expires, the consolidated entities may apply to the OEB for cost-of-service rate setting for the consolidated entity. The OEB believes that it is in the best interest of consumers to have consolidating entities operate as one entity as soon as possible after the MAADs transaction. The consolidated entity application will allow the OEB to establish rates that reflect the efficiencies from the consolidation transaction. Therefore, there is no requirement for the consolidated entity to wait until the deferred re-basing period is completed to apply to the OEB for re-basing.

The OEB also notes that despite the ability for consolidated entities to extend the rate re-basing period, all other regulatory requirements, including the requirement to file Distribution System Plans every five years remain in effect.

The OEB will continue to make use of its monitoring tools, available through distributor's annual reporting requirements, to determine whether the results of MAADs transactions for consumers and the industry warrant additional consumer protection measures. If so, future changes to the policy may be considered.

### **C. INCREMENTAL CAPITAL INVESTMENTS DURING THE DEFERRAL PERIOD**

***The Incremental Capital Module ("ICM") will now be available to consolidating entities during the rate rebasing period.***

When developing the 2007 Policy, the OEB considered the issue of how to deal with capital investments during the deferred rebasing period. The OEB determined that it

would not establish a mechanism to adjust for capital investment during the deferred rebasing period, and suggested that the matter should be considered as part of the next incentive regulation review.

Subsequently, in its September 17, 2008, [Supplemental Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors](#), the OEB established the Incremental Capital Module ("ICM") as the mechanism by which distributors could seek funding for extraordinary and unanticipated capital investments (but not normal expected investments) during the incentive regulation term. Of the three RRFE rate-setting options, the ICM application is available only to distributors that have chosen the Price Cap IR.

Distributors have indicated that while an extended deferral period may allow for the recovery of costs, the treatment of capital investments during this period may reduce the benefits of the extension. Some of the distributors suggested that few, if any, distributors would be able to operate over an deferred rebasing period without incorporating normal and expected capital expenditures into rate base. Their concern is that, if capital additions cannot be incorporated into rate base, the shareholder's rate of return would diminish and there would be impacts on financing for capital investments.

Distributors also expressed concern that they will be forced to choose between early rate-rebasing to address capital spending, or deferred rebasing in order to enhance the viability of a MAADs transaction. In their view, this may have a dampening effect on consolidation because the recovery of transaction costs will come at the expense of foregoing the recovery of capital expenditures. By contrast, if distributors who are considering a MAADs transaction know that they have the ability to apply to the OEB for the inclusion of on-going capital investments into rate base during the deferred rebasing period, they may be more willing to consider consolidation.

Stakeholders representing consumers suggested that the existing incentive rate-setting mechanisms already provide for the funding of capital, and that any additional mechanisms may result in an over-recovery from the consumer and could possibly reward underperforming distributors. Stakeholders who disagree with the proposed approach suggest that there is a risk that using a modified ICM would impact ratepayers worse than if no merger took place. Some parties have also suggested that the proposed approach would go against objective of the Annual IR which provides distributors with opportunity for increased rates, while protecting ratepayers with low



rate stable increases. They are concerned that the proposal would turn Annual IR into “Selective IR”, in which the full impacts of a utility’s costs would be deliberately ignored by the OEB for as long as the utility wanted. Other stakeholders have suggested that if a distributor has the need to incorporate capital investments into rate base, it should go through a Custom IR.

On September 18, 2014, the OEB issued the [Report of the Board, New Policy Options for Funding of Capital Investments: The Advanced Capital Module](#). In this Report, the OEB clarified that the opportunity for requests for review and approvals of incremental capital during an IR term will be maintained for projects that were unanticipated at the time of the development of a distributors’ system plan, and/or for projects anticipated but for which sufficient rationale was not available at the time of the system plan to establish need and prudence. The ability to apply for an ACM remains only with those distributors who are under the Price Cap IR.

On page 15 of the September 18<sup>th</sup> Report, the OEB stated the following:

*“The Board is of the view that the availability of incremental capital funding during the IR term should no longer be limited to non-discretionary projects. Any discrete project (discretionary or otherwise) adequately supported in the DSP (Distribution System Plan) is eligible for ACM funding subject to capital funding availability flowing from the formula results. The same approach shall apply going forward to new projects proposed as ICMs during the Price Cap IR term.” (emphasis added)*

### **OEB Policy**

The OEB believes that the clarification set out in the September 18<sup>th</sup> Report establishes that a distributor may now apply for an ICM that includes normal and expected capital investments. This clarification of policy should address the need of those distributors who may not consider entering into a MAADs transaction due to concerns over the ability to finance capital investments.

The one remaining limitation is that the ability to apply for an ICM continues to be limited to those distributors under the Price Cap IR, and it is anticipated that distributors

considering a MAADs transaction will be operating under one or more of the other rate setting options. The question that needs to be addressed, in the OEB's view, is the situation where one or more distributors that are part of a MAADs transaction are operating under Custom IR or Annual IR and the impact of the ICM policy for the combined entity.

As discussed in the next section, distributors who are part of a MAADs transaction and have their Custom IR plan expire during the deferred rebasing period, would transition to the Price Cap IR. Once the distributor has made this transition, it will have the option to utilize the ICM consistent with the OEB's existing approach to incentive regulation.

Distributors who are in the midst of their Custom IR plan at the time of the MAADs transaction and consolidate with an entity operating under a Price Cap IR or an Annual IR may only apply for an ICM that relates to investments incremental to its Custom IR plan.

The OEB believes that its proposal to allow a combined entity who is operating under an Annual IR plan to make use of the ICM is reasonable, effective and will address distributor's concerns over capital investment during a deferred rebasing period which may encourage consolidation efforts.

The OEB notes that distributors proposing amounts for recovery by way of an ICM must be assessed by the OEB through a hearing and must meet the tests of materiality, need and prudence. Therefore, ratepayers continue to be protected under the OEB's proposed approach. Further the OEB is of the view that part of a review of any ICM requests by the combined entity, where one of the combined distributors was on a Custom IR, would include a test to determine whether the requested amounts for ICM recovery were separate from the amounts that had been included in the distributor's Custom IR plan.

In regards to making an application for an ICM, the materiality thresholds for purposes of the ICM policy shall be calculated based on the individual distributor's accounts, i.e. depreciation expense, and not the consolidated entity's.

## **D. INCENTIVE MECHANISM DURING THE DEFERRAL PERIOD**

Under its renewed regulatory framework, the OEB has established three rate-setting approaches for distributors. A distributor may now choose amongst: Custom IR, Price Cap IR, and Annual IR.

As there are now three rate-setting options available to distributors, there will be potential for parties to a MAADs transaction to be on different rate options at the time of consolidation. The question that arises is which plan would apply to a distributor where its current approved rate plan ends during the deferred rebasing period

Distributor groups have suggested the consolidated entity should be allowed to continue under the existing Custom IR plan during the deferred re-basing period. Ratepayer groups believe the consolidated entity should undergo a Custom IR as soon as possible, in order to ensure any savings are properly shared.

Continuing to operate under a Custom IR where this is a form of rate adjustment is not feasible as the OEB has not approved rates for that distributor beyond the initial five years. Also, requiring a merged entity to undergo a Custom IR immediately would be counter to the intent of the 2007 policy as the consolidated entity would immediately lose any efficiency savings it expected to pay for transaction costs.

### **OEB Policy**

The OEB wishes to clarify which incentive rate plan would apply to distributors who are party to a MAADs transaction during any deferred rebasing period after the distributors original IR plan is complete.

- A distributor on Price Cap IR, whose plan expires, would continue to have its rates based on the Price Cap adjustment mechanism during the remainder of the deferral period. This approach is consistent with the current policy.
- A distributor on the Annual IR, whose plan expires, would continue to have rates based on the Annual IR index, until it selects a different option. This approach is consistent with the current policy, as there is no set rate rebasing timeframe under the Annual IR.

- A distributor on Custom IR, whose plan expires, would move to having rates based on the Price Cap IR adjustment mechanism, during the remainder of the deferral period.

The OEB believes that its proposal is in keeping with the original 2007 Policy and RRFE's focus on reducing regulatory burden and costs. This proposal will also assist in the efficient implementation of a deferred rebasing period, which in turn will support the objective of finding efficiencies through consolidation.

### **E. NEXT STEPS**

The policy changes made by the OEB are intended to encourage efficient and beneficial consolidation transactions within the electricity distribution sector. The OEB has made changes that reflect concerns of the industry with the current policy while ensuring consumers will benefit through earlier rebasing or sharing of savings.

Some of the policy changes outlined in the Report will require amendments to be made to the MAADs filing requirements. In the case of the policy statements that have been made in the Report, these are summarized below and are considered amendments to the existing policies.

1. Allow consolidating entities to choose a deferred rebasing period of up to 10 years after the closing of the transaction. Those consolidating entities that elect a re-basing period of only up to five years may do so as set out under the current policy.
2. Those consolidating entities requesting a deferred re-basing period of greater than five years will be required to present the OEB with an ESM plan that would be implemented if the consolidated entity's ROE was greater than 300 basis points above the allowed ROE as set out under the incentive regulation policy. The ESM will be based on a 50:50 sharing of excess earnings with consumers.
3. Distributors who are party to a MAADs transaction, and are operating under an Annual IR plan have the option to use the Incremental Capital Module during the deferred rebasing period.

4. Distributors who are party to a MAADs transaction that are on the Price Cap IR at the time of consolidation will continue to have their rates adjusted under the same mechanism until rebasing. In the case of distributors on the Annual IR the consolidated distributor would continue to operate under the Annual Index option unless and until it selects a different option. Distributors whose Custom IR plan expires during the deferred rebasing period will move to the Price Cap IR.